

Auditor Independence in the Spotlight

January 27, 2014 | Client Update | 3-minute read

The Enforcement Division recently [settled](#) with KPMG for its actions involving three companies, none of which were identified. In one case, the firm hired an employee who had just retired from a senior position at the company and then loaned him back to the company to do the same work he had previously done as an employee. Working with the company was his sole responsibility during the term of KPMG's engagement related to his service. The Enforcement Division determined that this caused the loaned employee "acting as a manager, employee and advocate" for the company.

The SEC also found that KPMG provided prohibited non-audit services at another company, including restructuring, corporate finance and expert services. It appears that the firm's engagement team did not recognize that the company had become an "affiliate" of an audit client when that client's subsidiary purchased all the stock of the company's general partner. KPMG also provided bookkeeping and payroll services to a different client during a transition period of a few months based on the firm's conclusions that the immaterial nature of the matters and their short duration would not be problematic. In addition, KPMG personnel owned stock in some of their audit clients.

In addition to the enforcement action, the Division also issued an [investigative report](#) under Section 21(a) of the Exchange Act, in order to address uncertainty regarding the Commission's interpretation of what it means to "act like an employee." An independent accountant is prohibited from being an employee of an audit client. The Division found that for several years from 2007 to 2011, KPMG loaned staff to their clients to perform junior level tasks related to tax compliance. These staff members were supervised by, took their direction from and had their performance evaluated by the clients' managers, performed the same work as the clients' employees, worked at the clients' places for up to six months and used clients' resources to perform their work.

The Division indicated that an auditor may not provide otherwise permissible non-audit services (such as tax services) in a manner that is inconsistent with other independence rules, so that both the nature of the service and the manner in which it was delivered must be examined. Indirectly "acting as an employee" raises similar concerns regarding impartiality as direct employment. A key inquiry in this analysis is the level of control that the audit client exercised over the audit firm personnel, regardless of the fact that the staff involved were junior, the functions ministerial and that the staff continued to be compensated by KPMG.

According to KPMG's own internal guidance, the engagement letters needed to be preapproved by the audit clients' audit committee. The Report stated that the provision in Rule 2-01 prohibiting "acting like an employee" requires both accountants and audit committees to carefully consider whether the relationship or service in question would cause the accounting firm's professionals to resemble company employees.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908

ning.chiu@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.