

## Update:

### SEC Flags “Close Personal Relationships” between Outside Auditors and Clients, Sanctions Auditors, Clients’ Financial Executives

Corporations and their independent auditors should note three recent SEC auditor independence cases. Auditor independence cases typically arise from financial, employment, or business ties between auditor and client. But these three cases arose from “inappropriately close personal relationships” between audit firm and client personnel, a first for independence cases according to SEC Enforcement Director Andrew Ceresney. The Commission charged not only the audit firm and the partners involved, but also the financial executives at the clients who were involved. The respondents settled the cases on filing and neither admitted nor denied the SEC’s finding. This summary is drawn from the Commission’s cease-and-desist orders.

The [first case](#) arose from a romantic relationship between the audit firm’s engagement partner and the client’s chief accounting officer. The two tried to conceal the relationship because they were concerned their employers would deem it inappropriate and remove the engagement partner. Client personnel had concerns about a possible relationship and shared them with the audit firm’s coordinating partner. He also thought the CAO had a romantic interest in the engagement partner, and he and another partner shared with client personnel their observations of potentially inappropriate interactions between the engagement partner and the CAO. Neither the coordinating partner nor the other partner pressed the issue with the engagement partner or elevated it internally.

An internal whistleblower complaint at the client led to internal investigations. The audit firm determined that it had not been independent of the client as a result of the relationship, and it withdrew its audit reports for the client’s 2012 and 2013 financial statements. The engagement partner and CAO resigned. The Commission found that the relationship caused the engagement partner (and, therefore, the firm) to not be independent from the client. Settling with the Commission, the firm agreed to disgorge \$3.37 million in audit fees, including pre-judgment interest, and to pay a \$1.0 million penalty. The engagement partner and CAO each agreed to pay a \$25,000 penalty and are barred from appearing or practicing before the Commission as an accountant for three years and one year, respectively.

In the [second case](#), the audit firm’s client-relationship partner spent more than \$100,000 over three years to develop and maintain a client relationship by entertaining the client’s chief financial officer and his family. This included several trips to out-of-town professional sporting events; vacationing and spending holidays together, sometimes at one another’s homes or vacation homes; and gifting sports tickets to the CFO’s son and his friends. Most of the expenses were billed to the client as audit expenses. Senior audit firm partners, and an engagement partner and senior manager, knew about certain aspects of the spending, but none inquired whether the spending complied with the firm’s independence policy, and none elevated the issue internally.

The Commission characterized the socializing as “excessive” and the spending as “significant” and, quoting from the audit firm’s policy, not “commensurate with the normal courtesies of business and social life.” As it result, it found that the client-relationship partner (and, therefore, the firm) lacked independence from the client for the 2012, 2013, and 2014 audit periods. Settling with the Commission, the audit firm agreed to disgorge \$3.78 million in audit fees, including pre-judgment interest, and to pay a \$1.2 million penalty. The client-relationship partner agreed to pay a \$45,000 penalty and is barred from appearing or practicing before the Commission as an accountant for three years. In the [third case](#), the CFO, now retired, agreed to pay a \$25,000 penalty.

### **Take-Aways**

Auditors will readily note the remedial measures taken by the audit firm, including revising policies and enhancing training and monitoring to better focus on close personal relationships – not just financial, employment, or business ties – that might undermine the fact or appearance of independence. Corporations should consider evaluating their compliance programs to ensure they provide sufficient guidance to help personnel, particularly those in the accounting and financial reporting areas, appropriately manage interactions with outside auditors.

**Murphy & McGonigle** lawyers represent auditors, issuers, and their personnel in audit, accounting, and financial reporting matters. For more information about our firm or our Audit & Accounting practice, please visit our website at [www.mmlawus.com](http://www.mmlawus.com) or contact:

**Stephen J. Crimmins** (202) 661 7031 [SCrimmins@mmlawus.com](mailto:SCrimmins@mmlawus.com)

**Steven D. Feldman** (212) 880 3988 [SFeldman@mmlawus.com](mailto:SFeldman@mmlawus.com)

**James K. Goldfarb** (212) 880 3961 [JGoldfarb@mmlawus.com](mailto:JGoldfarb@mmlawus.com)