SEC Administrative Order Flags Lobbying as an Auditor Independence Issue

On July 14, 2014, the Securities and Exchange Commission ("SEC") commenced administrative proceedings charging Ernst & Young ("E&Y") with auditor independence violations after finding that one of E&Y's subsidiaries provided improper lobbying services to two of its SEC-registrant audit clients.[1] To settle the charges, E&Y agreed to pay over $4 million in civil penalties without admitting or denying any wrongdoing.

Accounting firms are required to avoid conflicts of interest that may raise concerns about their objectivity and impartiality during a client's audit.[2] Therefore, accounting firms that audit SEC-registered companies are prohibited from engaging in activities that call into question their auditor independence and may not act as an "advocate" for audit clients.[3]

I. Background

E&Y, one of the "Big Four" accounting firms, primarily provides auditing, tax and consulting services to its clients. In May 2000, E&Y acquired the Washington Council, a lobbying firm that provides legislative advisory services on tax-related issues. Thereafter the lobbying firm changed its name to Washington Council Ernst & Young ("WCEY").

On March 8, 2012, Reuters reported that three SEC-registered companies had ongoing lobbying contracts with WCEY while using E&Y to audit their financial statements.[4] Although all of the "Big Four" firms monitor legislation for clients, E&Y was the only one that claimed to engage in "educating policy-makers on behalf of audit clients."[5] Thereafter in 2012, E&Y voluntarily ceased providing lobbying services to its SEC-registrant audit clients.

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[1] *In re Ernst & Young LLP*, Accounting and Auditing Release No. 3566, Exchange Act Release No. 72602, Admin. Proceeding File No. 3-15970, 2014 WL 3401161 (July 14, 2014) (Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order) (hereinafter "SEC Order").

[2] *See SEC* v. *Arthur Young*, 465 U.S. 805, 819 n.15 (1984) ("Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.").

[3] *See* Preliminary Note to Rule 2-01(b), 17 C.F.R. § 210.2-01 (2014) ("In consideration of [the general standard of auditor independence], the Commission looks in the first instance to whether a relationship or the provision of a service . . . places the accountant in a position of being an advocate for the audit client."); Rule 2-01(b) of Regulation S-X, 17 C.F.R. § 210.2-01 (2014) ("In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."). Auditor independence rules have strengthened as a result of the Enron-era accounting scandals that affected firms like Arthur Andersen and the more recent 2008 financial crisis that affected major banks and financial firms.

[4] *See* Dena Aubin, David Ingram & Sarah N. Lynch, *Exclusive: Ernst & Young Tightropes between Audit, Advocacy*, REUTERS (March 8, 2012), http://www.reuters.com/article/2012/03/08/us-usa-accounting-ernst-idUSBRE82718C20120308. Reuters also reported that similar arrangements occurred between 2006 and 2011 with three other SEC-registered companies.

[5] *Id.*

II. The SEC Order

The conduct at issue occurred prior to 2009, and involved lobbying services by WCEY to two of E&Y's SEC-registrant audit clients at the same time that E&Y made repeated representations that it was "independent" in audit reports of the clients' financial statements included or incorporated by reference in public filings with the SEC.

For Client A, the SEC alleged that WCEY, on two occasions, submitted letters on its behalf to congressional staff urging the passage of legislation and, on one occasion, requested that congressional staff insert a provision into a bill that was favorable to Client A's business interests. For Client B, the SEC alleged that WCEY attempted to persuade congressional offices to withdraw their support for unfavorable legislation and worked with congressional staff to draft an alternative bill that minimized the impact on Client B's business interests.

As a result of WCEY's conduct, E&Y was "in the position of being an advocate for an audit client in violation of the independence rules."[6] The SEC Order found that E&Y (i) violated Rule 2-02(b)(1) of Regulation S-X, (ii) caused violations of Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1 by Clients A and B and (iii) engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Securities Exchange Act of 1934 and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

The SEC Order required E&Y (i) to cease and desist from violating Rule 2-02(b)(1) of Regulation S-X and from causing its clients to violate Section 13(a) of the Securities Exchange Act of 1934 and Rule 13a-1 and (ii) to pay $1.24 million in disgorged profits, $351,925.98 in prejudgment interest and $2.48 million in additional penalties. Further, E&Y was censured for its conduct, which may result in more severe sanctions for any subsequent violation.

As a condition of the settlement, E&Y neither admitted nor denied the SECs allegations. The SEC Order noted that E&Y had a written independence policy addressing the provision of legislative advisory services to audit clients but failed to deliver formal, in-person training on that policy to WCEY employees. Factors considered in the SEC's decision to accept E&Y's settlement offer were (i) remedial measures taken by E&Y, including its voluntary issuance of new guidance in June 2012 and May 2013 that restricted lobbying services, and (ii) its cooperation during the SEC's investigation.

III. Significance of the SEC Order

The SEC Order reinforces the importance of complying with auditor independence rules and serves as a reminder that accounting firms can suffer disgorgement and civil penalties for the mere appearance of a less than independent relationship with an SEC-registrant audit client—regardless of the firm's knowledge of the violative conduct.

[6] *See* SEC Order, at *2, 3.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Edward Hillenbrand at 212.701.3752 or ehillenbrand@cahill.com.