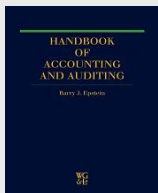




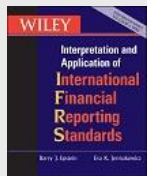
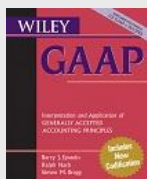
Dr. Barry Epstein,
CPA, CFF



Natasha Perssico,
MBA



Dr. Epstein is the author of *The Handbook of Accounting and Auditing*, published by the Warren Gorham & Lamont unit of Thomson Reuters.



Dr. Epstein served as the lead author of *Wiley GAAP* and *Wiley IFRS* for 26 and 14 annual editions, respectively.

Insider Trading and Other Auditor Independence Rules: What Litigators Should Know About Accountants' Malpractice

Natasha Perssico, MBA
Barry Jay Epstein, Ph.D., CPA, CFF
SS&G, Inc., Chicago IL

One of the hallmarks of the public accounting profession is the requirement that auditors be independent from their clients, both in fact and in appearance – an obligation that is not imposed on other professional service providers. Recently, violations of auditor independence rules have become more prominent as bases for auditors' liability litigation. Understanding these rules may thus be important to attorneys asserting accountants' malpractice, as well as for those defending actions taken and work performed by the auditors.

Independence in fact refers to a state of mind that permits the performance of an attest service (generally, audits or reviews) without being influenced in a way that compromises professional judgment, thereby allowing an individual to act with integrity, bringing the requisite degree of objectivity and professional skepticism to the conduct of the engagement.

Independence in appearance connotes conduct and circumstances that would lead a reasonable and informed third party – being in possession of all relevant information, including safeguards applied – to draw the inference that the integrity, objectivity, and professional skepticism of a firm, or of an individual on the attest engagement team, had not been compromised with reference to that particular client.

Insider trading is prohibited by SEC rules, and the AICPA's independence rules prohibit disclosing or using confidential client information for one's own benefit, since the use of such information impairs the independence of the member and the member's firm. Despite these prohibitions, violations of these rules -- and thus, concerns regarding auditor's independence, objectivity and ethics -- have recently been in the spotlight. For example, charges of insider trading brought by the SEC, alleging that an ex-partner of a major firm and his wife disclosed confidential information about merger deals planned by the firm's clients to their family members, were settled by the payment of \$1 million in late 2011. In another, unrelated situation, a former partner of a large firm pled guilty to one count of criminal securities fraud for engaging in insider trading after he obtained, used, and shared material, nonpublic information about several of the firm's clients, thereby reaping illegal trading profits.

An AICPA member who violates independence rules by acquiring an investment in the firm's client will trigger various repercussions, not for just the member, but also for the accounting firm, and even for the accounting firm's client.

For example, in the latter of the above-cited matters, the SEC found that between 2003 and 2008 the former partner executed 71 trades in the securities of nine of his firm's audit clients, 62 of which involved clients for which he was serving on the audit engagement team as the advisory partner, thereby violating multiple auditor independence rules. The SEC administrative order that settled the dispute stated that the firm had issued audit reports on the financial statements of nine of these audit clients during the time the audit partner had owned or controlled the securities - an obvious and even shocking abuse of the longstanding requirements for auditor independence.

Clearly, because of the partner's ownership of the audit clients' securities, the firm was not independent with respect to those reporting entities, violating professional standards as well as the SEC's auditor independence rules under Regulation S-X. Additionally, the annual reports and proxy statements the companies filed with the SEC, which included audit reports issued by the auditors who were not independent, violated the reporting and proxy provisions of the Securities Exchange Act of 1934.

In light of these and other instances of auditor independence rule violations that have recently surfaced, it is useful for litigators to maintain awareness of the most salient portions of

auditor independence rules. Further, an understanding of the differences between AICPA independence rules – i.e., those that are required for auditors of non-issuers -- and the SEC auditor independence rules, which are germane to auditors of issuers, will be helpful in litigation matters where the registration status of the audited company may have varied over time.

The newly-created PCAOB adopted certain preexisting independence standards from the AICPA's Code of Professional Conduct, Rule 101, and the various interpretations and rulings thereunder that were extant on April 16, 2003, as its interim independence standards. These rules and interim independence standards did not supersede the SEC's auditor independence rules, with which firms registered with PCAOB are also required to comply. Since its inception, PCAOB has gone on to issue staff guidance applicable to certain ethics and independence rules, and these too should be understood by accountants' liability litigators.

To the extent that a provision of the SEC rules varies from the PCAOB's interim independence standards, a registered public accounting firm is required to comply with the more restrictive rule. A non-registered public accounting firm (i.e., a firm that does not audit issuers), must follow the AICPA's independence rules.

A number of specific situations have been identified as causing an actual breach of independence, or -- just as serious -- the appearance of such a breach. These include the following:

1. **Employment relationships.** AICPA and SEC independence rules both provide that an audit firm's independence will be impaired if former firm professionals are subsequently employed by or associated with an attest client in a key position, unless certain conditions are met. In addition, the SEC rules, being the more restrictive, include shareholders as *covered members* and require a one year cooling-off period before a company can hire an individual formerly employed by its auditor for a position involving oversight of the financial reporting process at the registrant entity.
2. **Insider Trading.** The SEC, under the Securities Exchange Act of 1934, prohibits insider trading. The AICPA also addresses the use of confidential client information in its Code of Professional Conduct, Rule 301, which provides that members are not allowed to disclose confidential client information or use that information for their own benefit.

3. **Direct or material indirect financial interests.** The AICPA and SEC independence rules both explicitly state that a member or a member's firm may not have or be committed to acquire any direct or material indirect financial interests in a client. Further, both the AICPA and SEC independence rules provide similar, but not identical, language regarding guidance on situations in which serving as a trustee or executor of an estate that has a direct or material indirect financial interest in the client will impair independence.
4. **Loans to and from clients.** AICPA guidance provides that all loans to or from clients, without regard to materiality, impair independence (unless the loan is from a financial institution and certain criteria are met).
5. **Business relationships.** SEC independence rules provide that business relationships with clients – such as joint ventures, limited partnership agreements, investments in supplier or customer companies and sales by the member of items other than professional services – will impair independence. AICPA rules regarding business relationships with clients provide that if a member or a member's firm has a material joint, closely held business investment with a client, independence is impaired. A joint closely held business investment refers to an investment that is subject to the control of the member or the member's firm, the client, the client's officers, directors or principal stockholders or any combination thereof. Note that the SEC rules regarding business relationships are more restrictive than the AICPA rules in this regard.

The foregoing are certainly not the only instances in which auditor independence could be lost or threatened. Importantly, since the appearance of independence must be maintained, various permutations of these fact patterns, even if not expressly addressed by SEC or AICPA rules, could give rise to allegations of breaches making auditors vulnerable to assertions of malpractice. Common sense, and reasoning by analogy from the explicitly proscribed relationships, should be the guide.

As further scrutiny is placed on auditor independence, in both fact and appearance, it is probable that auditor liability due to violations of auditor independence will remain an area ripe for litigation.

About the authors: Natasha Perssico, MBA, is a senior associate, and Barry Jay Epstein, Ph.D., CPA, CFF is director of the forensic accounting and litigation consulting practice in the Chicago office of SS&G, Inc., a public accounting and consulting firm. Dr. Epstein is the author of the Warren, Gorham & Lamont *Handbook of Accounting and Auditing*, and was for many years the lead co-author of *Wiley GAAP*, *Wiley IFRS*, and *Wiley IFRS Policies and Procedures*. Dr. Epstein has authored or co-authored many professional books and articles, and has lectured in the U.S. and abroad. Contact him at BEpstein@SSandG.com or at 312-464-3520.

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