

# SECURITIES AND EXCHANGE COMMISSION

## SECURITIES EXCHANGE ACT OF 1934

Release No. 71390 / January 24, 2014

### Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: KPMG, LLP

#### **I. Introduction**

Rule 2-01 of Regulation S-X (“Rule 2-01”)<sup>1</sup> is “designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance.”<sup>2</sup> Rule 2-01(b) sets forth the general standard of auditor independence, and Rule 2-01(c) sets forth a non-exclusive specification of circumstances inconsistent with the general standard. Among other things, Rule 2-01 prohibits an independent auditor from acting as an employee of an audit client.<sup>3</sup>

The Division of Enforcement (“Division”), in consultation with the Office of the Chief Accountant, has investigated whether the independence of KPMG LLP (“KPMG”)<sup>4</sup> was impaired under Rule 2-01 when the firm loaned non-manager level tax professionals (“loaned staff”)<sup>5</sup> to certain audit clients. The loaned staff for the particular engagements assisted audit clients in tax return preparation and other tax compliance work, at the places of business of the audit clients, used audit client-provided resources, and worked under the direction and supervision of the management of the audit clients.

The Commission has determined not to pursue an enforcement action with regard to these loaned staff engagements. As a result of the Division’s investigation, however, the Commission deems it appropriate and in the public interest to issue this Report of Investigation (“Report”) pursuant to Section 21(a) of the Exchange Act of 1934 (“Exchange Act”) in order to address uncertainty regarding the Commission’s interpretation of the “acting as an employee” provisions of Rule 2-01.<sup>6</sup>

#### **II. Background Related to the “Acting as an Employee” Provisions of Rule 2-01**

Rule 2-01 was comprehensively amended in 2000 “to modernize the Commission’s rules for determining whether an auditor is independent in light of . . . , [among other things,] employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients.”<sup>7</sup> Rule 2-01 was amended again in 2003 in light of the Sarbanes-Oxley Act of 2002, which strengthened the auditor independence requirements.<sup>8</sup>

Circumstances that raise questions about an accountant’s independence always merit heightened scrutiny.<sup>9</sup> Our rule is designed to ensure that auditors are independent of their audit

clients both in fact and in appearance.<sup>10</sup> Under the general standard of independence set forth in Rule 2-01(b), the Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.<sup>11</sup> Rule 2-01(c) enumerates certain circumstances that are inconsistent with the general standard.<sup>12</sup> Those enumerated circumstances are not an exhaustive list. As specifically noted in Rule 2-01, "[t]he rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns...."<sup>13</sup> Thus, Rule 2-01 describes the Commission's approach to independence issues and identifies the core principles that guide the Commission's application of the general standard, including that the Commission will consider all relevant facts and circumstances.

Rule 2-01 addresses the issue of acting as an employee of an audit client.<sup>14</sup> First, Preliminary Note 2 to Rule 2-01 makes clear that, in applying the general standard in Rule 2-01(b), the Commission considers, among three other principles, whether a relationship or service "results in the accountant acting as management or an employee of the audit client."<sup>15</sup> Second, Rule 2-01(c)(4)<sup>16</sup> identifies specific non-audit services that are deemed inconsistent with an auditor's independence,<sup>17</sup> including:

Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.<sup>18</sup>

Accordingly, under the guiding principles of the Preliminary Note and the specific prohibition in Rule 2-01(c)(4)(vi), an accountant cannot maintain its independence if it is acting as an employee of an audit client.

The legal consequence of an auditor lacking independence is that it violates, and causes its audit clients to violate, various provisions of the federal securities laws. For example, Rule 2-02(b) of Regulation S-X requires that each accountant's report state "whether the audit was made in accordance with generally accepted auditing standards ["GAAS"]."<sup>19</sup> GAAS, in turn, requires auditors to maintain strict independence from their audit clients.<sup>20</sup> Consequently, issuing an audit report falsely stating that the audit was performed in accordance with GAAS violates Rule 2-02(b).<sup>21</sup> Likewise, Exchange Act Rule 10A-2 separately provides that it shall be unlawful for an auditor not to be independent under Rule 2-01(c)(4).<sup>22</sup> In addition, any time that non-independent audit reports are filed with an SEC audit client's annual reports, this causes the audit client not to comply with Section 13(a) of the Exchange Act and Rule 13a-1 thereunder (requiring that financial statements included in annual reports filed with the Commission be audited by an independent accountant).<sup>23</sup> Under such circumstances, the auditor may also be held liable for causing such violations.<sup>24</sup>

### **III. Facts**

#### **A. KPMG's Internal Guidance Permitting Tax Loaned Staff Engagements**

In March 2004, KPMG issued internal guidance prohibiting most loaned staff engagements with SEC audit clients, but permitting loaned staff engagements for certain tax services. Through testimony taken as part of this investigation, the Division learned that part of KPMG's rationale for continuing to allow loaned staff engagements for tax services was that auditors are permitted to provide tax services to audit clients and that the services to be provided were ministerial. The KPMG guidance specified that loaned staff were to be supervised by, and take direction from, the audit clients at the clients' places of business – effectively transferring control over the loaned staff to the audit client.

In August 2008, KPMG issued internal guidance that further revised its loaned staff policy. The 2008 KPMG guidance further restricted the conditions under which loaned staff services could be provided, but continued to allow loaned staff engagements with SEC audit clients for certain tax services. Among other things, the 2008 KPMG guidance: (i) prohibited loaning managers to SEC audit clients; (ii) specified that engagement letters must be preapproved by the client's audit committee and in KPMG's automated monitoring system; and (iii) specified that the engagements must be approved by KPMG's national office and could not exceed three months without pre-approval of the National Partner in Charge of Tax, Risk Management. The 2008 KPMG guidance further provided that loaned staff could not "perform management functions or act as an employee (even on a temporary basis)," but also provided that loaned staff "should report to a specified member of client management who will supervise the staff member, make all decisions affecting the staff member's work, and accept responsibility for the staff member's work."

#### **B. KPMG Tax Loaned Staff Engagements**

The Division's investigation identified that, from at least 2007 through 2011, KPMG entered into loaned staff engagements with multiple SEC audit clients. These loaned staff engagements involved non-manager level KPMG professionals performing junior level tasks related to tax compliance. For example, a typical task performed by the loaned staff was inputting data into federal or state tax returns using an audit client-issued computer, while being supervised by a member of the client's tax department. Among other things, KPMG loaned staff assigned to these engagements generally:

1. were supervised by, took sole direction from, and had their performance evaluated by, the audit clients' managers;
2. performed the same work as employees of the audit clients;

3. worked exclusively and continuously at the audit clients' places of business during such engagements for extended periods of time, ranging up to six months; and
4. used the audit clients' resources, including physical work spaces, client-issued computers and email addresses, and internal networks, spreadsheets and shared folders, to perform their loaned staff work.

KPMG paid the loaned staffers in accordance with its typical practices for compensating KPMG employees and continued to provide KPMG benefits to these individuals. Fees for loaned staff arrangements were billed to the audit clients in a manner similar to the manner in which KPMG bills its clients for other non-audit services.

#### **IV. Discussion**

Auditor independence can be impaired in numerous ways – one of which is the accountant acting as an employee of the audit client. As we have stated previously, “an auditor who provides services in a way that is tantamount to accepting an appointment as an ... employee of the audit client cannot be expected to be independent in auditing the financial consequences of management’s decisions.”<sup>25</sup> Rule 2-01(c)(4)(vi) reflects the Commission’s view that such arrangements are incompatible with the dual goals of the independence requirement – that auditors are “independent of their audit clients both in fact and in appearance.”<sup>26</sup> We take this opportunity to make three further points.

First, an auditor may not provide otherwise permissible non-audit services (such as permissible tax services) to an audit client in a manner that is inconsistent with other provisions of the independence rules (such as the prohibition against acting as an employee of the audit client).<sup>27</sup> Thus, an auditor must scrutinize both the nature of the proposed non-audit services, as well as the manner in which those services are to be delivered. Tax services are no different in this regard than any other non-audit services.

Second, an arrangement or relationship that results in an accountant acting as an employee of the audit client implicates Rule 2-01(c)(4)(vi), separate and apart from whether the accountant acted as a director or officer, or performed any decision-making, supervisory, or ongoing monitoring functions for the audit client.<sup>28</sup> We also point out that an accountant is not independent under Rule 2-01(c)(2)(i) when a current “professional employee of the accounting firm is employed by the audit client.”<sup>29</sup> In further restricting such professionals from “acting as” audit client employees, Rule 2-01(c)(4)(vi) prohibits accountants from doing indirectly (acting as an employee) what they may not do directly (being an employee). Either situation has the potential to raise concerns that the firm and its employees will not be impartial in appearance and/or in fact.

Third, we considered whether the “acting as an employee” provision of Rule 2-01 provides a sufficient standard by which an accountant can assess its non-audit services. We

believe that this provision requires accountants and audit committees to carefully consider whether the relationship or service in question would cause the accounting firm's professionals to resemble, in appearance and function, even on a temporary basis, the employees of the audit client. A key inquiry in this analysis is the degree of control that the audit client exercises over audit firm personnel. Where accounting firm personnel routinely work at the direction and under the supervision and control of audit client management, side-by-side with and in a capacity identical or substantially similar to the audit client's own employees at the audit client's place of business, the accounting firm's independence under Rule 2-01 could be put in jeopardy.

While no one factor is necessarily determinative, it is important to point out certain features that do *not* operate to exclude loaned staff arrangements from the prohibition of Rule 2-01(c)(4)(vi). For example, the fact that professionals loaned to an audit client may be junior-level in skill, experience or title, or are performing only ministerial tasks, does not exempt that individual from the prohibitions against acting as an employee of an audit client. Similarly, the fact that loaned staff were not directly paid by the audit client also does not exclude the relationship from the prohibition. Again, Rule 2-01 distinguishes between, and separately prohibits, "being" and "acting as" an employee of an audit client.

We note that today's statement is consistent with our prior statement that "an accounting firm can provide tax services to its audit clients without impairing the firm's independence."<sup>30</sup> As distinct from loaned staff arrangements, typical tax services engagements do not involve the audit firm providing *personnel* to the audit client, but rather involve the audit firm performing *services* for the audit client. Also, as distinct from loaned staff arrangements, auditor personnel working on typical tax services engagements are supervised by the firm's own managers who retain responsibility for directing the firm's personnel and ensuring the quality of their work product. For these reasons, typical tax services engagements do not present the same issues that loaned staff arrangements present.

Although every case must be evaluated on its own facts, as we have stated before:

We remind registrants and accountants that auditor independence is not just a legal requirement. It is also a professional and ethical duty. That duty requires auditors to remain independent of audit clients, and includes an obligation to avoid situations that may lead outsiders to doubt [the auditor's] independence.<sup>31</sup>

As a result, "[i]n certain situations, whether or not legally required, the best course may be for the accountant to recuse himself or herself from an audit engagement," or, in the alternative, decline a non-audit engagement.<sup>32</sup> Accountants should particularly bear this in mind in evaluating relationships that may implicate the prohibition against acting as an employee, given that the prohibition is embedded in the core principles of auditor independence. Loaned staff arrangements, by their nature, appear inconsistent with the prohibition against acting as an employee. As noted in Preliminary Note 3 to Rule 2-01, registrants and accountants are

encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships involving the provision of non-audit services if they have any questions about whether the arrangement may result in the accountant acting as an employee of the audit client.

## V. Conclusion

“Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets.”<sup>33</sup> As the U.S. Supreme Court has stated:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This “public watchdog” function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>34</sup>

Further, we have stated that:

Investors must be able to rely on issuers' financial statements . . . . If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities.<sup>35</sup>

As explained above, providing certain non-audit services to an audit client can impair the auditor's independence. Moreover, auditors who provide non-audit services in a manner which impairs independence should expect to be held accountable. Consequently, auditors must be rigorous in assessing the independence implications inherent in providing such services and be mindful that auditors must strictly assess, not only whether the proposed non-audit services fall within one of the enumerated categories of expressly prohibited services, but also whether the manner in which the services are to be provided potentially impairs the auditors' independence, in fact or appearance.

By the Commission.

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<sup>1</sup> 17 C.F.R. § 210-2.01.

<sup>2</sup> Preliminary Note 1 to Rule 2-01. The term “audit client” is defined in Rule 2-01(f)(6).

<sup>3</sup> See Rule 2-01(c)(4)(vi) (prohibiting “[a]cting, temporarily or permanently, as a director, officer, or employee of an audit client”). The phrase “acting as an employee” is not defined in Rule 2-01.

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<sup>4</sup> KPMG is a public accounting firm registered with the Public Company Accounting Oversight Board (the “PCAOB”) that provides auditing, tax and advisory services to its clients. KPMG is the U.S. member firm of KPMG International Cooperative.

<sup>5</sup> The Commission recognizes that the term “secondment,” as commonly used in countries outside of the United States, is analogous to the term “loaned staff engagement” used in the United States. As we have explained, a secondment or loaned staff engagement “‘is a temporary transfer of [an audit firm] employee (or secondee) to the business of a client,’ to perform work under the supervision and direction of the client rather than [the audit firm].” *In the Matter of KPMG Australia*, Rel. Nos. 34-63987 and AAER-3248 (Feb. 28, 2011) (quoting KPMG internal guidance).

<sup>6</sup> Section 21(a) of the Exchange Act authorizes the Commission to investigate “whether any person has violated, is violating, or is about to violate” the federal securities laws. “The Commission is authorized . . . to publish information concerning such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of” the federal securities laws. This report does not allege any violation of the independence rules by KPMG and further does not allege that KPMG’s independence with respect to any audit client was impaired. This Report also does not constitute factual findings or an adjudication of any issue addressed herein.

<sup>7</sup> See Final Rule: *Revision of the Commission’s Auditor Independence Requirements*, Rel. Nos. 33-7919, 34-43602 and 35-27279, 65 Fed. Reg. 76,008 (Dec. 5, 2000) (the “2000 Release”).

<sup>8</sup> See Final Rule: *Strengthening the Commission’s Requirements Regarding Auditor Independence*, Rel. Nos. 33-8183, 34-47265 and 35-27642, 68 Fed. Reg. 6,006 (Feb. 5, 2003) (the “2003 Release”).

<sup>9</sup> See Final Rule: *Amendment to Rule 102(e) of the Commission’s Rules of Practice*, Rel. Nos. 33-7593, 34-40567, 35-26929, 63 Fed. Reg. 57,164 (Oct. 26, 1998).

<sup>10</sup> See Preliminary Note 1 to Rule 2-01.

<sup>11</sup> Rule 2-01(b) further provides that, “[i]n 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.”

<sup>12</sup> See, e.g., 2000 Release at 76,008 (stating that one main purpose of the amendments was to “identify certain non-audit services that, if provided by an auditor to public company audit clients, impair the auditor’s independence”).

<sup>13</sup> Preliminary Note 2 to Rule 2-01.

<sup>14</sup> Since the earliest days after the enactment of the federal securities laws, employment by an audit client has been deemed inconsistent with an accountant’s independence. See Federal Trade Commission, Rules and Regulations under the Securities Act of 1933 (July 6, 1933), at Article 14 (providing that an accountant “will not be considered independent with respect to any person . . . with whom he is connected as an . . . employee, . . . or person performing similar function”); see also *Securities and Exchange Commission, Adoption of Regulation S-X*, 5 Fed. Reg. 954, 956 (Mar. 6, 1940) (adopting Rule 2-01(b), which prohibited independent accountants from being connected with an audit client as an employee).

<sup>15</sup> Preliminary Note 2 to Rule 2-01.

<sup>16</sup> The provisions in Rule 2-01(c)(1) to (c)(5) “reflect the application of the general standard to particular circumstances.” Preliminary Note 2 to Rule 2-01.

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<sup>17</sup> See Rule 2-01(c)(4)(i)-(x). Among other things, the rule prohibits an auditor from providing bookkeeping services, financial information system design and implementation services, appraisal and valuation services, actuarial services, internal audit outsourcing services, human resource services, broker-dealer, investment adviser or investment banking services, legal services or expert services to audit clients.

<sup>18</sup> Rule 2-01(c)(4)(vi) (emphasis added).

<sup>19</sup> 17 C.F.R. § 210.2-02(b).

<sup>20</sup> Pursuant to Release 33-8422, GAAS, as used in Regulation S-X, means “the standards of the PCAOB plus any applicable Commission rules.” Audit reports dated on or after May 24, 2004 – the effective date of PCAOB Auditing Standard 1 – are required to state they were performed in accordance with PCAOB standards. PCAOB rules and standards require auditors to be independent from their audit clients. See, e.g., PCAOB Rule 3520, PCAOB Rule 3600T, and PCAOB AU Section 220.

<sup>21</sup> See, e.g., *KPMG Peat Marwick LLP*, Rel. Nos. 34-43862 and AAER-1360, 2001 SEC LEXIS 98, at \*78 (Jan. 19, 2001), *reconsideration denied*, Rel. Nos. 34-44050 and AAER-1374 (Mar. 8, 2001), *petition for review denied*, 289 F.3d 109 (D.C. Cir. 2002); *Deloitte & Touche (South Africa)*, Admin. Proc. No. 3-15129, Rel. Nos. 34-68432 and AAER-3428, 2012 SEC LEXIS 3866, at \*10-11 (Dec. 13, 2012).

<sup>22</sup> 17 C.F.R. § 240.10A-2.

<sup>23</sup> See *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1167 (D.C. Cir. 1978) (holding that no showing of scienter is necessary to establish a violation of Exchange Act Section 13(a)).

<sup>24</sup> Under Section 21C of the Exchange Act, a person is a “cause” of another’s primary violation if the person knew or should have known that his act or omission would contribute to the primary violation. In addition, a showing of negligence is sufficient to establish “causing” liability under Section 21C when a person is alleged to have caused a primary violation that does not require scienter. See *KPMG Peat Marwick LLP*, Rel. Nos. 34-43862 and AAER-1360, 2001 SEC LEXIS 98, at \*82-84.

<sup>25</sup> See 2000 Release at 76,017.

<sup>26</sup> Preliminary Note 1 to Rule 2-01.

<sup>27</sup> See also, e.g., the 2003 Release, where we stated:

Nonetheless, merely labeling a service as a “tax service” will not necessarily eliminate its potential to impair independence under Rule 2-01(b). Audit committees and accountants should understand that providing certain tax services to an audit client would, as described below, or could, in certain circumstances, impair the independence of the accountant. Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations.

<sup>28</sup> The fact that the specific prohibition appears under the “management functions” heading has introduced some degree of ambiguity to the rule. However, both Preliminary Note 2 to Rule 2-01 – whether the relationship or provision of a service “results in the accountant acting as management or an employee of the audit client” and Rule 2-01(c)(4)(vi) – “acting, temporarily or permanently, as a director, officer, or employee” – are written in the disjunctive. See Preliminary Note 2 to Rule 2-01 and Rule 2-01(c)(4)(vi) (emphases added.)

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<sup>29</sup> Rule 2-01(c)(2). “In the most basic sense, the accountant cannot be employed by his or her audit client and be independent.” 2000 Release, 65 Fed. Reg. at 76,040.

<sup>30</sup> 2003 Release at 6,017.

<sup>31</sup> 2000 Release, 65 Fed. Reg. at 76,031 (quotations and footnotes omitted).

<sup>32</sup> *Id.*

<sup>33</sup> 2000 Release, 65 Fed. Reg. at 76,012.

<sup>34</sup> *U.S. v. Arthur Young & Company*, 465 U.S. 805, 817-818 (1984) (emphasis in original).

<sup>35</sup> *See* 2000 Release, 65 Fed. Reg. at 76,008.