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SEC Seeks to Modernize and Update Independence Rules

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A lot has changed in the twenty or so years since the US Securities and Exchange Commission (SEC) adopted a comprehensive framework of rules governing auditor independence in Rule 2-01, *Qualifications of Accountants*, under Regulation S-X (SEC independence rules).

A fluid and acquisitive business environment, coupled with proliferation in the private equity and fund industries, has made it increasingly difficult for firms to comply with certain aspects of the SEC independence rules. Inclusion of all entities under common control with the audit client in the definition of "affiliate of the audit client" has proven to be particularly challenging to auditors and audit committees struggling to monitor compliance with the independence rules. As a result, it's not uncommon for companies to have extremely limited choices when selecting or changing auditors due to firms' inability to meet the current independence criteria. Requirements, once violated, can have serious and costly consequences. Delayed corporate transactions, sudden work stoppages, auditor changes and other disruptions to businesses impact not only audit firms and their clients, but also corporate shareholders and other stakeholders.

Recognizing this, on December 30, 2019, the SEC issued Release No. 33-10738; 34-87864; FR-86; IA-5422; IC-33737; File No. S7-26-19, Amendments to Rule 2-01, Qualifications of Accountants (the Release). The SEC stated that, *"the primary reason for, and objective of, the proposed amendments is to update certain provisions within the Commission's auditor independence rules to more effectively focus the analysis on those relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality"*. In summary, the changes would amend key terms, *affiliate of the audit client*, *investment company complex*, and *audit and professional engagement period*; add as exemptions to the loan rule certain student and de minimis consumer loans; clarify and narrow application of the rule for business relationships; and introduce a transition framework for addressing business and service relationships that become prohibited as a result of corporate mergers and acquisitions.

WINTER 2020 Vol. 5 | Issue 2 | ISSN 2151-0857

This article discusses each of the SEC's proposed changes to the independence rules, its rationale for each change and the author's observations.

Affiliate of the Audit Client

Key definitions determine the scope and reach of the SEC independence rules; an auditor must be independent of not only its audit client (the entity whose financial statements or other information is being audited, reviewed, or attested to), but also any affiliate of the audit client (affiliate), a crucial definition that the proposal would amend in several ways. Proposed changes also impact the term, *Investment Company Complex* (ICC), an important element of the affiliate definition that has created significant compliance challenges for auditors of companies in the fund and private equity industries.

Clarify the rule's application. The rule would clarify that the auditor of an investment company, investment adviser or sponsor should look solely to the revised ICC definition in Rule 2-01(f)(14) to identify affiliates while the auditor of a portfolio company should look to Rule 2-01(f)(4)(i), which applies to operating companies. If a structure includes both portfolio and investment companies, advisers or sponsors, the auditor should analyze independence under each of these respective rules.

Sister Entities. For all types of entities under common control with the audit client (sister entity), the proposal adds a materiality qualifier so that a sister entity would only be an affiliate if it's material to the entity that controls it. This change would apply to both the affiliate and ICC definitions, as the SEC Staff has observed that an auditor's services or relationships with an immaterial sister entity typically would not cause a threat to the auditor's objectivity. Currently, all sister entities of an audit client are considered affiliates. So, while auditors would need to assess materiality of each sister entity to its controlling entity, the amendment should reduce the number of sister entities that the auditor needs to monitor for independence purposes.

Investment Company Complex. The term "investment company" would be expanded to include unregistered (private) funds and other investment companies excluded by Section 3(c) of the Investment Company Act of 1940. In addition, the SEC proposed that the analysis start at the affiliate's relationship with the entity under audit as opposed to the "audit client," which can add numerous affiliated entities to the ICC. Today, in an ICC, an auditor must be independent of not just the investment companies (e.g., mutual funds) that share an investment adviser or sponsor with its fund audit client, but also any *other* funds that are advised by a sister investment adviser or have a sister sponsor. However, the SEC Staff have observed that independence concerns mainly arise when the affiliate relationship is with the audit client itself and therefore would narrow the focus of the definition to the entity under audit.

Observations: *A helpful addition to the revised definitions would be to require the auditor to use "best efforts" to obtain the information needed to identify affiliates of the audit client, as in an interpretation,*

Sidebar 1

BEST EFFORTS (AICPA CODE)

A member must expend best efforts to obtain the information necessary to identify the affiliates of a financial statement attest client. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, threats would be at an acceptable level and independence would not be impaired if the member (a) discusses the matter, including the potential impact on independence, with those charged with governance; (b) documents the results of that discussion and the efforts taken to obtain the information; and (c) obtains written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the affiliates of the financial statement attest client.

Source: 1.224.010.03, Client Affiliates

WINTER 2020 Vol. 5 | Issue 2 | ISSN 2151-0857

Client Affiliates, of the AICPA's Code of Professional Conduct (See Sidebar 1 on page 2). A question in the Release asks whether auditors and their clients would face challenges in applying the materiality concept when assessing private portfolio companies. If a firm has no relationship with the parent and/or the sister entity, the audit client's commonly controlled, but otherwise unrelated, sister entity and the parent may be unwilling to provide financial information to the auditor. Public information may be nil or extremely limited. A "best efforts" approach would allow the auditor to discuss the matter with the client's audit committee, document the discussion and measures taken to obtain the information and obtain written assurance from the audit client that it is unable to provide the necessary information to the auditor. The SEC included a similar concept in the recently revised loan provision, that is, the qualifier, "known by reasonable inquiry" (see Sidebar 2). Alternatively, auditors lacking the requisite information to determine whether a sister entity is material to the controlling parent may have no choice but to identify all such sister entities as affiliates, giving no effect to the revisions being proposed.

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The Release states that although the SEC proposed the definition be narrowed to exclude immaterial sister entities, the "general standard" in Rule 2-01(b) would still apply, meaning that the nature, extent, relative importance and other aspects of the services or relationships between the auditor, the controlling entity, and immaterial sister entities must still be considered. Auditors and audit committees are well-aware of the general standard's application but will likely question this reference, believing the definition should provide a 'safe harbor'. Further, materiality qualifiers already exist in other aspects of the affiliate definition (i.e., significant influence) but without this specific caveat.

Audit and Professional Engagement Period

Another key term, *audit and professional engagement period*, dictates when and for how long an auditor is required to be independent and comprises two parts. The *audit period* is the period covered by any financial statements being audited or reviewed. The *professional engagement period* starts when the auditor assumes such role or begins performing attest services (whichever is earlier) and ends when the auditor relationship terminates or the final report is issued, whichever comes later.

Initial Public Offering (IPO). Today, an auditor of a domestic company filing an Initial Public Offering (IPO) must be independent during the *audit and professional engagement period*. IPOs typically include 2 – 3 years of audited financial statements in the filing and can create challenges for the auditor that has previously only been subject to AICPA or other independence rules for private, non-listed entities, which may be less stringent and prescrip-

Sidebar 2

"KNOWN BY REASONABLE INQUIRY" (Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships)

"We believe auditors and their audit clients could conduct the reasonable inquiry analysis by looking to the audit client's governance structure and governing documents, Commission filings about beneficial owners, or other information prepared by the audit client which may relate to the identification of a beneficial owner". And, "that would be a practical approach that would not impose an undue burden in identifying and evaluating beneficial owners of the audit client's equity securities".

Source: https://www.sec.gov/rules/final/2019/33-10648.pdf

WINTER 2020 Vol. 5 | Issue 2 | ISSN 2151-0857

tive than SEC rules. The current rule allows an exception for auditors of foreign private issuers (FPIs), which must comply with SEC independence rules for the most recently completed financial statement period and the auditor's applicable "home country" independence rules for any earlier periods included in the filing. The SEC Staff has generally found that the earlier prohibited services or relationships with a client existed, the less likely the Staff would conclude that the auditor lacked independence. Noting this disparity and that both types of entities are engaging in the same activity, the revised rule would permit auditors of domestic first-time filers to apply the same exemption to the *audit or professional engagement period* definition as auditors of FPIs.

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Observation: *Similar to the proposed amendments on affiliates of the audit client, the SEC notes in this section that "as it relates to relationships and services in prior years that would not be included in the look back period as a result of the proposed amendment, such relationships and services should still be considered under the general standard of Rule 2-01(b)". Auditors and audit committees may struggle with the notion that adherence to AICPA or other applicable independence rules in those prior periods does not satisfy the general standard when the revised rule states otherwise and is intended to achieve parity between domestic and foreign first-time filers.*

Personal Loans

SEC independence rules preclude many lending relationships between a "covered person" in the firm (or the covered person's immediate family) and an audit client, including the client's affiliates and other associated persons or entities. SEC rules permit certain types of loans such as de minimis credit card debt and pre-existing home mortgages tied to a person's primary residence when specific criteria are met.

Student loans. Similar to the exception provided for pre-existing mortgages, the proposal would allow student loans related to a covered person's educational expenses if the loan was obtained before he or she was a covered person. The exemption would not apply to the covered person's immediate family due to concerns that multiple student loans may be material to the covered person and impact independence.

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Clarify exemption for certain mortgage loans. The Release clarifies that a cov-

WINTER 2020 Vol. 5 | Issue 2 | ISSN 2151-0857

ered person may have more than one pre-existing *mortgage loan* outstanding on a primary residence and still be independent. Unclear from the singular use of the word, mortgage loan, in the current rule, the Release clarifies that these may include second mortgages, home improvement loans and equity lines of credit secured by the covered person's primary residence. The proposal would use the term *mortgage loans* (plural) to make that clearer.

Broaden the exemption for credit card borrowings. Currently, a covered person may have credit card debt with an audit client that is reduced to $10K or less on a current basis. The proposal would broaden the rule to allow other types of consumer debt such as retail installment loans, cell phone installment plans and similar finance arrangements. The SEC expects that these loans would typically have a payment due date that's consistent with credit card debt, that is, monthly.

Business Relationships

The SEC's business relationships rule prohibits any direct or material, indirect business relationship with an audit client, including all affiliates. Among other things, the prohibitions extend to persons associated with the client in a decision-making capacity such as the client's officers, directors and substantial stockholders.

Substantial stockholder. Citing a lack of definition or clarity as to what constitutes a "substantial stockholder," the proposal would replace "substantial stockholders" with beneficial owners

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(known through reasonable inquiry) of the audit client's equity securities who have significant influence over the audit client, consistent with the recently revised loan provision.

Entity under audit focus. The proposal would also clarify that the independence analysis should focus on whether the beneficial owner has significant influence over the entity under audit, removing the client's affiliates from that part of the equation. The SEC has observed in consultations on business relationships that influence over the audit client itself is the appropriate focal point when evaluating independence.

Observations: *The Release notes that focusing on the entity under audit is relevant not only for the proposed revision to the business relationships rule, but also to the recently amended loan provision. However, there's no indication in the Release that the amendments to either rule will clearly state such. Auditors and audit committees would likely benefit if this is clearly stated in the rules themselves or alternatively, in published guidance that is easily accessible, e.g., Frequently-Asked-Questions document, rather than solely in the commentary in this Release.*

Transition Framework

Based on the example in the Release, the following illustrates a fact pattern that has created myriad problems for auditors and their clients under the current rules structure:

- *Audit Firm audits Company X.*
- *Audit Firm provides nonaudit services (e.g., bookkeeping or valuation services) to Company Y, which is* ***not*** *an audit client.*
- *Company X acquires Company Y.*
- *Non-audit services provided to Com-*

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WINTER 2020 Vol. 5 | Issue 2 | ISSN 2151-0857

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pany Y are now considered prohibited because the Audit Firm provided the services to Company Y (a new affiliate of the audit client) during the audit or professional engagement period.

- *Company X has violated SEC independence rules.*

To address this problem, the proposal includes a transition framework that applies when auditors inadvertently violate independence in connection with a client's merger or acquisition. The proposed framework, modeled after Rule 2-01(d), *Quality Controls*, would require the auditor to:

- Comply with applicable independence standards related to the services or relationships throughout the period in which those standards apply;
- Correct the independence violations arising from the merger or acquisition as promptly as possible (*generally expected before the closing date of the transaction, but if this cannot be done in an orderly manner without significantly disrupting the client, as promptly as possible, no later than six months after the effective date of the transaction);*
- Have in place a quality control system as described in Rule 2-01(d)(3) procedures and controls that:
  - monitor the audit client's merger and acquisition activity to provide timely notice of a merger or acquisition; and
  - allow for prompt identification of potential violations after initial notification of a potential merger or acquisition that may trigger independence violations, but *before* the transaction has occurred.

Observations: *Allowing time, if warranted, to transition from prohibited services or relationships with a new affiliate should help auditors and their clients better manage their day-to-day businesses and minimize costly disruptions. Key controls needed to make this proposed framework function effectively will be the timely notice of corporate transactions and identification of violations so that the firm can take corrective action as promptly as possible.*

Conforming Amendments

The SEC proposed certain other updates to conform other rules to these proposed revisions.

Closing Thoughts

Overall, the proposed changes to Rule 2-01 should provide much-needed relief to auditors and companies grappling with certain aspects of the current rules. The SEC's focus on relationships and interests most likely to impact the auditor's objectivity would continue to protect capital market participants such as investors and lenders while alleviating some of the undue burden on auditors and their clients in maintaining independence under the securities laws.

The Release was published in the Federal Register on January 15, 2020; the proposed rule amendments will be open for comment until March 16, 2020 (60 days).

About The Author & Publisher

Cathy Allen, *founder of* **Audit Conduct, LLC**, *develops courses on professional ethics, independence, and related topics, provides specialized training and expert services, consults on critical independence matters, and advises firms on improving their quality controls.*