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SEC Update

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SEC updates auditor independence rule

The SEC recently updated its auditor independence rule in light of current market conditions and industry practice. The amendments, which were adopted over the dissenting votes of two Commissioners, relax a number of the rule's provisions addressing relationships that could compromise auditor independence. Because audit clients share responsibility with their accountants to monitor auditor independence, the amendments deserve close attention by registrants as well as auditors.

Rule 2-01 of Regulation S-X restricts financial, employment, and business relationships between an audit firm and its audit client to ensure that auditors are "independent of their audit clients both in fact and in appearance." The amendments focus the revised independence requirements on relationships and services the SEC considers more likely to impair an auditor's objectivity and impartiality.

Noteworthy amendments narrow the scope of independence assessments relating to entities under common control with the audited company that particularly affect private equity structures and investment company complexes. Other amendments shorten the look-back period for which domestic IPO issuers must evaluate independence. The SEC also has established a framework that will permit the audit client and its auditor to preserve the audit relationship by transitioning out of services and relationships resulting from merger and acquisition activity that would violate independence standards.

The SEC's adopting release describing the amendments (No. 33-10876) can be accessed here.

Effectiveness and early compliance

The amendments will become effective 180 days after their publication in the Federal Register. Voluntary early compliance will be permitted between the publication date and the end of the 180-day period so long as the amendments are applied in their entirety from the early compliance date. Compliance with the amendments is required on a prospective basis. Audit firms will not be permitted to apply the amended rules retroactively to relationships and services that existed before the date of effectiveness or early compliance.

Auditor independence rule

The auditor independence rule seeks to reduce the potential for external influence over the audit firm that could undermine the reliability, or investor confidence in the reliability, of the audited company's financial statements. The rule applies to audit relationships of domestic companies (including both operating and investment companies) and foreign private issuers that file, or are required to file, a registration statement or report with the SEC.

The general auditor independence standard is set forth in Rule 2-01(b) of Regulation S-X. An accountant will not be recognized by the SEC as independent with respect to its "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." Rule 2-01(c) provides a non-exclusive list of auditor relationships and non-audit services that would be inconsistent with the general independence standard, which states that the SEC will consider all relevant circumstances – including all relationships between the accountant and the audit client – in determining whether an accountant is independent.

Summary of amendments

In a statement accompanying publication of the amendments, the SEC Chairman said that the amendments are intended to reduce unnecessary restrictions on auditor choice by modifying rule provisions that, as markets have evolved, have had "unintended, negative consequences" for independence determinations.

Independence determinations involving entities under common control with audited entity

In amendments with potentially the most far-reaching consequences, the SEC has modified the rule's application to the auditor's relationships with affiliates of the audited entity that are under common control with the audited entity.

Independence determinations under current rule. The broad scope of the definitions of "audit client" and "affiliates of the audit client" under Rule 2-01(f) sweeps into the independence analysis under Rule 2-01(c) the auditor's relationships with affiliates of the audited entity. The current rule defines the term "audit client" to refer to "the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client." An "affiliate of the audit client" generally encompasses any entity that "has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries." The definition also extends to "[e]ach entity in the investment company complex when the audit client is an entity that is part of the investment company complex."

The obligation to monitor potential independence-impairing relationships and services under Rule 2-01(c) thus currently extends to "sister" affiliates of the audited entity regardless of whether the affiliates are material to the controlling entity. The extension of independence determinations to such affiliates frequently results in disqualification or potential disqualification of the auditor for portfolio companies and other sister entities that are part of private equity structures or investment company complexes. The sister entities often are unrelated to each other and have separate governance structures even though they are controlled by the same entity or entities. The SEC indicates that the application of Rule 2-01(c) to an audit firm's relationships with entities under common control can result in a determination that the firm's independence is compromised even if the relationships are unlikely to threaten the auditor's objectivity and impartiality with respect to the audited entity.

To address this concern, the SEC has revised Rule 2-01 to introduce a new materiality analysis into the common control prong of the affiliate definition for purposes of testing independence under Rule 2-01(c).

Dual materiality threshold. The SEC believes that "materiality is an appropriate principle to effectively focus on relationships with and services provided to sister entities that are more likely to threaten an auditor's objectivity and impartiality." The amendments narrow the scope of the definition of "affiliate of the audit client" to incorporate a "dual materiality threshold" for testing independence in these circumstances. A sister entity under the revised standard will qualify as an affiliate of the audit client only if the sister entity and the "entity under audit" are *each* material to the controlling entity. Accordingly, if either the sister entity or the entity under audit is not material to the controlling entity, the sister entity will not be deemed an affiliate of the audit client for purposes of evaluating auditor relationships and services under Rule 2-01(c). The SEC emphasizes, however, that the auditor's relationships with and services to a sister entity that is no longer deemed to be an affiliate as a result of applying the dual materiality test will continue to be subject to evaluation under the general independence standard of Rule 2-01(b).

In this and other amendments, the SEC has delineated the varying scope of particular independence requirements by distinguishing between the "audit client," which refers to both the audited entity and the audited entity's affiliates, and the "entity under audit," which refers solely to the entity "whose financial statements or other information is being audited, reviewed, or attested" and excludes the audited entity's affiliates.

The SEC did not define materiality for purposes of applying the new test, although the adopting release illustrates the application of the dual materiality threshold to particular fact patterns. The two Commissioners who dissented from adoption of the amendments expressed concern that the lack of specific guidance on materiality cedes unwarranted discretion to audit firms to make the materiality determination and thus "subjectively determine when their own independence is impaired."

The amendments also amend the definition of "investment company complex" for purposes of evaluating independence under Rule 2-01(c) where the audit client is an investment company or an investment adviser or sponsor. In these circumstances, the auditor and audit client must look to the amended definition to identify affiliates relevant to the independence analysis.

Relationships with controlling entities. Moving up the ownership chain, the SEC decided that a controlling entity should be considered an affiliate of the entity under audit for independence determinations under Rule 2-01(c) even if the entity under audit is not material to the controlling entity. The SEC noted that the controlling entity typically has some decision-making ability over, or an ability to influence, the entity under audit. Therefore, in the SEC's view, an auditor's independence likely would be impaired

if the auditor provides services to, or engages in other relationships with, the controlling entity of the type covered by the rule, irrespective of the materiality of the entity under audit to the controlling entity.

Shortened look-back period for domestic first-time filers

The amendments modify the definition of "audit and professional engagement period" in Rule 2-01(f) to shorten the "look-back period" for which domestic IPO issuers and other domestic first-time filers must assess independence.

The assessment for the look-back period requires an evaluation of auditor relationships and services identified in Rule 2-01(c) that are inconsistent with the general independence standard under Rule 2-01(b). Domestic first-time filers now will be subject to a look-back for the most recent fiscal year, consistent with the treatment under the current rule for first-timer filers that qualify as foreign private issuers. The SEC believes that providing this parity between domestic issuers and foreign private issuers may benefit capital formation.

Before this amendment, domestic first-time filers have been required to assess auditor independence under Rule 2-01(c) in light of specified relationships and services over the period dating back to the engagement of the auditor to audit or review the financial statements included in the applicable filing. The shortened look-back period, by contrast, will begin with the first day of the last fiscal year before the issuer first files or is required to file a registration statement or report with the SEC. The independence evaluation with respect to the audit and professional engagement period thus has been shortened to the most recent fiscal year for which financial statements are included in the first SEC filing. The SEC cautions that auditor relationships and services in prior years that did not occur during the look-back period "still would have to be considered under the general independence standard of Rule 2-01(b), either individually or in the aggregate."

The SEC clarifies in the release that:

- if an issuer withdraws an initial registration statement, the refiling of a new registration statement would be considered the issuer's first-time filing;
- a first-time filer undertaking a reverse merger "that is in substance similar to an IPO" should apply the shorter look-back period instead of the transition framework for mergers and acquisitions discussed below; and
- the amendment applies to both existing and new audit relationships.

Amendments to business relationships rule

Under the current "business relationships" provisions of Rule 2-01(c), the accounting firm or any covered person is prohibited, during the audit and professional engagement period, from having "any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders."

The amendment to this requirement concentrates the assessment on those persons with whom business relationships reasonably could be expected to affect an auditor's objectivity and impartiality by:

- shifting the current assessment of the auditor's business relationships with "substantial stockholders" to an assessment of the auditor's relationships with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has *significant influence* over the entity under audit" (emphasis added); and
- redirecting the assessment of the auditor's business relationships with the audit client's officers or directors generally to the auditor's relationships with those officers and directors of the audit client "that have the ability to affect decision-making at the entity under audit."

The addition of the "significant influence" test for evaluation of auditor relationships with equity holders brings this aspect of the business relationships rule into line with the same test in the loan provision discussed below. The revised formulation of the assessment of relationships with officers and directors clarifies that the business relationships rule applies to officers or directors of the *audit client* when such a person has the ability to affect decision-making at the *entity under audit*.

Amendments to treatment of loans and debtor-creditor relationships

Under the "loan provision" of Rule 2-01(c), an auditor generally will not be independent from the audit client if the audit firm, any covered person in the firm, or any immediate family member of a covered person has any loan "to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client."

Consistent with the changes to the business relationships rule, the restriction on loans to or from the audit client's officers or directors has been amended to refer to loans

involving those officers and directors of the audit client "that have the ability to affect decision-making at the entity under audit." The amendments also modify the following exceptions to the loan prohibition based on the nature of the loans made:

Addition of student loan exception. An amendment to Rule 2-01(c) excepts certain student loans from the general rule that loans from an audit client compromise auditor independence. To qualify for the exception, the student loan must be obtained from an audit client before the borrower becomes a covered person in the audit firm. The loan also must be obtained from a financial institution under its normal lending procedures, terms, and requirements. The SEC indicates that the exception also includes loans obtained by immediate family members of the covered person and that any such loans are not subject to dollar limits.

Clarification of mortgage loan exception. An amendment to Rule 2-01(c) clarifies that the existing mortgage loan exception to the loan prohibition permits more than one outstanding mortgage loan collateralized by the borrower's primary residence. The SEC declined to make this exception available for loans collateralized by secondary or vacation homes or other non-primary residences, but recites prior staff guidance confirming that the exception extends to second mortgages, home improvement loans, equity lines of credit, and similar mortgage obligations collateralized by a primary residence. Like student loans, mortgage loans must be obtained from a financial institution under its normal lending procedures, terms, and requirements before the borrower becomes a covered person in the audit firm.

Expansion of credit card exception to consumer loans. Under Rule 2-01(c), an outstanding credit card balance owed to a lender that is an audit client does not impair auditor independence if the balance is reduced to US$10,000 or less on a current basis, taking into consideration the payment due date and any available grace period. An amendment to this provision expands the types of loans excluded from the loan restriction from loans generated under "credit cards" to "consumer loans," while retaining the US$10,000 cap on permissible balances. The SEC explains that the enlarged loan category will encompass the types of consumer financing borrowers "routinely obtain for personal consumption," such as retail installment loans, cell phone installment plans, and home improvement loans that are not secured by a mortgage on a primary residence.

Transition framework for M&A transactions

An amendment to Rule 2-01(e) establishes a transition framework to address independence violations that would result from merger and acquisition activity. The amendment is intended to allow the auditor and its audit client to maintain the audit relationship by transitioning out of services and relationships that will become violations of independence standards as a result of the transaction. If the requirements of amended Rule 2-01(e) are met, the affected relationships and services will not constitute independence violations.

Conditions. Under the revised rule, an accounting firm's independence will not be impaired after a merger or acquisition by the audit client solely due to services and relationships resulting from the transaction, so long as the following conditions are satisfied:

- the accounting firm is in compliance with the applicable independence standards related to such services or relationships both when the services or relationships originated and throughout the period in which the applicable independence standards apply;
- the accounting firm has addressed or will address those services or relationships "promptly" under relevant circumstances as a result of the occurrence of the merger or acquisition; and
- the accounting firm has in place a quality control system that includes 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 – after initial notification of a potential merger or acquisition but before the effective date of the transaction – of services or relationships that might trigger independence violations.

Timing considerations. As noted, the amendment requires that the accounting firm address "promptly" services or relationships implicated by the M&A transaction. The SEC declined to impose an express deadline because of its concern that providing a deadline would lead to treatment of the timeline as standard practice in all situations, even when a shorter transition might be attainable and more appropriate. The SEC indicates that it expects that, "in most instances," the independence-impairing service or relationship "should and could be addressed before the effective date of the merger or acquisition." Where doing so is not possible, the SEC expects that the relationship or service will be

addressed promptly after the transaction effective date, and in any case no later than six months after the effective date.

The SEC notes that where a service or relationship resulting in an independence violation is identified only after the transaction effective date, the audit firm and the audit committee of the audit client will need to consider all relevant facts and circumstances in their evaluation of the auditor's objectivity and impartiality. The parties may seek consultation with the SEC's Office of the Chief Accountant in making the evaluation.

Reverse mergers. The SEC indicates that the transition framework would not apply to M&A transactions "that are in substance similar to IPOs," such as a transaction in which a shell company that files reports pursuant to the Exchange Act engages in a merger with a private operating company. In such a case, as noted earlier, the auditor should evaluate independence compliance using the look-back period contained in the amended definition of "audit and professional management period" discussed above.

Audit client responsibilities to monitor auditor independence

Registrants should be attentive to Rule 2-01's requirements in light of the SEC's admonition that the monitoring of auditor independence works most effectively when management, audit committees, and audit firms work together to evaluate the auditor's compliance with the independence requirements. In accordance with audit client responsibilities referred to in the adopting release, a company should:

- work with the auditor to identify and monitor potential affiliates falling within the scope of the applicable prohibition, and help the auditor to understand the audit client's organizational structure;
- notify the auditor in a timely manner of any change in circumstances that may affect the population of potential affiliates, including by notification in advance of the effectiveness of a merger or acquisition;
- identify to the auditor any beneficial owners of equity securities that have "significant influence" over the audit client;
- if not yet a reporting company, communicate to the auditor as early as possible the plan to file a registration statement, so that the independence rules may be considered in advance of the filing; and
- consider implementing policies and procedures, supplementing the auditor's system of quality control, to identify, consider, and monitor the provisions of services by and relationships with the auditor.

Each aspect of independence-monitoring is directed at identifying at the earliest possible time any relationship or service that could create a mutual or conflicting interest between the audit firm and the audit client, place the audit firm in the position of auditing its own work, result in the audit firm acting as management or an employee of the audit client, or place the audit firm in the position of being an advocate for the audit client. The SEC has indicated in a preliminary note to Rule 2-01 that each of these circumstances raises independence concerns. Accordingly, when any such relationship or service is contemplated or identified, it should be examined closely by the audit firm and its client's management or to ensure compliance with the independence requirements.

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