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SEC adopts amendments to update certain auditor independence requirements

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KPMG reports on the SEC's amendments[1] to Rule 2-01 of Regulation S-X to modernize certain aspects of auditor independence requirements

Applicability

Public companies, registered investment companies, registered investment advisors, registered broker-dealers, private funds complying with the SEC's custody rule[2] and any other entities otherwise subject to SEC independence rules.

Key changes

The SEC has finalized amendments to certain auditor independence rules. The changes seek to modernize auditor independence requirements, enhance efficiency of rule application, reduce compliance burdens, increase competition among auditors and improve audit quality over the long term. The SEC's amendments revise auditor independence rules in several important ways:

- amends the definitions of 'Affiliate of the Audit Client' and 'Investment Company Complex' (ICC) by incorporating a dual materiality threshold in certain common control scenarios, potentially resulting in fewer affiliates;
- specifies the use of the ICC definition for affiliate determination only when the audit client is an investment company or an investment adviser or sponsor;
- reduces the length of time that domestic first-time filers must comply with all SEC independence requirements to the most recent year (the year of the most recent audited financial statements);
- revises certain loan and debtor-creditor provisions to recognize that certain student, home equity and consumer loan relationships do not threaten an auditor's objectivity and impartiality;
- amends the business relationships rule to replace the reference to 'substantial stockholders' with the concept of "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"; and
- introduces a transition framework for services and relationships with new affiliates that result from an audit client's merger and acquisition transactions, whereby certain services and relationships continuing after the effective date of the transaction will not be deemed to impair independence.

1 SEC Release No. 33-10876; 34-90210; Qualifications of Accountants, October 16, 2020

2 Rule 206 (4) - 2 of the Investment Advisers Act of 1940

Why did the SEC propose the amendments?

In 2000, the SEC adopted a robust framework of rules governing auditor independence, which laid out governing principles and described specific financial, employment, business and non-audit service relationships that would cause an auditor to not be independent of its audit client. Except for significant revisions made in connection with amendments required by the Sarbanes-Oxley Act of 2002, many of the provisions from the 2000 Adopting Release have remained unchanged since adoption.

After considering feedback recently received from the public as part of the revision of the Loan Provision of the independence rules and the SEC's experience administering these rules since their initial adoption two decades ago, the SEC believes that the amendments to the auditor independence rules will more effectively focus the independence analysis on those relationships or services that are most likely to threaten an auditor's objectivity and impartiality.

Summary of the amended auditor independence rules

Regulation S-X Rule 2-01(f)(4) Affiliate of the Audit Client	
Regulation S-X existing rule	**Final amendment**
Entities under common control with the audit client, including those entities that meet the definition of an ICC, are considered affiliates and fall within the definition of 'affiliate of the audit client' **without regard to materiality**.	Entities under common control with the entity under audit that is an operating company (including a portfolio company in a private equity structure) are affiliates **only if both entities are material** to the common controlling entity.
All components of the definition of 'affiliate of the audit client' in Rule 2-01(f)(4), including the ICC must be considered, if applicable.	The ICC component of the affiliate definition is only applied when the entity under audit is an investment company or an investment adviser or sponsor.
Impact: The change in the affiliate definition will improve the focus of the independence analysis on those relationships and services that are more likely to threaten an auditor's objectivity and impartiality. Under the new 'dual materiality threshold' in the amended rule, companies controlled by private equity firms or other entities will likely have fewer common control affiliates and fewer independence impairing services and relationships. The SEC emphasized that auditors and their clients have a shared responsibility to monitor all aspects of Rule 2-01, including "the monitoring of affiliates and obtaining information necessary to assess materiality." The SEC's press release announcing the final amendments includes a portfolio company example, which illustrates the effect of the change in affiliate determination under the amended rules.	

Regulation S-X Rule 2-01(f)(14) Investment Company Complex (ICC)	
Regulation S-X existing rule	**Final amendment**
Affiliates determined under the ICC include, among others, entities controlled by or controlling an investment adviser or sponsor or any entity under common control with an investment adviser or sponsor if the entity: (1) Is an investment adviser or sponsor; or (2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor.	The amended ICC definition only applies when the entity under audit is an investment company or an investment adviser or sponsor. The ICC includes, and therefore affiliates would be: A. An entity under audit that is an investment company or an investment adviser or sponsor; B. The investment adviser or sponsor of any investment company identified in A; C. Entities controlled by or controlling the entity under audit; entities controlled by the investment adviser/sponsor of the investment company under audit if: i. The entity under audit and the controlled entity **are each material** to the investment adviser/sponsor, or ii. The controlled entity provides administrative, custodial, underwriting, or transfer agent services to the investment company under audit or its investment adviser/sponsor; D. Any entity under common control with entities identified in A, B or C if: i. Entity is an investment company, investment adviser or sponsor and such entity and the entity under audit identified in A **are each material to the controlling entity**, or ii. Entity provides administrative, custodial, underwriting or transfer agent services to any entity identified in A or B; E. Any entity over which the entity under audit identified in A has significant influence, unless the entity is not material to the entity under audit or any entity which has significant influence over the entity under audit identified in A unless the entity under audit is not material to the entity that has significant influence over it; and F. Any investment company that has an investment adviser or sponsor affiliate identified in A through D.
Impact: The amendments change the application of the definition of Affiliate of the Audit Client and the ICC affiliate definition, which will likely result in fewer affiliates and potentially increase the choices registrants have when considering providers for audit and non-audit services.	

Regulation S-X Rule 2-01(f)(5)(iii) Audit and Professional Engagement Period	
Regulation S-X existing rule	**Final amendment**
Auditors of domestic private companies seeking to go public have to be independent under the SEC's independence rules for all financial statement periods included in the issuer's registration statement filed with the SEC (generally two to three years of audited financial statements). Auditors of foreign private issuers seeking to go public only have to be independent under the SEC's independence rules during the immediately preceding fiscal year, provided there has been full compliance with home country independence standards in all prior periods covered by the registration statement.	Auditors of domestic companies seeking to go public are only required to be independent under the SEC's independence rules for the period beginning on the first day of the last fiscal year before the domestic company first filed, or was required to file, a registration statement or report with the SEC, provided there has been full compliance with home country independence standards in all periods covered by the registration statement.
Impact: The amendment narrows the definition of the audit and professional engagement period requiring SEC independence. The amended rule will likely be less onerous for domestic private companies looking to engage in an initial public offering by reducing the requirement to be independent under SEC rules from two or three look-back years to only one look-back year (the year of the most recent audited financial statements). The SEC believes that the changes may encourage capital formation, eliminate any potential economic disadvantage of domestic companies as compared to foreign private issuers, and help domestic companies "avoid the compliance costs associated with switching auditors or delaying the filing of an initial registration statement."	

Regulation S-X Rule 2-01(c)(1)(ii)(A)(1) and (E) Loans or Debtor-Creditor Relationships	
Regulation S-X existing rule	**Final amendment**
An accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loans (including any margin loan) to or from an audit client, beneficial owner (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client, or certain other entities or persons related to the audit client. Includes four categories of loans that are excepted from the prohibition above, provided they were obtained under normal lending procedures, terms and requirements, which are: — Automobile loans and leases collateralized by the automobile; — Loans fully collateralized by the cash surrender value of an insurance policy; — Loans fully collateralized by cash deposits at the same financial institution; and — A mortgage loan collateralized by the borrower's primary residence provided the loan was not	Clarifies that the fourth category of loans that are excepted from the prohibition applies to multiple mortgage loans (e.g. primary and second mortgages, home equity loans) collateralized by the borrower's **primary** residence provided the loans were not obtained while the covered person was a covered person. Adds a fifth category of loans that are excepted from the prohibited debtor-creditor relationships, which is: — Student loans obtained for a covered person or a covered person's immediate family members that were obtained before the individual became a covered person.

Regulation S-X Rule 2-01(c)(1)(ii)(A)(1) and (E) Loans or Debtor-Creditor Relationships	
Regulation S-X existing rule	**Final amendment**
obtained while the covered person in the firm was a covered person.	
Provides that an accountant is not independent if the accounting firm, any covered person in the firm, or any of his or her immediate family members has any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis, taking into consideration the payment due date and any available grace period.	Replaces the reference to 'credit cards' with 'consumer loans' to expand the current rule to encompass other types of consumer financing borrowers routinely obtain for personal consumption (i.e. retail installment loans, cell phone installment plans) provided that the aggregate balance is reduced to $10,000 or less on a current basis, taking into consideration the payment due date and any available grace period.
Impact: The amended rule will likely result in fewer breaches of the loan provision of the SEC's independence rules. Because the types of loans affected by the SEC's amendments are usually not significant or relevant to an auditor's objectivity in fact or appearance, the amendments should better focus the independence analysis on those lending relationships that affect the auditor's objectivity and impartiality[3].	

Regulation S-X Rule 2-01(c)(3) Business Relationships Rule	
Regulation S-X existing rule	**Final amendment**
Prohibits direct or material indirect business relationships between the accountant and the 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.	Replaces the reference to 'substantial stockholders' with the concept of "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."
Impact: The amended rule will likely reduce the number of instances of business relationships with entities and individuals that result in a breach of SEC independence rules. By replacing the reference to 'substantial stockholders' with the concept of significant influence over the entity under audit, it better aligns the intent of the business relationships rule by focusing on business relationships with those persons or entities in a decision-making capacity associated with the entity under audit that may be viewed as impacting an audit firm's objectivity or impartiality.	

Regulation S-X Rule 2-01(e) Transition and Grandfathering	
Regulation S-X existing rule	**Final amendment**
The current rules do not provide for any transition period when an inadvertent independence violation arises as a result of a corporate event such as a merger or acquisition during the audit or professional engagement period, whereby the closing of the transaction triggers an independence violation.	Adds a transition framework to allow for orderly transition out of impermissible services and relationships that arise from a merger or acquisition. The accounting firm's independence will not be impaired if the audit client engages in a merger or acquisition that gives rise to a relationship or service with a new affiliate of the audit client that is

[3] AICPA interpretations and PCAOB Rule 3500T *Interim Ethics and Independence Standards*, which apply if more restrictive, do not currently permit exceptions for previously obtained student loans if the balance is material to the covered person's net worth or new consumer loans of any amount to or from an audit client.

Regulation S-X Rule 2-01(e) Transition and Grandfathering	
Regulation S-X existing rule	**Final amendment**
	impermissible, provided that the accounting firm meets the conditions in the framework. To qualify for the transition framework, the accounting firm must:
	— Be in compliance with the applicable independence standards related to the services or relationships when they originated and throughout the period in which the applicable independence standards applied; — Terminate any impermissible services or relationships arising from the merger or acquisition promptly under the relevant circumstances (no later than six months after the effective date of the merger or acquisition); and — Have a quality control system that monitors audit client activity to provide timely notice of a merger or acquisition, and procedures/controls that allow for prompt identification of impermissible services and relationships after initial notification of a potential merger or acquisition that may trigger independence violations, but before the effective date of the transaction.
Impact: Auditor independence issues arising because of a corporate transaction often require termination of services in process. These terminations may be disruptive and costly to an audit client. The amended rules provide greater flexibility to audit clients when impermissible services or relationships are identified as a result of an audit client's merger or acquisition transaction. However, the SEC emphasized that the focus should be on terminating impermissible services and relationships as soon as reasonably possible and in most instances before the effective date of the merger or acquisition, but not to exceed six months after the effective date of the merger or acquisition.	

Important consideration of the SEC's general standard for independence

The SEC has indicated that the relationships with and services performed for entities excluded under the amended affiliate definition should still be evaluated, individually and in the aggregate, for their impact on the auditor's compliance with the general standard for independence in Rule 2-01(b) of Regulation S-X. The general standard includes, in part, that 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."

Similarly, the SEC has emphasized applicability of the general standard for independence for those services and relationships, individually and in the aggregate, that are now excluded under other amendments to the independence rules, including those covered by:

— the amendment providing that for domestic companies making an initial filing, SEC independence is not required for periods prior to the beginning on the first day of the last fiscal year subject to audit before the initial filing; and
— the amendment providing a transition framework for services and relationships with new affiliates resulting from mergers or acquisitions involving the audit client or its affiliates.

Effective dates and transition

The final rules are effective 180 days after the date of publication in the Federal Register. Voluntary early compliance is permitted after the amendments are published in the Federal Register provided that the final amendments are applied in their entirety from the date of early compliance. Except for the revisions to the exemptions regarding student loans, consumer loans and multiple mortgages, auditors are not permitted to retroactively apply the final amendments to relationships and services in existence prior to the effective date or the early compliance date if selected by an audit firm. While the SEC's amendments to Rule 2-01 of Regulation S-X provide for voluntary early compliance, audit firms will need to maintain compliance with other applicable independence requirements when such requirements are more restrictive. The PCAOB staff has stated that without amendments to conform the definitions in PCAOB Rule 3501 and the Board's interim independence standards (i.e. interpretations and rulings under Rule 101 of the AICPA Code, as previously adopted by the Board) to the Commission's recent amendments to Rule 2-01, the objectives of the SEC's rulemaking may not be fully achieved. The PCAOB reports that its staff are monitoring the SEC's rulemaking project regarding the changes to the Commission's independence requirements and plan to submit a recommendation for the Board's consideration.

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