BCLP. Client Intelligent

BCLPSecCorpGov.com

SEC MODERNIZES AUDITOR INDEPENDENCE RULES TO FOCUS ON ACTUAL THREATS TO OBJECTIVITY

Nov 09, 2020

The Securities and Exchange Commission (the "SEC") recently adopted final amendments to the auditor independence requirements set forth in Rule 2-01 of Regulation S-X. The SEC stated that the final amendments were based on recurring fact patterns that the SEC staff has observed over the years in which certain relationships and services triggered technical independence rule violations without necessarily impairing an auditor's objectivity and impartiality. These relationships either triggered non-substantive rule breaches or required potentially time-consuming audit committee review of non-substantive matters, thereby diverting time, attention, and other resources of audit clients, auditors, and audit committees from other investor protection efforts.

In the adopting release, the SEC stated that the amendments "…maintain the bedrock principle that auditors must be independent in fact and in appearance while…more effectively focusing the independence analysis on those relationships or services that are more likely to threaten an auditor's objectivity and impartiality." The SEC anticipates that Rule 2-01, as amended, will make the auditor independence rules easier to apply and appropriately limit the situations in which auditors are not deemed to be independent.

The amendments include, among others:

- In connection with determining whether auditor independence exists in the context of initial public offerings, an amendment shortening the applicable look-back period to cover the immediately preceding fiscal year (rather than the period covered by the registration statement, which can be up to three years);
- In connection with identifying relationships that may preclude a finding of auditor independence, an amendment providing that a sister entity will be considered an affiliate of an "entity under audit" (a new term added by the amendments) *only* if the sister entity and the entity under audit are each material to the common controlling entity (currently, all sister entities of an audit client are considered affiliates for the purpose of determining auditor independence);

- Amendments revising the definition of "investment company complex" for purposes of determining auditor independence where audit clients are investment companies or investment advisors or sponsors;

- In connection with identifying certain business relationships between persons related to the auditor, on the one hand, and the audit client and its "substantial stockholders," on the other hand, an amendment replacing "substantial stockholders" with "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client";

- With respect to the existing rule providing that, subject to certain exceptions, an auditor is not independent if specified persons within the audit firm or their family members maintain loans to or from an audit client, amendments:

- Narrowing the applicability of the rule from the audit client to those persons who have decision-making authority over the entity under audit;

- Adding student loans to the category of loans that will not preclude a finding of auditor independence as long as certain conditions are met (e.g., the loans are obtained from a financial institution under its normal lending procedures, terms and requirements for a covered person's educational expenses);

- With respect to the existing exception for certain mortgage loans provided certain conditions are met (e.g., collateralization by a primary residence), clarifying that more than one mortgage loan may be subject to the exception;

- With respect to the existing rule under which auditor independence will not be precluded if specified persons within the audit firm or their family members maintain credit card balances owed to an audit client lender provided certain conditions are met (e.g., the balances are reduced to $10,000 or less on a current basis), an amendment broadening "credit cards" to "consumer loan balances" (e.g., adding retail installment loans and mobile phone installment plans) as long as the same conditions are met; and

- Amendments addressing inadvertent violations of the auditor independence rules that may result from an audit client's merger and acquisition transactions, an amendment establishing a framework under which audit firms and their clients may transition out of the relationships or services that no longer allow for a finding of auditor independence.

The amendments will become effective 180 days after they are published in the Federal Register. Early compliance is possible, provided compliance is in full with respect to the entire rule, as amended. The amended rule applies prospectively and cannot be applied retroactively to relationships and services in existence prior to the effective date of the amendments or, if applicable, the date of early compliance.

The above is only a brief summary of certain of the final amendments to the auditor independence requirements. For additional information, please refer to the SEC's adopting release.

RELATED CAPABILITIES

- Securities & Corporate Governance
