

SEC Independence Rule Revisions (Part 2): Other Significant Changes

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01/7/21

In December 2019, the Securities and Exchange Commission (SEC) proposed revisions to [Rule 2-01, Qualifications of Accountants](#) of Regulation S-X, with the stated goal of focusing independence analyses on relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality. In summary, the SEC proposed to:

- amend key terms, *affiliate of the audit client, investment company complex, and audit and professional engagement period,*
- add certain student and de minimis consumer loans as additional exceptions to the loan rule,
- clarify application of the business relationships rule to persons and entities associated with the audit client, and
- introduce provisions for addressing prohibited relationships that result when an auditor's client is involved in a merger or acquisition.

On October 16, 2020, the [SEC released a final rule](#) (Final Release) that was largely consistent with the proposal, although the SEC adopted some meaningful and significant, additional changes based on the comments. [Part 1 of this article](#) highlighted significant amendments to two important definitions in Rule 2-01: *affiliate of the audit client* and *investment company complex*.

This second part focuses on other significant changes to Rule 2-01, specifically, revisions to the "look-back" period for domestic, first-time filers of an initial public offering (IPO), rules for personal loans and business relationships, and adoption of new transition provisions.

Audit and Professional Engagement Period

For many years, SEC rules required the auditor of a U.S.-domiciled private company planning to file an IPO to be independent under SEC rules for all periods included in the filing; typically, a "look-back period" of 2 or 3 years. Since audits of U.S. private companies generally require compliance with less-restrictive AIPCA independence rules, the auditor may have performed services or had business relationships with the company that preclude its compliance with SEC independence rules for all or part of the look-back period. However, if the first-time filer was a foreign private issuer who complied with all applicable (local) independence rules for prior periods, the auditor was required to be independent under SEC rules for only the most recent financial statement period in the filing.

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To address this inconsistency, the SEC proposed amending the term, *Audit and Professional Engagement Period*, so the independence requirements would be the same for both foreign and domestic first-time filers. Based on the staff's independence consultations, they believed that relationships and services that occurred during the earlier years included in an IPO filing were less likely to reduce the auditor's objectivity than those occurring more recently. The SEC adopted the revised definition as proposed.

Clarifications

The Final Release also responded to questions raised in the comment letters:

- The revised definition applies to both existing and new audit relationships.
- The revised definition applies to companies undergoing a reverse merger that is in substance like an IPO.
- If a company files a new registration statement after withdrawing the initial registration statement, it is still a first-time filing.

SEC General Standard

The Final Release reminded auditors to always consider relationships and services, both individually and in the aggregate, under the SEC's general standard of independence in Rule 2-01(b) (shown below). In other words, despite the amendments, the nature, extent, or relative importance of services or relationships (among other things) may still threaten an auditor's independence.

(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. In 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.

Loans or Debtor-Creditor Relationships

In part, the SEC's rules on loans or debtor-creditor relationships prohibit covered persons in a firm from having certain loans with audit clients. With certain criteria met, loans, such as home mortgages secured by a covered person's primary residence obtained prior to becoming a covered person and credit card balances, are permissible.

The SEC proposed the following two changes to these rules:

First, persons who obtained a student loan to pay for their educational expenses before they became covered persons in the firm would be permitted to continue that lending relationship when the loan was obtained from a financial institution audit client under normal lending procedures, terms, and requirements. The proposed change sought to provide an exemption like Rule 2-01's exemption for mortgages and other home loans collateralized by a covered person's primary residence.

Second, the SEC proposed expanding the current exception in the rules for di minimis credit card balances to include other types of routine personal consumer loans.

New Exemption for Student Loans

The SEC adopted the proposed exemption for student loans with two additional modifications. Based on comments received, the SEC agreed to extend the exemption for student loans to a covered person's immediate family (i.e., spouse, spousal equivalent, or dependent). The SEC also clarified that the entire balance qualifying under the loan's terms, conditions, and requirements are considered educational expenses within the scope of the rule. And any number of loans fitting these criteria qualifies. However, the exemption does *not* apply to student loans a covered person obtained to pay for educational expenses of those outside his or her immediate family, such as a nondependent child or nephew.

Consumer Loans

The SEC adopted its proposed expansion of the rule for credit cards to include other types of consumer loans a covered person owes to a financial institution audit client when the aggregate amount of such loans is reduced to \$10,000 or less on a current basis (that is, payment is made by the due date or within the available grace period). The SEC believes that such debt incurred by a covered person or his or her immediate family should not impair the auditor's objectivity in the audit. Examples of other consumer loans include cellular phone or other retail installment loans and home improvement loans that are not secured by the covered person's primary residence. The SEC maintained the current upper limit for these loans at \$10,000 per person covered by the exemption, rejecting calls to raise the amount to account for inflation.

Business Relationships Rule

The SEC clarified that a covered person may exempt more than one loan secured by their primary residence. For example, a covered person may have both a mortgage loan and a home equity line of credit secured by the same home.

Business Relationships Rule

The SEC bars auditors and covered persons from having a direct or material, indirect business relationship with an audit client or persons or entities associated with the client in a decision-making capacity, such as officers, directors, or substantial shareholders. Regulation S-X does not define *substantial shareholder*, so the rule created some confusion among auditors.

To provide greater clarity, the SEC proposed replacing the term, *substantial shareholder*, with the following phrase: *beneficial owner (known through reasonable inquiry) of the audit client's securities where such beneficial owner has significant influence over the audit client.*

The SEC adopted the above proposed change and replaced the term *audit client* in two places to clarify that the ability to make decisions and exert significant influence should be measured with respect to the *entity under audit*, not the audit client, which includes all the audit client's affiliates.

The revised language (in part) now states:

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has 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 or directors that have the ability to affect decision-making at the entity under audit or 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)

Transition Provisions

The SEC proposed adding transition provisions to Rule 2-01 that would allow auditors to address inadvertent independence violations that arise due to a corporate event, such as a merger or acquisition, involving the auditor's client. A summary of the final provisions follows:

- The auditor complied with applicable independence standards related to services or relationships for the entire duration of such services or relationships.
- The auditor has or will cease any prohibited relationships or services arising from the merger or acquisition as promptly as possible.
- The auditor has quality controls in place (as described in Rule 2-01(d)(3)) that monitor merger and acquisition activity to provide timely notice of these events and promptly identify prohibited relationships or services after notification of the event, but before the effective date of the transaction.

In response to comments, the SEC removed references to services or relationships identified as a result of a merger or acquisition as violations of the independence rules, since compliance with the new transition provisions in amended Rule 2-01(e) would avoid that situation.

Though not specified in the Final Release, the SEC expects firms to take any necessary actions no later than six months after a transaction's effective date or sooner, if possible, under the circumstances. In terms of disclosing such matters to a client's audit committee, the Final Release directed auditors to the Public Company Accounting Oversight Board's (PCAOB's) [Rule 3526, Communication with Audit Committees Concerning Independence Guidance](#) related to Rule 3526 may also be relevant.

If a firm identifies a prohibited service or relationship after the transaction's effective date, the firm and the client's audit committee should consider the facts and circumstances to determine the impact on the audit team's objectivity and consult with the SEC staff as needed.

Clarifications

While not explicit in the final rule, the SEC noted in the Final Release that the general standard applies, as always, noting that, "*For example, if an auditor is found to be auditing its own work over a significant amount of the acquired business as part of the audit of the financial statements, that fact most likely would affect the auditor's independence under Rule 2-01(b).*"

The SEC clarified that the transition provisions do not apply to merger and acquisition transactions that are in substance the equivalent of IPOs. For example, if a shell company merges in a firm's private company audit client, the firm should apply the revised definition, *Audit and Professional Engagement Period*, not the transition provisions.

Effective Date, Transition, and Grandfathering

Effective Date

The effective date of these and other amendments to Rule 2-01 is June 9, 2021. Earlier application is permitted if the firm applies the amended rules in their entirety.

Transition and Grandfathering

Auditors should comply with the amended rules on a prospective basis, beginning on June 9, 2021, or the date the firm elects early compliance (compliance date). Auditors may not retroactively apply the final amendments to relationships and services that existed before the compliance date. However, a covered person who has a student loan or consumer loan that was originated before the compliance date but complies with the final amendments as of the compliance date, will not violate the SEC independence rules if the conditions for exempting such loans continue to be met.

Additional Actions

PCAOB Rules

In November 2020, the Public Company Accounting Oversight Board (PCAOB) adopted amendments to its interim independence standards and rules of the Board, which are pending approval by the SEC. See [PCAOB Release 2020-003, Amendments to PCAOB Interim Independence Standards and PCAOB Rules to Align with Amendments to Rule 2-01 of Regulation S-X](#) for more information.

AICPA *Code of Professional Conduct*

On December 21, 2020, the AICPA's Professional Ethics Executive Committee (PEEC) adopted a policy that firms and their members who comply with the revised SEC independence rules will also be complying with the AICPA's *Code of Professional Conduct* (Code), pending the PEEC's consideration of possible changes to the Code to conform to revised SEC rules.

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