

MEMO# 12257

July 14, 2000

SEC ISSUES AUDITOR INDEPENDENCE RULE PROPOSALS

[12257] July 14, 2000 TO: ACCOUNTING/TREASURERS COMMITTEE No. 27-00 SEC RULES COMMITTEE No. 96-00 RE: SEC ISSUES AUDITOR INDEPENDENCE RULE PROPOSALS The Securities and Exchange Commission has proposed substantive rule amendments intended to modernize and strengthen auditor independence requirements.¹ The proposed rule amendments address primarily three areas: (1) investments by auditors or their family members in audit clients; (2) employment relationships between auditors or their family members and audit clients; and (3) the scope of services provided by audit firms to their clients. The proposals would reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor. They would also preclude auditors from providing certain non-audit services to audit clients. The proposed rules provide limited exceptions from the independence rules for certain independence failures that are cured promptly after discovery. Finally, the proposals would require companies to disclose in their annual proxy statements certain information about non-audit services provided by their auditors during the last fiscal year. The Proposing Release is attached to this memorandum and is summarized below. The Commission will hold the first of several hearings on the rule proposals to solicit public input on Wednesday, July 26. Comments on the rule proposals are due September 25, 2000. If you have comments you would like to be considered for the Institute's comment letter on the rule proposals, please submit them to Greg Smith at 202-326-5851 or smith@ici.org no later than August 11, 2000. Proposed Rule Amendments A. General Standard for Auditor Independence Rule 2-01 of Regulation S-X sets forth the required qualifications of accountants practicing before the Commission. Proposed rule 2-01(b) sets forth the basic test of an auditor's independence. The rule indicates that the Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. The proposed rule identifies four governing principles for determining when an auditor is not independent. They are when the auditor: 1 SEC Release No. IC-24549 (July 12, 2000) ("Proposing Release"). 2 • has a mutual or conflicting interest with the audit client, • audits the accountant's own work, • functions as management or an employee of the audit client, or • acts as an advocate for the client. B. Specific Applications of Independence Standard Proposed rule 2-01(c) provides that an accountant is not independent if during the audit and the professional engagement period, the accountant has any of the financial, employment, or business relationships with, provides certain non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5) of the rule. 1. Financial Relationships The proposed rules would narrow significantly the circle of people whose investments trigger independence concerns. For example, under

current rules, partners in firms that do not work on the audit of a client, as well as their spouses and families are restricted from investments in a firm's audit clients. However, the proposed rules limit such restrictions to principally those who work on the audit or can influence the audit, and their immediate family members.

a. Investments in Audit Clients Under the proposed rules, an accountant (and the accountant's firm) is not independent under the following circumstances:

- Any direct investment in an audit client or its affiliates by the firm, "covered persons" (i.e., those involved in the audit or in a position to influence the audit, or their "immediate family") (proposed rule 2-01(c)(1)(i)(A)).
- Direct investments of more than 5 percent of the equity of an audit client or its affiliates held by firm partners, professional employees and certain of their family members not included above, or any group of these persons (proposed rule 2-01(c)(1)(i)(B)).
- The firm, any covered person in the firm, or any immediate family member, or any group of these persons has any material indirect investment in an audit client, including, ownership of more than 5 percent of an entity that owns an interest in the audit client, or ownership of more than 5 percent of an entity of which the audit client owns an interest (proposed rule 2-01(c)(1)(i)(D)).

"Covered persons" in the audit firm include: (i) the audit engagement team; (ii) the audit engagement team's chain of command; (iii) any other professional employee of the firm who is involved in providing any professional service to the client, its parents, subsidiaries or other affiliates; and (iv) all other professional employees located in the office of the firm that participates in a significant portion of the engagement. "Immediate family members" includes a person's spouse, spousal equivalent and dependents. Proposed rule 2-01(c)(1)(i)(D) does not make a distinction for an indirect investment in an audit client by an auditor through an investment company. As a result, an auditor would not be independent if the auditor owns more than 5 percent of the outstanding stock of an investment company and the investment company holds an investment in an audit client. The proposed rule, however, does not impose a limit on the portion of an investee company's (including an investment company's) assets that may be invested in the audit client, assuming the auditor owns less than 5 percent of the investee company and the investee company is not an affiliate of the audit client. "Affiliate of the audit client" is defined in proposed rule 2-01(f)(5) as any entity that has significant influence over the audit client, or any entity over which the audit client has significant influence, including the audit client's parent and subsidiary. The Proposing Release indicates that significant influence can be exercised in several ways: board representation; participation in policy decisions; interchange of personnel and other means. The Proposing Release indicates that the Commission considered limiting the portion of an investee company's assets that could be invested in an audit client without impairing auditor independence. The Proposing Release requests comment on whether there should be a limit on the portion of an investee's total assets (e.g., 10 percent, 25 percent) that can be invested in an audit client without independence being impaired. The Proposing Release notes that limits on material indirect investments in an audit client may be difficult for auditors to apply in practice when they invest in an investment company. Auditors have no easy way to determine how much of an investment company's assets are invested in an audit client since fund portfolios are disclosed only twice each year and may change between reporting dates. As an alternative to a percentage limitation on an investee's total assets that can be invested in an audit client, the Proposing Release requests comment on permitting indirect investment in audit clients through an investment company so long as the company is diversified under the Investment Company Act. The Proposing Release solicits comment on all aspects of the financial interest rules. In particular, would reasonable investors be concerned that investments of the sort described above impair an auditor's independence? Is the five percent threshold for financial interest in an audit client by persons who do not influence the audit appropriate?

b. Other Financial Interests Certain other financial relationships with

an audit client also would preclude an accountant from being independent. These relationships include:

- Having loans to or from an audit client except for certain consumer loans, such as mortgages or auto loans.
- Maintaining savings, checking, brokerage, or similar accounts in excess of insured amounts.
- Maintaining a credit card with a balance in excess of \$10,000.
- Holding individual insurance policies, and for the firm, professional liability policies.
- Investing in an investment company that is in the same investment company complex as the audit client.

Proposed rule 2-01(c)(1)(ii)(G) sets forth the rule for investment by accounting firms, covered persons and covered persons' immediate family members in an investment company or related entity. The proposed rule provides that an auditor is not independent if the auditor invests in any entity in an investment company complex if the audit client is also an entity included in that investment company complex. The proposed rule makes clear that when an audit client is part of an investment company complex, the accountant must be independent of each entity in the complex. Proposed rule 2-01(f)(16) defines "investment company complex" as an investment company and its investment adviser or, if the company is a unit investment trust, its sponsor; any entity controlled by or under common control with or controlling the investment adviser or sponsor, such as the distributor, administrator or transfer agent; and any investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act that is advised by the same adviser or a related adviser, or sponsored by the same sponsor or related sponsor. The Proposing Release notes that the proposed rule generally follows ISB Standard No. 2 in that an accountant must be independent of the entire investment company complex to be independent of any entity in the complex. The Proposing Release requests comment on whether the proposed rule is sufficiently clear and capable of implementation. Also, are there any unique implications of applying the proposed independence rules to investment companies, investment advisers, sponsors of unit investment trusts, and affiliated or unaffiliated service providers?

c. Exceptions The proposed rules provide limited exceptions from the independence rules for certain independence failures that are cured promptly after discovery. The proposed rules provide that an accountant's independence will not be impaired if any person acquires a financial interest through an unsolicited gift or inheritance, and the financial interest is disposed of within 30 days. The Proposing Release requests comment on whether the exception captures all situations in which a covered person may enter into a restricted financial relationship and yet not give rise to independence concerns. Also, the proposed rules contain an exception designed to allow accounting firms to bid for and accept new audit engagements, even if a person has a financial interest that would cause the accountant to be not independent.

d. Audit Client Investment in the Auditor Proposed rule 2-01(c)(1)(iv)(A) provides that an accountant is not independent when its audit client has invested, or otherwise has a financial interest in the accounting firm or an affiliate of the accounting firm. The proposed rule defines "affiliate of the accounting firm" as any person controlling, controlled by, or under common control with the firm, shareholders of more than five percent of the firm's voting securities, and entities five percent or more of whose securities are owned by the firm. The rule also includes any officer, director, partner, or co-partner of any of the foregoing entities or persons. The Proposing Release notes that this definition is based generally on section 2(a)(3) of the Investment Company Act, and is intended to capture those entities that are financially tied to or associated with the accounting firm enough to warrant being treated like the accounting firm for independence purposes.

2. Employment Relationships The proposed rules identify the specific positions, namely those in which a person can influence the audit client's financial records, which would impair an auditor's independence if held by a close family member of the auditor. The restrictions on employment relationships are based on the premise that when an accountant is either employed by an audit client, or has a close

relative or former colleague employed in certain positions at an audit client, the accountant might not be capable of exercising impartial judgement. For this purpose “close family member” includes a person’s spouse, parent, dependent, nondependent child and sibling. An accountant will not be independent when any of the following employment relationships exist:

- A close family member of a covered person is employed by an audit client in an accounting or financial reporting oversight role.
- 5 • A former partner or professional employee is employed by an audit client in an accounting or financial reporting oversight role – unless the former partner has severed his or her financial ties with the firm.
- A former employee of an audit client becomes a partner of the accounting firm and participates in the audit of the audit client.

3. Business Relationships Proposed rule 2-01(c)(3) provides that independence will be impaired if the accountant or any covered person has a direct or material indirect business relationship with the audit client, other than providing professional services or acting as a consumer in the ordinary course of business.

4. Non-audit Services

a. Prohibited Services Proposed rule 2-01(c)(4) precludes an accounting firm from providing certain non-audit services to an audit client or its affiliate. The Proposing Release indicates that these services are incompatible with the governing principles for determining auditor independence included in proposed rule 2-01(b), even when the audit client, by contract or otherwise, accepts ultimate responsibility for the work performed or any decisions made. These services include:

- Bookkeeping or other services related to the audit client’s accounting records or financial statements.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports where there is a reasonable likelihood that the accountant will audit the results.
- Actuarial services.
- Internal audit outsourcing.
- Management functions.
- Human resources functions.
- Broker-dealer, investment adviser, or investment banking services.
- Legal services.
- Expert services.

The prohibition on providing broker-dealer and investment adviser services to audit clients includes a provision that would preclude an accounting firm from designing a system for compliance with broker-dealer or investment adviser regulations for an audit client or its affiliate. The Proposing Release indicates that to the extent that, during the performance of the audit, the auditor relies on the controls that are part of compliance systems designed by the accountant, the accountant will end up in the position of auditing its own work. The Proposing Release solicits comment on whether designing an audit client’s system for compliance with broker-dealer or investment adviser regulations would impair an auditor’s independence. The proposed rule would not affect tax-related services provided by auditors to their audit clients.

b. Alternatives The Proposing Release indicates that the Commission is considering a number of alternatives concerning scope of services, including:

- 6 • A complete prohibition on any non-audit service to audit clients.
- Segregation of audit and non-audit businesses into separate, autonomous units.
- A rule stating that an auditor’s independence would be impaired if the fees for all non-audit services provided to a client exceeded a percentage of the client’s financial statement audit fee.

C. Quality Controls and Independence Exceptions Proposed rule 2-01(d) establishes a limited exception from independence violations for accounting firms that maintain certain quality controls and satisfy certain conditions. Under the rule, an accounting firm’s independence will not be impaired if:

- The individual did not know, and was reasonable in not knowing, the circumstances giving rise to the violation.
- The violation was corrected promptly once the violation became apparent.
- The firm has quality controls in place that provide reasonable assurance that the firm and its employees maintain their independence.

D. Proxy Disclosure Requirement The proposal requires registrants to disclose in proxy statements relating to election of directors or ratification of accountants information relating to services provided by the auditor and fees paid to the auditor. The proposal would generally require a company to describe each professional service provided by the independent accountant

and the related fee. An exception is provided whereby issuers would not have to describe a non-audit service, nor disclose the fee for that service, if the fee was less than \$50,000 or 10 percent of the company's audit fee, whichever is smaller. Under the proposed rule the issuer must also disclose whether its audit committee considered the effect that the provision of each service could have on the auditor's independence. The Proposing Release indicates that the disclosure requirement will enable investors to make their own judgements about the auditor's independence and to assess whether their interests have been adequately considered by the audit committee. The Commission requests comment on whether the disclosures will be useful to investors and enhance auditor independence. The Proposing Release requests comment on application of the proxy disclosure requirement to investment companies. In particular, should the disclosure requirement extend beyond the registrant to require disclosure of all of the professional services that are provided to the investment company complex? Gregory M. Smith Director - Operations/ Compliance & Fund Accounting Attachment Attachment (in .pdf format) 7

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