SEC Adopts Amendments to Auditor Independence Rules

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The Securities and Exchange Commission (SEC) has issued final rules that significantly modify the framework that public companies and their auditors use to evaluate auditor independence, providing additional clarity for certain particularly difficult and recurring issues.

The final rules, adopted on October 16, 2020, principally focus on complications that arise from auditor independence assessments with respect to affiliates of the audit client. Such issues include situations where the entity under audit is under common control with other entities, which frequently is an issue for operating and portfolio companies, investment companies, and investment advisers and sponsors. In addition to cutting compliance burdens and costs for registrants and auditors, the SEC expects that these proposed amendments will reduce the instances in which auditors are not considered independent. Accordingly, this could expand the pool of auditors available to registrants, which would provide more relevant industry expertise, drive down audit costs and improve the quality of financial reporting. These final rules also change the auditor independence requirements related to initial public offerings (IPOs), M&A activity and similar corporate events, and certain requirements around ordinary course debtor-creditor relationships.

The SEC has repeatedly emphasized that "maintaining the independence of auditors is crucial to the credibility of financial reporting." As such, auditors and audit committees constantly — both before and during an engagement — must be vigilant against impairment of their independence and devote substantial resources to verifying and maintaining that independence. The SEC has made only limited modifications to its auditor independence requirements in the 20 years since their adoption. In June 2019, the agency amended the requirements regarding certain debtor-creditor relationships, with the intent of focusing on relationships most likely to impact an auditor's objectivity and impartiality.

On December 30, 2019, the SEC announced proposed amendments to its auditor independence requirements to further focus them on the relationships and services that the SEC believes are most likely to threaten an auditor's objectivity and impartiality. During a comment period that ended in April 2020, the SEC received approximately 30 comments on those proposals. The SEC's view of the comments received is that "[m]any commenters broadly supported the objectives of the proposed amendments or were generally in favor of the proposals." The SEC adopted the rules as proposed in a 3-2 vote on October 16, 2020, with only several modifications. These amendments take effect 180 days from their publication in the Federal Register.

The general standard of auditor independence under the requirements is that an auditor is not independent with respect to the audit client if a reasonable, fully informed investor would conclude that the auditor is not capable of exercising objective and impartial judgment on all issues encompassed within the audit engagement. The requirements set out a nonexclusive list of circumstances (including, for example, prohibited services or lending relationships) that would be inconsistent with independence with respect to the audit client. Under the soon-to-be modified requirements, the audit client is defined to include affiliates, which are defined as entities that the audit client controls, that have control over the audit client or that are under common control. Difficult analytical problems often arise in assessing independence issues with respect to affiliates of the audit client. For example, a parent company may own operating companies, which also may own further operating companies. In this situation, the parent company and each of the operating subsidiaries would be considered affiliates of each other. Thus, the entities and their auditors would have to grapple with independence issues if the parent company's audit firm has provided prohibited services, such as bookkeeping, to remote, immaterial entities.

In complex organizational structures, there is a significant compliance burden in identifying all such affiliates and making independence determinations. This especially is an issue in an investment company structure where the entities under control change frequently. Further, it is often the case that the relationship at issue will not reasonably threaten the auditor's objectivity and impartiality because of the affiliate's remoteness, the fact that sister companies have engaged different audit firms, and other factual circumstances surrounding the provision of nonaudit services to such an affiliate. The SEC also has now recognized that application of the current requirements may be detrimentally restraining competition for audit and nonaudit services by reducing the pool of qualified auditors or service providers based on independence issues that should not reasonably threaten the auditor's objectivity and impartiality.

The amendments in the final rules the SEC has adopted are meant to address some of these issues. Most significantly:

- The SEC has included materiality qualifiers for identifying affiliates of operating companies under common control with the audit client. The proposed rule focused the independence inquiry on sister entities that are material to the controlling entity and typically would not impair independence for the entity under audit if the auditor had relationships or provided services to immaterial sister entities. Taking into account comments the SEC received, the final rule went a step further and adopted a dual materiality threshold, meaning that for the audit client to include a sister entity, both the entity under audit and the sister entity must be material to the common entity.
- The SEC has made specific changes to the independence requirements with respect to the auditor of an investment company or an investment adviser or sponsor. The SEC has limited the definition of affiliates to exclude certain investment companies, advisers and sponsors not material to the controlling entity. This would in some circumstances prevent investment companies advised by related investment advisers from being swept up in the definition of "affiliate."
- Regarding the prohibition against certain business relationships between the auditor and the audit client as well as substantial stockholders of the audit client, the SEC has replaced the reference to "substantial stockholders" with a reference to beneficial owners (known through reasonable inquiry) that have significant influence over the audit client. The SEC believes this will improve the requirements by making them more clear and less complex. Further, the agency has clarified that the "significant influence" inquiry should be focused on whether influence exists at the entity under audit and not merely at an affiliate entity.

The final rules also include a variety of changes to auditor independence requirements around debtor-creditor relationships, intended to focus on those relationships that more reasonably create a self-interest competing with the auditor's obligations to serve investors. Under the soon-to-be modified requirements, an auditor is not independent if specified persons within the audit firm — or their family members — maintain loans to or from an audit client. Excepted from these loans are most automobile loans/leases, loans collateralized by insurance policies or cash, and mortgages obtained under normal market conditions, as well as credit card debt reduced to $10,000 or less on a current basis. The final rules have also excepted most student loans obtained from a financial institution under normal conditions and prior to the person becoming covered for purposes of the requirements; clarified that more than one mortgage loan (second mortgages, home equity loans, etc.) are excepted; and excepted consumer loans under the same criteria as credit card balances.

Finally, the SEC has given relief to auditors and entities that inadvertently violate the independence requirements as a result of corporate events such as mergers and acquisitions or IPOs. For example, one or both of the respective auditors of two companies that agree to merge may find that they provide prohibited services to the combined company as a result of the merger. The SEC has created a framework to address such situations, detailing the expectation that the independence violations will be corrected as promptly as possible and in most instances prior to the effective date of the merger or acquisition.

In addition, until now, the auditor of a company in an IPO had to be independent for the period co-extensive with the financial statements included in the registration statement. This might have required a private company to delay its IPO or engage a new auditor to comply with the auditor independence requirements, and also is inconsistent with the more relaxed independence rules applicable to foreign issuers in a U.S. IPO. The SEC has reduced the look-back period to assess auditor independence in an IPO to one year, regardless of the period of financial statements included in the registration statement.