Securities Law Developments

REVISION OF SEC AUDITOR INDEPENDENCE REQUIREMENTS

On November 15, 2000, the Securities and Exchange Commission ("SEC" or "the Commission") held an Open Meeting at which it adopted amendments to its auditor independence rules.[1] This action came after lengthy and detailed negotiations between the SEC and the Big Five accounting firms (Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers) in connection with the Commission's first comprehensive effort in eighteen years to modernize its regulations on auditor independence.

The new amendments have broad implications beyond the Big Five firms because, among other things, the adopted provisions require companies' audit committees to more closely monitor the nature and quality of audit and non-audit services provided by the companies' auditors. Moreover, in a statement seemingly at odds with past Commission practice in this area, SEC Chief Accountant Lynn E. Turner recently warned during a speech delivered to the American Institute of Certified Public Accountants ("AICPA") that "[t]he staff expects that the rules will be complied with fully," and that auditors should not "come ask for a waiver" if a rule has been violated because the rules are clear.[2]

I. Introduction

In May 2000, SEC Chairman Arthur Levitt publicly proposed that the Commission adopt new and significantly more stringent auditor independence restrictions. At the time, the SEC's regulatory guidance in this area had been scattershot, consisting of little more than a patchwork of Commission rules, interpretations, and orders, as well as various staff letters and reports. (In its orders, in particular, the Commission had relied on incorporation of the accounting industry's own independence standards into GAAS as a basis for sanctioning specific conduct.)

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1 *Revision of the Commission's Auditor Independence Requirements*, Securities Act Release No. 7919, 65 Fed. Reg. 76008 (Dec. 5, 2000), *available at* http://www.sec.gov/rules/final/33-7919.htm ("Auditor Adopting Release").

2 Steve Burkholder, "SEC Chief Accountant Turner Warns That Independence Rules Will Be Enforced," *Securities Law Daily* (Dec. 7, 2000).

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The Commission released a comprehensive rule proposal in June 2000; over 3,000 comments were submitted by the public regarding the rule proposal; and the SEC conducted extensive public hearings in Washington and New York. Throughout the public comment period, the SEC and the two largest accounting firms -- Ernst & Young and PricewaterhouseCoopers -- were negotiating over compromise terms for new independence rules. For some time, the other three firms in the Big Five sought to thwart the SEC's rule initiative through lobbying and the threat of legal challenges.

On November 14, 2000, however, the SEC announced that it successfully had reached a settlement with four members of the Big Five regarding the parameters of the new amendments.[3] By a 4-0 vote at the Open Meeting on November 15th, the Commission approved the compromise rules, thereby enacting substantial new regulations regarding auditor independence.[4]

II. Auditor Independence Standards

The amendments adopted by the Commission include a general standard for gauging auditor independence, as well as specific prohibitions on a number of activities believed to compromise auditor independence. In the event that none of the specific provisions are applicable, the new, default general standard provides that

> [t]he 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.[5]

The Commission appended to the beginning of the new rules a "Preliminary Note" to be consulted for guidance whenever applying the general independence standard. This Note explains that auditors must be independent both "in fact" and "in appearance." The Note contains four general principles:

> [a]n accountant is not independent when the accountant (1) has a mutual or conflicting interest with the audit client, (2) audits his or her own firm's work,

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[3] KPMG was the one member of the Big Five that did not sign off on the final compromise by the time that the Commission adopted it.

[4] In adopting the rule amendments, the Commission noted that revenues received by the Big Five in 1999 for management advisory and similar services amounted to more than $15 billion, or about one half of the total revenues received by the firms. In 1981, the Big Five received only about 13 percent of their total revenues for these kinds of services. *See* Auditor Adopting Release.

[5] 17 C.F.R. § 210.2-01(b).

(3) functions as management or an employee of the audit client, or (4) acts as an advocate for the audit client.[6]

In tandem with this new general rule for determining auditor independence, the Commission also adopted a number of detailed rule changes, described below in Sections III-VI, that ban or limit specific activities or relationships previously engaged in or maintained by auditors. The amendments modernize the requirements for auditor independence in three main areas: (1) the scope of services provided by audit firms to their audit clients; (2) investments in audit clients by auditors or their family members; and (3) employment relationships between auditors or their family members and audit clients.

III. Non-Audit Services

The amendments limit the scope of a number of non-audit services that auditors legally may offer to their audit clients. The rules only apply when the auditor is providing non-audit services to a public company or to any other entity otherwise required to file audited financial statements with the Commission. *Thus, the rules do not apply to services offered to non-audit clients.* Under the new provisions, the nine kinds of non-audit services discussed below are restricted or prohibited because they are deemed inconsistent with the sort of independence an auditor must maintain vis-à-vis its audit clients.[7]

A. Information Technology Systems

The matter of whether auditors would be allowed to continue to offer their audit clients information technology (IT) systems consulting, and if so, under what terms, was one of the most contentious issues in the negotiations between the Commission and the Big Five. Ultimately, the two sides reached a compromise, according to which auditors will be allowed to continue offering IT services under certain conditions, but will not be permitted to operate or supervise the operation of an audit client's IT systems. The rule does not apply to services auditors perform in connection with the assessment, design, and implementation of internal accounting controls and risk management controls.[8]

In order for an auditor to offer such services, the management of the auditor's client must (1) acknowledge, both to the auditor and to an internal audit committee of the client, management's responsibility for the client's system of internal controls; (2) identify a person within management to make all managerial decisions with respect to the project; (3) make all of the significant decisions with respect to the IT project; (4) evaluate the adequacy and results of the project; and (5) not rely on the auditor's work as the primary basis for determining the adequacy of the client's financial reporting system.

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[6] SEC Fact Sheet, *The Commission's Proposal to Modernize the Rules Governing the Independence of the Accounting Profession* (Nov. 15, 2000) (handout at Open Meeting; *available at* http://www.sec.gov/news/extra/faqaud.htm).

[7] In the proposing release, the Commission also discussed restricting auditors' provision of expert services. However, the Commission decided not to make these provisions part of its final rule.

[8] 17 C.F.R. § 210.2-01(c)(4)(ii).

B. Bookkeeping, Accounting Records, and Financial Statements

Consistent with the current prohibition on auditors providing bookkeeping services to their audit clients, under the new rules, audit firms cannot maintain or prepare any audit client accounting records or financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission. However, the rules include an exception for providing these services in an emergency situation, as long as the auditor does not undertake managerial actions or make managerial decisions for the audit client. In certain cases, the new rules also exempt from coverage bookkeeping for foreign divisions or subsidiaries of an audit client.[9]

C. Appraisal or Valuation Services or Fairness Opinions

The final rule includes restrictions that apply when it is reasonably likely that the results of any valuation or appraisal will be material to the client's financial statement, or when the accountant audits the results of its own valuation or appraisal.[10]

D. Actuarial Services

Under the new rule, actuarial-oriented advisory services are limited only when they involve the determination of insurance company policy reserves and related accounts. However, even insurance-related actuarial services may be performed as long as (1) the audit client uses its own actuaries or third party actuaries to provide management with the primary actuarial capabilities; (2) management accepts responsibility for actuarial methods and assumptions; and (3) the auditor does not render actuarial services to an audit client on a continuous basis.[11]

E. Internal Audit Services

Under the new rules, an audit firm is allowed to perform up to 40 percent of an audit client's internal audit work (measured in terms of hours). The rule does not restrict operational internal audits unrelated to accounting controls, financial systems, or financial statements. The rule also provides an exception for smaller businesses by excluding companies with less than $200 million in assets. In all cases, the provision of internal audit services for an audit client is contingent on management taking responsibility for, and making all management decisions concerning, the internal audit function.[12]

F. Management Functions

The new rule reiterates that an auditor's independence is impaired if the auditor acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any

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9 17 C.F.R. § 210.2-01(c)(4)(i).

10 17 C.F.R. § 210.2-01(c)(4)(iii).

11 17 C.F.R. § 210.2-01(c)(4)(iv).

12 17 C.F.R. § 210.2-01(c)(4)(v).

decision-making, supervisory, or ongoing monitoring function for the audit client.[13]

G. Human Resources

The rule prohibits auditors from (1) recruiting or acting as a negotiator on behalf of audit clients; (2) engaging in employee testing or evaluation programs for such clients; (3) undertaking reference checks of prospective candidates for an executive or director position; (4) acting as a negotiator on behalf of audit clients; or (5) recommending or advising an audit client to hire a specific candidate for a specific job. On the other hand, the rule allows an auditor, upon request by its audit client, to interview candidates and advise the audit client on candidates' competencies for financial accounting, administrative, or control positions.[14]

H. Broker-Dealer Services

Consistent with the old Rule 2-01 of Regulation S-X, the new rule provides that an auditor cannot serve as a broker-dealer, promoter, or underwriter of an audit client's securities.[15]

I. Legal Services

In keeping with general principle that an auditor should never be in the position of being an "advocate" for its audit client,[16] the rule prohibits auditors from providing any services to audit clients under circumstances in which the person providing the service is required to be admitted to practice before the courts of a U.S. jurisdiction.[17]

IV. Investments, and Business or Financial Relationships Involving Audit Clients

The Commission has significantly narrowed the circle of people whose investments trigger independence concerns. Under the rules previously in effect, the SEC took the position that partners of audit firms, as well as their spouses and families, were barred from investing in an audit client of the firm, even if the partner did not personally work on that particular client's audit. In contrast, the new rules limit these restrictions principally to those who actually work on an audit or those who can influence it.[18]

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13 17 C.F.R. § 210.2-01(c)(4)(vi).

14 17 C.F.R. § 210.2-01(c)(4)(vii).

15 17 C.F.R. § 210.2-01(c)(4)(viii).

16 *See* Auditor Adopting Release (Preliminary Note to § 210.2-01).

17 17 C.F.R. § 210.2-01(c)(4)(ix).

18 It should be noted that, even after the SEC's adoption of new regulations on investment, the vast majority of the *states* retain investment prohibitions similar or identical to the more restrictive regulations just abandoned by the SEC. Thus, until these existing, stringent state rules are eliminated or materially amended, the real world effect of the SEC's adoption of less restrictive rules will be minimal, at best. With regard to many states, this caveat also applies to many of the rule amendments adopted by the SEC regarding employment relationships.

According to the rules, independence also is impaired if auditors or other covered persons have direct or material indirect business relationships with audit clients, other than providing professional services, or certain financial relationships with audit clients, including relationships involving trustee positions with investment decision-making authority; investments in common with audit clients; debtor-creditor relationships; deposit, brokerage, or commodity accounts; or certain insurance policies.

V. Employment Relationships

Adopted substantially as proposed, the new employment relationship rules narrow the scope of personnel within audit firms whose families are affected by employment restrictions necessary to maintain auditor independence.[19] The new rules also specify the positions that impair an auditor's independence if held by a "close family member" of the auditor; proscribed positions include those in which a relative can influence the audit client's accounting records or financial statements.

VI. Contingent Fee Arrangements

Consistent with existing AICPA rules, the Commission's new rule amendments provide that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

VII. Other Provisions

A. Affiliates

One of the more significant changes between the proposed and adopted rules involves the treatment of affiliates. The proposed rule defined the term "affiliate of an accounting firm" as any entity that has "significant influence" over the audit client, or any entity over which the audit client has significant influence. Many commenters felt that this definition swept too broadly, and that it thereby might affect accounting firms' joint ventures with companies that are not their audit clients, as well as the continuation of small firm alliances, which are not relationships that traditionally have been thought to impair independence.

In light of these comments, the SEC backed away from its initial proposal. Instead, the Commission will continue to analyze these situations under existing guidance. Thus, an "affiliate of an audit client" will continue to be defined as any entity that can significantly influence, or is significantly influenced by, the audit client, *provided the equity investment is material to the entity or the audit client*. "Significant influence" generally is presumed when the investor owns 20% or more of the voting stock of the investee.

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[19] Under the old rules related to employment, a wide variety of familial relationships potentially could cause an auditor to be deemed incapable of exercising independence. The Commission's new provisions narrow these prohibitions, and dispense entirely with the old "five-hundred mile rule," under which consideration was given to whether there was a sufficient geographic separation between the family member and both the person in the firm and the conduct of the audit in order to lessen the negative impact of the relationship on the auditor's independence.

B. Quality Control Exception

The rules also provide a limited exception from certain investment, business, or employment independence violations if certain factors are present. Under this provision, an accounting firm's independence will not be impaired solely because a covered person in the firm is not independent if

?? the individual did not know the circumstances giving rise to his or her violation;

?? the violation was corrected promptly once it became apparent; and

?? the firm has quality controls in place that provide reasonable assurance that the firm and its employees maintain their independence. For the largest public accounting firms, the basic controls must include, among others, written independence policies and procedures, automated systems to identify financial relationships that may impair independence, training, internal inspection and testing, and a disciplinary mechanism for enforcement.

C. Proxy Disclosure Requirement

The new rules provide that most public companies must disclose in their annual proxy statements the fees for audit, IT consulting, and all other services provided by their auditors during the last fiscal year. Companies also must state whether their audit committees have considered whether the provision of non-audit services is compatible with maintaining the auditor's independence. Chief Accountant Turner noted at the Open Meeting that this new provision is important because it "reinforces the importance of the role the audit committee plays in ensuring that investors receive quality information, that has been thoroughly examined by an independent auditor, whose judgment is unquestionably unbiased."[20] Finally, companies also are required to disclose the percentage hours worked on the audit engagement by persons other than the accountant's full time employees if that figure exceeds 50 percent.

D. Effective Date

The effective date of these new amendments is February 3, 2001. However, the rules also contain a limited exception that grants auditors an eighteen month "transition period" during which, under certain circumstances, they can continue to provide to their audit clients appraisal or valuation services, or internal audit services. The rules also contain a limited three-month transition period for several of the new restrictions involving certain financial and employment relationships.

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[20] Lynn E. Turner, *Commission Open Meeting on Market Structure Initiatives in the Options and Equities Markets*, Opening Statement (Nov. 15, 2000) (handout at Open Meeting; *available at* http://www.sec.gov/news/extra/ltaudind.htm).

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