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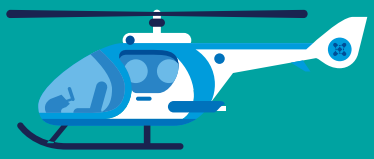

Defining Issues®

SEC proposes amendments to auditor independence rules

May 18, 2018

KPMG reports on the SEC's proposal[1] to amend auditor independence rules with respect to certain loans or debtor-creditor relationships.

Applicability

Public companies, registered investment companies, registered investment advisors, registered broker-dealers and private funds complying with the SEC's custody rule.[2]

Key facts and impacts

The SEC has proposed amendments to revise its auditor independence rules related to loans or debtor-creditor relationships.

The SEC's auditor independence standard [3] requires auditors to be independent of their audit clients both in fact and in appearance. The current rules prohibit certain direct financial relationships between an accountant and audit client. The existing loan provision specifies that an accountant is not independent when the accounting firm, or any covered person, has a loan to or from an audit client, or the client's officers, directors or record or beneficial owners of more than 10 percent of the audit client's equity securities.

The proposed revision to the rules excludes loans with record owners that are not beneficial owners and only includes beneficial owners (known through reasonable inquiry) of the audit client's equity securities where the beneficial owner has significant influence over the audit client.[4]

Why did the SEC propose the amendments?

The SEC believes that, in certain circumstances, the loan provision may not be functioning as intended and may not be effectively identifying lending relationships that raise questions about an auditor's objectivity and impartiality. The application of the loan provision has resulted in an unexpected rate of noncompliance, which the SEC indicates could cause audit committees and other stakeholders to become desensitized to violations of the independence rules.

The SEC has also stated that the rules may have caused companies and auditors to incur significant costs and time to identify and analyze lending relationships that did not threaten the objectivity and impartiality of the auditor in fact or appearance.

1 SEC Release No. 33-10491; 34-83157; Auditor independence with respect to certain loans or debtor-creditor relationships, May 2, 2018

2 Rule 206 (4) - 2 of the Investment Advisers Act of 1940

3 Regulation S-X, Rule 2-01, Qualifications of accountants

4 The loan provision does not apply to specific types of loans made by a financial institution under its normal lending procedures, terms and requirements, such as automobile loans and leases collateralized by the automobile. The proposed amendments do not consider expanding or otherwise modifying the specific types of loans that will not affect the loan provision.

Proposed amendments

<table>
<tr><th colspan="2">Regulation S-X Rule 2-01 (c)(1)</th></tr>
<tr><td colspan="2">The amendments are shown in bold.
(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:
(A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities, where such beneficial owner has significant influence over the audit client. …
(2) For purposes of paragraph (c)(1)(ii)(A) of this section: (i) the term audit client for a fund under audit excludes any other fund that otherwise would be considered an affiliate of the audit client; (ii) the term fund means an 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 of 1940 (15 U.S.C. 80a-3(c)).</td></tr>
<tr><th colspan="2">Type of ownership</th></tr>
<tr><th>Regulation S-X guidance</th><th>Proposed amendment</th></tr>
<tr><td>Requires analysis of both record and beneficial ownership.</td><td>Focuses the analysis solely on beneficial ownership rather than on both record and beneficial ownership.</td></tr>
<tr><td colspan="2">Impact: The loan provision would no longer apply to financial intermediaries (e.g. broker-dealers, banks, trusts, insurance companies and other third-party administrators) that maintain the audit client's equity securities as a holder of record on behalf of the beneficial owners of the audit client's equity securities.</td></tr>
<tr><th colspan="2">Ownership test</th></tr>
<tr><th>Regulation S-X guidance</th><th>Proposed amendment</th></tr>
<tr><td>Includes a bright-line ownership test of more than 10 percent of the audit client's equity securities.</td><td>Replaces the existing 10 percent bright-line shareholder ownership test with a 'significant influence' test.[5]</td></tr>
<tr><td colspan="2">Impact: The 10 percent ownership threshold would be replaced by a significant influence test. To assess compliance, an audit firm, in coordination with its audit client, would be required to determine if the audit firm or covered persons in the firm held loans with beneficial owners of the audit client's equity securities that also have the ability to exert significant influence over the audit client's operating and financial policies.
The SEC commented that "the current bright-line 10 percent test may be both over- and under-inclusive as a means of identifying those debtor-creditor relationships that actually impair the auditor's objectivity and impartiality."</td></tr>
</table>

[5] The term 'significant influence' is not defined in the proposed change to the rules. However, the term does appear in other parts of Rule 2-01 of Regulation S-X, and the SEC intends to use the term significant influence in the proposed change to refer to the principles in ASC 323, Investments – Equity Method and Joint Ventures.

Identifying beneficial ownership	
Regulation S-X guidance	**Proposed amendment**
Requires identification of underlying beneficial owners, which may be difficult and complex to access or unavailable to audit clients.	Adds a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities.
Impact: An audit firm, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's equity securities that are "known through reasonable inquiry." The proposed amendment recognizes the difficulty and inability in certain circumstances for audit clients to obtain information about underlying beneficial owners, specifically when shares are held by 'record' holders of securities as custodians or omnibus account holders. The SEC commented that "if an auditor does not know after reasonable inquiry that one of its lenders is also a beneficial owner of the audit client's equity securities, including because that lender invests in the audit client indirectly through one or more financial intermediaries, the auditor's objectivity and impartiality is unlikely to be impacted by its debtor-creditor relationship with the lender."	
Definition of audit client	
Regulation S-X guidance	**Proposed amendment**
The current definition of 'audit client' in Rule 2-01 of Regulation S-X includes all "affiliates of the audit client," including other entities in the audit client's Investment Company Complex (ICC).	For purposes of the loan provision, amends the definition of 'audit client' for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client.
Impact: The current loan provision covers lending relationships with record and beneficial owners of more than 10 percent of the audit client's and the audit client's affiliate's equity securities, which may include entities that the auditor does not audit. Under the proposed amendment, the loan provision would no longer implicate the loans of the audit firm or covered persons in the firm with owners of more than 10 percent of the equity securities of funds that are affiliates of the audit client in an ICC that are not audited by the audit firm. As a result, an auditor's noncompliance with the loan provision at one fund audit client would no longer result in noncompliance at other funds in the ICC that are not audited by the audit firm. The basis for this change is that the record and beneficial owners could not reasonably have any influence over the operating or financial decisions of the funds audited by the audit firm.	

Next steps

Comments are due July 9, 2018 on the proposed amendments and other changes to Regulation S-X Rule 2-01 that were not included in the proposal.

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KPMG's Financial Reporting View

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