



SEC Issues New & Updated Independence Guidance

iStock/Bill Oxford

In June 2019, the Securities and Exchange Commission (SEC or the Commission) Staff issued a new version of *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions* ("FAQs Document" or "the guidance").

The FAQs are indexed to the SEC's rules that define or relate to auditor independence ("independence rules"), specifically [Rule 2-01, Qualifications of Accountants](#) and [Rule 2-07, Communication with Audit Committees](#) of Regulation S-X and [Schedule 14A, Item 9, Information Required in Proxy Statement](#), of the Securities Exchange Act of 1934 (collectively, "the independence rules"). The guidance does not constitute rules or statements of the SEC, which neither approves nor disapproves them. However, they can help auditors,

audit committees and others gain a better understanding of how to apply the independence rules in various circumstances.

The Staff issued the original version of the FAQs Document in January 2001 – almost 19 years ago – following the first round of revisions to the independence rules. The Staff updated the guidance in 2003 (following additional rule revisions), and in 2004, 2007, 2011 and most recently in June 2019. Each FAQ notes the date it was added and, if applicable, the date(s) the

FAQ was substantively changed. The Staff removes FAQs from the guidance when they are no longer relevant.

June 2019 Update

The changes incorporate ten (10) new FAQs and update six (6) existing FAQs. Auditors, audit committees and others charged with monitoring auditor independence should be familiar with the guidance. This article provides a brief overview of the FAQs by rule section and highlights the changes appearing in the June 2019 FAQs Document.

General standard of independence [Rule 2-01(b)]

The preliminary note to Rule 2-01 (Qualifications of Accountants) states that the rule does not consider all

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.



iStock/ Sezeryadigar

circumstances that raise independence concerns, but all are subject to the rule's general standard in 2-01(b). In considering the general standard, the SEC looks first to whether a relationship or the provision of a service: (1) creates a mutual or conflicting interest between the auditor and the audit client; (2) places the auditor in the position of auditing its own work; (3) results in the auditor acting as management or an employee of the audit client; or (4) places the auditor in a position of being an advocate for the audit client.

FAQ 1 addresses the SEC's longstanding view that when an auditor and its client enter into an agreement that limits the auditor's liability, the auditor is not independent.

New FAQs. FAQ 2 provides another of the Staff's longstanding positions; fees that the client owes to the auditor for an extended period that are

material in relation to the fee expected to be charged for the current audit raise independence concerns. FAQ 3 asks whether exchanges of gifts or entertainment between the auditor and its client impact independence under the general standard. This FAQ cites [two \(2\) SEC enforcement matters](#) involving close personal

relationships and the exchange of gifts and entertainment with clients that caused a firm to violate independence rules under the general standard. Specifically, the SEC found that the senior partner on an engagement team for the audit of a public company

maintained an improperly close friendship with its chief financial officer. In an unrelated matter, a partner serving on an engagement team for the audit of a public company was romantically involved with its chief accounting officer.

Financial relationships [Rule 2-01(c)(1)]

FAQ 1 addresses the types of mortgage loans that might qualify for an exemption in the loan rule that allows an individual to have certain types of loans if the individual obtained the loan while she was not a covered member. The Staff did not update the guidance in this section.

Employment relationships [Rule 2-01(c)(2)]

Both existing FAQs address questions relate to the "cooling off" provision, which precludes certain audit team members from joining an

The changes incorporate ten (10) new FAQs and update six (6) existing FAQs. Auditors, audit committees and others charged with monitoring auditor independence should be familiar with the guidance.

issuer audit client (or its subsidiary) in a financial reporting oversight role within one (1) year preceding the date that audit procedures commence. FAQ 1 addresses the scope of the rule, that is, the rule is not limited to the issuer itself but also includes the issuer's

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.

subsidiaries. FAQ 2 explains that when a non-public audit client files an initial public offering (IPO), the auditor must be independent under SEC rules for all audited periods in the filing, which includes compliance with the “cooling-off” provision. The Staff did not update the guidance in this section.

Business relationships [Rule 2-01(c)(3)]

FAQ 1 describes the prohibition on business relationships such as limited partnerships and joint ventures. The FAQ cites portions of the Commission’s 1989 letter to Arthur Andersen that explains why business relationships create mutual interests that impair independence. Addressing perception, the guidance notes that joint interests between the auditor and its client create the appearance of diminished objectivity regardless of whether the engagement was performed objectively. The Staff did not update the guidance in this section.

Non-audit services [Rule 2-01(c)(4)]

Several FAQs appear in this section, covering a variety of topics:

- Bookkeeping services (FAQ 1)
- Prohibited services performed in a prior period (FAQ 2)
- The “not subject to audit” exemption, which allows the auditor to perform certain nonaudit services if it’s reasonable to conclude that the auditor’s nonaudit work will not be subject to audit procedures (FAQs 3, 4 and 5)



iStock/Pinkypills

- Language translation services (FAQ 6)
- Legal services (FAQ 7)
- Tax preparation software (FAQs 8 and 9)
- Impact of nonaudit services rules on Form 11K (employee benefit plan) filers (FAQ 10)
- Proposing nonaudit services while completing the audit (FAQ 11)

New FAQs. Under new FAQ 5, the auditor may apply the “not subject to audit” exemption if the results of the otherwise prohibited nonaudit services will not be subject to audit procedures, which may or may not be the case when the firm provides nonaudit services to a separate entity that is under common control with an audit client. If the audit client and its affiliated entity have separate and distinct financial reporting and

operations (for example, the entities are funds or portfolio companies in a private equity group), the auditor may be able to apply the exemption and provide prohibited nonaudit services to the prospective nonaudit client. However, a traditional corporate structure or investment company complex would not qualify for the exemption if the financial and business operations of the audit client and the company that would receive the nonaudit services are not separate and distinct. FAQ # 11 notes that a firm exiting an audit relationship may impair its independence if the firm proposes new nonaudit services to the client while the audit is still being performed. The Staff cites this situation as a potential independence impairment under the general standard (Rule 2-01(b)) as audit team members may be less objective and acquiesce to

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.



iStock/fizkes

management in an attempt to win the nonaudit work.

Updated FAQs. FAQ 1 clarifies that providing the client an accounting or financial statement template for use in its financial reporting process impairs independence because it means the auditor is participating closely in the client’s process to maintain its books, records and prepare financial statements, which impairs independence. Under FAQ 4, a successor auditor helped its client design its financial system in a prior period, but the client will not implement the system until the current period that the successor will audit. In this case, the “not subject to audit” exemption would not apply, even if the predecessor audited the prior period financial statements.

Contingent fees
[Rule 2-01(c)(5)] [Reserved]

No FAQs currently exist in this

section.

Partner rotation
[Rule 2-01(c)(6)]

Several existing FAQs explain the application of the partner rotation rule:

- to relationship partners (FAQ 1);
- in an IPO (FAQ 2) or re-audit (FAQ 3);
- when auditing a stub period (FAQ 5);
- in meeting the small firm exemption (FAQ 6).

- to a partner’s “time off” the engagement (FAQ 7);
- when relying on the work of another auditor (FAQ 8);
- to the definition of audit partner (FAQ 9); and
- when transitioning from one lead partner to another (FAQ 10).

New FAQs. FAQ 11 states that a partner who has served the maximum period on an audit engagement would impair independence if he performs any services related to a quarterly review occurring in the subsequent “time-out” period. FAQ 12 states that all equity partners, shareholders and others in equivalent roles in a firm, regardless of practice area, count when determining whether the firm meets the small firm exemption in the rule. FAQ 13 explains that in a reverse merger, the lead or concurring partner on the audit of a pre-transaction “shell” company would be permitted to serve as the lead or concurring audit partner of the new operating company, but only if the company establishes new governance, management, operations and accounting policies and procedures (i.e., in keeping with

Under new FAQ 5, the auditor may apply the “not subject to audit” exemption if the results of the otherwise prohibited nonaudit services will not be subject to audit procedures, which may or may not be the case when the firm provides nonaudit services to a separate entity that is under common control with an audit client.

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.

the requirement for a fresh look at the audit client’s financial statements by the lead or concurring review partner after five (5) years of service). FAQ 14 asks how many years count toward the partner service limitations under this fact pattern: A private company’s confidential draft submission included years 20X1, 20X2, and 20X3; during the comment process, the company’s auditor updated the submission to include year 20X4; the registration statement declared effective included years 20X2, 20X3, and 20X4; and, the same partner led the private company audits for years from 20X1 – 20X4. The FAQ states that the audit partner has served four (4) years for purposes of the partner rotation rules, which would also apply to a foreign private

partner rotation rule. FAQ 7 asks whether a lead or concurring partner who has completed five (5) years of service may continue serving the client as a specialty partner during his “time-off” period. The answer indicates that any continuation of services to the client during that period would not qualify as time off the engagement and refers to FAQ 10, which was also updated. FAQ 10 describes the types of activities a partner required to rotate off an engagement could perform in completing an audit without violating the independence rules. Activities should be limited to discussions between such partner and the audit team about historical accounting and auditing issues.

update the guidance in this section.

Compensation
[Rule 2-01(c)(8)] [Reserved]

No FAQs currently exist in this section.

Quality controls
[Rule 2-01(d)] [Reserved]

No FAQs currently exist in this section.

Definitions
[Rule 2-01(f)]

FAQ 1 addresses the definition of “associated entity” in the context of “affiliate of an accounting firm,” in which the Staff referred readers to previous guidance cited in [Release No. 33-7919 \(November 21, 2000\)](#). [Final Rule: Revision of the Commission’s Auditor Independence Requirements](#).

FAQ 3 explains how to apply the term, “audit and professional engagement period” when an auditor’s termination is contingent on a future event. FAQ 4 notes that tax or specialty partners who also serve as the client’s relationship partner meet the definition of “audit partner” for purposes of the partner rotation and compensation rules.

Updated FAQ. In FAQ 2, the Staff clarified that the auditor of consolidated financial statements must be independent of all entities within a consolidated group because they are “affiliates of the audit client”.

Audit committee communications
[Rule 2-07]

FAQ # 11 notes that a firm exiting an audit relationship may impair its independence if the firm proposes new nonaudit services to the client while the audit is still being performed.

issuer. In addition, the firm must be independent under SEC and PCAOB rules for all four (4) years, although the rule for foreign private issuers would allow independence for prior periods under the applicable home country standards.

Updated FAQs. In FAQ 4, a lead audit partner leaves her firm, and the client follows that partner to another firm where she continues as lead partner. In this instance, prior service in her former firm counts in applying the

Audit committee administration of the engagement
[Rule 2-01(c)(7)]

A handful of FAQs clarify the rule’s application to an issuer and its subsidiaries, and to statutory audits performed on an issuer’s subsidiaries. Others address pre-approval via an audit committee’s policies and procedures and the rule’s application to employee benefit plans and variable interest entities. The Staff did not

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.

Existing FAQs discuss the requirements to communicate with the client’s audit committee under this rule when:

- the auditors provide a consent (FAQ 1),
- alternative applications of GAAP are used (FAQ 2),
- a predecessor/successor auditor relationship exists (FAQ 3), and
- the issuer’s auditor refers to the work of another auditor in its report (FAQ 4).

The Staff did not update the guidance in this section.

Disclosure required in proxy statements [Schedule 14A, Item 9]

FAQ 1 addresses whether the client should disclose an assessment of auditor independence in the proxy statement and FAQ 2, whether fee disclosures should include “out-of-pocket” costs. Other FAQs address the application of the rules to employee benefit plans, carve-out audits and other issues. The Staff did not update the guidance in this section.

Broker dealer and investment advisers

The guidance discusses the application of the rules to non-issuer broker-dealers regarding:

- application of partner rotation and compensation requirements (FAQ 1);
- application of the “not subject to



iStock/Sanja Radin

audit” exemption for certain nonaudit services when issuing an audit or attest report under the custody rule (FAQ 2);

- application of the term “audit and professional engagement period” when issuing an audit or attest report under the custody rule (FAQ 3); and
- performance of a surprise examination under the custody rule when performing audits of an advisory firm’s books or the books of a limited partnership the advisory firm operates (FAQ 4).

The Staff did not update the guidance in this section.

Other independence

FAQs in this section address

whether SEC independence rules apply when performing audit or attest service under various securities regulations.

New FAQs. The Staff added guidance that the SEC independence rules apply to:

- audits performed under Regulation D (Rule 506(b)), even though Regulation D does not require those financial statements to be filed with the Commission (FAQ 2); and
- separately audited financial statements of an equity investee under Rule 3-09 of Regulation S-X (FAQ 3).

Read the full version of the FAQs for more details and a fuller appreciation of the guidance. The SEC encourages consultations regarding the auditor independence. Guidance for consulting with the Staff is available at <https://www.sec.gov/page/oca-form-delivery-and-content-correspondence-oca-consultations>.

About The Author & Publisher

Cathy Allen, founder of **Audit Conduct, LLC**, develops courses on professional ethics, independence, and related topics, provides specialized training and expert services, consults on critical independence matters, and advises firms on improving their quality controls.

The material in this publication is provided with the understanding that the author and publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees as to and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material. You may reprint material in this newsletter as long as it is unaltered and credited to the author and AUDIT CONDUCT. If being reproduced electronically, the following link must also be included: www.auditconduct.com.