

CORPORATE LAW AND PRACTICE
Course Handbook Series
Number B-2764

The SEC Speaks in 2022

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U.S. Securities and Exchange Commission,
Paul Munter, Acting Chief Accountant, Office
of the Chief Accountant, Public Statement,
The Critical Importance of the General
Standard of Auditor Independence and an
Ethical Culture for the Accounting Profession
(June 8, 2022)

Statement

The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession[1]



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June 8, 2022

Introduction

High-quality audits are critical to the process of providing decision-useful financial information for the benefit of investors, and auditors[2] serve an important gatekeeping and investor protection function by helping to ensure that issues are promptly identified and addressed.[3] The Commission has long-recognized that audits by professional, objective, and skilled accountants that are independent of their audit clients contribute to both investor protection and investor confidence in the financial statements.[4] As such, the Commission's auditor independence rule is integral to its mandate to protect investors and is fundamental for promoting investor confidence in the quality of financial disclosures. Rule 2-01 of Regulation S-X sets forth the Commission's auditor independence requirements and emphasizes the importance of an accountant's independence from its audit client in both fact and appearance.[5]

We believe that auditor independence is grounded in an understanding of accounting as a profession rather than an industry, which is critical to serving the public interest. As a profession, accountants have a responsibility to the public interest and to act ethically and with integrity in every professional activity.[6] Such responsibility includes observance of both the form and spirit of the Commission's auditor independence rule, and consideration of the foundational objective to provide investors with financial statements that contain reliable and decision-useful financial information.[7]

In this Statement, we discuss (1) the critical importance of the auditor independence framework under Rule 2-01(b) of Regulation S-X ("Rule 2-01(b)" or the "general standard"); (2) OCA's approach to auditor independence consultations;[8] (3) certain recurring issues in recent auditor independence consultations; and (4) the paramount importance that accounting firms foster an ethical culture with respect to auditor independence and fulfill their professional responsibilities.[9]

The Auditor Independence Framework of Rule 2-01(b) of Regulation S-X

The general standard of Rule 2-01(b) is the heart of the Commission's auditor independence rule. This general standard is grounded in the auditor's objectivity and impartiality, and is measured by reference to the reasonable investor standard: "[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 of all issues encompassed within the accountant's engagement."^[10]

The general standard of auditor independence does not end there, however, but states that when determining whether an accountant is independent the Commission takes into consideration "all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."^[11] As described in more detail in our recent statement,^[12] the text of Rule 2-01(b) of Regulation S-X, together with the four guiding principles that the Commission specified in the introductory text to Rule 2-01, provides a framework for considering whether an accountant is independent with respect to an audit client.^[13] Those four principles include a consideration as to whether all the relevant circumstances:

- Create a mutual or conflicting interest between the accountant and the audit client;
- Place the accountant in the position of auditing their own work;
- Result in the accountant acting as management or an employee of the audit client; or
- Place the accountant in a position of being an advocate for the audit client.^[14]

The introductory text of Rule 2-01 goes on to specify that the application of these four guiding principles may depend on particular facts and circumstances.

The remainder of the Commission's auditor independence rule, beginning in paragraph (c), consists of a non-exclusive list of circumstances that are plainly inconsistent with the general standard. However, we caution that accountants, audit firms, registrants, and their audit committees should never make the mistake of assuming that just because a particular circumstance is not expressly prohibited in, or captured by, Rule 2-01(c), their independence analysis is over. Instead, accountants, audit firms, registrants, and their audit committees must always assess and approach auditor independence for purposes of considering, beginning, or continuing an audit engagement under Rule 2-01(b).^[15]

Stated differently, compliance with the prohibitions enumerated in Rule 2-01(c) is necessary but not sufficient. The general standard requires an evaluation of auditor independence, including an assessment of independence both in fact and appearance from the perspective of a reasonable investor. Such a determination cannot be limited to a checklist compliance exercise under Rule 2-01(c). To reiterate: the general standard of Rule 2-01(b) is the heart of the Commission's auditor independence rule, it always applies, and the Commission investigates and enforces against violations of the general standard.^[16]

We remind audit committees, registrants, and audit firms of the importance of understanding the applicability of the general standard to all relevant reporting periods. The Commission's 2020 amendments to the independence rule clearly emphasize that compliance with Rule 2-01(b) is required for all years included in a filing.^[17]

OCA's Approach to Auditor Independence Consultations

Through its long-standing consultation process, OCA staff assist accountants, registrants, and audit committees with interpretation of, and compliance with, the Commission's auditor independence rule.^[18] We believe that this consultation process promotes greater consistency in the application and interpretation of the Commission's auditor independence rule for the benefit of investors. OCA's auditor independence consultations provide a mechanism for accountants, registrants, and audit committees to consult with experienced and knowledgeable

OCA staff for assistance in assessing whether the auditor is and reasonable investors would believe they are able to act with objectivity and impartiality for either an existing set of facts or a specific contemplated circumstance such as a future merger or acquisition involving known parties. OCA staff do not, we should clarify, engage in a consultative process on issues of auditor independence premised on inchoate or unknown facts that are not describable, or hypothetical circumstances. OCA staff are available to discuss, on an informal basis, potential circumstances that may result from a contemplated arrangement or transaction.

As part of the consultation process, OCA staff routinely engage with existing registrants as well as private companies that are in the process of preparing for an initial public offering.^[19] The OCA auditor independence consultation process enables accountants, registrants, and their audit committees to better evaluate potential auditor independence issues, and in so doing, potentially reduce the need for costly re-audits of historical financial statements that could erode investor confidence.

Critical to the effectiveness of the auditor independence consultation process is that any party seeking guidance communicate *all* relevant circumstances of their specific question to OCA staff.^[20] When a formal, written submission is received, OCA staff consider, among other things, the conclusions reached by management of the registrant, the audit committee, and the accounting firm when evaluating the accountant's objectivity and impartiality, both in fact and appearance, with respect to the audit client. OCA staff may refer to prior consultations to assess any potential relevance to the current consultation, but in so doing, OCA staff will always also assess, among other things, (i) how recently such prior consultations occurred, (ii) risks presented to investors, and (iii) the impact of any rulemaking, judicial precedent, or legislation subsequent to any prior consultations. It is critical to recognize that in an independence consultation, OCA staff can only consider the specific facts and circumstances in the context of the Commission's auditor independence rule and other relevant legal authorities at the time of the consultation.

On occasion, OCA staff are asked to take into account certain historical OCA staff positions that were previously provided on purportedly similar circumstances. In any such consultation request, OCA staff first independently assess how similar the circumstances of the current consultation are with respect to a historical consultation and any other relevant prior consultations of which a party seeking guidance may be unaware. OCA staff always take into consideration the degree to which applicable legal requirements may have changed since the time of historical staff consultations. We therefore strongly discourage accountants from placing undue reliance on any historical OCA staff positions, which are necessarily limited to the particular circumstances of the consultation. We instead actively encourage accounting firms, registrants, and audit committees to consult with OCA staff on current auditor independence issues and questions on their own terms. We caution that developments, including risk to investors, may affect the applicability of prior OCA staff positions and note that prior OCA staff positions may not apply to your particular set of facts and circumstances—even if you think they may appear similar.

Certain Recurring Issues in Recent OCA Staff Auditor Independence Consultations

We frequently engage in external dialogue, including in our auditor independence consultations, with audit committees, auditors, and registrants.^[21] Based on such dialogue, OCA staff have seen situations that reflect loosening attitudes toward the Commission's general standard of auditor independence in a few notable areas. The first, which we discussed earlier, is when accounting firms, registrants, and audit committees treat the Commission's auditor independence rule as a mere checklist of prohibitions under Rule 2-01(c) of Regulation S-X and ignore the general standard. This is not conducive to compliance, and the Commission investigates and enforces against violations of its general standard of auditor independence.^[22]

Another notable and increasing area of concern involves the provision of non-audit services. While non-audit services are often not provided directly to the company being audited, OCA staff encounter circumstances in which the extent and magnitude of the non-audit services and business relationships between the accountant and affiliates and non-affiliates of the company being audited would make it difficult for a reasonable investor to

conclude that the accountant could exercise objective and impartial judgment in its audit. In such circumstances, the accounting firm risks not being in compliance with the general standard of auditor independence.

Finally, numerous accounting firms have recently been engaging in increasingly complex business arrangements and, in some cases, attempting to facilitate these arrangements through restructurings and the use of alternative practice structures. Such arrangements have the potential to undermine auditor independence.^[23] We caution firms to carefully consider the implications for auditor independence when considering alternative practice structures, as will the OCA.

Concluding Remarks on the Paramount Importance that Accounting Firms Foster an Ethical Culture with Respect to Auditor Independence and Fulfill Their Professional Responsibilities

It is of paramount importance that public accounting firms foster a culture of ethical behavior with respect to all aspects of their professional responsibilities, including auditor independence. As we noted at the outset, high-quality audits are critical to the process of disclosing financial information for the benefit of investors and serve an important gatekeeping function to help protect investors by ensuring that issues are promptly identified and addressed. The Commission has long-recognized that audits by professional, objective, and skilled accountants that are independent of their audit clients contribute to both investor protection and investor confidence. Any perceived erosion of auditor independence or the profession's ethics or integrity breaks down the critical gatekeeper role of public accountants and can, over time, lead to diminished investor confidence.

The examples of such erosion need not be as extreme as those instances that result in Commission enforcement action.^[24] As we mentioned earlier, OCA staff have seen situations of decreased vigilance when it comes to auditor independence—what we describe as a “checklist compliance” mentality. This has, in turn, led to a deterioration in the ethical culture in some firms.^[25] We caution leadership of accounting firms to remain focused on the trusted role that public accountants play in the disclosure of high-quality financial information to the investing public and to take compliance with all aspects of the Commission's auditor independence rule very seriously.

To preserve the critical role that accountants play in serving the public interest and fulfilling an investor protection mandate, audit firms should lead by example. They should, for example, prioritize auditor independence and a culture of ethical behavior in all professional activities, and where independence on an audit engagement is a close-to-the-line call, the firms must be willing to forego audit and review fees or potentially lucrative restructuring proposals to comply with their independence responsibilities. Further, firms should establish and maintain quality controls that adequately reckon with regulatory requirements and be vigilant about internal efforts to circumnavigate those requirements. Finally, firms should address auditor independence compliance with the seriousness and urgency it deserves.

Accountants serve a critical role in the integrity of our markets and the protection of investors, and audit professionals in particular have a difficult job—they are forced to sometimes make difficult determinations. But that is precisely how public accountants fulfill their gatekeeping function to help protect investors—by ensuring that issues are promptly identified and addressed. To maintain that function, and in training the next generations of public accountants, it is critical that our accounting firms foster and prioritize a culture of ethical behavior in all their professional activities, but especially with respect to auditor independence.

[1] This Statement represents the views of the staff of the Office of the Chief Accountant (“OCA”). It is not a rule, regulation, or statement of the Securities and Exchange Commission (“SEC” or the “Commission”). The Commission has neither approved nor disapproved its content. This Statement, like all staff statements, has no

legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this Statement to refer to OCA staff.

[2] For purposes of this Statement, except where specified otherwise, the terms "accountant" and "auditor" are used interchangeably.

[3] See Paul Munter, Acting Chief Accountant, *The Importance of High Quality Independent Audits and Effective Audit Committee Oversight to High Quality Financial Reporting to Investors* (Oct. 26, 2021) (the "Staff Statement on High Quality Independent Audits").

[4] *Qualifications of Accountants*, SEC Release No. 33-10876 (Oct. 16, 2020) [85 FR 80508 (Dec. 11, 2020)] ("2020 Adopting Release"); *Revision of the Commission's Auditor Independence Requirements*, SEC Release No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)] ("2000 Adopting Release").

[5] 17 CFR § 210.2-01.

[6] See, e.g., AICPA Code of Professional Conduct, ET § 0.300.030–040.

[7] See *id.* (stressing the accountant's role in "maintain[ing] the orderly functioning of commerce").

[8] "[R]egistrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in [Rule 2-01]." Introductory Text to 17 CFR § 210.2-01; see also 2000 Adopting Release at 128.

[9] 15 U.S. Code § 78d-3(a)(2); 17 CFR § 201.102(e)(1)(ii).

[10] 17 CFR § 210.2-01(b).

[11] *Id.*

[12] See Munter, *supra* note 3.

[13] We call this a framework because these four principles are what "the Commission looks [to] in the first instance" when considering the general standard, but the rule itself notes, as highlighted above, that the Commission will also "consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission." 17 CFR § 210.2-01(b).

[14] See Introductory Text to 17 CFR § 210.2-01.

[15] See 2020 Adopting Release at 21 (stressing that the responsibility of ensuring auditor independence is shared between auditors and their audit clients).

[16] We understand that, in the past decade, the Commission has brought four enforcement actions for "standalone" violations of the general standard of auditor independence, that is, where the settled charges stem principally from violations of Rule 2-01(b) but may be related to other violations, including, for example, secondary reporting violations. See *In re Ernst & Young LLP et al.*, SEC Release No. 34-92540 (Aug. 2, 2021) (addressing the violation of Rule 2-01(b) accompanied by the violation of Rule 2-02(b)(1) and causing the violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In re Ernst & Young LLP et al.*, SEC Release No. 34-78873 (Sept. 19, 2016) (addressing the violation of Rule 2-01(b) accompanied by the violation of, or aiding and abetting or causing the violation of, Rule 2-02(b)(1), and causing the violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In re Ernst & Young LLP et al.*, SEC Release No. 34-78872 (Sept. 19, 2016) (same); *In re Ernst & Young LLP*, SEC Release No. 34-7602 (July 14, 2014) (addressing the violation of Rule 2-01(b) accompanied by the violation of, or causing the violation of, Rule 2-02(b)(1), and causing the violations of Sections 13(a) and 14(a) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-9 thereunder) [hereinafter Standalone Actions].

[17] See 2020 Adopting Release at 52 (applying "Rule 2-01 to the most recent fiscal year, together with the application of the general independence standard in Rule 2-01(b) and the requirement to comply with applicable

independence standards for the earlier years”); see *also* 2020 Adopting Release at 17, 28–32 (emphasizing the importance of the general standard).

[18] SEC, Consulting with OCA: What to Expect (Sept. 28, 2018), <https://www.sec.gov/page/oca-consulting-oca-what-expect>.

[19] We note that as a result of increasingly complex business relationships, it is incumbent upon private companies actively seeking access to the public markets in the U.S., together with their audit committees, to consider early in the process the implications of all services or relationships provided by, or held with, their auditor (including services or relationships with affiliates of the audit client) during audit periods that will be included in an initial public registration filing. When a company is preparing to enter the public markets in the U.S., the company, its audit committee, and its auditor need to evaluate the impact to auditor independence as a result of the transition from local auditor independence rules to the Commission’s auditor independence requirements. OCA staff emphasize that a violation of the Commission’s auditor independence rule cannot somehow be mitigated by, or overcome with, safeguards or cures implemented by the company or the accountant—even where such measures would, perhaps, be permitted or considered by the AICPA rules or other regulators.

[20] See SEC, Form of Delivery and Content of Correspondence for OCA Consultations (Sept. 14, 2020), <https://www.sec.gov/page/oca-form-delivery-and-content-correspondence-oca-consultations>.

[21] The Commission’s auditor independence requirement is foundational to the credibility of the financial statements, and, as the Commission has consistently noted, it is a shared responsibility among audit committees, management, and their independent accountants. 2020 Adopting Release at 21.

[22] See Standalone Actions, *supra* note 16.

[23] Jeff Drew, Private Equity’s Push into Accounting, *Journal of Accountancy* (Oct. 6, 2021), available at <https://www.journalofaccountancy.com/news/2021/oct/private-equity-push-into-accounting.html>.

[24] See, e.g., Standalone Actions, *supra* note 16.

[25] Such deterioration includes, for example, accounting firm scandals involving cheating on professional ethics exams by firm partners and professional staff, and accounting firm leadership viewing accounting errors and restatements as “business opportunities”—views that are antithetical to the trusted role accountants occupy as gatekeepers. See, e.g., *In re KPMG LLP*, SEC Release No. 34-86118 (June 7, 2019).

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