



# Financial Reporting

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## SEC Revises Independence Rules

After months of intense debate and significant publicity, the SEC recently issued a watered-down version of the highly controversial set of proposed independence rules that it had exposed for public comment in mid-2000.

The final rules, which generally went into effect February 5, 2001:

- Identify certain non-audit services which would impair auditor independence<sup>1</sup>;
- Permit SEC-reporting companies to receive, under specified conditions, information technology consulting and internal audit services from their auditors (which the proposal would have banned outright);
- Place reliance on audit committees to determine whether a particular non-audit service raises independence problems;
- Require separate disclosure in annual proxy and information statements of the amount of fees for audit, information technology consulting and other non-audit services; and
- Modernize the independence requirements for auditors by significantly reducing the number of firm professionals and their family members whose investments in, or employment with, clients would impair the firm's independence.

By and large, the final rules were changed from the proposal to reflect many of the concerns expressed by the

accounting profession, including BDO Seidman, LLP (BDO) and the American Institute of Certified Public Accountants (AICPA), to more closely align with the common goal of protecting the public interest. The proposal generated about 3,000 comment letters and led to four days of often heated public hearings.

The remainder of this newsletter summarizes key provisions of the final rules. As many of the provisions are extremely detailed, the entire text of the new rules should be consulted at [www.sec.gov/rules/final/33-7919.htm](http://www.sec.gov/rules/final/33-7919.htm) to resolve particular compliance questions.

### General

The rules are based on the premise that an auditor must be independent both "in fact" and "in appearance." While avoiding a definition of "in appearance" because of its subjectivity, the new rules state that an auditor's independence is impaired when, in light of all relevant facts and circumstances, a reasonable investor would conclude that the auditor would not be capable of acting without bias. In making independence determinations, the SEC

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<sup>1</sup> "Auditor" or "auditors" means an SEC-reporting company's auditing firm, as well as certain of the firm's professionals and their family members who are required to be independent with respect to that client.

will consider all such facts and circumstances, as well as four general principles. These principles include whether a particular relationship or non-audit service:

- Creates a mutual or conflicting interest between the auditors and the client;
- Puts the auditor in the position of auditing his or her own work;
- Results in the auditor acting as management or an employee of the client; or
- Places the auditor in a position of being an advocate for the client.

These principles are quite broad, allowing the SEC staff considerable discretion in their application.

## Non-Audit Services

The rules codify the non-audit services that may be deemed inconsistent with a firm's independence. Most are already prohibited or restricted by the AICPA, its SEC Practice Section (SECPS) or the SEC. These include, to varying degrees:

- Financial Information Systems Design and Implementation
- Internal Audit Services
- Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements
- Appraisal or Valuation Services or Fairness Opinions
- Actuarial Services
- Management Functions
- Human Resources Services
- Broker-Dealer Services
- Legal Services

Omitted from the final rules is the SEC's proposed ban against a firm providing currently permitted expert services. This proposed ban would have hindered the long-standing and widely accepted practice of auditors representing clients before taxing authorities.

## Financial information systems design and implementation

As financial information systems have become larger and increasingly more complex, public companies have reached out to professional service firms, including their own auditors, for help in systems design and implementation. Since such systems often generate the financial statements that are eventually audited, the SEC has questioned the firm's independence in these cases.

While the proposed rules would have prohibited auditors from performing most consulting services relative to a client's information technology (IT) systems, the final rules only prohibit them from (a) operating or supervising the operation of the client's IT systems, (b) managing its local area network, and (c) assuming management responsibilities. Auditors are, however, permitted to design or implement a system that provides information relevant to the financial statements, provided that the client's management:

- Acknowledges in writing, to the auditors and audit committee, management's responsibility for the client's system of internal controls;
- Identifies a competent person within management to make all management decisions with respect to the project;
- Makes all the significant decisions with respect to the IT project;
- Evaluates the adequacy and results of the project; and
- Does not rely on the auditors' work as the primary basis for determining the adequacy of its financial reporting system.

Further, an auditor may perform, without limitation, IT services in connection with the assessment, design and implementation of a client's internal accounting controls and risk management controls, provided that the auditor does not act

as an employee or perform management functions.

## Internal audit services

Some public companies "out-source" their internal audit (IA) work to their external auditors. Since the IA function is essentially an arm of management, the SEC has questioned the independence of auditors that provide IA services to their clients.

While the proposed rules would have prohibited auditors from performing any IA services for an SEC client, the final rules allow them to perform certain amounts of IA services, provided that:

- The client's management acknowledges in writing, to the auditors and the audit committee, the client's responsibility to establish and maintain a system of internal accounting controls;
- The client's management may not rely on the auditors' work as the primary basis for determining the adequacy of its internal accounting controls; and
- The client complies with certain other conditions designed to ensure that the client retains management responsibility for such services.

Assuming all of the aforementioned conditions are met, auditors may perform (a) up to 40% of the client's IA work, measured in hours, if the client has assets of \$200 million or more, and (b) any amount of IA work if the client has assets of less than \$200 million. The 40% limitation does not apply to operational-type internal audits (i.e., those unrelated to internal accounting controls, financial systems or financial statements).

## Bookkeeping or other services related to the audit client's accounting records or financial statements

Closely paralleling the previous prohibition on bookkeeping, the rules bar auditors from (a) maintaining or preparing the client's

accounting records, or (b) preparing the client's financial statements that are either filed with the SEC or form the basis of such financial statements, including underlying source data, except for (1) emergencies, provided the accountant does not undertake any managerial actions or make any managerial decisions, and (2) limited or routine bookkeeping services for immaterial foreign divisions or subsidiaries of an audit client where certain criteria are met.

#### **Appraisal or valuation services or fairness opinions**

The SEC has questioned the independence of auditors that provide appraisal or valuation services or fairness opinions to their clients because of its perception that the auditors are, in effect, reporting on auditor-produced amounts.

While the proposed rules would have banned all valuation and appraisal services and fairness opinions for clients, the final rules prohibit such services only where it is reasonably likely that the results of such services would be material to the client's financial statements, or where the auditors would audit the results.

The previous rules, in contrast, permitted auditors to provide immaterial appraisal or valuation services. This "immateriality" exception will still apply with respect to assistance concerning immaterial purchase-price allocations.

The restrictions imposed by the final rules do not apply where:

- The auditors' valuation expert reviews the work of the client or a third-party specialist, and the client or specialist provides the primary support for the balances recorded in the financial statements;
- The auditors' actuaries value a client's pension, other post-employment benefit or similar liabilities, provided the client determines and takes responsibility for all significant assumptions and data;

- The valuation is for planning and implementation of a tax planning strategy or for tax compliance services; or
- The valuation is for non-financial purposes that do not affect the financial statements.

#### **Actuarial services**

Closely tracking the SECPS prohibition on actuarial services, actuarial-oriented advisory services would be permitted only when they involve the determination of insurance company policy reserves and related accounts, and if the client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities and certain other conditions are met.

#### **Management functions**

Consistent with previous SEC rules, an auditor's independence would be impaired when he or she, either temporarily or permanently, acts as a director, officer or employee of a client, or performs any decision-making, supervisory or ongoing monitoring function for the client.

#### **Human resources services**

Paralleling the current SECPS rules regarding recruiting and other human resources services for clients, the new SEC rules prohibit an auditor from:

- Recruiting prospective candidates for managerial, executive or director positions;
- Acting as a negotiator on the audit client's behalf;
- Developing employee testing or evaluation programs;
- Recommending or advising that the audit client hire a specific candidate for a specific job; or
- Performing reference checks for prospective clients for executive or director positions.

If requested, an auditor may, however, interview candidates and advise the client on the candidate's competence for financial accounting, administrative or control positions.

#### **Broker-dealer services**

An auditor is barred from serving as a broker-dealer, promoter or underwriter of a client; making investment decisions for it; executing transactions to buy or sell investments on its behalf; or having custody of its assets.

#### **Legal services**

The new rules prohibit an auditor from providing any service to a client that would require the person providing the service to be admitted to practice before the courts of a U.S. jurisdiction.

### **New Disclosures in Proxy and Information Statements**

Reflecting the SEC's view that enhanced disclosure can help an investor to evaluate auditor independence, the rules require companies to disclose:

- Total fees, including out-of-pocket expenses, billed and expected to be billed by the principal auditor, for the most recent fiscal year, broken down into three categories:
  - a. Auditing, including quarterly reviews of financial statements, attendance at audit committee meetings at which matters related to the audits or reviews are discussed, and preparation of a "management letter";
  - b. IT consulting; and
  - c. All other services, including work performed in connection with registration statements, such as issuance of "comfort letters," due diligence procedures performed in connection with mergers and acquisitions, income tax services other than those directly related to the audit of the income tax accrual, internal control advisory services outside of the scope of the audit, risk management advisory services, internal

audit services, statutory audits of immaterial foreign subsidiaries where such audits are not necessary under U.S. generally accepted auditing standards, and audits of employee benefit plans. (The fees in this category may be shown in total or broken down by the nature of services.)

- A statement as to whether the audit committee, or its equivalent, considered the compatibility of the non-audit services provided by the firm with the firm's independence.
- The percentage of hours worked on the audit engagement by persons other than the firm's full-time, permanent employees (e.g., leased employees or consultants), if that figure exceeded 50%.

BDO's engagement teams are prepared to provide clients with sufficient information to enable them to make these disclosures, a sample of which follows. These disclosures might be included under a heading called "Services Provided by the Company's Auditors."

For the year ended December 31, 2000, the Company incurred professional fees to its auditors in the amount of \$500,000, of which \$300,000 related to auditing services, \$20,000 related to information technology services and \$180,000<sup>2</sup> related to all other services. Approximately 52% of the total hours spent on the engagement to audit our financial statements for the year ended December 31, 2000 related to persons other than the auditors' full-time, permanent employees.

The Company's audit committee has considered whether the non-audit services provided by the Company's auditors in connection with the year ended December 31, 2000 were compatible with the auditors' independence.

## Financial and Employment Relationships

The previous rules on financial and employment relationships of auditors were developed largely when firms were much smaller and less diversified, and family demographics were much different from those of today. Such rules, for example, prohibited the spouse of a partner, having no connection with the audit, from holding certain positions at an audit client or stock in the client.

Substantial changes over the years in the profession, the business environment and family demographics have underscored the need for the SEC to re-address its rules in these areas, which had been widely viewed as outdated and overly restrictive and a disincentive for individuals contemplating careers in public accounting. Consequently, the final rules for financial and employment relationships have been liberalized as discussed below.

### Financial relationships

The new rules in the area of financial relationships are similar to those proposed. They narrow significantly, from previous rules, the circle of a firm's professionals and family members whose investments could cause independence problems.

Under the new rules, for the most part, financial interests in clients impair independence only if they are financial interests of the audit firm, "covered persons" in the firm (as defined below) or "immediate family members" of covered persons (i.e., spouses, spousal equivalents and dependents). However, in no event may a covered person or immediate family mem-

ber own 5% or more of a public company client.

A "covered person" is generally one who is directly involved in the audit, or if not directly involved in the audit, could influence the outcome of the audit (e.g., firm's managing partner, national audit partner or any partner located in the same office as the lead audit partner).

Besides direct and material indirect investments, the new rules extend to a variety of other financial relationships with audit clients. A number of exceptions are provided, as long as the financial interest is disposed of within 30 days (e.g., where the interest had been acquired before the client-auditor relationship was established, by inheritance or unsolicited gift, or where the acquisition was the unavoidable consequence of participation in an employment benefit program by an immediate family member of a covered person who performed non-audit service to the audit client).

The new SEC rules relating to financial interests are now more liberal than the existing rules of the AICPA and certain other regulatory bodies, that are expected to liberalize their rules in due course. BDO will continue to adhere to the existing, more stringent rules in this area until those bodies formally change their rules.

### Employment relationships

Adopted substantially as proposed, the new employment relationship rules greatly narrow the circle of family members of firm personnel whose employment with a client impairs the firm's independence. Specifically, the new rules apply to "close family members" of a covered person (i.e., "immediate family members" of covered persons, as discussed previously, plus parents, nondepen-

<sup>2</sup> A company may, if it wishes, provide a further breakdown of fees related to "all other services," as long as the total of fees related to "all other services" is clearly stated. Additionally, a company may, if it wishes, provide commentary with its disclosure. For example, where a substantial portion of fees for "all other services" consists of traditional audit-related services, the company might add to its disclosure: "A substantial portion of the fees in this category relates to services traditionally provided by auditors, including work performed in connection with registration statements, due diligence procedures performed in connection with mergers and acquisitions, and income tax services."

dent children and siblings) who work for a particular client in an accounting role or financial reporting oversight role, including individuals who:

- Influence the preparers or the contents of the financial statements of the client (e.g., a member of the client's board of directors; chief executive; financial, operating or accounting officer; general counsel; controller; director of internal audit or financial reporting; treasurer; vice president of marketing; or any equivalent position); or
- Prepare or have more than minimal influence over the contents of the accounting records. This category may include certain individuals, such as an accounts receivable supervisor or manager, who are relied on by management to calculate amounts that are placed directly into the company's financial statements.

There are also specified employment restrictions that apply to certain former employees of the firm who become employed by a client, and to certain former employees of a client who become employed by the firm.

## Business Relationships

Consistent with previous rules, independence is impaired if a covered person has a direct or a material indirect business relationship with the client or any person associated with the audit client in a decision-making capacity, such as the client's officers, directors or "substantial stockholders." However, such relationships do not include those in which the auditor provides professional services to an audit client or associated individuals or is a consumer in the ordinary course of business.

In the proposed rules, the SEC sought to replace the term "substantial stockholders" with "beneficial owners of more than 5% of a client's equity securities." In

response to concerns from commenters about such a low threshold, the SEC reverted to its previous guidance.

The following are examples of non-permissible business relationships:

- Covered person owns a significant interest in a small business investment company that has made a loan to a client;
- A client is the general partner and 10% owner in a real estate limited partnership in which the firm holds a 5% limited partnership interest;
- Audit firm rents, as its offices, 25% of a building owned by a client. The remaining 75% is owner-occupied; and
- Covered person acts as executor under the will of a client's principal officer in which the estate's principal asset is voting stock of the client.

## Affiliates

### Affiliate of audit client

Independence rules apply to SEC clients and their affiliates. However, the definition of affiliate was unclear under the old rules. Under the new rules, an "affiliate of an audit client" is defined as any entity:

- That has control over the client, or can be controlled by the client, or is under common control with the client, including the client's parent and subsidiaries;
- Over which the client has significant influence, unless the entity is not material to the client; or
- That has significant influence over the audit client, unless the client is not material to the entity.

### Affiliate of audit firm

The SEC omitted from the final rules a proposed expansive definition of an "affiliate" of an audit firm (to which independence restrictions also would have extended) and, instead, reverted to existing practice in identifying, on a "facts and circumstances" basis, entities whose activities, by reason of their rela-

tionship with an auditing firm, may be attributed to the firm for independence purposes.

As a result, the new rules continue to permit cooperative networks between accounting firms and strategic alliances established under existing standards that effectively would have been eliminated under the proposal.

## Contingent Fee Arrangements and Commissions

The new rules bring forward the accounting profession's current ban on an accountant performing any service for an audit client under a contingent fee arrangement. Also, consistent with existing AICPA rules, the new SEC rules prohibit auditors from providing any service or product to a client for a commission or from receiving a commission from a client.

Contingent fee arrangements are those in which no fee is charged unless a specified result is attained, or the amount of the fee otherwise depends on the auditors' findings or the results of the auditors' services. Exceptions to the contingent fee ban are fees fixed by a court or other public authority, or, in tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies.

## Effective Date and Transition

The new rules generally took effect on February 5, 2001. Companies must comply immediately with the new proxy disclosure requirements. Transition periods beyond the effective date, ranging from 3 to 18 months, are provided for certain relationships and services. In particular, the existence of specified financial interests and employment relationships do not impair independence until May 7, 2001, provided they do not impair independence under pre-existing indepen-

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dence standards. Also, auditors may continue providing, until August 5, 2002, newly restricted appraisal, valuation services and internal audit services, if permitted under pre-existing standards. Contracts for IT services in existence on the effective date of the rules also are grandfathered and, therefore, will not impair independence, provided they satisfy pre-existing independence standards.

Furthermore, international accounting firms with more than 500 SEC clients will have until December 31, 2002 to implement prescribed quality control systems in offices located outside the United States.

## Quality Controls

The final rules provide a safe harbor for inadvertent loss of independence by a covered person unaware of the circumstances causing the impairment. To qualify, the lack of independence must be corrected as soon as possible upon discovery, and the accounting firm must maintain a quality control system that provides "reasonable assurance" that the firm and its personnel do not lack independence.

The rule provision indicates that the quality control system must encompass "at least all employees and associated entities of the firm participating in the engagement, including employees and associat-

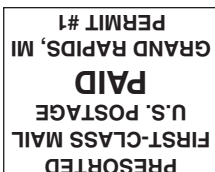
ed entities located outside of the U.S." BDO has in place such a quality control system.

## Implementation Guidance

The SEC staff has issued guidance, in the form of responses to "Frequently Asked Questions," to help companies and their auditors implement the new rules. Some of that guidance has been incorporated into this newsletter. However, the complete text of the guidance can be found on the SEC's Web site at [www.sec.gov/offices/account/audinfofaq.htm](http://www.sec.gov/offices/account/audinfofaq.htm). Also, the Chief Accountant of the SEC has gone on record as saying the staff will not grant any waivers from the new rules.

**Material discussed in this *Financial Reporting* newsletter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.**

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BDO Seidman, LLP  
770 Kenmoor S.E.  
Suite 300  
Grand Rapids, Michigan 49546