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July 9, 2018

Brent J. Fields
Secretary
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

File No. S7-10-18 Proposed Rule: Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships

Members and Staff of the Commission:

The American Institute of Certified Public Accountants (the "AICPA") Professional Ethics Executive Committee (the "PEEC") respectfully submits the following comments on the proposed rule of the Securities and Exchange Commission (the "SEC" or the "Commission") regarding auditor independence with respect to certain loans or debtor-creditor relationships (the "Proposal" or "Proposed Rule"). The AICPA is the world's largest member association representing the CPA profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. AICPA members represent many areas of practice, including business and industry, public practice, government, education and consulting. The AICPA sets ethical standards for the profession and U.S. auditing standards for private companies, nonprofit organizations, federal, state and local governments. It develops and grades the Uniform CPA Examination, offers specialized credentials, builds the pipeline of future talent and drives professional competency development to advance the vitality, relevance and quality of the profession.

Throughout its history, the AICPA has been deeply committed to promoting and strengthening independence and ethics standards. Through the PEEC, the AICPA devotes significant resources to independence and ethics activities, including evaluating existing standards, proposing new standards, and interpreting and enforcing those standards.

General Comments

We support the Commission's overall efforts to focus the analysis of loan relationships between an audit client and certain shareholders of the audit client on factors other than record ownership. As discussed below, there may be some overlap in the concepts of significant influence, materiality, and beneficial ownership that warrant additional consideration. We appreciate the opportunity to provide comments on select items addressed by the Proposal, and

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have provided those along with additional comments regarding other changes to the Commission's independence provisions for consideration.

In addition, we strongly support and welcome the Commission's effort to consider suggestions for revisions to other areas of its auditor independence rules that will benefit the public interest and enhance the effectiveness of the Commission's independence rules.

Response to Specific Requests for Comment on Proposed Rule

Beneficial Ownership and Record Ownership

The PEEC agrees that the proposed elimination of the need to consider lending relationships of a record owner of the audit client is appropriate for the reasons stated in the Proposal. In many instances, a record owner of the audit client does not have control or significant influence over the audit client (for example, influence the audit client's operational policies or management decisions), and may be inappropriately scoped into the SEC rule, although any threats to independence are insignificant. As such, PEEC agrees that the Proposal is effective by removing the focus from record owners and focusing instead on beneficial owners identified as having significant influence over the audit client.

Significant Influence Test

The PEEC agrees that the extant 10 percent bright-line test can be problematic in that it does not consider other non-quantitative factors, such as the ability to influence or approve client policies or management decisions. Some owners may be inappropriately scoped either in or out of the rule due to the 10 percent test, regardless of the level of influence or control over the audit client or the significance of threats to independence. The PEEC also agrees that the concept of significant influence is a term that most practitioners are familiar with and is reasonably effective in identifying those beneficial owners who have lending relationships with the auditor that may compromise independence.

PEEC notes that the AICPA Code of Professional Conduct ("AICPA Code") contains a similar 10 percent test for *individuals* who are owners of the attest client, but *entities* that are record owners are not scoped into that aspect of the AICPA loans provisions. It is also understood that the loan provisions of the AICPA "Independence Rule" (ET Sec. 1.200) only apply to loans with individuals, which would be rare and by virtue of their unusual nature, could be greater threats to independence. As a result, the AICPA Code may be more restrictive than the Proposal as it relates to *individuals* owning 10 percent of the attest client; the SEC proposed provisions are applicable to any beneficial owner who has significant influence. Notwithstanding the differences between the AICPA Code and the Proposal, PEEC agrees that it is reasonable for the Commission to propose and adopt the significant influence test for purposes of identifying lending relationships with a beneficial owner that are subject to the Proposal. As one of the objectives of the PEEC is to promote uniformity of the profession's independence rules, we would expect the PEEC to consider the Commission's final rule for purposes of determining whether it would be appropriate for non-public attest clients.

Known Through Reasonable Inquiry

We agree that the proposal to include an assessment of beneficial ownership based upon what is known through reasonable inquiry is consistent with the intention of the independence rules. A practical rule that limits the determination about whether such a relationship exists to those relationships that are known through reasonable inquiry is appropriate, as it is difficult to see how such relationships that are not identified through reasonable inquiry could impact objectivity if the auditor (and presumably, a reasonable investor) is unaware of the relationship. As noted in our additional comments below regarding alignment of the Commission's and the AICPA's affiliates provisions, we believe that the "known through reasonable inquiry" standard is closely aligned with the concept of expending "best efforts" to identify affiliates of the attest client as explained in the "Affiliates" interpretation of the "Independence Rule" [1.200.001].

Proposed Exclusion from "Audit Client" Other Funds that Would Be Considered an "Affiliate of the Audit Client"

The Proposal would "exclude from the definition of audit client…any other fund that would otherwise be considered an affiliate of the audit client." We agree with the exclusion of other funds proposed by the Commission for "a fund under audit," but we suggest that the Proposal be broadened or clarified as it relates to investment company complexes (ICC). Specifically, the exclusion does not appear to apply to downstream affiliates of those funds that are excluded. In addition, the exclusion does not appear to apply to non-fund entities within the ICC that are affiliated with the fund (for example, the investment advisor). We recommend that the Commission consider clarifying that these other entities are excluded from the definition of audit client for purposes of the Proposal. Furthermore, we encourage the Commission to consider a similar approach for audit clients outside the ICC environment.

Materiality Qualifier

The Commission requested comment on whether the addition of a materiality qualifier to the significant influence test would be more effective in identifying lending relationships that are likely to threaten independence. According to the Commission, if the qualifier is included, independence would only be impaired if there is beneficial ownership, significant influence, and the investment is material to the lender and to the audit client. PEEC is not recommending the addition of a materiality qualifier as it relates to identifying lending relationships, but as previously noted, the Proposal does not exclude downstream affiliates of the exempt funds from the provisions. PEEC believes that, a materiality qualifier may helpful in identifying downstream affiliates of the audit client for purposes of the Proposal, should the Commission decide not to exclude them altogether.

Comments Regarding Other Independence Rules

<u>Affiliates</u>
The AICPA "Independence Rule" [1.200] requires independence with respect to affiliates of a financial statement attest client, with limited exceptions. The AICPA Code defines an affiliate at ET Sec 0.400 as follows:

> ***Affiliate.*** *The following entities are affiliates of a financial statement attest client:*
>
> *a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.*
>
> *b. An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.*
>
> *c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.*
>
> *d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.*
>
> *e. A sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both.*
>
> *f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.*
>
> *g. The sponsor of a single employer employee benefit plan financial statement attest client.*
>
> *h. Any entity, such as a union, participating employer, or a group association of employers, that has significant influence over a multiemployer employee benefit plan financial statement attest client and the plan is material to such entity.*
>
> *i. The participating employer that is the plan administrator of a multiple employer employee benefit plan financial statement attest client.*
>
> *j. A single or multiple employer employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. All*

participating employers of a multiple employer employee benefit plan are considered sponsors of the plan.

k. A multiemployer employee benefit plan when a financial statement attest client or entity controlled by the financial statement attest client has significant influence over the plan and the plan is material to the financial statement attest client.

l. An investment adviser, a general partner, or a trustee of an investment company financial statement attest client (fund) if the fund is material to the investment adviser, general partner, or trustee that is deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

PEEC notes that the AICPA definition of an affiliate does not contain a bright-line percentage ownership test, but references the terms "control" and "significant influence" as it relates to determining whether an entity is an affiliate of the financial statement attest client. Both terms are described in the accounting literature. Specifically, "control" is defined in ASC 810 *Consolidations*, and "significant influence" is defined in ASC 323, *Investments – Equity Method and Joint Ventures.* The AICPA Code refers to the definitions in ASC 810 and ASC 323 for purposes of determining whether an entity would be considered an affiliate. It is our view that the reference to these accounting standards is appropriate as they are widely known standards and would lead to consistent application of the affiliate definition. In particular, we recommend that the Commission consider incorporating a reference to ASC 810 for purposes of determining "control" in its definition of an affiliate, and avoiding a bright-line percentage ownership test in that regard.

We also recommend that the Commission consider closer alignment to the AICPA's definition of an affiliate as it relates to sister entities of the attest client (affiliate type "e"). Specifically, the AICPA Code stipulates that a sister entity is only an affiliate of the attest client if both the sister entity and the attest client are material to the entity that controls both. The inclusion of materiality as a factor in identifying affiliates would prevent sister entities that are not material to the common parent (and in many cases, not audited) from being considered affiliates, as such immaterial sister entities do not create significant threats to independence. We believe that alignment with the AICPA in this regard would improve the focus of the SEC's independence rules on those relationships that could actually impact the auditor's objectivity and impartiality in performing audits of a registrant's financial statements.

As noted previously, we support the inclusion of a "known through reasonable inquiry" standard in the Proposal as it relates to identifying beneficial owners. Similarly, we suggest the Commission consider a similar approach to identification of affiliates of the audit client, which would align with the extant AICPA Code, which stipulates that members "must expend best efforts" in identifying affiliates of the attest client:

AICPA Code Sec. 1.224.010

> .03 A member must expend best efforts to obtain the information necessary to identify the affiliates of a financial statement attest client. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, threats would be at an acceptable level and independence would not be impaired if the member (a) discusses the matter, including the potential impact on independence, with those charged with governance; (b) documents the results of that discussion and the efforts taken to obtain the information; and (c) obtains written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the affiliates of the financial statement attest client.

In addition, the AICPA allows exceptions to permit prohibited services to certain affiliates that are not audited by the accounting firm (such as brother-sister affiliates, plan sponsors) if certain requirements are met (ET Sec. 1.224.010 paragraph .02b). The rationale for the exception is that such services do not create a significant threat to independence or impair the accounting firm's objectivity or integrity to perform or continue the audit. The Commission may want to consider this when reviewing its independence rules (e.g., nonaudit services).

> **AICPA Code Sec. 1.224.010.02**
>
> b. A member or the member's firm may provide prohibited nonattest services to entities described under items c–l of the definition of affiliate during the period of the professional engagement or during the period covered by the financial statements, provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), the member should apply safeguards to eliminate or reduce the threats to an acceptable level.

<u>Breaches of the Independence Rules</u>

The independence rules of the AICPA and International Ethics Standards Board of Accountants (IESBA) provide guidance to members that encounter a violation of the independence rules. The AICPA *"Breach of an Independence Interpretation"* interpretation [1.298.010] addresses situations where a member or member's firm has appropriate quality controls in place, but nevertheless, independence has been technically impaired due to a relationship or service that was not prevented by the existing quality control system. Depending on the circumstances, the member may be able to address the technical violation such that the engagement team's integrity, objectivity, and professional skepticism have not been compromised. The process provided by the AICPA Code includes identifying the breach, communicating it appropriately within the firm, evaluating the consequences of the breach, and addressing the consequences of the breach. The provisions provide further guidance for members on communicating the breach and related actions to those charged with governance at the attest client. If the audit firm and those charged with governance believe the consequences of the breach can be addressed as described in the interpretation, such that the integrity, objectivity, and professional skepticism are not compromised, the firm can continue to perform the audit.

We believe that the Commission should consider aligning with the AICPA and IESBA as it relates to addressing breaches of the independence rules in a manner that benefits the public interest and allows continuance of the attest service provided that certain controls are in place and appropriate safeguards are met. Using the guidance provided in the AICPA provisions, members are able communicate with the client and avoid unwarranted consequences for the client, regulators, and the public that may be created by de minimis and/or inadvertent violations of the independence rules that did not impact the engagement team's integrity or objectivity to conduct the audit. Such a provision would also be beneficial in transition rules for initial public offerings (IPO), as noted below.

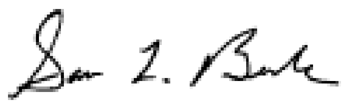
The SEC rules also permit accounting firms to apply a "safe harbor" where the independence of a covered person is inadvertently impaired, provided that the violation is addressed timely and the firm maintains an adequate quality control system. This "safe harbor" approach addresses instances of non-compliance related to financial relationships only. Therefore, we recommend the SEC to evaluate and consider this approach/framework to other types of non-compliance with the independence rules (e.g., nonaudit services) if the instance of noncompliance is inadvertent or de minimis.

Transition Rules for IPO's

PEEC believes that private company clients in an initial public offering would benefit from transition provisions to assist in implementation of the SEC independence rules. In many instances, there are relationships or services that are prohibited for public companies that are in existence prior to the client needing an audit performed in accordance with PCAOB auditing standards. Transition provisions that recognize the independence rules that the private company was subject to would provide some relief for initial offerings while requiring compliance with the SEC provisions on a go-forward basis (or for the most recent year in the filing), and would make the transition more seamless and less likely to result in delayed offerings due to a change in auditors as a result of insignificant or de minimis matters that did not impact the auditor's objectivity. Similarly, we believe the SEC should consider providing a grace period during which immaterial service arrangements can be terminated following an event (e.g. a change in control of the entity) that results in an entity becoming an affiliate of the audit client. Such a grace period could avoid inadvertent breaches of independence rules where, for example, minor engagements are not identified prior to an immaterial acquisition within an affiliated group. We further suggest consideration of requirements to evaluate whether the auditor was independent under the general standard for independence and disclose the auditor's compliance with such provisions with the audit committee or similar body.

PEEC appreciates the opportunity to comment on the Proposal and other independence provisions, and we welcome any questions or comments you may have on the suggestions we have presented in response to your requests for comment. Please contact Brandon Mercer, CPA CGMA (Senior Manager – Professional Ethics) at [redacted] or [redacted] with any questions or comments.

Respectfully submitted,



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