July 9, 2018

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Submitted via rule-comments@sec.gov

Dear Mr. Fields:

This letter is being submitted by Financial Executives International's (FEI) Committee on Corporate Reporting (CCR) in response to the Securities and Exchange Commission's (SEC or "the Commission") request for comment on the proposed rule: *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships* (the "proposal").

FEI is a leading international organization of more than 10,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior-level financial executives. The Committee on Corporate Reporting (CCR) is a technical committee of FEI that reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. CCR member companies represent approximately $8.6 trillion in market capitalization and actively monitor the regulatory activities of the SEC.

This letter represents the views of CCR and not necessarily the views of FEI or its members individually.

Executive Summary

High quality, independent audits are an essential component of the U.S capital markets. We support independence rules which require auditors to exercise impartiality and objectivity with respect to all issues that arise throughout the course of an audit engagement, as these rules serve to protect the investor.

It is our observation that certain independence rules may not always function as intended, resulting in the identification of independence violations that are "false positives." These situations arise when certain bright-line tests trigger a violation, yet there fails to be any impairment to impartiality or objectivity, nor any evidence that a self-interest or economic incentive exists on the part of the auditor by any reasonable or practical measure. As issuers, we feel the effect of these rules when a violation prohibits us from using a preferred service provider. With a limited number of firms with the requisite experience and knowledge from which to choose, certain compliance rules may unnecessarily prohibit the engagement of certain providers.

In practice, the restrictions on debtor-creditor relationships in Rule 2-01(c)(1)(ii)(A) (the "Loan Provision") have given rise to such scenarios. We therefore commend the SEC for its proposed amendments to auditor independence rules. We believe the proposed amendments better align the rules with realistic expectations for scenarios that reflect a true impairment to independence. Improving this alignment may help to eliminate unwieldy and costly analyses that fail to provide corresponding improvements to auditor independence. We believe the proposed amendments strike the appropriate balance of permitting relationships that are unlikely to impair objectivity and impartiality, while more effectively identifying actual threats to independence.

We support the Commission's proposed amendments to refocus the analysis conducted to determine whether an auditor is independent in the presence of certain lending relationships. We also support the potential changes to the Loan Provision and to Rule 2-01 that are described in the proposal for consideration, but that are not yet proposed at this time. Specific feedback supporting these amendments and potential changes are included in the appendix to this letter.

We also appreciate that the Commission is seeking input on other potential changes to the independence rules. Keeping in line with the proposed practical and principle-based improvements, we highlighted for the Commission's consideration below, common challenges we face related to independence. We request the Commission consider these as independence rules are revisited.

Additional considerations for changes to auditor independence rules

Expanding non-audit services and auditor rotation requirements

We appreciate the need to maintain independence throughout the duration of the professional engagement period, however in practice, the application of this requirement presents challenges in certain situations. If an accountant provides certain non-audit services (as outlined in Rule 2-01) at any point during the audit and professional engagement period, the accountant is not independent. Therefore, based on the definition of the audit and professional engagement period, the following challenges may arise:

- Many large public companies engage one of the Big Four accounting firms (the "Big Four") as their auditor and engage at least one other of the Big Four as providers of non-audit services; though in some cases a large public company may engage the other three accounting firms to some degree. In the event the issuer wishes to change auditors, pre-existing non-audit service relationships with a Firm precludes that Firm from bidding on the audit, since the non-audit service work more than likely impacts the audit period under bid. As a consequence, the issuer is limited in its ability to switch to an audit firm of its preference.

Another common scenario that is more difficult to avoid arises when transactions such as mergers and acquisitions occur, which result in the merging of an audit client with another company and/or result in new entities becoming affiliates of the audit client. In this scenario, independence rules apply immediately and thus the auditor of the acquiring entity and/or the "surviving" entity must be independent on the date the transaction is complete. Because many issuers use at least two of the Big Four (one for audit services, one or more for non-audit services) the auditor of the acquiring/surviving entity is often engaged in existing non-audit services to an entity involved in the transaction. The firm is therefore forced to immediately cease such services in order to comply with the independence rules in relation to the audit of the acquiring/surviving entity. The rapid pace at which transactions materialize, and the current absence of a transition period to allow appropriate time to comply with independence rules in these scenarios, may create significant disruption for the issuer. Some relief could be granted by establishing a reasonable period of time subsequent to the closing of a transaction, during which the auditor and the audit client could appropriately restructure or terminate impacted relationships as necessary.

- A separate but related issue arises as a result of mandatory auditor rotation rules that exist internationally. Similar to the scenario described above, many U.S. Global companies engage at least two of the Big Four firms; one as their auditor and one as their non-audit services provider (though often all four are engaged to some degree). Because of the need to comply with the requirements abroad, these U.S. Global companies will also engage a third firm at a later date when the auditor rotation takes effect. This scenario necessitates the issuer to consider the impact of the pending auditor rotation, which results in refraining from engagement with one of the Big Four firms in anticipation of the independence rules that will apply to the future relationship. The ultimate result is one firm as the auditor, one as the non-audit services provider, one "on-hold" for future audit rotation. This leaves one of the Big Four remaining, should a change or additional service provider be needed or preferred. (However, even in this scenario, the firm "on-hold" and the "remaining" firm may also have competing objectives and thus be more focused on providing non-audit services to the company's subsidiaries rather than audit services.) This scenario is further complicated if the implications of a transaction such as a merger and/or acquisition as described above, must also be considered.

Substantial stockholders

The auditor independence rules around business relationships between the audit client and the accounting firm or any covered person, includes any direct or material indirect business relationship with a substantial stockholder in a decision making capacity. Consistent with the Commission's proposal to the Loan Provision, we would be supportive of a significant influence test to replace the current substantial stockholder in a decision making capacity test that exists in the business relationship rules. We believe an ability to exert significant influence over the audit client is more reflective of the likelihood of a lapse in objectivity and/or impartiality than the quantitative threshold test that is applied in practice.

Audit committee involvement

We appreciate that when violations do occur under existing rules, principles are applied and judgment is exercised to evaluate whether a reasonable investor would conclude, given the facts and circumstances, that the breach impaired the auditor's ability to be impartial and objective. We suggest exploring the role the audit committee can play in these scenarios and believe that providing the audit committee with clearer information about the judgments applied as part of this evaluation process may allow the audit committee to play a bigger role in the assessment process.

Considerations to evolving technologies

Given the pace of change in how business is conducted through the use of innovative technologies, there may be additional scenarios that give rise to unique independence situations. We recommend the Commission monitor the evolution of these businesses and technologies and maintain an open dialogue of independence rules as relationships become increasingly interdependent.

Conclusion

We view the proposed amendments to the Loan Provision as a meaningful step toward a more practical and principles-based approach to auditor independence rules. We believe the proposed amendments will result in greater focus on relationships that present the greatest risk to independence while eliminating any dilutive effect of analyzing and identifying "false positives". We hope you consider the additional independence related challenges outlined above. We stand ready to assist in continued dialogue on this topic.

Sincerely,

Mick Homan

Mick Homan
Chairman, Committee on Corporate Reporting
Financial Executives International

Cc: Wes Bricker, Chief Accountant, Office of Chief Accountant
Kyle Moffatt, Chief Accountant, Division of Corporation Finance

financial executives international

APPENDIX

Consistent with our comments above, we are supportive of the SEC's proposal to amend certain provisions of the auditor independence rules. Highlighted below are some of the key amendments and potential changes that we support and the rationale for such support.

Proposed amendments

Focus the analysis solely on beneficial ownership

We support the Commission's proposal to focus the Loan Provision analysis on beneficial ownership rather than on book of record ownership. Under current rules, even if a book of record owner is unable to influence an audit client through its holdings of the audit client's securities, (and/or has no economic incentive to do so) an independence violation could be triggered. Such a violation is misaligned with the intent of the independence rules. Therefore an analysis focused only on beneficial owners, results in a more effective identification of actual debtor-creditor relationships that could impair independence while also eliminating costs and efforts to assess relationships that present little to no risk to independence.

"Significant influence" test

We support the Commission's proposal to replace the 10 percent bright-line test with a "significant influence" test. We believe an ability to exert significant influence over the audit client, and not a quantitative ownership threshold, is more reflective of the likelihood of a lapse in objectivity and/or impartiality. Focusing the analysis on the lender's ability to significantly influence the operational and financial policies of the audit client introduces a more practical principles-based approach and aligns the analysis with the objective to achieve auditor independence, "both in fact and in appearance". Replacement of the 10 percent threshold also results in time and costs savings by reducing the number of "false positives" that may be identified through reliance on a bright-line test (i.e. an independence violation resulting from a 10 percent owner when the owner is unable to influence the auditor).

We understand the Commission's intent to use "significant influence" to refer to the principles in the FASB's ASC Topic 323, *Investments – Equity Method and Join Ventures* (ASC 323). Given the use of "significant influence" in the Commission's existing independence rules as well as in ASC 323, auditors and issuers are familiar with how to apply the concept within the context of independence. Though there may be some areas that may not be congruent in its application for financial reporting purposes and for evaluation of auditor independence, we do believe the framework provided by ASC 323 and the existing familiarity with the concept should result in a relatively straightforward implementation if included in the Loan Provision.

ASC 323 includes a rebuttable presumption of 20 percent, which provides room for consideration in the independence analysis when ownership is less than 20 percent but when the lender does have the ability to exert significant influence. In such circumstances, it may be determined that independence has been impaired, despite the existence of the 20 percent threshold in that framework. For purposes of the Loan Provision and the proposed significant influence test, we recommend an assessment that is consistent with the accounting standard. It is recommended that the significant influence test be made part of the SEC rules with clear guidance to provide a principles-based approach with all relevant facts and circumstances (including materiality) to be considered in making final determinations on whether independence is ultimately impaired both in fact and in appearance, with audit committees being provided the authority to make those ultimate determinations.

"Known through reasonable inquiry"

We agree with the proposed amendment to include a "known through reasonable inquiry" standard in the Loan Provision. This standard would support a practical approach and address some of the compliance challenges currently faced in situations where information is not readily available and/or when the relationship involves work with a private fund.

To support prudent application, we recommend guidelines that facilitate consistent understanding of what constitutes "reasonable effort to attempt to obtain information", including: consideration to the frequency of such inquiries, the types of inquiries that should be made, who should be inquired of, and the nature of events that may trigger inquiry. It would also be appropriate for the audit committee to ultimately determine if the application of "known through reasonable inquiry" was satisfied based on the level and timing of efforts made to speak to the appropriate parties, and the questions that were asked of them. If a prudent process is followed with oversight from the audit committee, we do not believe inclusion of the "known through reasonable inquiry" standard will raise new concerns regarding auditor independence. We believe inclusion of this standard is also a more careful approach than simply requiring application of the significant influence test to "known beneficial owners". This is because the interpretation of "known beneficial owners" would still suggest that a "known through reasonable inquiry" is needed.

Proposed amendment to exclude from "audit client" other funds that would be considered an "affiliate of the audit client"

We agree with the proposal to exclude from the definition of "audit client", other funds that would be considered an affiliate of the audit client. Given the nature of an investment company complex (ICC), the current definition of "audit client" may result in an expansive list of entities that are subject to compliance with the Loan Provision, when in fact it is accurate to presume that investors in a fund do not possess the ability to influence the policies or management of another fund within the ICC. Therefore we believe this amendment would further alleviate compliance challenges while maintaining the appropriate focus on those relationships that could present a risk to auditor independence.

We recommend expanding the scope of this exception to apply to all audit clients, not just to those within a fund environment. Otherwise, we believe the Loan Provision would continue to apply too broadly by scoping in entities which are affiliates of the audit client but that do not have the ability to exert significant influence over the audit client. We believe expanding the scope of this exclusion to all audit clients, except when the owner of an affiliate has the ability to influence the policies and management of the audit client, is in line with the objectives of the proposal overall.

<u>Potential changes to the loan provision and to other provisions in Rule 2-01 (considered but determined not to propose at this time)</u>

Materiality

A materiality test is a relevant fact and circumstance to consider as it relates to independence. For example, it is highly unlikely that independence would be impaired if a 21 percent investment is made by a bank in a fund that is audited by a firm when the investment is immaterial to the bank and the lending relationship is performed under normal lending procedures, terms, and requirements. When assessing independence, the perspective of the lender and the audit client (inclusive of all relevant and available facts and circumstances) should both be considered when making a determination on independence.

We believe any inclusion of a materiality qualifier to the Loan Provision is appropriate as long as the lending relationship is performed under normal lending procedures, terms, and requirements. Materiality assessment should be conducted consistent with current SEC guidance within the Staff Accounting Bulletins.

Accounting firms' "covered persons" and immediate family members

We support consideration to amending the current definition of "covered persons". Specifically, we agree with an approach to remove from the current definition, the inclusion of any partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit. We do not believe the simple fact of a common "office" presents significant risk and we believe it is unlikely that others within the same office of the lead audit engagement partner would be able to, or be incentivized to, exercise influence of that audit client in question – simply because of their location. As written, the definition casts an expansive net on the number of individuals to be considered in the application of the rules and therefore is a source of false positives. Personal independence rules should be focused on individuals within the audit firm who have a significant role in influencing practice and on those who dedicate a significant amount of time to the respective audit client.

Given that the Loan Provision applies to covered persons of the accounting firm and their immediate family members, we believe the Loan Provision should also address student loans and partner capital account loans. The assessment of independence should be a facts and circumstances-based exercise with oversight by the audit committee and allows for pre-existing loans by financial institutions under normal lending procedures, terms, and requirements. So long as this inclusion is implemented in connection with other suggested changes, we believe this approach is consistent with the objectives of the Provision while focusing on an appropriate and reasonable scope.

Evaluation of compliance

We believe that independence should be formally assessed at both the planning and reporting stages of the audit. Potentially significant/material events should also be established to trigger appropriate interim evaluations when such events occur. Such events should include any significant changes in governance and ownership structure.

Secondary market purchases of debt

Secondary market relationships should not be taken into account from the loan provision as long as the lending relationship is under normal lending procedures, terms, and requirements.