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FDIC Clarifies Independence Regulations

In June, 2009 the Federal Deposit Insurance Corporation (FDIC) Board of Directors, after consulting with the other federal banking agencies, amended Part 363 of its regulations, *Annual Independent Audits and Reporting Requirements*. Part 363 implements Section 36 of the Federal Deposit Insurance Act (FDI Act) and applies to insured depository institutions with $500 million or more in total assets (***"covered institutions"***). The FDIC also made a technical amendment to its rules and procedures (Part 308, Subpart U) for the removal, suspension, or debarment of accountants and accounting firms. In addition to other changes, the amendments to Part 363 clarify the auditor independence requirements and are significant because they apply to both public *and private* institutions.

According to the Financial Institution Letter ("FIL")[1] announcing the revisions, some of the key areas addressed in the regulations include:

- **Independent Public Accountants –** Part 363 clarifies the independence standards applicable to accountants, requires certain communications with audit committees, and establishes a uniform retention requirement for audit working papers.

- **Audit Committees –** The amendments expand the audit committee's duties regarding the independent public accountant, require audit committees to ensure that audit engagement letters do not contain unsafe and unsound limitation of liability provisions, and require boards of directors to develop and apply written criteria for evaluating audit committee members' independence.

- **Scope –** For the first time, the assets of a covered institution and its insured depository institution affiliates must comprise a certain percentage of its holding company's assets in order for the covered institution to comply with Part 363 at a holding company level.

Revisions to Part 308, Subpart U, regarding the removal, suspension, or debarment of accountants and accounting firms, were purely technical in nature and garnered no comments in the rulemaking process, i.e., they specified where accountants or accounting firms should file required notices of orders and other actions with the FDIC.

This article focuses on the revisions that address auditor independence, including required communications between the auditor and the audit committee.

INDEPENDENT BY WHOSE STANDARDS?

The amendments retain the original independence concept of Part 363, clarifying that firms auditing covered institutions must comply with the independence standards and interpretations of the American Institute of CPAs (AICPA), the Securities and Exchange Commission (SEC), *and* the Public Company Accounting Oversight Board (PCAOB). Where the requirements differ, auditors should apply the most restrictive provisions of these three standards. Some commenters asserted that applying PCAOB rules to audits of private institutions was a "best practice" in the industry, and others, that rules geared for public companies should not apply to privately held banks. Requesting relief for covered institutions in smaller communities, some raised cost/benefit concerns and warned of negative consequences due to a dearth of service providers. As part of its response, the FDIC stated

[1] See (www.fdic.gov/news/news/financial/2009/fil09033.html)

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that, *"While changes in independence standards can be burdensome to auditors and their clients, given the importance of the independence of the accountants who provide audit services to institutions subject to part 363, which in number comprise the largest 17 percent of the insured depository institutions, the FDIC continues to believe that it is in the public interest for independence standards to apply uniformly to all accountants performing these services"*.

In its discussion of the final rules, the FDIC noted that the SEC and AICPA independence rules have applied to audits of public and nonpublic institutions subject to Part 363 since 1993. After the PCAOB was created and given authority by the Sarbanes-Oxley Act of 2002 (SOX) to set independence standards for auditors of public companies (i.e. "issuers"), the FDIC concluded that PCAOB independence standards were tantamount to SEC independence rules, noting that PCAOB rules do not become effective until the SEC approves them. A review of the comment letters on the FDIC's proposal clearly shows that some did not share this view (primarily on the basis that many covered institutions are not issuers), hence clarification was needed.

In addition to clarifying the applicable independence standards, the FDIC moved the independence requirements for independent public accountants from Guideline 14, *Independence*, into the regulation itself (i.e., created a new section; 363.3(f), *Independence*) to enhance the enforceability of the independence standards.

IMPACT ON ACCOUNTING FIRMS

Accountants performing services under Part 363 must continue to comply with the independence standards applicable to audits of both private and public companies. Firms that audit private covered institutions but are not registered with the PCAOB may face some challenges implementing the PCAOB rules if they have not previously adopted policies or procedures to ensure compliance with these rules. If they have not yet done so, these firms need to get up-to-speed very quickly. Firms registered with the PCAOB who audit issuers will find it somewhat easier to comply with Part 363 as those firms should have policies and procedures in place to ensure their independence under PCAOB standards. However, these firms will need to work quickly to evaluate the impact of the additional rules on their audits of covered institutions and make adjustments, if needed.

For example, PCAOB Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles*, concludes that a firm (or affiliate of a firm) that provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, has impaired its independence. The provision applies during the audit or professional engagement period. Although certain persons at the client are exempt from this rule (e.g., non-executive board members), the rule generally includes all financial reporting executives of the client and their immediate families. To maintain their independence under PCAOB rules, firms would need to cease providing tax services to these persons.

MONITORING DEVELOPMENTS

Accounting firms should monitor their covered institution audit clients that are approaching the $500 million asset threshold. In particular, nonaudit services performed for, or business, fee, and other relationships with, covered institutions during the audit period may impair the firm's independence. The restrictions also apply to firm and client affiliates so it is important to identify all of these entities and their interactions with the client. Firms should also keep the PCAOB's standard setting-activities (in addition to those of the SEC and AICPA) on their radar screens; since Part 363 adopts all of these rules by reference, any changes to them will directly impact their engagements.

The following chart outlines some of the key independence provisions in the SEC and PCAOB rules that are more restrictive than AICPA independence rules:

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SUBJECT MATTER	SEC RULES [2]	PCAOB RULES [3]
Audit partner rotation	Depending on their role on the engagement, audit partners are subject to periodic rotation (every five or seven years), unless the firm meets the SEC's small firm exemption.	
Partner compensation	Audit partners cannot receive compensation for selling nonaudit services to their audit clients, unless the firm meets the small firm exemption.	
Nonaudit services	Several nonaudit services, including bookkeeping, IT, human resources, valuation, appraisal and actuarial, internal audit, management functions, legal, and expert services, are subject to significant scope restrictions and in some cases, outright prohibitions.	Prohibits the provision of personal tax services to persons in financial reporting oversight roles (with certain exceptions), and services involving marketing, planning, or opining in favor of a confidential transaction or an aggressive tax position transaction.
Audit committee communications		Requires communications with the audit committee (or other appropriate governing body) about independence prior to accepting a new audit client and annually thereafter.
Services pre-approval by audit committee	The audit committee must pre-approve all professional services (audit and nonaudit) provided by the audit firm.	Requires the audit committee to specifically pre-approve all permissible tax and internal control related services provided by the auditor.
Business relationships	Prohibits direct or indirect, material business relationships with the audit client and any officers, directors, or significant shareholders of the audit client. Audit client includes related entities such as parents, subsidiaries, material equity method investees / investors, etc.	
Contingent Fees / Commissions		Firms (or their affiliates) may not have direct or indirect contingent fee or commission arrangements with audit clients (or their affiliates).

[2] See complete rules for details (http://www.sec.gov/info/accountants/independref.shtml).

[3] See complete rules for details (http://www.pcaobus.com/Standards/Standards_and_Related_Rules/index.aspx).

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APPLYING PART 363 AT THE HOLDING COMPANY LEVEL

Currently, firms may apply Part 363 at the holding company level regardless of the proportion of a covered institution's consolidated total assets to the holding company's consolidated total assets. Effective for fiscal years ending on or after June 15, 2010, the consolidated total assets of a holding company's insured depository institution subsidiaries must constitute 75% or more of the holding company's consolidated total assets in order for a covered institution to comply with Part 363 at a holding company level. Auditors should discuss this rule change immediately with their clients to determine the impact on their engagements.

RELATIONSHIPS WITH THE AUDIT COMMITTEE

The amendments add to the audit committee's responsibilities. As amended, Part 363 requires a covered institution's board of directors to develop and adopt written criteria for audit committee members. Part 363 also provides transition guidance for forming and restructuring audit committees when covered institutions reach certain thresholds. Additionally, the amendments require audit committees to appoint, compensate, and oversee the independent auditor. In doing so, the FDIC has aligned its regulations with those of the SEC, which were implemented under SOX. As part of its new responsibilities, audit committees must ensure that the auditor is independent and has met other Part 363 requirements. This includes, for example, ensuring that audit engagement letters do not contain "unsafe and unsound" limitation of liability provisions.

EFFECTIVE DATE

With two exceptions, the new regulations become effective on **August 6, 2009** (i.e., Part 363 Annual Reports with a filing deadline on or after **August 6, 2009**, should be prepared in accordance with the final rule). The compliance date for the new regulations requiring the creation and adoption of written policies to address audit committee independence is delayed until **December 31, 2009**. New criteria for applying Part 363 at a holding company level will be effective for fiscal years ending on or after **June 15, 2010**.

ABOUT THE AUTHOR & PUBLISHER

Cathy Allen, founder of Audit Conduct, LLC, develops courses and customized training on professional ethics and auditor independence for CPA firms, professional organizations, and other stakeholders of the accounting profession. She also helps CPA firms enhance their quality controls over ethics and independence compliance.