

PCAOB and SEC Independence Pitfalls and How to Avoid Them

The Public Company Accounting Oversight Board (PCAOB) [inspectors and staff cited several problem areas for auditor independence in 2017](#) and [previewed areas that would be scrutinized in 2018](#). This article provides a summary of those issues and advice on how firms can avoid these independence pitfalls.

Misapplied Quality Control Rule

In inspections, the PCAOB observed that some audit firms misapplied [Rule 2-01\(d\), Quality Controls](#), of Securities and Exchange Commission (SEC) Regulation S-X, incorrectly concluding that a covered person's financial relationship with an audit client did not impair the firm's independence under that "safe harbor" rule. The rule allows firms to conclude that a covered person's financial interest did not impair independence when two conditions are met: 1) the firm had a reasonable quality control system in place to assure independence, and 2) once discovered, the covered person promptly resolved the previously unknown circumstances that caused the violation. In a December 2017 speech, Helen Munter, PCAOB Director of Registrations and Inspections, said that firms failed to meet the second criteria because the covered person's knew about the circumstances causing the violation; however, they failed to realize that those circumstances violated the independence rules.

AVOID THIS PITFALL: Admittedly, the independence rules can be daunting. But, if a firm has clear and easy-to-find independence policies and procedures and

consistently stresses awareness through training and messaging, problems can be avoided. Less information at frequent intervals yields the best results. Remember; the goal is not to create independence "experts" but to ensure your staff know the basics and where to go for more information and help. Incentives are also key to compliance —linking compensation and advancement to maintaining independence sends a strong message. Noncompliance—whether through ignorance, sloppiness or a cavalier attitude – must have consequences that suit the violation. Your "system" for sanctioning employees should be well-vetted, communicated and fair to all.

Insufficient Audit Committee Communications

Inspectors found that some firms did not communicate sufficiently with their audit committees about the scope of proposed tax consulting services and the potential impact on the firm's independence. [Rule 3524, Audit Committee Pre-approval of Certain Tax Services](#), requires firms to provide to the audit committee a written detailed description of tax services, the fee structure, and any side agreements with management. The lead audit partner should discuss those details and any potential impact on the firm's independence with the audit committee and document the substance of that discussion.

AVOID THIS PITFALL: Engagement teams fall short of this requirement when they provide boiler plate, generic language to describe the proposed services and fee

arrangement, which leads to a less effective discussion of independence. Also, tax services should only be performed after the audit committee has approved the services. If the committee chair or another delegate approved the services initially, the entire committee should be apprised of the services at its next meeting. The firm's work papers must reflect the substance of the discussion with the audit committee, otherwise, it did not happen.

Liability-Limiting Clauses in Audit Engagement Letters

For decades, the SEC has prohibited indemnification and liability-limiting clauses in audit engagement letters, which they believe removes an integral safeguard to the auditor's independence. The PCAOB staff presented a discussion paper on indemnification as an emerging issue to the Board's [Standing Advisory Committee](#) in 2006 but no action was taken and the SEC position still stands. For years, the AICPA has allowed the auditor to be indemnified for liabilities or costs caused by management's knowing misrepresentations; in some instances, firms have inadvertently used a (wrong) AICPA engagement letter template for an SEC engagement.

AVOID THIS PITFALL: If a firm discovers it is using an incorrect template in an SEC engagement letter (or otherwise including a prohibited clause in the contract), the firm should take immediate steps to address independence. For example, the firm should rescind the provision, discuss the matter with the client's audit committee, disclose the error in the PCAOB inspection process, and review existing policies, procedures and training to avoid the error going forward.



Impermissible Bookkeeping and Other Nonaudit Services

Auditors, especially of brokers and dealers, failed to observe the SEC's [longstanding nonaudit services restrictions](#), including bookkeeping, financial statement preparation and other services that involve the performance of management responsibilities. Nonaudit services restrictions apply to the "audit and professional engagement period." That period starts when a firm is first appointed as auditor and continues until the firm notifies the SEC that the appointment has ended. It also includes the period covered by the financial statements under audit or review.

To serve an existing audit client after an Initial Public Offering (IPO), the auditor must be independent for all audited periods in the filing, which often includes periods that did not previously require SEC or PCAOB independence compliance. The PCAOB's Ms. Munter recently commented that the staff have observed firms accepting new audit clients unaware that an affiliated firm had provided prohibited services to the client during the period covered by the financial statements.

AVOID THIS PITFALL: Auditors should closely monitor their clients' intentions to become public and when possible, proactively comply with PCAOB and SEC rules for nonaudit services, fee arrangements, business and other relationships if they expect to remain the company's auditor. Also, a firm's attest client acceptance policies and procedures should trigger (among other things) a thorough review of nonaudit services provided by firms throughout the firm's network during the audit and professional engagement period. For example, many firms query other network firms by e-mail, require a response from each firm and follow-up with any identified services, fee or other issues. All this information is then documented in the requesting firm's files.

Failure to Communicate with the Audit Committee about Independence

PCAOB [Rule 3526, *Communication with Audit Committees Concerning Independence*](#), requires auditors to discuss their independence with a prospective audit client prior to appointment and afterwards, at least annually. Sometimes firms fail to have this conversation prior to appointment and sometimes, the annual discussion is overlooked or poorly executed.

Avoid this pitfall: Another matter for education, clear policies and procedures and emphatic reminders from firm leadership. Note that even when discussions take place, firms sometimes fail to flag issues that are not explicitly addressed in the rules but may impact the appearance of independence. The PCAOB rule was designed to foster a frank and open dialogue on independence between the auditor and

the audit committee, which serves as a proxy for the reasonable and informed investor.

Inspection Interests in 2018

With the advent of new accounting standards for revenue recognition, leases and credit losses, inspectors are expected to probe whether firms maintain their independence as clients implement new standards. (See my [Spring 16 Newsletter](#) for advice on navigating your independence when helping clients implement new accounting standards.) Inspection staff will also monitor whether firms' quality control systems are addressing ongoing growth in consulting and other nonaudit services created by acquisitions of consulting firms.

In Summary

Firms can address these possible pitfalls with quality controls that strengthen awareness of independence requirements, trigger compliance through straightforward policies and procedures, and reward (or discipline) personnel for upholding (or violating) independence standards. Reminders from leaders throughout the firm emphasizing the importance of independence help assure that staff will apply these requirements with care and diligence.

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