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## PCAOB Offers Guidance on Communications to Audit Committees Related to Independence

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In response to audit firm requests for guidance and a number of deficiencies identified during the Public Company Accounting Oversight Board's audit firm inspections process, the PCAOB has recently released new [Staff Guidance on Rule 3526\(b\) Communications with Audit Committees Concerning Independence](#) (the "Guidance"). The Guidance summarizes the required audit firm communications to audit committees under PCAOB Rule 3526(b) and offers interpretive guidance regarding communications to be provided in instances where an auditor has not complied with the auditor independence rules but where the audit firm and the client audit committee each determines that the engagement can continue. Given the Guidance, audit committees may begin to see more detailed communications from their auditors when the auditor identifies noncompliance with the independence rules.

### **PCAOB Rule 3526**

In 2008, the PCAOB adopted Rule 3526 so that audit firms would "provide the audit committee with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion between the firm and the audit committee." Among other things, the rule requires that audit firms annually complete the following four actions for each of their audit clients:

1. describe, in writing, to the audit committee all relationships between the audit firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;
2. discuss with the audit committee the potential effects of the described relationships on the independence of the audit firm;
3. affirm to the audit committee, in writing, that, as of the date of the communication, the audit firm is independent in compliance with Rule 3520; and
4. document the substance of its discussion with the audit committee.

The affirmation under the third requirement above must state that the audit firm and its associated persons are and have been independent of the audit client in accordance with SEC and PCAOB rules for the entire audit and professional engagement period, which includes the entire period

covered by the financial statements under audit and the period from the signing of the engagement letter to the issuance of the audit opinion.

Because the affirmation requirement was unequivocal and without qualification, it created a dilemma for auditors and audit committees that identified noncompliance with the independence rules but nevertheless believed that the auditor remained impartial and objective and should continue in its role. In those circumstances, auditors typically disclosed the noncompliance pursuant Rule 3526(b)(1) but nevertheless later in their report affirmed their compliance with the independence rules, as required by Rule 3526(b)(3). The Guidance responds to this situation by proposing a more extensive disclosure by the auditor to the audit committee.

The types of situations that the PCAOB staff identified in its inspections often followed the same fact pattern:

- The audit firm addressed the underlying reasons for the noncompliance or had made a determination that its objectivity and impartiality had not been impaired and was in the process of implementing a plan to address the noncompliance;
- The audit firm communicated the matter to the audit committee, either shortly after discovery or after the noncompliance was remediated and audit firm analysis was completed;
- The audit committee separately evaluated the audit firm's determination; and
- The audit committee and the firm each determined independently and then agreed that the auditor remained objective and impartial and that shareholders, if apprised of all relevant facts, would not question the auditor's independence.

With regards to a year in which the fact pattern described above occurs, the Guidance sets forth the following specific actions for audit firms to comply with Rule 3526:

- Summarize for the client audit committee each instance of noncompliance with auditor independence requirements during the year;
- Summarize for the client audit committee the audit firm's analysis, for each instance of noncompliance and all instances of noncompliance during the year in the aggregate, of how the audit firm concluded that its objectivity and impartiality had not been impaired with respect to all issues encompassed within its engagement and the reasons why the audit firm believes that a reasonable investor with knowledge of all relevant facts and circumstances would have concluded that the audit firm was capable of exercising objective and impartial judgment on all issues encompassed within the audit firm's engagement;
- Engage in a dialogue with the audit committee regarding all instances of noncompliance and the audit firm's related analyses noted above;
- Document the substance of the audit firm's discussion with the client audit committee; and
- Affirm in writing to the client audit committee that, except for any instances of noncompliance expressly identified, the audit firm would be independent in compliance with Rule 3520.

The Guidance also offers some suggested language that audit firms may wish to include in their written communications for purposes of rendering a complete and accurate affirmation in accordance with Rule 3526:

We have concluded that our objectivity and impartiality with respect to all issues encompassed within our engagement has not been impaired, and we believe that a reasonable investor with knowledge of all relevant facts and circumstances would conclude that we are capable of exercising objective and impartial judgment on all issues encompassed within our engagement. Except for the violation(s) expressly identified and discussed with you [and as set forth above/in separate communications dated XX/XX/XXXX], the Firm would be independent in compliance with Rule 3520.

From a public disclosure perspective, PCAOB rules do not *require* disclosure in an unqualified auditor's report about auditor independence issues where communications to the audit committee about auditor independence are made and the audit firm and audit committee both conclude that the audit firm's objectivity and impartiality have not been impaired. Of course, in limited circumstances, some companies have provided public disclosure related to auditor independence issues.

#### **Other Auditor Independence Considerations**

Audit committees should keep in mind, however, that an audit firm cannot "cure" noncompliance with independence rules by following the Guidance. The Guidance addresses how auditors should endeavor to comply with applicable audit committee communications requirements, but nothing in the Guidance addresses the broader, and more challenging, question of overcoming a noncompliance situation and "whether the SEC will accept financial statements with a report from an auditor that has violated the independence rules, but whose objectivity and impartiality have not been impaired."

In the case of an actual or potential instance of noncompliance with auditor independence requirements, discussion between the audit firm and the audit committee is critical to complete a thorough analysis of the issue, considering technical independence requirements under applicable PCAOB and SEC rules and common practice solutions. As the Guidance notes, an audit committee has "an important role in representing the interests of the audit client's investors in this regard, particularly with respect to the 'reasonable investor' portion of the analysis" under Regulation S-X Rule 2-01(b), which states that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." However, the analysis extends beyond Rule 2-01(b) and often involves an evaluation of specific prohibitions under Regulation S-X Rule 2-01(c),<sup>1</sup> which do not expressly include the "reasonable investor" consideration explicitly referenced Rule 2-01(b).

The Guidance does not resolve how the "reasonable investor" analysis might be applied to situations involving noncompliance with Rule 2-01(c) and deciding how to proceed in the face of a

known impairment not subject to the safe harbor in Rule 2-01(d) will therefore continue to require the exercise of significant judgment. Presumably, both the PCAOB and SEC's Office of the Chief Accountant (OCA) will expect audit committees and audit firms to continue to evaluate such circumstances on a case-by-case basis, taking into account the [OCA's Guidance for Consulting with the Office of the Chief Accountant](#) and [Application of the Commission's Rules on Auditor Independence Frequently Asked Questions](#) for when to consult with the OCA.

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<sup>1</sup> Regulation S-X Rule 2-01(c) sets forth a non-exclusive list of circumstances that are deemed to be "inconsistent" with the auditor independence requirements set forth in Rule 2-01(b). Such enumerated circumstances include, among others, impermissible financial, employment and business relationships, prohibited non-audit services, impermissible forms of audit firm and auditor compensation, and compliance failures involving requirements for partner rotation and audit committee administration of the audit engagement.

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