

Rule 3526(b) Communications with Audit Committees Concerning Independence

Overview

PCAOB staff is issuing guidance on PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, (Rule 3526) to address questions that have arisen in practice regarding application of Rule 3526(b) in certain circumstances. This guidance (1) provides a summary of Rule 3526(b) and background information; (2) addresses the purpose of the guidance; and (3) provides specific direction to registered public accounting firms on how to comply with their Rule 3526(b) obligations in the circumstances described below. In addition to providing direction to registered public accounting firms, this guidance also may be useful to other relevant parties, such as audit committees and investors.

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Summary and Background

Rule 3526(b) provides that a registered public accounting firm (Firm) must, at least annually, with respect to each of its audit clients:

1. describe, in writing, to the audit committee of the audit client, all relationships between the 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 of the audit client the potential effects of the relationships described in paragraph (b)(1) on the independence of the Firm;
3. affirm to the audit committee of the audit client, in writing, that, as of the date of the communication, the Firm is independent in compliance with PCAOB Rule 3520, *Auditor Independence* (Rule 3520); and
4. document the substance of its discussion with the audit committee of the audit client.

Rule 3520 states that a Firm and its associated persons must be independent of the Firm's audit client throughout the audit and professional engagement period, which includes satisfying the independence criteria of the SEC and the PCAOB. For the

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1. Rule 2-01(b) states, in relevant part, 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."

This guidance was developed by the PCAOB staff as of May 31, 2019. The guidance does not establish rules of the Board and does not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person. It also is not a statement of the Board, nor does it necessarily reflect the views of the Board or any individual Board member.

SEC, these criteria are set forth primarily in Rule 2-01 of Regulation S-X (Rule 2-01), which addresses both the general standard of independence in Rule 2-01(b)¹ and the application of the general standard to specific circumstances in Rule 2-01(c).² For the PCAOB, these criteria are set forth primarily in Rules 3500T-3526.

The Board adopted Rule 3526 in 2008. In adopting the rule, the Board stated that the purpose of Rule 3526(b) is for a Firm to “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.”³

Purpose

PCAOB inspections staff has observed that Firms have affirmed their independence under Rule 3526(b)(3) in certain situations in which they had violated one or more independence rules.⁴ These situations generally involved each element of the following fact pattern:

- **The Firm addressed the underlying reasons for the violation.** The Firm analyzed the facts and circumstances related to the violation and addressed the underlying circumstances that resulted in the violation before the Rule 3526(b)(3) communication and the signing of the auditor’s report.

Based on its analysis, including the conclusion that the violation would have no ongoing effects, the Firm determined that (i) the violation was of such a nature that the Firm was capable of exercising objective and impartial judgment as it related to all issues encompassed within the engagement,⁵ and (ii) a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the Firm was capable of exercising objective and impartial judgment on all issues encompassed within the Firm’s engagement.⁶

Alternatively, if the Firm had not yet fully addressed a violation, it had nevertheless made a determination that the Firm’s objectivity and impartiality had not been impaired and was in the process of implementing a plan to address the violation.⁷

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2. See Preliminary Note 2 to Rule 2-01; see also Rule 2-01(c) (stating that “[t]his paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section”). The PCAOB also considers relevant SEC releases and SEC staff guidance relating to Rule 2-01. See, e.g., Rel. No. 33-7919, *Revision of the Commission’s Auditor Independence Requirements* (Nov. 21, 2000), and the Codification of Financial Reporting Policies, at Section 600 et seq. thereof.
 3. See PCAOB Rel. 2008-003 (Apr. 22, 2008), at 6.
 4. Many of these violations related to one of the specific prohibitions under Rule 2-01(c) of Regulation S X (e.g., the existence at some point during the professional engagement period of a financial relationship prohibited by Rule 2-01(c)(1)). Other violations related to PCAOB independence rules (e.g., the performance of certain tax services for a person in a financial reporting oversight role prohibited by Rule 3523).
 5. In some instances, a conclusion that a violation would not impair a Firm’s ability to exercise objective and impartial judgment on all issues encompassed within the Firm’s engagement may not be reasonable (for example, due to the ongoing effects of a prohibited non-audit service, such as the design or implementation of the audit client’s financial information system, on the audit client’s financial statements or system of internal control over financial reporting). In such instances, the Firm may be unable to conclude that it is capable of exercising objective and impartial judgment.
 6. Cf. Rule 2-01(b), supra note 1.
 7. Such circumstances might include, for example, the need for judicial approval to withdraw from a relationship, which had been sought but not yet granted. In this circumstance, however, the Firm would be expected to have fully understood the scope of the violation and concluded as to its objectivity and impartiality; put differently, the only steps remaining would be those necessary to formally complete the termination of the relationship.

- ☉ **The Firm communicated the matter to the audit committee.** The Firm communicated the violation and its analysis to the audit committee of its audit client. The timing of the communications may have varied from shortly after discovery (with subsequent communications as the Firm completed its analysis), to after the violation was remediated and analysis completed, or as part of the Rule 3526(b) communication.
- ☉ **The audit committee separately evaluated the Firm’s determination.** The audit committee of the audit client, based on the information communicated by the Firm, separately evaluated the information to determine whether the Firm was capable of exercising objective and impartial judgment on all issues encompassed within the Firm’s engagement. The audit committee of the audit client 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.⁸
- ☉ **The audit committee and the Firm agreed to continue the audit engagement.** Following the audit committee’s separate evaluation, the audit committee and the Firm agreed to continue the audit engagement.

After this issue arose in a number of inspections, numerous Firms requested clarification of their obligations under Rule 3526(b) in circumstances where one or more violations had occurred, and the Firm and the audit committee of the audit client had each determined that the engagement could continue.

To address this issue, and with due consideration to the policies underlying the applicable rules and practices in this area⁹, the PCAOB staff is providing this guidance to Firms regarding the application of Rules 3520 and 3526(b)(3).

The PCAOB staff believes this guidance will promote robust communications between the Firm and the audit committee consistent with the underlying principles embodied in, and the other communications required by, Rule 3526. This guidance does not address, however, 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. This is a question for the SEC, the audit client (including its audit committee), and the Firm.¹⁰ The PCAOB staff expresses no view on this issue.

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8. See, e.g., Section 10A(m)(2) of the Securities Exchange Act of 1934 (stating that the “audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer . . . for the purposes of preparing or issuing an audit report or related work. . .”).
 9. A Firm or an audit client, including the audit committee, can consult with the SEC staff concerning the Firm’s and the audit client’s respective conclusions regarding independence issues. See SEC Office of the Chief Accountant, *Auditor Independence Matters*, at <https://www.sec.gov/page/oca-auditor-independence-matters#>. The PCAOB staff understands that, based on the facts and circumstances, the SEC staff has in certain situations not objected to a Firm continuing to serve as its audit client’s auditor where a Firm is capable of exercising objective and impartial judgment on all issues encompassed within the engagement. See, e.g., Rel. No. 33-10491, *Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships* (May 2, 2018) at 43 (“As discussed above, Commission staff has engaged in extensive consultations with audit firms, funds, and operating companies regarding the application of the Loan Provision. . . These discussions also revealed that in certain scenarios, in which the Loan Provision was implicated, the auditor’s objectivity and impartiality in performing the required audit and interim reviews were not impaired.”).
 10. The decision to continue an engagement when a Firm is not in compliance with SEC or PCAOB independence rules creates a risk that an audit client’s filing that is required to contain financial statements that comply with Regulation S-X could be deemed deficient — and that the Firm could be deemed to have caused the deficiency.

Staff Q&As

1. In a year in which the fact pattern identified above occurred one or more times with respect to an audit client of a Firm,¹¹ how would the Firm conduct its annual Rule 3526(b)(3) communication?

The Firm would comply with Rule 3526 by:

- a. summarizing for the audit committee each violation that existed during the year;
- b. summarizing for the audit committee the Firm's analysis of why, for each violation and notwithstanding the existence thereof, the Firm concluded that its objectivity and impartiality with respect to all issues encompassed within its engagement had not been impaired, and why the Firm believes that a reasonable investor with knowledge of all relevant facts and circumstances would have concluded that the Firm was capable of exercising objective and impartial judgment on all issues encompassed within the Firm's engagement;
- c. if more than one violation existed during the year, providing to the audit committee a separate analysis of why, notwithstanding all of the violations taken together, the Firm concludes that its objectivity and impartiality with respect to all issues encompassed within its engagement has not been impaired, and why the Firm believes that a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the Firm was capable of exercising objective and impartial judgment on all issues encompassed within the Firm's engagement;
- d. engaging in dialogue with the audit committee regarding the violation(s) and the Firm's related analyses (as described in (a)-(c) above);
- e. documenting the substance of the Firm's discussion(s) with the audit committee (as described in (d) above); and
- f. affirming in writing to the audit committee that, except for the violation(s) expressly identified, the Firm would be independent in compliance with Rule 3520. For example, a Firm may choose to use the following language: "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."

This approach can be incorporated in a Firm's existing practices relating to compliance with paragraphs (b)(1), (b)(2), and (b)(4) of Rule 3526.

11. The approach set forth in this guidance applies only in situations where each of the elements set out in the fact pattern is met.

2. Rule 3526(b)(3) refers to the “date of the communication.” If a violation is addressed by the time of a Firm’s Rule 3526(b)(3) communication, may the Firm simply affirm to the audit committee of the audit client that the firm is independent, rather than providing the communications set out in Q&A 1?

No. Rule 3526(b)(3) sets out a requirement that the Firm affirm that it is “independent in compliance with Rule 3520.” In a year in which the fact pattern identified above occurred one or more times with respect to an audit client of a Firm, then an affirmation under Rule 3526(b)(3) that the Firm is independent in compliance with Rule 3520 — with nothing more — would be inaccurate, and the firm should not provide it. Rather, the Firm would comply with Rule 3526(b)(3) by following the process and providing the communications set out in Q&A 1.

3. If the Firm communicates to the audit committee of its audit client the elements described in Q&A 1 with respect to one or more violations, including the Firm’s analysis that its objectivity and impartiality have not been impaired, the audit committee separately evaluates the violations, and the Firm and the audit committee determine to continue the engagement, does that “cure” the Firm’s violation of Rule 3520?

No. The guidance in Q&A 1 relates solely to communications between the Firm and the audit committee of the audit client for purposes of Rule 3526. It does not relate to questions of whether:

- ⦿ there was a violation of the independence criteria of the PCAOB or the SEC applicable to the engagement, which is a matter for the Firm and the audit committee to consider and with respect to which, in certain circumstances, the Firm and the audit committee may decide to consult with SEC staff concerning their conclusions; or
- ⦿ the audit client engages a new independent auditor, which is a matter that the Firm and the audit committee evaluate and with respect to which, in certain circumstances, the Firm and the audit committee may decide to consult with SEC staff concerning their conclusions.

4. If a violation was identified during a prior audit period and was covered in that period’s Rule 3526(b)(3) communication, but is still within the professional engagement period, does the Firm follow the process set out in Q&A 1 and include that prior violation in its communication to the audit committee in the current year?

If the violation was addressed prior to the current year, and no additional facts have come to light that would alter the resolution of the prior violation, then the Firm need not describe the violation again in the current year’s Rule 3526(b)(3) communication

and the violation would not preclude the Firm from affirming to the audit committee of the audit client that, as of the date of the communication, the Firm is independent in compliance with Rule 3520. If the violation was not fully addressed or a new violation of the same type has arisen in the current year, or if the facts previously communicated to the audit committee have changed or need to be supplemented, then the Firm would include the violation in the current year's Rule 3526(b)(3) communication, following the process set out in Q&A 1.

5. If the process set out in Q&A 1 has been followed with respect to an audit client — including that both the Firm and the audit committee have concluded that the Firm's objectivity and impartiality have not been impaired — does the Firm need to alter the language of the auditor's report for purposes of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*?

No. The Firm may use the language in AS 3101.06 and .09(g) without modification. AS 3101.06 sets forth the required title of the report ("Report of Independent Registered Public Accounting Firm"); it is not a specific assertion of compliance with Rule 3520. Likewise, AS 3101.09(g) is a statement of the legal requirement, not an assertion of compliance therewith.¹² This Q&A applies, however, only to a Firm's compliance with AS 3101.

12. See PCAOB Rel. No. 2017-001 (June 1, 2017), at 50 ("The statement regarding auditor independence is not intended to, and will not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.").

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