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## PCAOB Undertakes To Ensure That Auditor Independence Evaluations Are Better Informed:

### The PCAOB Adopts Rule 3526, Enhancing Audit Committees' Ability to Evaluate an Auditor's Independence

**T**he Public Company Accounting Oversight Board (the "PCAOB" or the "Board") last week adopted Rule 3526 regarding Communication with Audit Committees Regarding Independence.<sup>1</sup> The Board's action concluded a rulemaking focused on assuring that public company audit committees have before them, at the time they consider engaging a new auditor, certain additional information that could inform the committees' assessments of the auditors' independence. The PCAOB's new disclosure requirement and revised standard will become operational on the SEC's approval.

Until now, the rules required only that auditors make an annual independence disclosure to their clients' audit committees. PCAOB Rule 3526 adds the requirement that an auditor, *prior to its initial engagement*, disclose to the audit committee all relationships that could "reasonably be thought to bear on the auditor's independence" from the prospective audit client.

#### Rule 3526 Replaces ISB No. 1

In 1999, the PCAOB first addressed auditor independence with the passage of Interim Standard No. 1 ("ISB No. 1"), which required that, once a year, an auditor disclose to its client's audit committee all relationships that, "in the auditor's professional judgment," may reasonably be thought to bear on independence. ISB No. 1(1)(a). Before issuing ISB No. 1, the PCAOB had considered requiring auditors to make such a disclosure *before* they could be engaged, but decided against doing so because "many audit committees have established meeting schedules which would not accommodate such a discussion before the audit begins, and it concluded that imposing such a requirement was not essential." ISB No. 1 at ¶ 10.

<sup>1</sup> The Board also amended Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles. That Rule prohibits an auditor from providing tax services to an employee in a financial reporting oversight role once the professional engagement for an audit has begun.

In the years since the passage of the Sarbanes-Oxley Act of 2002, which required enhanced communication between auditors and issuers' audit committees and designated the audit committee as directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by the issuer, independence has become a greater focus, prompting the PCAOB to rethink this conclusion. See PCAOB Release 2007-008 at p. 7-8 (July 24, 2007) ("Proposing Release"). Rule 3526 supersedes ISB No. 1 and its purpose is to further empower the audit committee by "[providing it] with sufficient information to understand how a particular relationship might affect independence and to foster a robust discussion between firms and the audit committee." PCAOB Release 2008-003 at p. 6 (April 22, 2008) ("Adopting Release").<sup>2</sup>

#### **Rule 3526: New Disclosure, Updated Standards**

The practical consequences of the new Rule are two required disclosures (one new, one revised), as well as two new standards:

Rule 3526(a): The New Initial Disclosure: Prior to the initial engagement, a prospective auditor must describe to a public company's audit committee, in writing, all relationships "that may reasonably be thought to bear on independence." The prospective auditor must then "discuss . . . the potential effects of the relationships" and "document the substance of the discussion."

The PCAOB declined to specify precisely when the requisite disclosure should be made. Adhering to a consistent theme, the Board left the question of timing to the discretion of the audit committee. In addition, the Board did not require auditors to affirm their independence – *i.e.*, state that they did not have any conflicting relationships – at the time of the initial disclosure. The Board indicated, rather, that a prospective auditor first had to identify possible conflicts and relay them to the audit committee, after which it might need time to resolve them before beginning the engagement. Adopting Release at p. 7.

Rule 3526(b): The Revised Annual Disclosure: As under ISB No. 1, auditors must disclose to the audit committee "at least annually" relationships that could reasonably be thought to bear on independence. Consistent with the newly-conceived initial disclosure, the auditor must describe the relationships in writing, discuss with the audit committee their potential effects, and document the discussion. The auditor must then affirm its independence in writing.

As with ISB No. 1, the Rule is silent as to the when during a given year this disclosure should occur. The Board observed that, "[i]n most cases, the communications will be more useful if they take place near the beginning of the audit process." Adopting Release at p. 14. Such early disclosure would afford an audit committee the greatest opportunity to work with the auditor to cure any conflict or, if that is not possible, to engage another auditor. Notwithstanding that observation, the Rule permits the audit committee and its auditor to determine the timing "appropriate in the circumstances of the particular engagement." *Id.*

A Reasonableness Standard Instead Of "The Auditor's Professional Judgment": ISB No. 1 required that auditors disclose all relationship that "*in the auditor's professional judgment* may reasonably

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<sup>2</sup> Rule 3526 also supersedes ISB Interpretations 00-1 and 00-2, issued in 2000, which explained that ISB No. 1 held primary auditors responsible for the actions of secondary auditors.

be thought to bear on independence.” ISB No. 1 at ¶ 1. Rule 3526, as adopted by the Board, excludes the italicized words.

Commenters that supported inclusion of the italicized words noted that similar “professional judgment” language recently was included in PCAOB Auditing Standard No. 5 (judgment required in integrating the audits of both a company’s financial statements and its internal controls over financial reporting), as well in Auditing Standard No. 3 (judgment required to determine the documentation appropriate to accompany an audit). They argued that leaving the language out of Rule 3526 would create inconsistency and confusion.

The Board explained in both the Proposing and Adopting Releases that auditors plainly would have to employ judgment in determining which relationships could reasonably be thought to bear on their independence, so the omitted language did not do away with the need for the auditor to exercise professional judgment. Rather, according to the Board, it deliberately omitted the language to focus the auditor on “consideration [of] how a third party – not the auditor – would view the relationship.” Adopting Release at p. 11. *See also* Proposing Release at p. 10. This, the Board felt, was consistent with the SEC’s general standard on auditor independence, 17 C.F.R. § 210.2-01, which requires exercise of both the auditor’s professional judgment and consideration of the reasonable investor’s perception of the auditor’s independence from the issuer. *Id.*

The Board also considered comments regarding, but ultimately decided not to limit the disclosure requirement to, relationships that existed during a particular time period. Commenters suggested limiting the Rule to relationships either within the “audit and professional engagement period” or to a set two- or three-year “look-back” period. Consistent with the Board’s theme of flexibility, the Rule as adopted does not specify a time limit, but leaves it to the audit committee and the auditor to decide what relationships and what time periods are relevant to an independence assessment.

A Standard Directing Disclosure Of All Relevant Relationships “As Of The Date Of Disclosure”: The only notable change in the Rule’s language from that which had been proposed is the addition of the phrase “as of the date of disclosure” to both the initial and annual disclosure requirements. The Adopting Release explains that the intent of this language is to prevent auditors from disclosing only *new* relationships during annual disclosures while ignoring old ones. Adopting Release at p. 12. The Board noted that auditors could mention a previously-disclosed relationship and refer the audit committee back to an earlier disclosure for more information. Thus, “an earlier disclosure may reduce the amount of information that needs to be disclosed, but it does not obviate the need for disclosure altogether.” *Id.* The consequence of this additional language is that audit committees are to be provided a snapshot of the relevant relationships, as of the date of the disclosures – *i.e.*, on a yearly basis, new relationships are to be added to the listing and prior relationships no longer relevant are to be omitted.

The Board also rejected commenters’ suggestions that the Rule allow auditors to exclude certain relationships from their disclosures. Commenters sought to exclude relationships disclosed under other PCAOB Rules, such as tax services provided to company management that must be disclosed under Rule 3523. They also sought to exclude relationships that were completed before the audit period or the professional engagement period and had ongoing effects on the company, but that arguably did not bear on independence. The Board refused to grant any such *per se* exclusions and stressed that the auditor would have to consider the effect of every relationship

and, consequently, would give the audit committee the most complete picture possible of its independence. *Id.* at p. 8.<sup>3</sup>

#### Status Of The PCAOB's Rule

PCAOB Rule 3526 is now subject to SEC review. If approved as adopted, Rule 3526 will be effective on the later of September 30, 2008 or the date of the SEC's approval.

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<sup>3</sup> To this point, the Board provided a specific example: "if the firm customized and implemented the company's financial reporting system, that relationship, depending on the circumstances, might reasonably be thought to bear on independence even if the engagement to design the system was concluded before the beginning of the audit and professional engagement period." *Id.* at p. 12.