

SPOTLIGHT

Inspection Observations Related to Auditor Independence

September 2024

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OVERVIEW

Auditor independence is foundational to building investor confidence and fostering trust in the capital markets. Public companies (or “issuers”) and brokers and dealers (“broker-dealers”) hire audit firms as unbiased third parties to provide reasonable assurance to investors that the entity’s financial reporting is reliable.

Although auditor independence is a critical element of an audit firm’s quality control system, PCAOB inspections show it is an area of common deficiencies year after year.¹ The PCAOB is committed to providing timely and relevant insight on issues identified during inspections. This Spotlight highlights recent staff observations on independence, including common deficiencies which resulted in the issuance of comment forms,² good practices, and other reminders, that can help audit firms and audit firm personnel comply with PCAOB and U.S. Securities and Exchange Commission (SEC or “the Commission”) independence standards and rules.

AUDITOR INDEPENDENCE: IMPORTANCE AND RECENT TRENDS

Auditor independence is a critically important topic not only for the PCAOB and audit firms but for anyone who invests in a public company or uses the services of a broker-

Independence, Integrity, and Objectivity

As noted in **QC 20, System of Quality Control for a CPA Firm’s Accounting and Auditing Practice Independence-Integrity-Objectivity** (“QC 20”):³

Independence encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the firm’s audit report. The audit firm and its personnel must be free from any obligation to or interest in the client, its management, or its owners.

Integrity requires personnel to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage.

Objectivity is a state of mind and a quality that lends value to an audit firm’s services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

dealer. Investors expect (and SEC and PCAOB rules require) that audits are being performed by skilled professionals capable of exercising objective and impartial judgment and maintaining their independence from

¹ See our “Staff Update and Preview” Spotlights (2017–2023), which provide insights into common deficiencies observed on our inspections.

² A comment form is a written communication with the audit firm when, after discussion with the audit firm, the inspection team still believes that a potential deficiency exists with the audit work. Comment forms are evaluated for inclusion in the audit firm’s inspection report.

³ On May 13, 2024, the PCAOB adopted a new quality control standard QC 1000, *A Firm’s System of Quality Control*. The new standard and related amendments will take effect on December 15, 2025.

the public companies or broker-dealers they audit. Therefore, compliance by all personnel and partners with SEC and PCAOB standards and rules and an audit firm's internal process to preserve independence from their audit clients, in fact and in appearance, is fundamental to investor confidence and to building a strong audit firm culture of integrity and audit quality.

In May 2023, the PCAOB announced it had enhanced its inspection reports with a new section on auditor independence and a range of other improvements that increase transparency by making publicly available more information that is relevant, reliable, and useful for investors and stakeholders. This new section discusses instances, some of which were revealed by an inspection while others were self-identified by audit firms, of potential noncompliance with SEC rules or instances of noncompliance with PCAOB rules, if any, related to maintaining independence.

In its inspections, the PCAOB is required by the Sarbanes-Oxley Act of 2002⁴ to identify any act, practice, or omission to act that may be in violation of either PCAOB or SEC rules. When identifying deficiencies, PCAOB inspectors cite the rules that are most applicable to the independence issue in question in our inspection reports – sometimes that will be a PCAOB rule, and sometimes it may be an SEC rule.

Given the importance of auditor independence to the public's trust in the quality of audit services, and the history of deficiencies identified, independence remains a priority in our inspections. In 2023, we began to perform procedures to review compliance with certain independence requirements on every audit firm we select for inspection and on every engagement that we review.

PCAOB Rule 3520 – Auditor Independence

PCAOB Rule 3520, *Auditor Independence* (“Rule 3520”) states that a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

- Under Rule 3520, a registered public accounting firm or associated person's independence obligation with respect to an audit client encompasses not only an obligation to satisfy the independence criteria applicable to the engagement set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the SEC under the federal securities laws.
- Rule 3520 applies only to those associated persons of a registered public accounting firm required to be independent of the firm's audit client by standards, rules, or regulations of the PCAOB or SEC or other applicable independence criteria.

The PCAOB staff has observed that an increasing number of comment forms have been issued related to independence issues, in all inspection categories,⁵ over the last three inspection periods (2021–2023). In particular, instances of potential noncompliance with SEC rules or instances of noncompliance with

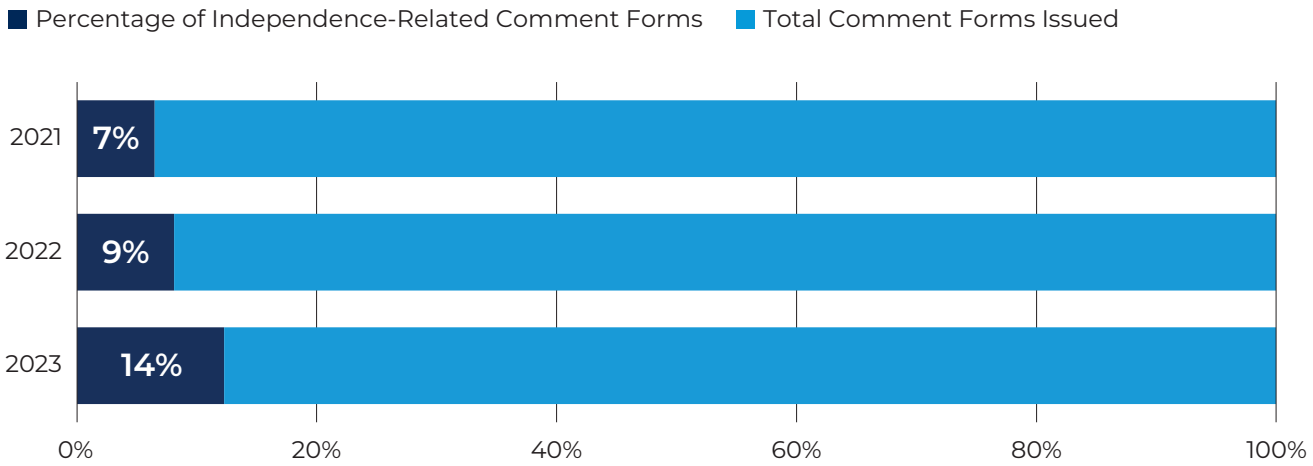
⁴ See Sarbanes-Oxley Act of 2002 Sec. 104 - Inspections of registered public accounting firms.

⁵ For definitions of PCAOB inspection categories, see the Appendix.

PCAOB rules, regardless of the means of identification of the deficiency (by the PCAOB or reported to us by the audit firm) increased significantly during 2023, which may have been driven in part by our expanded focus on independence as noted above.

The following figure shows the percentage of independence comment forms in relation to the total number of comment forms issued in 2021, 2022, and 2023.

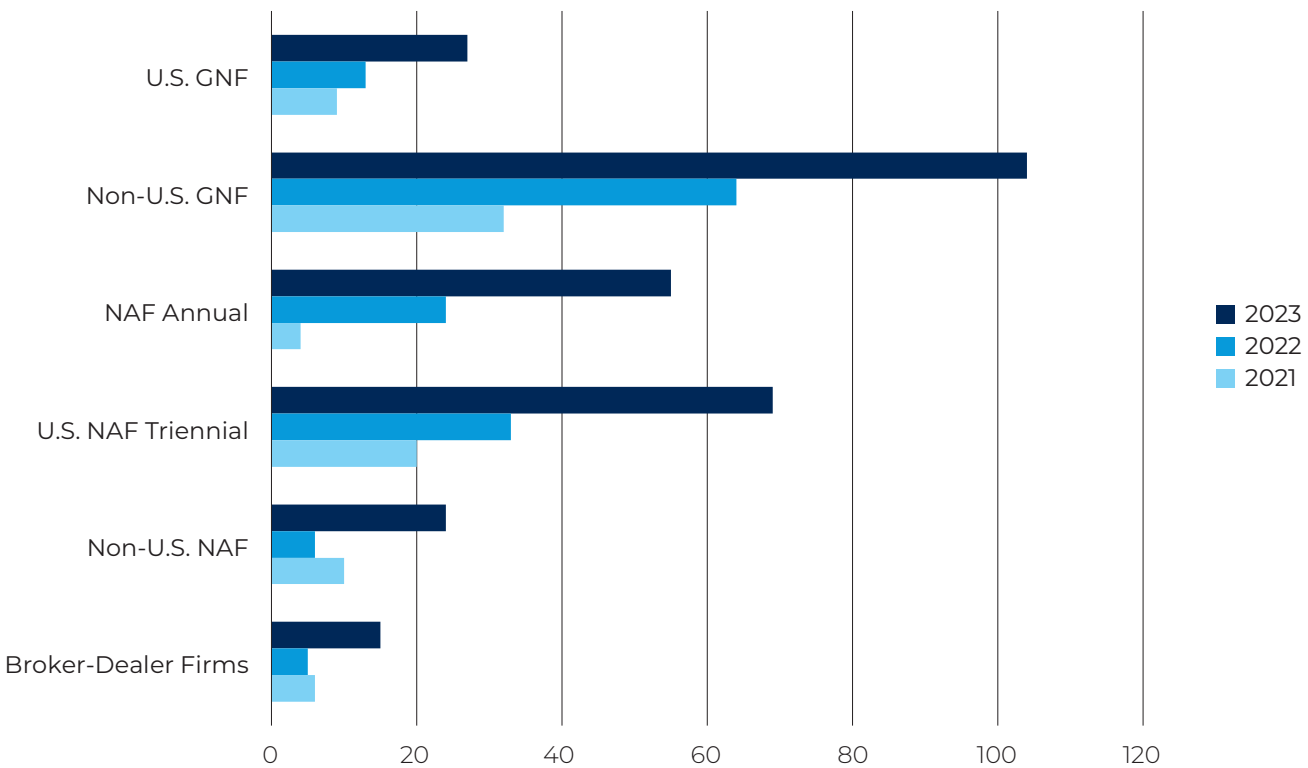
Figure 1 – Percentage of Independence-Related Comment Forms⁶ to Total Comment Forms Issued



⁶ The information presented in this figure and throughout this Spotlight captures independence-related comment forms from 2021 – 2023 issued as of August 2024.

Figure 2 shows the total number of independence comment forms issued in each inspection category for 2021, 2022, and 2023.

Figure 2 – Number of Independence-Related Comment Forms⁷ by PCAOB Inspection Category



PCAOB INSPECTION PROCEDURES RELATED TO INDEPENDENCE

Focus Areas

During our inspection procedures, we assess, among other things, compliance with SEC independence requirements (“SEC rules”), PCAOB independence and ethics requirements (“PCAOB rules and standards”), and compliance with an audit firm’s own policies that could

be more restrictive than the SEC or PCAOB independence requirements. Examples of areas of focus include evaluating such items as:

- Audit committee pre-approval of audit and non-audit services provided by the audit firm to its audit client.
- Permissibility of non-audit services provided by the audit firm to its audit client.
- Communications with audit committees regarding matters that may reasonably be thought to bear on the auditor’s independence.

⁷ While Broker-Dealer Firms can also be part of issuer inspection programs as described in the Appendix, below, the number of comment forms in the category only pertains to the audits of broker-dealers.

- Audit or attestation engagement letters that might contain indemnification clauses.
- Engagement partner and engagement quality reviewer rotation requirements.
- Independence representations of engagement team members and other associated persons with respect to an audit client.
- Independence consultation process within the audit firm.
- Monitoring of employee financial relationships.
- Identifying and evaluating independence violations.

We also evaluate how effective an audit firm's quality control system is in providing the firm reasonable assurance that its personnel maintain independence. In conducting this evaluation, we may focus on the audit firm's:

- Monitoring of its business relationships.
- Independence representation process to confirm independence of the engagement team members prior to beginning the audit.

Figure 3 summarizes the percentage of independence-related comment forms over the past three inspection periods by area of focus.

Please note: The percentages in the chart below add up to more than 100% because a comment form can identify more than one independence-related deficiency. The percentages represent the proportion of the total independence-related comment forms issued each year.

Figure 3 – Percentage of Independence-Related Comment Forms by Area of Focus

Independence Related to:	2023	2022	2021
Audit Committee Pre-Approval of Services ⁸	34%	37%	25%
Independence Representations	31%	13%	12%
Personal Independence Compliance Testing	7%	17%	27%
Prohibited Financial Relationships	9%	14%	12%
Communication With the Audit Committee	9%	8%	14%
Permissibility of Non-Audit Services	4%	9%	4%
Business and Employment Relationships	3%	8%	5%
Indemnification Clauses	3%	6%	2%
Permissibility of Tax Services	4%	4%	2%
Independence Policies	5%	3%	0%
Partner Rotation	0%	2%	11%
Restricted Entity List	1%	1%	2%
Contingent Fees	1%	1%	1%
Mutual Interest-Unpaid Fees	1%	0%	3%

⁸ This data includes all instances in which the audit firm had no documentation evidencing the fact of audit committee pre-approval, which does not necessarily indicate that the audit committee had not pre-approved the public company engaging the audit firm to provide the service in question.

INSPECTION OBSERVATIONS RELATED TO INDEPENDENCE

This section sets out high-level inspection observations, regardless of the means of identification of the observation (by the PCAOB or reported to us by the audit firm), from the past three inspection periods (2021–2023) for each area of focus with at least one independence-related comment form. The “Applicable Standard or Rule” column in the charts below captures relevant excerpts that pertain to the noted observations in each focus area.

Please note: The percentages in the charts below add up to more than 100% because a comment form can have more than one independence-related deficiency identified. The percentages represent the proportion of the total independence-related comment forms issued each year.

Audit Committee Pre-Approval of Services/Communication With the Audit Committee

	2023	2022	2021
Percentage of Independence-Related Comment Forms	43%	45%	38%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(c)(7)⁹, <i>Audit Committee Administration of the Engagement</i>, before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render audit or non-audit services, the engagement is approved by the issuer’s or registered investment company’s audit committee. With respect to the provision of services other than audit, review or attest services, the pre-approval requirement is waived if:</p> <ol style="list-style-type: none"> 1. The aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided; 2. Such services were not recognized by the issuer or registered investment company at the time of the engagement to be non-audit services; and 	<p>We have observed instances where audit firms may not be independent of the audit client, as the audit firms provided no persuasive evidence that the necessary pre-approval from the audit committee had occurred prior to the audit firm commencing audit, non-audit, and/or tax services or that the pre-approval requirement had been waived.</p>

⁹ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

<p>3. Such services are promptly brought to the attention of the audit committee of the issuer or registered investment company and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.</p> <p>In addition, the audit committee should be informed of all services in order to make a well-reasoned assessment of the impact of the service on the audit firm's independence.</p>	
<p>In accordance with PCAOB Rule 3526, <i>Communication with Audit Committees Concerning Independence</i> ("PCAOB Rule 3526"), an audit firm must:</p> <p>Prior to accepting an initial engagement pursuant to the standards of the PCAOB –</p> <ol style="list-style-type: none"> 1. Describe, in writing, to the audit committee of the potential audit client, all relationships between the registered public accounting firm or any affiliates of the public accounting firm and the potential audit client or persons in financial reporting oversight roles at the potential 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 potential audit client the potential effects of the relationships on the independence of the registered public accounting firm, should it be appointed the potential audit client's auditor; and 3. Document the substance of its discussion with the audit committee of the potential audit client. 	<p>We have observed instances where the auditor prior to its initial engagement did not describe, in writing, to the potential audit client's audit committee the scope of the non-audit service(s) it provided that may reasonably be thought to bear on independence of the audit firm.</p>

<p>In accordance with PCAOB Rule 3526, an audit firm must:</p> <p>At least annually with respect to each of its audit clients –</p> <ol style="list-style-type: none"> 1. Describe, in writing, to the audit committee of the audit client, all relationships between the registered public accounting 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 subsection (b)(1) on the independence of the registered public accounting firm; 3. Affirm to the audit committee of the audit client, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and 4. Document the substance of its discussion with the audit committee of the audit client. 	<p>We have observed instances where the auditor did not describe, in writing, annually to the audit client's audit committee non-audit services it provided that may reasonably be thought to bear on independence of the audit firm. We also observed that the audit firm's annual communications to the audit committee were inaccurate, including, but not limited to, instances where the audit firm's independence communication:</p> <ol style="list-style-type: none"> 1. Did not include the ownership and subsequent sale of shares of the audit client by a covered person in the audit firm. 2. Inaccurately presented the professional standards related to the required communications under PCAOB Rule 3526.
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Independence Representations/Personal Independence Compliance Testing

	2023	2022	2021
Percentage of Independence-Related Comment Forms	37%	30%	40%

Applicable Standard or Rule	PCAOB Observation
In accordance with <i>AS 2101, Audit Planning</i> , the auditor should determine compliance with independence ¹⁰ and ethics requirements at the beginning of the audit.	We have observed instances where the audit firms and/or engagement teams that performed the audits of the public companies or broker-dealers did not perform any procedures to determine compliance with PCAOB standards and rules and SEC rules with respect to independence of engagement team members from other audit firms, including those that are members of global networks or non-network, that participated in the audit.
<p>In accordance with <i>QC 20</i>,¹¹ an audit firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the audit firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality. The policies and procedures designed to implement the system in one segment of an audit firm's practice may be the same as, different from, or interrelated with the policies and procedures designed for another segment, but the purpose of the system is the same for all segments of an audit firm's practice.</p> <p>Additionally, policies and procedures should be established to provide the audit firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.</p>	<p>We have observed multiple deficiencies that indicate that various audit firms' quality control systems may not provide reasonable assurance that the audit firms' personnel complied with the audit firms' independence policies and procedures to ensure the audit firms' independence. For example, we have observed instances where:</p> <ol style="list-style-type: none"> 1. The engagement quality reviewer and/or professional staff did not confirm their independence at the beginning of the audit, as required in the audit firm's quality control policies and procedures. 2. The engagement team did not evaluate whether all audit firm personnel who charged time to the engagement were members of the engagement team and were therefore required to complete an engagement confirmation as required by the audit firm's independence policies and procedures.

¹⁰ Under *PCAOB Rule 3520, Auditor Independence*, a registered public accounting firm or associated person's independence obligation with respect to an audit client encompasses not only an obligation to satisfy the independence criteria applicable to the engagement set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the SEC under the federal securities laws.

¹¹ See supra note 3.

3. The engagement team did not obtain an independence confirmation from certain audit firm personnel who participated in the audits, as required by the audit firm's independence policies and procedures.

These instances also raised concern about the effectiveness of the audit firm's communication and enforcement of its independence policies and procedures.

Additionally, we have observed that audit firms have identified, through the audit firms' personal independence compliance testing results, a high rate of managers, directors, and/or partners who did not report all of their reportable financial interests in accordance with audit firms' policy (which requires all professionals that are at the manager level or above, in all service lines, to report financial relationships with all publicly traded companies). This also provides cause for concern about the effectiveness of the audit firms' communication and enforcement of its independence policies and procedures, especially because these individuals are required to certify on an annual basis that they have complied with the audit firm's independence policies and procedures.

Prohibited Financial Relationships

	2023	2022	2021
Percentage of Independence- Related Comment Forms	9%	14%	13%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(c)(1),¹² Financial Relationships, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as:</p> <ul style="list-style-type: none"> • Investments in audit clients. • Other financial interests in audit clients, including certain: <ul style="list-style-type: none"> ○ Loans/debtor-creditor relationships. ○ Savings and checking accounts. ○ Broker-dealer accounts. ○ Futures commission merchant accounts. ○ Consumer loans. ○ Insurance products. ○ Investment companies. • Exceptions. Notwithstanding paragraphs...of this section an accountant will not be deemed not independent if: <ul style="list-style-type: none"> ○ Inheritance and gift. Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance that would cause an accountant to be not independent under paragraph ... of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest. 	<p>We have observed instances where the audit firm did not appear to be independent of its audit clients, as the audit firm identified one or more prohibited financial relationships between the audit client and the audit firm's personnel.</p> <p>Additionally, we have observed an instance where the audit firm did not appear to have a process in place to monitor the composition of its investments in non-diversified funds to ensure such funds do not have investments in the audit firm's clients that amount to 20% or more of the value of the non-diversified funds' total investments.</p>

¹² Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

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- New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraph ... of this section, and:
 - (1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and
 - (2) The accountant is independent under paragraph ... of this section before the earlier of: (i) Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or (ii) Commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).
 - Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs...of this section and the acquisition of the financial interest was an unavoidable consequence of participation ... provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.
 - Audit clients' financial relationships, including:
 - Investments by the audit client in the accounting firm.
 - Underwriting.
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Permissibility of Non-Audit and Tax Services

	2023	2022	2021
Percentage of Independence-Related Comment Forms	8%	14%	7%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(c)(4),¹³ <i>Non-Audit Services</i>, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client, including its affiliates, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements:</p> <ul style="list-style-type: none"> • Bookkeeping or other services related to the accounting records or financial statements of the audit client. • Financial information systems design and implementation. • Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. • Actuarial services. • Internal audit outsourcing services. <p>An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client, including its affiliates:</p> <ul style="list-style-type: none"> • Management functions. • Human resources. • Broker-dealer, investment adviser, or investment banking services. • Legal services. • Expert services unrelated to the audit. 	<p>We have observed instances where the audit firm provided the following prohibited non-audit services to an audit client or its affiliates:</p> <ol style="list-style-type: none"> 1. Maintenance or preparation of the audit client's accounting records. 2. Preparation of source data underlying the audit client's financial statements. 3. Preparation of the audit client's financial statements. 4. Printing and assembly of the audit client's annual reports. 5. Whistleblower services.

¹³ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

<p>In accordance with PCAOB Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles, an auditor is not independent of an issuer audit client if the audit firm, or any affiliate of the audit firm, during the professional engagement period 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, unless:</p> <ul style="list-style-type: none"> a) The person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client. b) The person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited. c) The person was not in a financial reporting oversight role at the issuer audit client before a hiring, promotion, or other change in employment event and the tax services are (1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and (2) completed on or before 180 days after the hiring or promotion event. 	<p>We have observed instances where the audit firm identified that it was providing prohibited tax services for a person in a financial reporting oversight role at an issuer audit client.</p>
<p>In accordance with PCAOB Rule 3524, Audit Committee Pre-approval of Certain Tax Services, in connection with seeking audit committee pre-approval to perform for an issuer audit client any permissible tax service, a registered public accounting firm shall:</p> <ul style="list-style-type: none"> a) Describe, in writing, to the audit committee of the issuer: <ul style="list-style-type: none"> (1) the scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the audit firm and the audit client, relating to the service; and 	<p>We have noted instances where the audit firm did not:</p> <ol style="list-style-type: none"> 1. Describe, in writing, to the audit committee, the scope of the proposed tax services, 2. Have a discussion with the audit committee related to the potential effects of the tax services on the independence of the audit firm, in connection with seeking audit committee pre-approval or if such discussion occurred after the services were already pre-approved by the audit committee, and/or 3. Document the substance of its discussion with the audit committee regarding the potential effects of the provision of tax services on the independence of the audit firm.

<p>(2) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the public accounting firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service.</p> <p>b) Discuss with the audit committee of the issuer the potential effects of the services on the independence of the audit firm; and</p> <p>c) Document the substance of its discussion with the audit committee of the issuer.</p>	
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Business and Employment Relationships

	2023	2022	2021
Percentage of Independence-Related Comment Forms	3%	9%	5%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(c)(2),¹⁴ <i>Employment Relationships</i>, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:</p> <ul style="list-style-type: none"> • Employment at audit client of accountant. • Employment at audit client of certain relatives of accountant. • Employment at audit client of former employee of accounting firm.¹⁵ • Employment at the accounting firm of former employee of audit client. 	<p>We have observed instances of auditors having prohibited employment relationships with audit clients, including but not limited to instances where the audit firm has an employment relationship with an individual employed by the audit client.</p>

¹⁴ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

¹⁵ Refer to SEC Rule 2-01(c)(2)(iii) for further considerations relating to employment at audit client of former employee of accounting firm.

<p>In accordance with SEC Rule 2-01(c)(3),¹⁶ <i>Business Relationships</i>, an accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the audit firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client’s officers or directors that have the ability to affect decision-making at the entity under audit, or beneficial owners (known through reasonable inquiry) of the audit client’s equity securities where such beneficial owner has significant influence over the entity under audit. The relationships described in this paragraph (c) (3) do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.</p>	<p>We have observed audit firms not satisfying the independence criteria, including (but not limited to) instances in which:</p> <ol style="list-style-type: none"> 1. An associated entity of the audit firm had a direct business relationship with an entity under common control with its audit client. 2. The audit firm had a direct business relationship with a controlled affiliate of the audit client.
<p>In accordance with Ethics & Independence Rules (“ET”) Section 101.04, <i>Considering Employment or Association With the Client</i>, when a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the audit firm and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the audit firm. The appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that</p>	<p>We have observed instances where a member of the attest engagement did not communicate to an appropriate person in the audit firm his/ her intention to seek employment and, as a result, the member was not removed from the audit engagement prior to discussing potential employment.</p>

¹⁶ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

<p>person was performed with objectivity and integrity as required under ET Section 102.01 - <i>Integrity and Objectivity</i>.¹⁷ Additional procedures, such as reperformance of work already done, will depend on the nature of the engagement and the individual involved.</p>	
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Indemnification Clauses

	2023	2022	2021
Percentage of Independence-Related Comment Forms	3%	6%	3%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(b),¹⁸ the SEC 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. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.</p> <p>In addition, SEC Codification of Financial Reporting Policies 602.02.f.i, <i>Indemnification by Client</i>, states that when an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies.</p>	<p>We have observed instances in which an associated entity of an audit firm (i.e., a different member firm that participates in the group audit as a component auditor) has been engaged to provide audit services to a consolidated entity's audit in which the subsidiary's engagement letter included indemnification provisions. Such agreements are inconsistent with 602.02.f.i and the general standard of independence.</p>

¹⁷ On May 13, 2024, the PCAOB adopted a new standard EI 1000, *Integrity and Objectivity*. The new standard will take effect on December 15, 2025.

¹⁸ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

Independence Policies

	2023	2022	2021
Percentage of Independence-Related Comment Forms	5%	3%	0%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with QC 20,¹⁹ an audit firm has a responsibility to ensure that its personnel comply with the professional standards applicable to its accounting and auditing practice. A system of quality control is broadly defined as a process to provide the audit firm with reasonable assurance that its personnel comply with applicable professional standards and the audit firm's standards of quality. The policies and procedures designed to implement the system in one segment of an audit firm's practice may be the same as, different from, or interrelated with the policies and procedures designed for another segment, but the purpose of the system is the same for all segments of an audit firm's practice.</p>	<p>We have identified instances where the audit firm's quality control system did not appear to provide reasonable assurance that the audit firm will maintain independence in all required circumstances. Specifically, the audit firm's quality control system was not properly designed to ensure compliance with the audit firm's policies and procedures to prevent or detect SEC or PCAOB independence violations. The following are a few examples, that we have observed:</p> <ol style="list-style-type: none"> 1. Audit firms that did not establish written independence policies covering business relationships with restricted entities. 2. An audit firm's policies required individuals to certify on an annual basis that they have complied with the audit firms' independence policies and procedures, but there were: <ul style="list-style-type: none"> o Partners, directors, senior managers, and managers that did not report all their reportable financial interests in accordance with audit firm policy. o Partners who served on a supervisory body of a restricted entity in violation of audit firm policy.
<p>In accordance with <i>QC 30, Monitoring a CPA Firm's Accounting and Auditing Practice</i>,²⁰ monitoring procedures taken as a whole should enable the audit firm to obtain reasonable assurance that its quality control system is effective. Procedures that provide the audit firm with a means of identifying and communicating circumstances that may necessitate changes to or the need to improve</p>	<p>We have observed instances where the audit firm's quality control system did not provide reasonable assurance that the audit firm's personnel will comply with the audit firm's independence policies and procedures or ensure that the audit firm's monitoring procedures, taken as a whole, enable the audit firm to obtain reasonable assurance that its quality control system is effective.</p>

¹⁹ See supra note 3.

²⁰ See supra note 3.

<p>compliance with the audit firm’s policies and procedures contribute to the monitoring element. An audit firm’s monitoring procedures may include –</p> <ul style="list-style-type: none"> • Inspection procedures. • Pre-issuance or post-issuance review of selected engagements. • Analysis and assessment of – <ul style="list-style-type: none"> ○ New professional pronouncements. ○ Results of independence confirmations. ○ Continuing professional education and other professional development activities undertaken by audit firm personnel. ○ Decisions related to acceptance and continuance of client relationships and engagements. ○ Interviews of audit firm personnel. • Determination of any corrective actions to be taken and improvements to be made in the quality control system. • Communication to appropriate audit firm personnel of any weaknesses identified in the quality control system or in the level of understanding or compliance therewith. • Follow-up by appropriate audit firm personnel to ensure that any necessary modifications are made to the quality control policies and procedures on a timely basis. 	<p>Specifically, we have observed where an audit firm’s independence monitoring system did not include procedures to:</p> <ol style="list-style-type: none"> 1. Ensure that the audit firm’s restricted entity list and related updates are communicated in a timely manner. 2. Verify that acceptance and continuance procedures, including independence procedures, were completed prior to commencing the performance of non-audit services. 3. Monitor the nature and timing of the services provided to audit clients by audit firm personnel in order to assess independence compliance.
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Partner Rotation

	2023	2022	2021
Percentage of Independence-Related Comment Forms	0%	2%	12%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with SEC Rule 2-01(c)(6),²¹ <i>Partner Rotation</i>, an accountant is not independent of an audit client when:</p> <p>a) Any audit partner performs:</p> <ol style="list-style-type: none"> (1) The services of a lead partner, or Engagement Quality Reviewer, for more than five consecutive years; or (2) One or more of the defined services for more than seven consecutive years; <p>b) Any audit partner:</p> <ol style="list-style-type: none"> (1) Within the five consecutive year period following the performance of services for the maximum period permitted, performs for that audit client the services of a lead partner, or Engagement Quality Reviewer, or a combination of those services; or (2) Within the two consecutive year periods following the performance of services for the maximum period permitted, performs one or more of the defined services. <p>Any accounting firm with less than five audit clients that are issuers, and less than 10 partners shall be exempt from this section provided the PCAOB conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this paragraph.</p> <p>In addition, <i>AS 1220, Engagement Quality Review</i> states that the person who served as the engagement partner during either of the two audits preceding the audit subject to the engagement quality review may not be the engagement quality reviewer. Registered firms that qualify for the exemption under SEC Rule 2-01(c)(6),²² are exempt from the requirement in this paragraph.</p>	<p>We have observed instances where the audit firm identified that:</p> <ol style="list-style-type: none"> 1. The lead audit partner or engagement quality reviewer provided services to the audit client for more than five consecutive years. 2. An audit partner, other than the lead partner and concurring partner, served in their role for more than seven consecutive years. <p>We also observed instances where the engagement quality reviewer served as the engagement partner during the audit preceding the audit engagements subject to the engagement quality review, and the audit firm did not qualify for exemption from the partner rotation requirement because the audit firm had five or more audit clients that were public companies.</p>

²¹ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

²² Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

Restricted Entity List

	2023	2022	2021
Percentage of Independence-Related Comment Forms	1%	1%	3%

Applicable Standard or Rule	PCAOB Observation
<p>In accordance with QC 20,²³ policies and procedures should be established to provide the audit firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.</p> <p>Additionally, in accordance with SEC Practice Section Appendix L- Independence Quality Controls, each member firm shall maintain a database (“Restricted Entity List”) that includes all restricted entities. The member firm’s policies should explain why, when and how SEC registrant audit clients (and other related entities as discussed above) are to be placed on the Restricted Entity List. For member firms that provide an annual audit to more than 500 SEC registrants, an automated system to identify investment holdings of partners and managers that might impair independence is required. Member firms that provide an annual audit to more than 500 SEC registrants are required to have the automated system in place by December 31, 2000, or within a reasonable transition period upon achieving that number, not to exceed one year.</p>	<p>We have observed instances where the audit firm’s restricted entities list was not inclusive of all of the audit clients and affiliates of which the audit firm or its personnel must be independent.</p>

²³ See supra note 3.

Contingent Fees

	2023	2022	2021
Percentage of Independence-Related Comment Forms	1%	1%	1%

Applicable Standard or Rule	PCAOB Observation
In accordance with SEC Rule 2-01(c)(5), ²⁴ <i>Contingent fees</i> , an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission or receives a contingent fee or commission from an audit client.	We have observed instances where audit firms provided a service or services to issuer audit clients for a contingent fee.

Mutual Interest - Unpaid Fees

	2023	2022	2021
Percentage of Independence-Related Comment Forms	1%	0%	3%

Applicable Standard or Rule	PCAOB Observation
In accordance with SEC Rule 2-01(b), ²⁵ 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. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.	We observed instances where at the commencement of the audit of the financial statements, there were unpaid prior year fees that appeared to be material in relation to the fee expected to be charged for the audit of the financial statements and there were not (1) a definite commitment made by the public company to pay the prior year fees before the issuance of the audit report or an agreed upon arrangement for periodic payments to settle the delinquent fees, and (2) reasonable assurance that the audit fee would be paid before commencement of the ensuing audit.

²⁴ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

²⁵ Refer to 17 CFR § 210.2-01 for auditor independence requirements in the Application of Regulation S-X.

Additionally, circumstances giving rise to concern about mutual interest can include, among others, circumstances in which the accountant appears to have a direct interest in the results of operations of the client. This can include some circumstances involving unpaid prior professional fees owed to the accountant. See SEC Codification of Financial Reporting Policies 602.02.b.iv (unpaid fees owed for extended period and material in relation to fee to be charged for current audit, and a lack of certain commitments and assurances regarding payment).

[ET Section 191.103-104, *Unpaid Fees*](#), states that independence is considered to be impaired if, when the report on the client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

GOOD PRACTICES

A good practice could be a procedure, technique, or methodology that is appropriately comprehensive and suitably designed in relation to the size, nature, and complexity of the audit firm and thus may contribute to the quality of audit services. The following are good practices we have observed related to independence:

- **Increasing the use of technology-based tools** – Some audit firms increasingly use technology-based tools to promote early detection of potential personal independence violations. For example:
 - o Audit firms have implemented tools to frequently compare time charged by audit firm personnel to financial holdings reported by the personnel for early identification of potential violations.
 - o Audit firms have also automated the process, including using direct feeds from broker systems, to compare financial holdings reported by personnel to the firms' restricted entity listings to identify potential violations prior to audit engagement assignment.
 - o Some audit firms have developed automated tools that audit firm personnel use to report financial holdings that include prompts to remind audit firm personnel of reporting requirements for various types of financial holdings and features that allow professionals to pre-clear acquisitions of financial holdings.
 - o Certain audit firms use tools to analyze areas of repeated independence violations to send targeted communication to other audit firm personnel with similar reported financial holdings, to prompt them to consider if they have a similar inaccurate or non-reported financial holding and, if so, to take action to update their financial holding disclosures as may be appropriate.
- o Certain audit firms monitor their independence reporting system for individual metrics and send targeted compliance reminder emails to personnel who (a) had no spousal entries, (b) had not accessed the monitoring system within the last three months, and/or (c) had empty monitoring system accounts with nothing to declare.
- **Enhancing the frequency of personal independence representations** – Certain audit firms have increased the frequency for personnel to provide independence compliance representations to a quarterly or semi-annual basis. Also, to enhance the process, certain audit firms have tailored the representations based on personnel's financial interests and/or services provided to audit clients.
- **Enhanced processes** – Certain audit firms employed an enhanced process that includes mandatory meetings with firm personnel skilled in independence matters to guide personnel through their financial holding disclosures, and those of close family members, to ensure proper considerations are given to reporting all financial holdings. During this process, disclosed financial holdings may be compared to supporting documentation, such as current account statements or tax filings, to verify the accuracy and completeness of reported financial holdings.
- **Establishing disciplinary actions** – Audit firms have put in place specific policies and procedures providing sanctions for personal independence policy violations including, but not limited to, failure to timely complete semi-annual or quarterly personal independence representations. The procedures include audit firms

assessing the severity, frequency, and nature of personal independence policy violations and determining disciplinary actions commensurate with the violations. Disciplinary actions may include financial sanctions, promotion deferrals, mandatory independence training, removal from issuer audit engagements, or required independence reviews in subsequent years.

- **Use of templates** – Using a global template with standardized language for all audit engagement letters for clients subject to SEC and PCAOB independence standards and rules. This template has helped prevent the inclusion of indemnification clauses, contingent fees, and other prohibited fees or services in the engagement letters of “other auditors.”²⁶

REMINDERS FOR AUDITORS

Audit firms and auditors are encouraged to consider the following reminders:

- It is important for the lead auditor to review the engagement letters of “other auditors” to ensure that the letters do not include indemnification clauses, contingent fees and/or prohibited services. It is also important that the lead auditor proactively engages in discussions to understand any work being performed by an affiliate of the audit firm.
- Do not presume that the audit committee has approved or will pre-approve services.
- The audit committee must pre-approve all permitted services provided by the independent auditor before the independent auditor is engaged to perform those services, except in very limited situations. It is important for the lead engagement team to establish a process to ensure that services provided by other auditors are pre-approved by the audit committee prior to being engaged.
- Independence is the responsibility of all audit firm partners and personnel, including non-audit partners and personnel. Covered persons should (1) be aware of all their financial and business relationships, including those of immediate family members, (2) be mindful of such relationships prior to providing services, and (3) timely report the relationships to the audit firm monitoring system, as applicable.
- Audit firms that are considering or have completed transactions with investors that are not traditional audit firms (e.g., private equity investors) should carefully consider and evaluate the audit firm’s compliance with independence requirements and continued ability to monitor and comply with such requirements after completing the transaction.
- Enhanced training and support in conjunction with events (e.g., promotions or marriages) that may cause independence violations may be beneficial in preventing noncompliance.
- Have continuous conversations with audit clients about their future plans and take a proactive approach to independence rather than a reactionary one to avoid violations. For example, if an audit client informs its auditor of a potential plan for an initial public offering (IPO) or transaction, the audit firm may elect to perform an independence evaluation under SEC and PCAOB rules and

²⁶ On June 21, 2022, the PCAOB [adopted amendments](#) to its auditing standards to strengthen requirements that apply to audits involving multiple audit firms. These amendments will take effect for audits of financial statements for fiscal years ending on or after December 15, 2024.

standards and self-impose independence restrictions sooner rather than later to prevent violations.

- Prior to entering business relationships or non-audit services that may be more difficult to exit with a private entity audit client, discuss the audit client's long-term plans (i.e., whether considering a potential IPO or transaction). It is important for all parties to understand the potential implications to the audit firm's ability to continue as the company's auditor if it becomes subject to SEC and PCAOB independence rules and standards.

AUDIT COMMITTEE CONSIDERATIONS

The Sarbanes-Oxley Act of 2002 mandates that audit committees be directly responsible for the engagement and oversight of the company's independent auditor, and the SEC's rules are designed to ensure that auditors are independent of their audit clients. Audit committees should also be aware of the PCAOB's Ethics and Independence Rules. The following are some considerations for audit committees on their oversight responsibilities regarding their auditor's independence:

- Audit committees are required to consider whether any services provided by the audit firm may impair the audit firm's independence in advance.
- Audit committees should be aware that certain financial relationships between the company and the independent auditor are prohibited.
- Audit committees should consider whether the public company's policies and procedures require that all audit and non-audit services are brought before the audit committee for pre-approval.
- Audit committees should not approve engagements that remunerate an independent auditor on a contingent fee or a commission basis, as such remuneration is considered to impair the auditor's independence.
- Audit committees should consider whether their auditor has implemented processes to identify prohibited relationships.
- Audit committees should discuss the following with the audit firm:
 - o Processes the audit firm uses to ensure complete disclosure of all relationships with the public company and its affiliates.
 - o Relationships the audit firm may have with officers, board members, and significant shareholders.
- If the audit committee pre-approves services using pre-approval policies and procedures, the audit committee should consider whether the pre-approval policies and procedures are sufficiently detailed as to the particular services to be provided so that the audit committee can make a well-reasoned assessment of the impact of the service on the auditor's independence.
- Independence is a shared responsibility between the entity under audit, its audit committee, and its auditor. It is important for the company to have policies and procedures to proactively alert auditors to proposed or pending merger and acquisition activity that could have an impact on auditor independence.

APPENDIX: PCAOB INSPECTION CATEGORIES

Global Network Firm (GNF)

U.S. GNF – These audit firms are headquartered in the U.S. and are members of global networks through which they affiliate with audit firms in other countries for various business and client service purposes. Registered public accounting firms provide information about those affiliations in their annual reports on PCAOB Form 2. These U.S. firms all issue more than 100 issuer audit reports each year and are therefore inspected annually.

Non-U.S. GNF – These audit firms are headquartered outside of the U.S. and are members of global networks. Currently, all of these audit firms are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.

Non-Affiliate Firm (NAF)

NAF Annual – These audit firms are non-affiliated firms that are not part of a global network but are inspected annually because they issue more than 100 issuer audit reports per year. Currently all NAF Annual audit firms are headquartered in the U.S.

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U.S. NAF Triennial – These audit firms are non-affiliated firms that are not part of a global network, are headquartered in the U.S., and are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.

Non-U.S. NAF – These audit firms are non-affiliated firms that are not part of a global network, are headquartered outside of the U.S., and are inspected on a triennial basis because they issue 100 or fewer issuer audit reports per year.

Broker-Dealer Firms

These audit firms, which can also be part of an issuer inspection program as described in this Spotlight, perform audits of broker-dealers. There is no mandated inspection cycle for audit firms of broker-dealers.

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