

A Refresher on Auditor Independence: Best Practices Every CPA Should Know

PCAOB Inspection Observations Related to Auditor Independence

To comply with the Sarbanes-Oxley Act, PCAOB inspects audit firms involved in auditing publicly registered companies on an annual basis. In September 2024, PCAOB issued a Spotlight Report that highlighted the specific independence issues observed in conjunction with their most recent inspections and emphasized the need for auditors to be mindful of these problematic areas.

Communication with Audit Committee and Pre-Approval of Services

Firms failed to provide evidence that pre-approval of services from the audit committee was obtained prior to beginning work. Additionally, there were instances in which the auditor did not appropriately communicate matters that could impact their independence, including the scope of non-audit services. Firms are required to inform the audit committee of all services so the committee may consider potential independence issues, prior to approval of the engagement and scope of services.

Personal Independence Compliance Testing

Firms and/or individual engagement teams failed to verify the independence of engagement team members from other audit firms that participated in the audit. PCAOB also identified numerous deficiencies within firms' quality control systems, as it relates to independence of their employees. As part of their quality controls, firms are required to design policies and procedures to ensure personnel comply with professional standards, including maintaining independence (in fact and appearance) and objectivity.

Specific violations included engagement teams' failure to:

- 1) Obtain independence confirmations from all personnel who participated in the audit
- 2) Assess need for an independence confirmation for all personnel who charged time to the engagement; and
- 3) Obtain independence confirmations at the beginning of the audit, as required by PCAOB standards.

Lastly, management level (and above) personnel failed to report all relevant financial interests.

Prohibited Financial Relationships

Observations of prohibited financial relationships between the firm's personnel and the audit client were made. Independence rules state that auditors may not have a direct or material indirect financial interest in the client.

Permissibility of Non-Audit and Tax Services

Firms were found to be providing non-assurance services to their audit clients or affiliates. Such services included preparation of accounting records or source data underlying the financial statements and preparation of the financial statements and/or annual reports. Those engaged to perform audits of publicly registered companies are prohibited from performing most non-assurance services, including bookkeeping, preparation of accounting records or financial statements, actuarial services, appraisal and valuations services, internal audit functions, management or oversight functions, legal services, etc.

Inspected firms were also found to be providing prohibited tax services to individuals who serve in a financial reporting oversight role at a client.

Business and Employment Relationships

Auditors were found to have prohibited employment relationships with the client, including instances where engagement team members did not communicate their intent to seek employment with the audit client. In turn, these team members were not appropriately removed from the audit prior to discussing employment opportunities with the client and continued to perform audit procedures.

If a team member is approached with an offer of employment or desires to seek employment with the client, they should recuse themselves from the engagement until the offer is rejected or until they are no longer seeking employment. Reperformance of their work may also be appropriate, if objectivity was deemed to be compromised.

Indemnification Clause

Firms were found to have included indemnification clauses in the engagement letter. A provision like this, which grants immunity from liability for negligent acts, can influence an auditor's judgement and impairs independence. AICPA also deems the inclusion of an indemnification clause to be an act discreditable to the profession.

Independence Policies

Firms are required to implement a quality control system to ensure both the firm and employees of the firm comply with professional standards, including independence. Inspections noted instances where firms failed to:

- 1) Have sufficient policies and procedures in place that would prevent or detect independence violations;
- 2) Take appropriate steps to ensure policies and procedures were followed; and
- 3) Failed to monitor the quality control system to ensure policies were designed appropriately.

Partner Rotation

Partners provided services to audit clients in excess of the maximum number of years permitted. To maintain independence, lead audit partners and quality review partners are required to rotate off an engagement after five consecutive years. Other partners may serve in their role for no more than seven consecutive years.

Restricted Entity List

Firms failed to maintain a comprehensive listing of restricted entities and communicate updates in a timely manner. Without this list, personnel may be unaware of audit clients and affiliates from which they must be independent. Frequent monitoring and continuous updates to a restricted entities list is a critical procedure that should be included in the firm's quality control system.

Contingent Fees

Firms were found to have provided services to clients based on a contingent fee. This type of fee arrangement creates a conflict of interest. Like indemnification clauses, it can compromise independence and is considered to be an act discreditable to the profession.

Mutual Interest – Unpaid Fees

Firms failed to collect (material) unpaid fees from the client prior to beginning work on the subsequent year's audit. Unpaid fees may pose a threat to independence, depending on the significance of the fee, the length of time the fees have been due, and the client's commitment and ability to pay the unpaid fees.