

Many different circumstances (or combinations of circumstances) can create threats to an auditor's independence. It is impossible to identify every situation that threatens independence. However, seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed. They are (1) self review (auditors reviewing the results of their own nonattest work); (2) advocacy (actions by the auditor to promote the client's interests or position); (3) adverse interest (actions or interests between the auditor and the client that are in opposition); (4) familiarity (auditors having a close or long-standing relationship with an attest client); (5) undue influence (attempts by the client's management to coerce or exercise excessive influence over the auditor); (6) financial self-interest (potential benefit to the auditor from a financial interest in, or from some other financial relationship with the client); and (7) management participation (the auditor taking the role of client management or performing management functions on behalf of the client).¹⁶

SEC Independence Standards

The SEC's independence rules are set forth in Rule 2-01 of Regulation S-X (Rule 2-01).¹⁷ Rule 2-01 was amended in January 2003 by Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*, to fulfill the mandate of Title II of the Sarbanes-Oxley Act of 2002. To assist practitioners in comply-

ing with the SEC's independence rules, the SEC's Office of the Chief Accountant has also issued and periodically updates a document titled *Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions*.

Unlike the AICPA's independence rules, the SEC's independence rules provide that an accountant is not independent if, at any point during the audit and professional engagement period,¹⁸ the accountant provides any of the following nonaudit services to an audit client:

- 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;
- Management functions;
- Human resources services;
- Broker-dealer, investment adviser, or investment banking services;
- Legal services; or
- Expert services unrelated to the audit.

The SEC's rules state that bookkeeping, financial information systems design and implementation, appraisal or valuation services, actuarial services, and internal audit outsourcing services

¹⁶ ET Section 100.01, Conceptual Framework for AICPA Independence Standards, paragraphs 12 to 19.

¹⁷ See 17 CFR 210.2-01.

¹⁸ Under Rule 2-01(f)(5), the audit and professional engagement period includes both: (1) the period covered by any financial statements being audited or reviewed (the "audit period"); and (2) the period of the engagement to audit or review the audit client's financial statements to prepare a report filed with the SEC (the "professional engagement period"). The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and the professional engagement period ends when the audit client or the accountant notifies the SEC that the client is no longer that accountant's audit client.

are prohibited “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.”¹⁹ This limited exception to the general prohibition regarding nonaudit services is quite narrow in the SEC’s view, establishing a rebuttable presumption that these services are subject to audit procedures. In other words, the SEC presumes that, when an accountant audits an audit client’s financial statements, the accountant will end up auditing the work he or she performed when rendering the aforementioned nonaudit services for the audit client.

Like the AICPA’s independence rules, the SEC’s independence rules do not purport to consider all circumstances that raise independence concerns. In this regard, the SEC considers whether a relationship or the provision of a service (a) creates a mutual or conflicting interest between the accountant and the audit client (b) places the accountant in a position of auditing his or her own work (c) results in the accountant acting as management or an employee of the audit client or (d) places the accountant in a position of being an advocate for the audit client.

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 SEC will consider all relevant circumstances, including relationships between the accountant and the audit client, and not just those relating to reports filed with the SEC.

PCAOB Independence Standards

Title I of the Sarbanes-Oxley Act of 2002 established the PCAOB and charged it with the responsibility of overseeing the audits of public companies that are subject to the U.S. Federal securities laws. Only accounting firms that register with the PCAOB (registered public accounting firms) may audit public companies. The PCAOB’s duties include the establishment of auditing, quality control, ethics, independence, and other standards relating to public company audits.

The PCAOB adopted all of the independence standards described in the AICPA’s Code of Professional Conduct Rule 101, and the interpretations and rulings thereunder, as in existence on April 16, 2003, as the PCAOB’s Interim Independence Standards. These Interim Independence Standards also include Standards Nos. 1, 2, and 3 and Interpretations 99-1, 00-1, and 00-2 of the former Independence Standards Board. Generally, this means that the PCAOB applies the independence standards/principles discussed under the “AICPA Independence Standards” section of this article to registered public accounting firms.

The PCAOB’s Interim Independence Standards do not supersede the SEC’s auditor independence rules. Therefore, to the extent that a provision of the SEC’s rules is more or less restrictive than a provision of the PCAOB’s Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

The PCAOB’s interim standards will remain in effect until modified or superseded, either by PCAOB action approved by the SEC, or by SEC action pursuant to its independent authority under the Federal securities laws to establish independence standards for auditors of public companies.

¹⁹ See Rule 2-01(c)(4)(i) through (v) of SEC Regulation S-X (17 CFR 210-01).

Recent Developments in Auditor Independence

Recent AICPA Developments

On September 8, 2006, the AICPA's Professional Ethics Executive Committee (PEEC) re-exposed its Proposed Interpretation 101-16 under Rule 101: Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters. The comment period for the revised Exposure Draft (ED) ended on December 8, 2006. The AICPA's initial ED on this subject was issued on September 15, 2005.

The revised ED is significantly different from the September 2005 ED. The revised ED has an underlying principle that would permit external auditors to include indemnification and limitation of liability provisions in audit engagement letters if such provisions are contingent upon the related services being performed in compliance with professional standards, in all material respects. However, the revised ED would also permit certain indemnification and limitation of liability provisions to be included in audit engagement letters and not be subject to the underlying principle. For example, under the revised ED, the audit client could waive the right to seek punitive damages and indemnify the auditor for third-party punitive damage awards, the time period for the client to file a claim for damages could be limited, and the client's right to assign or transfer a claim could be limited.

On February 3, 2006, the Federal banking agencies, together with the National Credit Union Administration, issued an Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement

Letters.²⁰ The Interagency Advisory applies to audit engagement letters executed on or after February 9, 2006, and provides that the inclusion of indemnification and limitation of liability provisions in external audit engagement letters will generally be considered an unsafe and unsound practice. Appendix A of the Interagency Advisory contains examples of unsafe and unsound limitation of liability provisions.

While the Interagency Advisory addresses indemnification and limitation of liability from a safety and soundness perspective, rather than from an auditor independence perspective, it is fairly consistent with the PEEC's September 2005 ED. However, the PEEC's September 2006 revised ED is generally inconsistent with its September 2005 ED and the Interagency Advisory.

Recent PCAOB Developments

On April 19, 2006, the SEC approved the PCAOB's proposed ethics and independence rules concerning independence, tax services, and contingent fees. These rules have varying effective dates, most of which are in 2006.

Besides establishing general rules with respect to ethics and independence, these new PCAOB rules restrict certain types of tax services a registered public accounting firm may provide to an audit client and certain members of the client's management, and prohibit contingent fee arrangements for any services a registered public accounting firm provides to an audit client, in order for the firm to maintain its independence with respect to that client. Nonpublic financial institutions subject to Part 363 of the FDIC regulations or Section 562.4 of the OTS regulations and their auditors

²⁰ FIL-13-2006, External Audit Engagement Letters: Unsafe and Unsound Use of Limitation of Liability Provisions, February 9, 2006, www.fdic.gov/news/news/financial/2006/fil06013.html. Also see the February 3, 2006, Joint Press Release, www.fdic.gov/news/news/press/2006/pr06011.html and the *Federal Register*, Volume 71, Page 6847, www.fdic.gov/regulations/laws/federal/2006/06notice29.pdf.

should note that these new independence rules from the PCAOB apply to institutions' external auditors.

Examiner Considerations

Auditor independence is the cornerstone for CPAs and audit firms that provide audit/attestation services to financial institutions. Sometimes concerns regarding an auditor's independence with respect to a specific audit client are "black and white" and a decision as to whether the auditor's independence is impaired can be reached rather easily. However, many times, the resolution of concerns regarding auditor independence requires a thorough and complete analysis of all of the relevant facts and circumstances before a conclusion can be made. In the end, ensuring auditor independence is a responsibility of both the auditor and the client financial institution.

Accordingly, as noted in the February 2006 Interagency Advisory and the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, examiners should consider an institution's policies and processes surrounding its external auditing program, including those for determining whether the auditor maintains appropriate independence in its relationship with the institution under applicable professional standards, when they evaluate the institution's program. Examiners should also review external audit engagement letters to determine whether they include any limitation of liability provisions of the types that are deemed unsafe and unsound by the Interagency Advisory.

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Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) or Financial Institution Letter (FIL) designations are included so the reader may obtain more information.

Subject	Summary
Comments Requested on Proposed Illustrations of Consumer Information for Nontraditional Mortgage Product Risks (PR-93-2006, October 18, 2006; FIL-90-2006, October 5, 2006; and Federal Register Vol. 71, No. 192, p. 58672, October 4, 2006)	The FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Federal financial regulatory agencies) sought comment on proposed <i>Illustrations of Consumer Information for Nontraditional Mortgage Product Risks</i> (the illustrations). The illustrations were intended to assist institutions in implementing the consumer protection portion of the <i>Interagency Guidance on Nontraditional Mortgage Product Risks</i> . Comments were due December 4, 2006.
Final Rule Issued to Provide One-Time Assessment Credits to Insured Institutions (PR-91-2006, October 10, 2006; FIL-93-2006, October 18, 2006; and Federal Register Vol. 71, No. 201, p. 61374, October 18, 2006)	The FDIC issued the final rule to implement the One-Time Assessment Credit, as required by the Federal Deposit Insurance Reform Act of 2005. Under this rule, eligible institutions will share in an aggregated one-time deposit insurance assessment credit of \$4,707,580,238.19. The final rule took effect November 17, 2006.
Final Rule Issued on Assessment Dividends (FIL-92-2006, October 18, 2006; and Federal Register Vol. 71, No. 201, p. 61385, October 18, 2006)	The FDIC issued the final rule to implement assessment dividends, as required by the Federal Deposit Insurance Reform Act of 2005. The Act generally requires the FDIC to pay dividends from the Deposit Insurance Fund (DIF) to insured institutions when the DIF reserve ratio at the end of a calendar year exceeds 1.35 percent. The final rule takes effect January 1, 2007.
Interagency Guidance Issued on Non-traditional Mortgage Product Risks, and an Addendum to Credit Risk Management Guidance for Home Equity Lending Issued (PR-86-2006, September 29, 2006; FIL-89-2006, October 5, 2006; and Federal Register Vol. 71, No. 192, p. 58609, October 4, 2006)	The Federal financial regulatory agencies issued <i>Interagency Guidance on Nontraditional Mortgage Product Risks</i> and an <i>Addendum to the Credit Risk Management Guidance for Home Equity Lending</i> . These documents describe how financial institutions should both address the risks associated with underwriting nontraditional mortgage loan products and provide consumers with clear and balanced information before they make a product or payment choice.
Final Rule Issued Covering Changes to Deposit Insurance Coverages (FIL-83-2006, September 18, 2006; and Federal Register Vol. 71, No. 176, p. 53547, September 12, 2006)	The FDIC Board of Directors permanently adopted the final rule implementing provisions of the Federal Deposit Insurance Reform Act of 2005 pertaining to deposit insurance coverage. The final rule took effect October 12, 2006.
Comments Requested on a Proposed Rule on Risk-Based Capital Standards: Market Risk (PR-82-2006, September 5, 2006; FIL-87-2006, September 25, 2006; and Federal Register Vol. 71, No. 185, p. 55958, September 25, 2006)	The FDIC, Federal Reserve Board, OCC, and OTS (collectively, the Federal bank and thrift regulatory agencies) jointly issued a notice of proposed rulemaking (NPR) on possible modifications to the risk-based capital standards for market risk. The proposed rule would incorporate improvements to the current trading book regime as proposed by the Basel Committee on Bank Supervision and the International Organization of Securities Commissions in the joint document <i>The Application of Basel II to Trading Activities and the Treatment of Double Default Effects</i> , published in July 2005. The proposed rule would also apply to certain savings associations, which currently are not covered under the rule. The FDIC will accept comments on the NPR through January 23, 2007.

Regulatory and Supervisory Roundup

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Comments Requested on a Proposed Rule on Risk-Based Capital Standards: *Advanced Capital Adequacy Framework* (PR-82-2006, September 5, 2006; FIL-86-2006, September 25, 2006; and *Federal Register* Vol. 71, No. 185, p. 55830, September 25, 2006)

The Federal bank and thrift regulatory agencies jointly issued and sought comment on an NPR concerning the domestic application of selected elements of the Basel II capital framework. The proposed rule would require some core banks, and permit other banks, to use an internal ratings-based approach to calculate regulatory credit risk capital requirements and an advanced measurement approach to calculate regulatory operational risk capital requirements. The FDIC will accept comments on the NPR through January 23, 2007.

Comments Requested on Wide-Ranging Issues Related to Industrial Loan Companies (PR-77-2006, August 17, 2006; FIL-79-2006, August 29, 2006; and *Federal Register* Vol. 71, No. 163, p. 49456, August 23, 2006)

The FDIC sought public comment on wide-ranging issues involving industrial loan company charters. Comments were due by October 10, 2006.

Frequently Asked Questions Published Regarding Authentication in an Internet Environment (FIL-77-2006, August 21, 2006)

The Federal Financial Institutions Examination Council (FFIEC) published frequently asked questions to assist financial institutions and their technology service providers in conforming to the FFIEC guidance entitled *Authentication in an Internet Banking Environment*, which was issued on October 12, 2005.

Revised *Bank Secrecy Act/Anti-Money Laundering Examination Manual* Released (FIL-71-2006, August 2, 2006)

The FFIEC released a revised *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual* on July 28, 2006. The manual can be accessed on the FFIEC BSA/AML InfoBase at http://www.ffiec.gov/bsa_aml_infobase/default.htm.

Revisions Issued to the FDIC Statement of Policy Regarding the National Historic Preservation Act (FIL-70-2006, August 1, 2006; and *Federal Register* Vol. 71, No. 143, p. 42399, July 26, 2006)

The FDIC revised its Statement of Policy (SOP) Regarding the National Historic Preservation Act of 1966. The purpose of the SOP is to inform affected parties of the FDIC's practices in applying the requirements of the National Historic Preservation Act and its implementing regulations. The SOP is relevant to applications for deposit insurance for de novo institutions, applications for establishment of domestic branches, and applications for the relocation of domestic branches or main offices.

Comments Requested on Proposed Deposit Insurance Rules (PR-70-2006, July 11, 2006; FIL-65-2006, July 25, 2006; and *Federal Register* Vol. 71, No. 141, p. 41910, July 24, 2006)

The FDIC sought comment on three proposed rules. The first proposed rule would create a new system for risk-based assessments. The second proposed rule would set the designated reserve ratio at 1.25 percent. The third proposed rule would govern the penalties for failure to pay assessments. Comments on the first two proposed rules were due September 22, 2006; comments on the third proposed rule were due September 18, 2006.

Comments Requested on Proposed Guidelines for Identity Theft Procedures (PR-71-2006, July 18, 2006; FIL-64-2006, July 18, 2006; and *Federal Register* Vol. 71, No. 137, p. 40786, July 18, 2006)

The Federal financial regulatory agencies and the Federal Trade Commission requested public comment on the proposed regulation to implement sections 114 and 315 of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act). The proposed regulation would require financial institutions and creditors to adopt reasonable policies and procedures to indicate the possible existence of identity theft and to validate addresses under certain circumstances. Comments were due September 18, 2006.

<p>Revisions Issued to the Uniform Standards of Professional Appraisal Practice (FIL-53-2006, June 23, 2006)</p>	<p>The Federal financial regulatory agencies issued a statement notifying regulated institutions of the Appraisal Standards Board's issuance of the 2006 version of the Uniform Standards of Professional Appraisal Practice. These changes were effective July 1, 2006.</p>
<p>Guidance Issued on Managing Risks in Relationships with Foreign-Based Third-Party Service Providers (FIL-52-2006, June 21, 2006)</p>	<p>The FDIC issued guidance to address the risks inherent in outsourcing relationships between U.S. financial institutions and foreign-based third-party service providers. The guidance outlines steps institutions should take to manage reputational, operational/transactional, compliance, strategic, and country risks.</p>
<p>Standard Flood Hazard Determination Form Updated (FIL-51-2006, June 21, 2006)</p>	<p>The FDIC notified FDIC-supervised institutions that the Federal Emergency Management Agency had issued a revised Standard Flood Hazard Determination Form, which included a new Office of Management and Budget control number and a revised expiration date of October 31, 2008. The form's format and content have not changed. Institutions were required to use the updated form beginning July 1, 2006.</p>
<p>Booklet Issued to Institutions on Lessons Learned from Hurricane Katrina (FIL-49-2006, June 15, 2006)</p>	<p>The FFIEC and the Conference of State Bank Supervisors jointly issued a booklet of the lessons that financial institutions learned in the aftermath of Hurricane Katrina. Institutions can use the booklet in preparing to respond to a catastrophic event. The booklet can be found at http://www.fdic.gov/regulations/resources/lessons/index.html.</p>
<p>Examination Procedures Issued for New Regulations on Medical Information (FIL-47-2006, May 25, 2006)</p>	<p>The FFIEC Task Force on Consumer Compliance issued examination procedures to assess compliance with the medical information regulations that became effective on April 1, 2006. The regulations implement the Protection of Medical Information provisions of the Fair Credit Reporting Act, as amended by the FACT Act. The new procedures were effective May 25, 2006.</p>
<p>Comments Requested on a Revised Statement Concerning Elevated Risk in Complex Structured Finance Activities (PR-44-2006, May 9, 2006; FIL-45-2006, May 16, 2006; and <i>Federal Register</i> Vol. 71, No. 94, p. 28326, May 16, 2006)</p>	<p>The Federal bank and thrift regulatory agencies and the Securities and Exchange Commission requested public comment on a revised proposed statement on the complex structured finance activities of financial institutions. The revised statement describes the types of internal controls and risk management procedures that should help financial institutions identify, manage, and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions. Comments were due June 16, 2006.</p>
<p>Comments Requested on Access to Banking Services by Money Services Businesses (FIL-37-2006, May 2, 2006; and <i>Federal Register</i> Vol. 71, No. 47, p. 12308, March 10, 2006)</p>	<p>The FDIC notified FDIC-supervised institutions that the Department of the Treasury's Financial Crimes Enforcement Network had issued a request for public comment on an Advance Notice of Proposed Rulemaking regarding the impact of Bank Secrecy Act regulations on the ability of money services businesses to open and maintain accounts and obtain other banking services at banks and other depository institutions. Comments were due July 9, 2006.</p>

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