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## Introducing the Independence Standards Board, OCC/FDIC/FRB Bank Accounting Seminar, September 16,1998

Richard H. Towers

Independence Standards Board

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**INTRODUCING THE  
INDEPENDENCE STANDARDS BOARD**

**Richard H. Towers  
ISB Technical Director**

**September 16, 1998  
OCC/FDIC/FRB Bank Accounting Seminar  
Arlington, VA**

# INDEPENDENCE STANDARDS BOARD

## BACKGROUND, ORGANIZATION, MISSION AND GENERAL OPERATION

### Introduction (Slide 1)

Thank you for your welcome to the Washington area and, as my part of this session, I am eager to introduce you to the activities of the Independence Standards Board. However, as is customary, I need to remind you that my comments today reflect solely my personal views and not necessarily those of the Board.

My comments will be divided into two segments. The first half will be background – matters of organization, mission, and general operation. The second half will be about our activity to date and where we're headed.

The ISB is a new standard-setter, only having held its organizational meeting on June 30, 1997, and having hired its first employee last

October 20th. Further, the SEC's Financial Reporting Release 50, officially "empowering" us, only was issued on February 18th. The Board came into being because both the SEC and the accounting profession have long wanted a better conceptual framework for independence rules for auditors of public companies.

(Slide 2) So why might a better conceptual framework be needed?

Since the federal securities laws were enacted in the 1930's, the independence rules have evolved in a piecemeal fashion, with no clear underlying set of principles. There are now more than 200 pages of published rules, interpretations and "no-action" letters of the SEC and its staff. These are supplemented by another 50 pages of rules, interpretations and ethics rulings of the AICPA.

The absence of clearly articulated principles, however, means that the rules often can not be used to analogize by those seeking guidance for new situations. And there are many new kinds of situations. These would include financial applications of new technologies, the expanding scope of services offered by accounting

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firms including outsourcing, the generally shrinking relative size of the audit practice compared to the size of the total firm, and the prevalence of “teaming arrangements” in the economy.

In addition, the present rules generally assume that “one size fits all” – but what is appropriate for a 10-person firm in one small city is not necessarily appropriate for a firm of 20,000 people spread across the country. Finally, the multitude of detailed independence rules would eventually make it difficult to harmonize U.S. independence requirements with those of other nations.

However - and importantly - despite its shortcomings, the current system has worked. Investors are comfortable in relying on published financial statements in large part because they have confidence in the integrity and objectivity – and in the *independence* – of the auditor. Therefore, before we discard what we have, we must have confidence in that with which we are replacing it – a framework which *better* protects the public interest.

In developing its new framework and in its other activities, the Board's express intent is to "encourage broad public participation" and to "stimulate constructive public dialogue." This emphasis on *public* involvement is not accidental. It is consistent with our objectives and mission.

### **Objective and Mission (Slide 3)**

The Board's formal Operating Policies clearly define its objectives and mission. We are "to establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets." (Slide 4) Our five specific charges are as follows:

1. First, at inception, to adopt as our standards, the existing guidance of the SEC. This was done at the Board's first meeting, and you should not expect significant change in the short term.

2. To develop a conceptual framework to “serve as the foundation for the development of principles-based independence standards.” (As an aside, one of the key reasons we believe in the need for a principles-based approach is to provide a better basis in the future for analogizing to new situations and developing consistent rules.)
  
3. To promulgate standards and review and ratify, as appropriate, consensuses of the Independence Issues Committee (known as the “IIC”) and interpretations of the ISB staff. I’ll explain more about the operations of the IIC and the staff in a few minutes.
  
4. To develop a process, including utilizing the IIC, for identifying emerging issues for guidance and resolution.

5. And lastly, to provide a consultative function for practitioners and registrants who have questions about independence standards.

### **The Board (Slides 5 & 6)**

The Board itself is comprised of eight members - four from the public and four from the accounting profession. The names of the members and their affiliations are shown on the slide. William Allen, the Chairman, was for twelve years the Chancellor of the Court of Chancery in Delaware, that is, the head of what is generally recognized as the most important business court in the country. In addition, the Chief Accountant of the SEC has observer status at all Board meetings. This group of prominent individuals has the experience and senior status to place proper emphasis on achieving the Board's mission.

The Board is an independent body. While it is funded by the AICPA SEC Practice Section, it sets its own budget and operates autonomously.



(Slide 7) In that respect, and in the openness of its processes, it is very similar to the FASB. The ISB, for example, also is required to issue exposure drafts of any planned pronouncements, and will issue invitations to comment and hold public hearings when warranted. The Board also expects to sponsor research for its education, and will look for neutral analysis of subjects presented for possible Board consideration and action.

In addition, the Board's deliberative processes are conducted "in the sunshine," and you are welcome to attend its meetings or to listen by telephone. The next meeting, by the way, is November 3 in New York.

### **The ISB Staff**

The ISB professional staff presently consists of me as Technical Director, Art Siegel as Executive Director and Sue McGrath, plus Susan Lange as administrative assistant. We will consider further

increases when warranted by the work level. The Board and staff addresses, telephone numbers, etc., are published on the website.

The staff's role generally is two-fold. First, we support the Board and the IIC in the development of standards and all their other missions. And second, we receive and respond to inquiries from practitioners as described under FRR – 50.

While informal inquiries may be made by telephone, and I've already had one from one of your organizations, formal consultation requests must be submitted in writing. This is to ensure that we have a complete and agreed-upon understanding of the issues. Only written requests and responses may be relied upon for SEC purposes and then only by the parties involved. The SEC will not treat a response as authoritative for others until ratified by the Board.

We have developed an inquiry form that is available on our website and which the SEC Practice Section has sent to all its 1300 member firms.

To minimize overlap, the staff also is working with the AICPA and its Professional Ethics Executive Committee, which will continue to provide independence guidance for auditors of all entities. We also are coordinating with NASBA, the National Association of State Boards of Accountancy, and with international independence standard-setters.

The staff maintains a public file of all appropriate documents, including minutes of meetings. However, the best source of ISB information is our website, which I'll describe later.

### **The IIC**

The Independence Issues Committee is comprised of eight members from the profession, whose names and information also are published on the website. Until the August 31 Board meeting it had nine members, but that was reduced to reflect the

PricewaterhouseCoopers merger. Art Siegel serves as the Committee's non-voting Chairman, and, just as at EITF, the SEC chief accountant or his designee serves as an observer. The Committee also operates in public, and its next meeting is October 13, in New York.

(Slide 8) The defined mission of the IIC is:

1. First, to timely identify and discuss emerging independence issues within the framework of existing authoritative literature.
2. To address broader interpretative issues, including those that emerge from inquiries to the ISB staff, and communicate its consensuses to the Board and the public.  
And lastly,
3. To conduct research. Here we mean practical research, not technical types of research performed by academics.

Although the IIC will use issue summaries and publish minutes and consensuses, just as the EITF does, there is a key difference. Unlike the EITF, an IIC consensus will not become “substantial authoritative support” in the eyes of the SEC staff, unless and until it is ratified by the ISB.

### **FRR – 50 (Slide 9)**

Some of you will remember that in 1973, after the FASB was formed, the SEC issued Accounting Series Release 150 which, in effect, delegated accounting standard-setting authority to the FASB. Under the agreement leading to the formation of the ISB, the SEC on February 18th issued a similar pronouncement – Financial Reporting Release 50 — empowering us to act. The full FRR is on our website.

The Release states that the SEC intends to look to the ISB “for leadership in establishing and improving auditor independence regulations applicable to the auditors of the financial statements of

Commission registrants, with the expectation that the ISB's conclusions will promote the interests of investors." There's no doubt of the SEC orientation here.

The SEC also in the Release provided some insight into its reasoning for participating in forming the ISB. Many of these reasons are the same as we discussed upfront in support of developing a new conceptual framework, and the SEC acknowledged that some existing SEC regulations may "not provide obvious guidance" in today's business environment. The SEC's bottom line is that they agree that an "update of the Commission's regulations may be in order."

The FRR makes it abundantly clear that the SEC retains its existing authority to set independence standards. It is my personal hope, however, that most of any differences of view which will arise with the SEC can be resolved through the SEC's timely oversight of, and participation in, our ISB processes. The Commission, of course, still

can bring enforcement actions, and state disciplinary authorities still have their power, as do you banking regulators.

The SEC requires auditors to have “substantial authoritative support” for their independence positions. ISB principles, standards, interpretations and practices are recognized as having such substantial authoritative support, but views contrary to ISB positions are not.

The FRR also notes that when ISB activity changes existing SEC guidance, the SEC will consider modifying or withdrawing its conflicting guidance. In this respect, the SEC’s relationship with the ISB differs somewhat from that with the FASB as, on a relative basis, the SEC generally has more independence rules to be amended than it does detailed accounting rules.

The SEC also states that it will review the ISB’s operations within five years, especially considering changes occurring within the profession.

## **ACTIVITY TO DATE**

Now, I want to move into the matters which more likely will directly interest you – what the Board has been doing and intends to do.

Let's start with the ISB itself.

### **ISB**

1. The ISB has had a number of educational presentations, including an address by Arthur Levitt, Chairman of the SEC. These have been helpful in informing the Board – especially the public members – of the environment, and the complexities, of auditor independence. As an aside, it seems to me that education of the public with regard to the Board's new rules as they evolve is an important ancillary objective.

Note also that the Board, through its Research Task Force, may be considering independence research, possibly both on a focus group basis and as to an empirical study of present and past disclosures of non-audit services.



2. (Slide 10) Likely the most prominent - and controversial - component of the early educational effort was the submission by the accounting profession last October of its 300-page White Paper entitled: "Serving the Public Interest: A New Conceptual Framework for Auditor Independence."

Without going into detail, the White Paper proposed use of a conceptual framework for independence with three core principles, development of guidelines identifying independence threats and safeguards, and firm codes to implement the guidance in a particular practice. While the Board decided not to expose the White Paper for public comments, the ideas from that Paper, and from the related SEC staff comments, undoubtedly will be considered as the ISB deliberates its current projects.

### **Current ISB Projects (Slide 11)**

Now let's spend a few minutes reviewing the four active projects of the ISB.

- Development of a Conceptual Framework for Independence
- Partners and Staff Being Employed by Audit Clients
- The Effect of Family Relationships on Independence, and

- Annual Independence Confirmation to Clients.

### **On the Road to a Conceptual Framework (Slide 12)**

Presumably, the most important project on the Board's agenda – really its reason for existing – is the conceptual framework. The Board has recently hired Professor Henry Jaenicke of Drexel University as a consultant project director, and has formed a broad-based project task force. This advisory task force will meet on October 29th, and has representatives from the user community, such as institutional investors and financial analysts, the profession, directors, academe and corporations.

The Board's objective is first to develop a neutral discussion memorandum for Board consideration, although this DM may express some tentative views on some of the issues that are integral to the development of the conceptual framework. After Board consideration and approval, current plans are to expose the discussion memorandum for public comment. With that input, the Board would then deliberate on the contents of a conceptual framework with the goal of issuing an exposure draft, again for public comment. At each stage of this process the Board would consider whether public hearings also should be held. After all of that, the Board would then again deliberate and conclude on the contents of the conceptual framework.

Let me share with you some early thinking on the possible contents of a conceptual framework.

### **Conceptual Framework – Issues to Consider (Slide 13)**

As can be expected, there are many issues that need to be considered. Among those identified so far are:

- The investor's need for credible financial statements
- The objectives of independence
- The relationship of independence to objectivity and integrity. This presumably will include a definition of independence. This is not as easy as it sounds, and will include considering whether auditor independence is to relate primarily to the client company or to the information being audited.
- If there is a "reasonable investor" test, how that theoretical person might be defined.

### **Factors to be Considered in Setting Standards (Slide 14)**

- Also, what factors should be considered in setting independence standards? For example:
  - Can costs and benefits, if they can be measured, be considered?
  - Can threats to independence be satisfied by firm-specific safeguards, or compensating controls, and if so, when?
  - When should the appearance of impaired independence be a factor, and how should that be determined?

- Is materiality a consideration in reaching – or applying – independence standards, and if so, how should it be measured?
- What does “mutuality of interests” mean and when might it properly be considered a threat to independence?

### **Additional Issues to Consider (Slide 15)**

Additional issues that may need to be considered are:

- What is the role of firm codes of conduct and cultures?
- What role, if any, in maintaining independence is properly assigned to corporate officers and directors, including the audit committee? This is the “corporate governance” link.
- What role should be played by the profession’s overseers. This would include the SEC, the Public Oversight Board, the state boards of accountancy, the AICPA , and your organizations.

As can be seen, the conceptual framework is the most basic and important issue facing the Board. It also is complex and multi-faceted, and we should not expect any final conclusions for probably two years or so. When it is completed, it will not, of itself, “answer” independence questions, but it should logically lead to the process to consistently determine their answers.

### **Employment with Audit Clients**

In order to benefit from cross-development of projects and to move ahead as timely as possible, the Board has chosen to proceed with

several other projects on a parallel track to the development of the conceptual framework. Let's first review the issues related to the project on Partners and Staff joining audit clients. (Slide 16)

The concerns expressed when professionals leave firms to join audit clients generally are threefold:

- First, that members of the audit team, who may have been friendly with, or respectful of a former partner or professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept a client's proposed accounting without exercising appropriate objectivity and skepticism.
- Second, in situations where partners or other audit team members resign to accept positions with audit clients, questions may be raised regarding whether the individuals exercised an appropriate level of skepticism during the audit process prior to their departure.
- And finally, that the departing partner or professional may be familiar enough with the firm's audit approach and testing strategy so as to be able to circumvent its design.

In developing guidance, there are additional issues that need to be considered (Slide 17):

- What effect do the previous audit responsibilities of the individual going to the client have on independence concerns?

Responsibilities could vary from being the engagement partner or manager, tax partner or the concurring reviewer. Also, what if a “nationally prominent” partner joins the audit client?

- Does it make any difference as to whether a partner leaves the audit firm by normal retirement or withdraws prior to being eligible for retirement? What effect would termination by the firm have?
- What types of positions at the audit client would cause independence concerns? For example, should employment as a Chief Information Officer cause similar concerns to those of employment as Chief Financial Officer?

Generally, proposed solutions to this contentious issue center either around (Slide 18):

- Establishment of safeguards or mitigating controls by the audit firm, or
- Establishment of a mandated cooling-off period – specifying some period of time for which independence would be considered to be impaired – thus forcing the client to engage a new auditor if the partner is hired in the planned role.

There is a strong polarization of views between these two choices and, at least at first glance, there seems to be no easy way to meld the choices into a compromise answer. Therefore, this is expected to be a difficult issue to resolve.

Now, let’s consider the type of safeguards (Slide 19) an audit firm could establish in a situation where a partner leaves the firm to join

an audit client. Obviously, the types of procedures need to be tailored to the position of the former partner, but the audit firm can:

- If an offer is made, immediately remove the individual from the engagement. (This already is an AICPA independence rule.)
- If employment with a client is accepted, require an in-depth review of prior work to assess the individual's objectivity.
- Review the staffing of the engagement and subject the subsequent audit to an in-depth review to ensure that the remaining audit team members have not been unduly influenced by the departing individual.

A related sub-issue (Slide 20) that may affect a firm's independence relates to the financial interests of the departing partner. When a partner retires, or even before, there may be financial obligations between the firm and the partner – for example, final profit sharing, retirement benefits and repayment of capital. Depending on the particular partnership agreement, these issues can be complex and can have serious tax implications. Depending on the new position of the partner, the SEC, and the AICPA in certain instances, have held that the existence of a financial interest between the departing partner and the audit firm would impair a firm's independence, because of a perceived too-strong continuing relationship with the firm. The issue clearly has to be studied to determine the types of situations in which a continuing financial interest would create a threat to independence.

The Board also has created a broad-based project task force on this topic, which will meet on October 6th, with the goal of helping to prepare a discussion memorandum examining all viewpoints on the issues. The DM will be exposed for public comment, and presumably lead through the public process to the issuance of an exposure draft and, eventually, an ISB independence standard.

### **Family Relationships**

Let's now discuss the family relationships issue (Slide 21).

There presently are circumstances involving an auditor's family relationships that are deemed to impair the auditor's independence.

For example:

- An auditor cannot own stock in a client, and neither can the auditor's spouse or dependent children.
- Also, an auditor cannot audit his or her own work. Since the activities of an auditor's spouse are attributed to the auditor, he or she cannot audit financial statements prepared by his or her spouse.

In concept, the notion of attributing direct family relationships to the auditor makes sense – the auditor can directly or indirectly benefit from the actions of his or her immediate family. But there are new stresses on the operation of the existing rules. For example, (Slide 22)



- What constitutes a family relationship? The notion of a close family has evolved. This includes parents, siblings, in-laws and co-habitants. Does it continue to make sense for independence to be impaired, for example, for actions of a spouse's brother's wife?
- The notion of "who is the auditor" has evolved. Firms operate through different organizational structures than in the past. In addition to audit engagement teams, often many others in different firm divisions provide professional services to the client. Also, chain-of-command management, and technical and industry leaders, may influence a particular engagement – yet most firm personnel have no direct relationship to the engagement. Is the entire firm "the auditor"?
- In this age of instant communications, do the previously applied "geographic separation" rules continue to be appropriate?
- Finally, the success of women in business has increased the number of employment-related family relationship questions.

Here are some of the complex issues that need to be considered

(Slide 23):

- Should considerations be different for those participating on an engagement vs. firm personnel not on an engagement? For that matter, who is considered to be "on an engagement"?
- What are "close family" relationships? Should the rules be rigid or flexible, and where should the lines be drawn?
- Do different rules for partners, managers and all other employees make sense?

- (Slide 24) Is geographic distance a mitigating control today, or is using the line of command better?
- Are there materiality considerations that need to be considered?
- Can “firewalls” within the auditing firm be effective?
- What is the best practice? What rules are in existence in other professions, government regulators, etc., and should the rules be conformed?

The Board also has created a broad-based project task force on family relationships, which will meet on October 9th. This task force will assist in preparing alternatives for deliberation by the Board with the objective of issuing an exposure draft for public comment.

### **Annual Independence Confirmation – Invitation to Comment**

The last Board project I want to discuss is one that is taking a faster track than the others and is one that you may already have seen. This is our Invitation to Comment 98-1 (Slide 25).

In an effort to enhance awareness of independence and the issues being faced by auditors, and to emphasize the role of auditor independence in the process of “corporate governance,” the Board proposed to recommend to the AICPA SECPS Executive Committee that they require member firms to confirm their independence annually to the audit committees or boards of their public clients – and offer to meet to discuss independence issues.

Input was sought by the ISB on a variety of matters in the Invitation to Comment, including (Slide 26):

- If adopted in this or another fashion, will the proposal help to focus additional attention on independence by audit committees and their auditors?
- Is there a better mechanism to accomplish this than that proposed by the Board?
- (Slide 27) Is there a cost of providing this independence confirmation, and, if so, do the benefits of an increased focus on independence outweigh that cost?
- The recommendation is being made to the SECPS Executive Committee. Is this the right venue – or should the recommendation be made to the Auditing Standards Board (or possibly both)?
- (Slide 28) When would be the best time to issue the required independence confirmation?

Our invitation to comment received 26 comment letters, and triggered a lively discussion at the Board's August 31st meeting. The significant majority of the letters were supportive, but both the SEC and the Public Oversight Board pushed strongly for the inclusion in the auditor's letter of more detailed – though likely not more "technical" – independence information, such as a brief discussion of

major independence issues considered by the firm, rather than simply a confirmation of independence. The idea is to increase the likelihood of substantive independence dialogue between the auditor and the audit committee, realizing that the SECPS does not have authority to mandate such discussions.

Concerns were expressed to try to keep the auditor's letter from becoming "rote communication" or "boilerplate." Under the original invitation to comment proposal, the concern was about the letter being too brief to convey significant value. And under the expanded version just described, a concern is that the topics selected for mention may come too much from a routine checklist, rather than from a careful analysis of the differing independence concerns of each engagement. Concerns also were expressed as to what degree of responsibility for auditor independence exists with the audit committee. The auditor must be independent under generally accepted auditing standards and SEC rules, but the client likely also has certain legal responsibilities regarding hiring an "independent accountant."

You might wonder why the ISB doesn't just issue its own standard on this matter, rather than requesting the SECPS to install it as one of its membership requirements. One reason is that, as a corporate governance matter, the proposed auditor letter is more a matter of "audit performance" than one where failure to issue the letter should be considered to "impair the auditor's independence." Also, while a small number of US public company auditors are not members of the SECPS, as well as foreign firms, present thinking is those firms likely also should be covered by a similar request to the AICPA's Auditing Standards Board, or by action of the SEC.

Therefore, the present status of this project is that the ISB staff will revise the proposal as just described, intended to send a stronger signal to audit committees. A revised draft is expected to be discussed at the Board's November 3rd meeting.

## IIC

1. Let's switch now to the Independence Issues Committee. The IIC has two additional task forces operating beyond those supporting the Board projects just described.

A. Materiality –The first is the materiality task force, which has for some months been analyzing a number of the more important aspects of materiality related to independence. The task force's work was just summarized, for informational purposes only, for the Board at its August 31st meeting. These materiality concepts may be worked into specific area projects, and I believe will be an important focus as the Board's work progresses, although this depends largely on reaction to the concept of materiality in the conceptual framework project. I do not necessarily see a separate independence standard on the horizon for "Materiality" per se.

B. Outsourcing – The other active IIC task force may be of more direct interest to you – it is the one on Outsourcing. As you know, the only independence literature so far directly on outsourcing is

the AICPA's Ethics Interpretation 101-13 on "Extended Audit Services" for internal auditing, and your related Interagency Policy Statement. The general purpose of this task force is to build background for the Committee and the Board as to the key types of outsourcing being provided (including, but specifically in addition to, internal auditing), and the issues involved in this dynamic area. Possible related threats to independence have been identified, as have certain safeguards and other circumstances that may mitigate those threats. While no proposal yet has been made, my personal speculation is that in the near future the IIC would recommend that the ISB add to its agenda a project on outsourcing.

2. In addition, two other areas recently have been identified for IIC discussion, through issue summaries.

A. "Alternative Practice Structures" - The first of these is known as the "Alternative Practice Structures" issue. As you may have seen in the recent financial press, American Express and several other corporations have become "consolidators" of the non-attest operations of small to middle-sized

accounting firms. Often the attest services remain in a separate firm owned by the CPAs, but they lease staff, facilities, etc. from the corporate entity. The AICPA's Professional Ethics Executive Committee also is addressing the independence aspects of these structures, primarily with respect to nonpublic clients, and several state regulators, including New York, have placed significant restrictions on this type of practice. But, as to SEC registrant clients, the IIC began discussions on September 8 to develop its own consensus for submission to the Board and has formed a new task force on the issue. The issue summary on this matter is available on our website, and the IIC is expected to continue its discussion during its October 13th meeting, including, possible presentations from some of the "consolidators."

- B. FAS 133 – Another matter expected to be studied by the IIC relates to FAS 133, "Accounting for Derivative Instruments and Hedging Activities." The subject of this project was intended to relate solely to the kind and level of assistance



that auditors can provide their audit clients in valuing derivatives as part of implementing FAS 133. However, discussion at last week's Committee meeting may lead to this project expanding to address "Valuations" in some more broad sense.

### **Staff of the ISB**

1. (Slide 29) Website – As to the ISB staff, we have had developed and made available an ISB website whose address is [www.cpaindependence.org](http://www.cpaindependence.org).

Our site contains much information about the ISB, and should be your primary source of reference for ISB matters. For example, it includes:

- (1) Our people and how to reach them
- (2) Our Operating Policies
- (3) Our meeting dates, agendas and minutes
- (4) Publications and speeches (and presumably, this speech will be entered)
- (5) Staff consultations

(6) The SEC's FRR – 50, and

(7) Future pronouncements, exposure drafts, issue summaries, and invitations to comment (such as our ITC-98-1)

Also, in the future, we expect to utilize a helpful electronic communication feature called "Document Express." After registering for one or more of a dozen topics, you would be electronically notified when new entries on these topics are posted to our website.

2. The staff also have been active responding to questions from practitioners. We've fielded over 50 informal questions on various topics, and we've entered a copy of one lengthy formal consultation on our website.

### **Conclusion**

In conclusion, we at the ISB know we have a major challenge ahead of us. However, this also is a unique opportunity.

I believe I can speak for the Board in encouraging all organizations, including yours, who have an interest in the subject of auditor

independence to fully participate in our processes. Only in that way can we be confident that we are best serving the public interest. And it is clear to me that an emphasis on the public good has been, and continues to be, in the best long term interests of the profession.

Thank you. And I'd be glad to respond to any questions you have after the other "Auditing Issues" presentation.

## INDEPENDENCE STANDARDS

### BOARD

Rick Towers

Technical Director

## What's wrong with the existing standards?

- Independence rules have evolved in a piecemeal fashion.
- Requirements cannot be used to analogize to new situations.
- Rules assume "one size fits all."
- Detailed requirements makes harmonization difficult.



## Mission of ISB

To establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets.

## The ISB's Specific Charges

- Adopt existing SEC guidance
- Develop conceptual framework
- Promulgate standards and ratify interpretations
- Develop process for identifying and resolving new issues
- Provide consultation function

## Board Members

**William T. Allen, Chairman**

Director, NYU Center for Law and Business

**John C. Bogle**

Senior Chairman, The Vanguard Group

**Stephen G. Butler**

Chairman and CEO, KPMG Peat Marwick LLP

**Robert E. Denham**

Partner, Mungler, Tolles & Olson LLP

**Manuel H. Johnson**

Co-Chairman and Senior Partner, Johnson Srnick International

**Phillip A. Laskawy**

Chairman and CEO, Ernst & Young LLP

**Barry C. Melancon**

President and CEO, AICPA

**James J. Schiro**

CEO, PricewaterhouseCoopers LLP

## Processes

- Operate “in the sunlight”
- Issue exposure drafts
- Consider use of invitations to comment and public hearings

## IIC Mission

- Identify new issues for Board consideration
- Interpret rules and publish consensus
- Conduct research

## The SEC’s Empowering Financial Reporting Release - FRR-50

## The Profession’s White Paper

“Serving the Public Interest:  
A New Conceptual Framework  
for Auditor Independence”

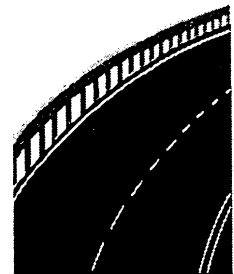
## Current ISB Projects

- Conceptual Framework
- Employment with Audit Clients
- Family Relationships
- Annual Independence Confirmation

## On the Road to a Conceptual Framework

Form Task Force with  
representatives from  
the user community

- institutional investors
- financial analysts
- the profession
- academe
- corporations



**Conceptual Framework**  
Issues to Consider

- The investor's need for credible financial statements
- The objectives of independence
- The relationship of independence to objectivity and integrity
- If there is a "reasonable investor" test, how that person might be defined

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**Conceptual Framework**

Factors to be Considered in Setting Standards

- Cost/benefit analysis?
- Safeguards?
- Appearance?
- Materiality?
- Mutuality of interests?

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**Conceptual Framework**  
Issues to Consider

- Role of firm codes of conduct and cultures?
- Role of corporate officers and directors, including the audit committee?
- Role of overseers?

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**Employment with Audit Clients**  
Concerns

- Audit team would be reluctant to challenge former professional.
- Exercise of skepticism during the audit, prior to departure.
- Departing professional's familiarity with audit approach.

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**Employment with Audit Clients**  
Other Issues

- Partners vs. professional staff.
- Partner retirement vs. withdrawal vs. termination.
- Position at client.

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**Employment with Audit Clients**  
Proposed Solutions



- Safeguards or mitigating controls.  
or
- Mandated "cooling-off" period.

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## Employment with Audit Clients Sample Safeguards

- Removal of individual from engagement until offer resolved.
- If employment with client accepted, in-depth review of prior work to assess objectivity.
- Subsequent audit subjected to in-depth review to ensure that remaining audit team not unduly influenced.

## Employment with Audit Clients Financial Interests - Balances/Benefits Owed to Former Partner



## Family Relationships Overall Concept

Circumstances or activities that impair the auditor's independence also create an impairment when ascribed to close family members.

- Auditor prohibited from owning client stock - so are auditor's dependent children.
- Auditor cannot audit his/her own work - cannot audit financials prepared by spouse.

## Family Relationships

What puts stress on the existing rules?

- Notion of "close family" has evolved.
- Notion of "who is the auditor" has evolved.
- Notion of "geographic separation" has been challenged.
- Success of women in business.

## Family Relationships Complex Issues Include:

- Degree of conflict with "on engagement" vs. "not on engagement" relationships. Who is "on the engagement?"
- What is "close family?" Where should the lines be drawn?
- Do different rules for partners, managers, and all other employees make sense?

## Family Relationships Complex Issues, Continued

- Is distance a mitigating control today, or is line of command better?
- How should materiality be applied?
- Can "firewalls" be effective?
- Should rules be conformed to other professions, government regulators, etc.? What is best practice?

## Annual Independence Confirmation ITC 98-1

Recommendation to SECPS to require members to confirm their independence annually to the audit committees or boards of their public clients.

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## Annual Independence Confirmation

Input sought on the following:



- Will proposal help foster additional attention on independence by audit committees and their auditors?
- Is there a better mechanism?

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## Annual Independence Confirmation

Input sought on the following:

- Do the benefits outweigh the costs?
- Should recommendation be to SECPS or the ASB, or both?



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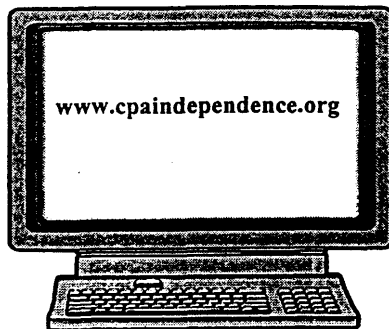
## Annual Independence Confirmation

Flexibility in timing of confirmation - can be delivered at any time during the audit:

- During the planning phase.
- As part of the SAS 61 report to the Audit Committee.

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## ISB Website



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## Questions?



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