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Independence Standards Board

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**INTRODUCING THE
INDEPENDENCE STANDARDS BOARD**

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INDEPENDENCE STANDARDS BOARD

BACKGROUND, ORGANIZATION, MISSION AND GENERAL OPERATION

Introduction (Slide 1)

Thank you for your welcome to Kansas, and 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 presentation, prior to Kurt Pany's discussion and the question period, will be divided into two segments. The first half will be background – matters-of-organization, mission, and general operation. The second half will be our activity to date, which has expanded significantly - including at Tuesday's Board meeting - since I wrote my brief advance paper. Therefore, be assured that we are now making progress on substantive matters.

The ISB is a new standard-setter, only having held its organizational meeting on June 30, 1997, and having hired its first employee on October 20. 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, even if they may have somewhat differing ideas about the content of that framework.

(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, as you know, many new kinds of situations. This would include application of new technologies to the manner in which companies generate financial data and financial statements, the expanding scope of services offered by accounting firms, the relative size of the audit practice to 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 all over the country. Finally, the multitude of detailed independence rules makes 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 – 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 August 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 general inquiries may be made by telephone, official 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 the specific 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 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 nine members from the profession, whose names and information also are published on the website. 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 June 15, 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 consensus to the Board and the public. And lastly,

3. To conduct research.

Although the IIC will use Issues 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 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 18 issued a similar pronouncement – Financial Reporting Release 50 — empowering us to act. The full FRR is on our website, and I encourage you to read it.

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 old 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.

The SEC will require 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 does not have as many detailed accounting rules to be amended, as it does independence 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 our activities to date, starting with the ISB.

ISB

1. The ISB has had a number of educational presentations, which have been helpful in informing the Board 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.
2. (Slide 10) Likely the most prominent - and controversial - component of the early educational effort was the submission by the accounting profession in October of its 300-page White Paper entitled: "Serving the Public Interest: A New Conceptual Framework for Auditor Independence."

A. Without going into detail, here's a capsule summary of the White Paper. It proposes:

- (1) A principles-based conceptual framework for independence – and three core principles are proposed.
- (2) Then, ISB would develop “guidelines” to explain those principles. These would identify possible related threats to independence and safeguards that could counter those threats.
- (3) Then, each firm would adopt a Code to implement the principles and guidelines in its practice environment; subject to ISB review and peer review.

B. The SEC staff, in response to an ISB request, issued a comment letter on the White Paper. That 18-page letter's bottom line was that it would have been premature for the ISB to request public comments on the White Paper. The SEC called for more research and, when exposure was appropriate, a more balanced document. While the staff found many of the Paper's proposals troublesome, they did not reject the overall approach out-of-hand.

C. The ISB debated the issues and decided against exposing the White Paper at that time, and instead established four Board task forces.

3. (Slide 11) In addition to a task force considering possible independence disclosures, the other ISB's task forces are:

A. First, a task force on Other Approaches to Requesting Public Comments – whose purpose is to consider whether, and if so how, to request public comments on the White Paper and/or related broad issues. Given the Board's recent entry into substantive projects at both the conceptual and specific topic levels, at Tuesday's Board meeting it was decided to seek public comments on a project-by-project basis, instead of in reaction to the White Paper itself or on some other global basis.

B. Another task force is the one on Research – which is to consider possible research projects that might be helpful to the Board's deliberations, and several have been considered. As with the Board's requesting of public comments, the Board appears headed toward research on an individual project basis. Katherine Schipper, a professor at the University of Chicago, has agreed to advise the Board and staff on research matters.

C. The last of the four task forces is on Corporate Governance – which is to consider increased involvement of client boards of directors and audit committees in auditor independence matters.

For example, at Tuesday's Board meeting it was decided to proceed with a proposed Invitation to Comment describing to the public a recommendation that the SEC Practice Section require auditors to explicitly confirm their independence to client boards, as a way to increase focus and communication. Auditors also would be required to offer to meet with their clients to discuss independence matters. The Board expects that such meetings will increase mutual understanding about matters such as the nature and degree of nonaudit services provided.

The Invitation to Comment will specifically ask readers to comment on several key questions, including whether there is a more effective and cost/beneficial way to accomplish its objectives. It also will ask whether the confirmation should be done upon appointment of the auditor, or at any time during the audit. This initial public ISB document should be issued shortly, with a comment period extending to July 23. The Board expects to consider the comments at its August 3 meeting and if all proceeds on schedule, the SECPS could have a rule in place for calendar 1998 audits.

4. The ISB, at its April 17th telephonic meeting, agreed to undertake parallel development of possible pronouncements on specific practice areas at the same time as proceeding with its long-term Conceptual Framework project.

The two issues under consideration are “Family relationships” and “Auditors going to work for clients”. The idea here is to make progress on several areas of particular concern, while learning first hand about how those issues would interplay with a conceptual framework. We note that the FASB used a similar approach in beginning the development of its conceptual framework for accounting 25 years ago. Presentations on all three topics were made at the May 26 Board meeting by IIC members and the ISB staff.

A. As to the Conceptual Framework project, I mentioned earlier that is at the core of the ISB’s reason for existence.

While the Conceptual Framework won’t directly provide answers, it should lead to the process to develop answers.

Among the many questions it might address are:

- what is “independence”, and
- what is the goal of independence regulation – that is, whether independence should consider cost/benefit ramifications.

The Board decided to proceed with a new four-member Board oversight task force. It likely will select a broad-based larger task force to advise on the development of the paper and on likely related research. At least initially, the paper is envisioned as espousing Board positions on some issues, as a FASB Preliminary Views document might do, and as being neutral on other contentious issues as a Discussion Memorandum might be. It is expected that the task forces

will propose to the Board a workplan, research and a budget by the Board's next meeting.

B. Family Relationships – The first of the specific issues to be discussed at the Board's May meeting was that of "family relationships". While in theory this sounds like an easy area, in practice it has become increasingly difficult because of the existence of huge international firms, mergers, the changing societal definition of a family and many more women becoming executives of both clients and accounting firms.

A key idea in this project is whether a new and stronger differentiation should be made for auditors on the engagement, versus those not on the engagement. That is, what should be the relevant definition of a "member" in this area for independence purposes?

Here, the Board plans to head directly toward an Exposure Draft of an independence standard, rather than toward some more preliminary document. A new two-member Board task force will oversee this project and likely recommend to the Board an additional broad-based task force. Research also may well be undertaken, especially as to public perceptions.

B. Auditors Going to Work for Clients – The other specific issue the Board discussed Tuesday was the contentious case of auditors going to work for their audit clients. Such employment has occurred relatively frequently in the past, and has some positive ramifications. Nonetheless, it also raises certain independence concerns as to both the future client actions of the departing member, and the actions of the remaining auditors who later audit their former partner or associate.

The basic issue here is whether the independence threats can best be addressed by requiring some sort of so-called “cooling off period,” or by adding further “safeguards”. A cooling-off period would in some manner “prohibit” such employment for a year or more. Examples of possible additional safeguards are to require a review of the seniority level of the new partner compared to the former colleague he or she now is to audit, and to add independent reviews and quality assurance and peer review testing.

Both cooling-off periods and safeguards raise questions of practicality and effectiveness. Also, issues exist as to the degree of disengagement of former partners from their old firms, including possible cash-out of retirement benefits.

Here, because the issue is quite polarized, the Board plans to develop a neutral Discussion Memorandum. Another new two-man Board task force will oversee the selection of a broad-based task force and the possible sponsorship of research.

IIC

1. (Slide 12) The Independence Issues Committee has two additional task forces operating beyond those supporting the Board projects just described.
 - A. Materiality –The first is the materiality task force, which is to analyze a number of the more important aspects of materiality related to independence. These materiality concepts may be worked into specific area projects, and I believe will be an important focus as the Board’s work progresses. However, I do not necessarily see an independence standard on the horizon for “Materiality” per se.
 - B. Outsourcing – Also, the Outsourcing task force was formed more recently and includes a working group of non-IIC members more closely involved in providing outsourcing services. Its general purpose will be 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 key area.

Staff of the ISB

1. (Slide 13) Website – As to the ISB staff, we have had developed and made available an ISB website whose address is www.cpaindependence.org.

A. 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
- (5) Staff consultations, and
- (6) The SEC's FRR – 50.

B. We also shortly will have a “Document Express” feature that allows you to request electronic notification of when major new postings have been made to the site.

2. The staff also has been active responding to questions from the field. We've fielded over 20 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 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.

On a more specific note, if the Symposium has any ideas for me to take back to the Board, please let me know.

Thank you.