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IIC-98-2 Independence Issues Committee Issue Summary Alternative Practice Structures

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Independence Issues Committee

Issue Summary

Alternative Practice Structures

Background

Firms are entering into “alternative practice structures” with increasing frequency. This issue summary analyzes the threats to independence that these structures may pose, and suggests alternatives to protect auditor independence.

Typical Structure

A typical alternative practice arrangement might be constructed as follows (see attached organizational chart):

- A company, which may be public (PublicCo.), buys the non-attest portion of a CPA firm practice from the firm’s partners for cash or stock, or a combination of both.
- PublicCo. may have subsidiaries such as a bank, an insurance company, or a broker-dealer, and a professional services subsidiary that offers clients non-attest public accounting services.
- The firm’s partners and employees become employees of PublicCo. (or one of its subsidiaries), performing non-attest public accounting work under the PublicCo. name.
- The firm’s attest practice remains intact (AttestFirm), and continues to be owned by its original partners (who are now also employees of PublicCo.).
- AttestFirm leases staff below the partner level from PublicCo. and pays administrative fees, which may vary based on a percentage of revenues or profits, for the use of office space and equipment, and for administrative services and advertising performed by PublicCo. on behalf of AttestFirm. The AttestFirm partners supervise the attest work and issue reports in the partnership name.
- This transaction may be replicated so that there are several attest firms affiliated with, but not owned by, PublicCo.

In this situation, PublicCo. management directly supervises the owners of AttestFirm (in their work and role as PublicCo. employees), and PublicCo, through its employee leasing and administrative agreements, may in effect control AttestFirm – a fact pattern not addressed directly in the current literature.

Other Arrangements

Other alternative practices may be structured as “roll-up transactions.” A number of firms may be assembled under a holding company (PublicCo.) that is sold to the public. Firm partners may receive a combination of cash and stock for the sale of their firms to PublicCo. The underlying firms may or may not be merged together in conjunction with the initial public offering.

In a roll-up transaction, where firms are assembled under a holding company that is sold to the public (PublicCo.), it would seem that the resultant “sister firms” and sister firm “members” would have to be independent with respect to each other by analogy to the current independence rules. The sister firms are united by common ownership, and former partners are now shareholders of PublicCo., sharing in the profits of the combined firms.

If the attest business were not included in the roll-up transaction, but was instead left in separate firms (AttestFirms) owned by the former partners of the combining firms, then the concerns related to business relationships and investments of PublicCo. and its subsidiary firms with AttestFirm clients would be similar to those in the typical alternative practice structure.

We understand that several groups are currently attempting to sign-up firms for these roll-up transactions.

There may be additional structures or variations of these alternative practice structure transactions in the future.

Examples of Potential Relationships between PublicCo. and AttestFirm Attest Clients

In the following examples of potential relationships, “PublicCo.” should be interpreted broadly to include the corporate entity, its subsidiaries, and its management, officers, and directors. Since we are only concerned with the independence of auditors of SEC registrants, assume that all AttestFirm clients are public companies.

- PublicCo. may have loans to and from AttestFirm clients.
- PublicCo. or investment companies managed by it may have investments in AttestFirm clients, or it may promote investments in such clients through its broker-dealer.

- PublicCo., through its professional services subsidiary, may provide extensive bookkeeping services to AttestFirm attest clients.
- PublicCo. may have business relationships with AttestFirm clients that AttestFirm would be prohibited from having with these attest clients.
- PublicCo. may perform custodial or trustee services for AttestFirm clients.
- PublicCo. could enter into a contingent fee arrangement with an AttestFirm attest client or AttestFirm partners may accept commissions for the referral of products or services to such attest clients. While current rules would prohibit AttestFirm partners or employees from accepting commissions for the referral of business from attest clients, bonuses or salary increases could be used to implicitly compensate AttestFirm partners for these referrals.

Potential Threats to Independence

The following potential threats to auditor independence posed by alternative practice structures are written in bold type, while alternative safeguards are written in regular type, and follow a single potential threat, or a group of threats to which they pertain.

- **PublicCo. management, because of a loan due from or a personal or corporate investment in an AttestFirm client, could attempt to exert influence over an AttestFirm partner to allow a client favorable accounting treatment or to deliver an inappropriate auditors' report (e.g., the absence of a going-concern opinion).**
- **PublicCo. management, because of a material personal or corporate business venture with an AttestFirm client, could attempt to exert influence over an AttestFirm partner to allow a client favorable accounting treatment or to deliver an inappropriate auditors' report.**
- **AttestFirm partners may become sufficiently concerned about the impact of their audits on the business of PublicCo. that, even without direct attempts to influence them, their judgment is affected.**
- **PublicCo., through its professional services subsidiary, may provide extensive bookkeeping services to AttestFirm attest clients, which may result in the AttestFirm partner and other engagement team personnel auditing the work performed by people in their own organization.**
- **PublicCo., through its professional services subsidiary, may provide AttestFirm clients with other services that put PublicCo. personnel in the position of attest client management.**

Some believe that virtually all PublicCo. corporate investments in or business ventures with AttestFirm clients should be prohibited, as if they were conducted by AttestFirm, to protect auditor independence. They would have PublicCo. and its subsidiaries agree that they would not enter into certain specified prohibited business relationships with any of the attest clients of AttestFirm. Similarly, AttestFirm would agree that it would not accept as a client any party for which PublicCo. or any of its affiliated entities has or has had any prohibited relationship or activity during the period under audit. Prohibited business relationships with an AttestFirm client might include:

- Loans or extensions of credit.
- Deposit relationships (some would be less restrictive here, and only prohibit deposits with PublicCo. that were greater than \$100,000, or not fully insured by the Federal Deposit Insurance Corporation).
- Qualified or non-qualified retirement plan management.
- Certain investment advisory and / or broker-dealer services by PublicCo. for an AttestFirm client.
- Beneficial ownership by PublicCo. of an AttestFirm client's securities, other than through mutual funds owned but not managed by PublicCo.
- Joint ventures and similar business relationships between PublicCo. and an AttestFirm client.
- Personal trust services for an AttestFirm client, or its officers or directors, or for individuals owning more than 10% of the client's securities.
- Bookkeeping, recordkeeping, payroll services, recruiting, etc.

Note that these prohibitions do not address personal investments and business ventures by PublicCo. officers and employees in or with AttestFirm clients.

The AICPA's Professional Ethics Executive Committee (PEEC) has proposed rules that would expand the definition of "member or member's firm" in the ethics literature to identify additional persons and entities to which some of the independence rules apply in an alternative practice structure. PEEC would define "member" to include the individuals who directly supervise or directly control (Immediate Supervisors) the activities of one or more of (a) the owners of AttestFirm or (b) the individuals with a managerial position located in an office participating in a significant portion of an AttestFirm engagement (including leased managerial employees), and the entity or entities within PublicCo. in which such Immediate Supervisors have a managerial position.

In addition, they would preclude individuals (other than those included in the expanded definition of “Member”) who indirectly supervise, indirectly control, or could be perceived as influencing the actions of Member, and PublicCo. and its subsidiaries (other than those included in Member) from:

- Having a relationship contemplated by Interpretation 101-1.A with an AttestFirm client that is material. Further, any investment held by such individual or entity should not allow the investor to exercise significant influence over the AttestFirm client. These proponents of the expanded “Member” definition would assess materiality of an individual’s aggregate investments in an attest client in comparison to the individual’s net worth, and the materiality of PublicCo. and its subsidiaries’ investments in relation to the consolidated financial statements of PublicCo.
- Being connected with an AttestFirm client as a promoter, underwriter, voting trustee, director, or officer.

Critics of the expanded “Member” definition believe that the auditor could be unduly influenced by the business relationships of a PublicCo. subsidiary with an attest client – a subsidiary that falls outside of the proposed definition of Member – even if that relationship is not material to the consolidated financial statements of PublicCo. They note that the term “not material” is not the same as “immaterial,” and believe that managers and employees are frequently evaluated, praised, criticized, and rewarded for profit and loss contributions that are quite immaterial to the consolidated financial statements of their employers.

Others might argue that the expanded “Member” definition does not go far enough; they would say that all business relationships and investments between PublicCo. officers and management and AttestFirm clients impair the auditor’s independence. They point out that under the current independence rules, every partner is precluded from investing in or having business relationships with his or her firm’s attest clients – even if the partner resides on the opposite side of the country from where the attest engagement is being performed, and regardless of the materiality of the investment or relationship to either the partner or the client. Following the logic of the current rule, they would ask why even an immaterial business relationship between, say, the PublicCo. CEO and an AttestFirm client would not impair the auditor’s independence.

In addition, while the expanded definition of “Member” proponents would restrict the financial interests of other individuals and entities within PublicCo. that could have an indirect control or influence over the auditor, they would allow PublicCo. entities and employees outside of the expanded Member group to perform services that the auditor would be prohibited from providing directly (e.g., bookkeeping and asset custody services). Others might say that the auditor’s employer should not be allowed to provide services to the auditor’s clients that the auditor could not provide

directly, even if the auditor performs the audit under the auspices of a firm not owned by his employer.

- **One of the perceived benefits of some alternative practice structures is the business referral opportunity created by linking an accounting firm with a large, multi-line financial services firm. AttestFirm personnel can refer business to the personnel of PublicCo. subsidiaries (e.g., bankers, brokers, and insurance agents), while PublicCo. personnel can refer clients to the professional services subsidiary for consulting work. Accountants, who have their clients' trust, can serve as a low-cost distribution network for the products and services of a multi-line financial services corporation.**

Under the current independence rules, the acceptance of commissions by auditors for referring attest clients to brokers, insurance agents, bankers, etc. is prohibited, presumably because the auditor could end up auditing the value or financial consequences of a product or service he or she was paid to recommend. However, in these alternative practice structures, bonuses or salary increases could be used to implicitly compensate AttestFirm partners for these referrals, which may threaten the auditor's independence.

Some believe that strict and unambiguous policies and procedures both within AttestFirm and PublicCo., that could be tested in peer review, would be effective in ensuring that AttestFirm personnel did not accept commissions for referring attest clients to PublicCo. bankers, agents, or brokers. They might argue that both PublicCo. and the AttestFirm should agree that compensation records for personnel participating in attest engagements would be open to peer review teams, that commissions received on non-attest client referrals are in accordance with established formulas, and that salaries and bonuses paid to these people by PublicCo. represent the fair value of services rendered, and can be supported by time records and performance reviews. While they acknowledge that this last criterion may be hard to independently verify, they point out that current practitioners in traditional structures may be receiving commissions for referrals of non-attest clients, and there is not major concern that the payments also include a component for improper, attest-client referrals.

Others believe that the financial interests that attest engagement personnel have in PublicCo. (e.g., employment and maybe even stock or stock options), their close connection with PublicCo. bankers, brokers, and agents who are in a sense colleagues, and the routine payments that would flow between PublicCo. and its employees performing attest engagements increase, to an unacceptable level, the likelihood of independence impairment and the difficulty of monitoring the propriety of payments to employees. They believe that the commission or referral fee concerns exacerbate the potential auditor independence risks posed by banking, brokerage, or insurance relationships between PublicCo. and AttestFirm clients.

These critics believe that even if safeguards were designed to effectively preclude compensation of the auditor for attest client referrals, the public's perception of the

auditor's independence would be eroded if auditors referred their clients to their own colleagues and co-workers (colleagues and co-workers when the auditors are wearing their PublicCo. employee hats) for services and products that the auditor would be prohibited from providing directly to the client. While audit firms are currently prohibited from providing certain types of consulting services to attest clients, even if they were to be performed by separate people, offices, or divisions within the firm, alternative practice structures allow a company to perform prohibited services to attest clients based on the separate legal ownership of PublicCo. and AttestFirm, even though AttestFirm auditors are also employees of PublicCo. It's the dual employment status of the auditor, and the influences and pressures of PublicCo. employment, that these critics find objectionable.

- **AttestFirm partners may have received stock or options in PublicCo. stock as compensation for the sale of their firm, and these partners and other audit personnel may receive stock or options under their employment arrangements with PublicCo. The independence of the audit firm personnel may be impaired if the value of this stock or these options is dependent on preservation of PublicCo.'s business dealings with or the value of its investments in an attest client.**

Some might argue that partners in traditional accounting firms face the same threats when their firms provide consulting services to attest clients, and the partners are compensated based on total firm profits. However, in traditional firm structures, the nature of accounting and consulting services provided to attest clients is limited to prevent the audit firm from, say, auditing its own work, and business relationships with attest clients are limited to prevent an unacceptable level of mutuality of interests. In alternative practice structures, some suggest that these services and relationships should be permitted between the auditor's employer and the attest client.

As an example of the increased risks that these relationships may pose, imagine a situation where significant bookkeeping services were performed by such a PublicCo. subsidiary for an attest client. The value of the auditor's stock holding in PublicCo. might decrease if the auditor delayed the attest client's 10K filing due to lack of confidence in its financial statements. Not only would PublicCo.'s bookkeeping contract with the attest client be in jeopardy, but the bad publicity that might result from the filing delay could cause PublicCo. to lose several bookkeeping clients or opportunities.

This potential threat to the auditor's independence is mitigated if PublicCo.'s business relationships and investments in AttestFirm clients are restricted as some have proposed. As an alternative, stock holding limitations could be prescribed for personnel working on attest engagements where PublicCo. has certain relationships with the attest client.

Some would dispute this concern as misguided – they note that the auditor, under the current rules, is not prohibited from owning the stock of his or her client's

bookkeeper. They might argue that the threat to auditor independence in this example, if any, is more likely to emanate from the auditor's employment relationship with PublicCo., then from concerns over the value of his or her PublicCo. stock.

Others suggest that PublicCo., its employees, and possibly its other owners should be independent with respect to AttestFirm clients if, and only if:

- AttestFirm partners and other "Members" are actively involved in PublicCo.'s business of providing professional services, or
- AttestFirm "controls" PublicCo. Proponents of this view suggest a Statement of Financial Accounting Standards No. 94 notion of control (a majority voting interest as the general rule). They add that PublicCo. would be controlled by AttestFirm if two or more members, choosing to act together, could control PublicCo.'s operating, financial, or accounting policies.

Note that it would be difficult to require that PublicCo.'s other owners remain independent with respect to AttestFirm clients, if PublicCo. were widely-held. In addition, the threats to independence posed by a minor PublicCo. shareholder's relationships with an AttestFirm client are unclear.

- **If effective safeguards were designed to protect the independence of AttestFirm personnel in performing attest services, could the public be convinced of the auditors' independence knowing:**
 - **PublicCo.'s business interests in and with AttestFirm attest clients; and**
 - **the employment and other economic interests that AttestFirm personnel have in PublicCo?**

Safeguards suggested to enhance the public's perception of the distinctness of PublicCo. and AttestFirm operations include requirements that PublicCo. and AttestFirm maintain:

- **Separate businesses** – AttestFirm must be a separate and distinct legal entity wholly-owned by CPAs, and not owned in any part by PublicCo. PublicCo. should not have any control over the governance, structure, or operations of AttestFirm. Administrative, employee leasing, and office and equipment rental agreements must be non-exclusive arrangements; in other words, AttestFirm must be able to choose to handle these internally, or to hire or contract with other providers. All agreements or contracts between PublicCo. and AttestFirm must be at fair value; there can be no sharing of AttestFirm profits with PublicCo.
- **Separate client engagements and billing** – PublicCo. and AttestFirm must issue separate engagement letters, and billings and collections must be handled separately. PublicCo. and AttestFirm funds must not be commingled. AttestFirm

partners use AttestFirm business cards and letterhead when conducting AttestFirm business.

- Names, logos, and marketing – AttestFirm and PublicCo. will use distinct names and logos so that clients and the general public will understand that they are separate entities, running separate businesses. Marketing materials for PublicCo.’s professional services subsidiary will reflect this separation. Where there is a potential for or apparent confusion, the two entities will take affirmative steps to inform the public and potential clients of the distinction between the two firms.
- Business risk – AttestFirm partners will bear all risk of loss for the services AttestFirm provides. In addition, at its sole cost and expense, AttestFirm will agree to maintain professional liability insurance.

Others would argue that these measures are more “form over substance;” they believe the public will look at PublicCo.’s employment arrangements with AttestFirm partners, and the administrative and employee leasing arrangements between the two, and conclude PublicCo. and AttestFirm are “one and the same.”

- **If safeguards could be designed to effectively protect the independence of AttestFirm audit personnel, these control systems would require the support and participation of individuals and PublicCo. subsidiaries, many of whom are not members of the AICPA and do not have the training and experience of operating under the AICPA’s *Code of Professional Conduct*, or the SEC’s independence rules and regulations. As such, safeguard systems would be difficult to enforce and monitor.**

Some believe that agreements between PublicCo. and AttestFirm on policies and procedures to protect the independence of personnel working on attest engagements could be developed and effectively communicated to all personnel within PublicCo. and AttestFirm. They acknowledge the difficulty that non-CPAs sometimes have in understanding auditor independence requirements, but point to the success that the firms have had in the difficult process of educating their consulting staffs, and getting them to understand and comply with independence requirements.

They might also argue that independence is ultimately the responsibility of AttestFirm partners and other CPAs working on attest engagements, and although PublicCo. and its non-CPA employees may not be bound by the *Code of Professional Conduct* and the SEC’s independence rules and regulations, or regulated by the state boards of accountancy, attest engagement personnel are subject to these constraints. And in a disagreement between PublicCo. management and AttestFirm partners on who should terminate or refuse an engagement because of an independence conflict, if the matter cannot be settled to the auditor’s advantage (i.e., PublicCo. resignation), then the AttestFirm would be forced, under the independence rules and regulations, to forego the engagement.