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## Independence Issues Committee Minutes of September 8, 1998 Meeting Public Session

Independence Standards Board. Independence Issues Committee

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September 8, 1998

## Independence Issues Committee - Minutes of Meetings

### Independence Issues Committee Minutes of September 8, 1998 Meeting Public Session

The Independence Issues Committee (IIC, or the Committee) held a public meeting on Tuesday, September 8, 1998.

The meeting began at approximately 1:30 PM and was attended by:

#### Committee Members

Edmund Coulson  
Kenneth E. Dakdduk  
John M. Guinan  
Charles A. Horstmann  
Robert J. Kueppers  
Edward W. O'Connell  
Frank J. Pearlman

Arthur Siegel, Executive Director of the Independence Standards Board (ISB, or the Board), served as Chairman.

Others present by invitation were:

W. Scott Bayless - SEC Staff  
Gary Illiano\*  
Susan McGrath - ISB Staff  
Richard H. Towers - ISB Staff  
Lynn E. Turner - SEC Staff

\* Mr. Illiano was sitting in for Mr. Barber.

#### **Minutes**

The minutes of the IIC's last Public Session meeting, held on July 14, 1998, were approved unanimously.

#### **Committee Size**

Mr. Siegel reported that Gerald Ward had resigned from the IIC. Mr. Ward is a partner in the newly-formed firm of PricewaterhouseCoopers, as is Kenneth Dakdduk, also an IIC member, and they felt that PricewaterhouseCoopers should only be represented by one individual. Mr. Siegel noted that the merger forming PricewaterhouseCoopers raised a question as to whether the Board should reduce the size of the IIC. At its August 31, 1998 meeting, the Board decided to

reduce the IIC's size to eight, the number of members needed for a quorum from seven to six, and the number of votes necessary for a consensus from six to five.

### **Alternative Practice Structures**

At Mr. Siegel's request, Ms. McGrath presented several "alternative practice structures" and the potential threats to auditor independence that these may pose. These concerns were more fully discussed in the issue summary that was distributed to Committee members prior to the meeting and posted to the ISB website for the benefit of other interested parties.

Mr. Siegel asked Mr. Pearlman to update the Committee on the status of the AICPA Professional Ethics Executive Committee's (PEEC's) exposure draft on the applicability of the AICPA's independence rules to alternative practice structures. Mr. Pearlman stated that PEEC reviewed comments received on the exposure draft at its recent meeting in Seattle, and did not anticipate any substantive changes to the independence guidelines outlined in the draft. However, several comments illuminated the need for clarity on several points. The proposal had been put "on hold," however, in view of the IIC's study of these issues. Mr. Pearlman stated that the PEEC Committee members would like to work with and assist the IIC, sharing experience gained through PEEC's prior examination of the issues.

When asked by an IIC member whether the SEC Staff was leaning towards the approach taken in the PEEC exposure draft to address independence issues, or more towards the "more restrictive" approach suggested by the New York State Education Department (state board of accountancy), Mr. Turner replied that while the SEC Staff did not yet have a position on these issues, the letter issued by New York did not address all of the items that the SEC Staff would have liked to see addressed, such as personal investments by PublicCo. management in attest firm clients, and personal and business ventures with attest firm clients. He asked why the independence rules should not be extended throughout the entire PublicCo. organization if everyone on the audit team from the partner through the staff accountants were receiving paychecks and evaluations from PublicCo.

A Committee member noted that the current model proposed by the New York State Board did not address investments by attest clients in PublicCo.

At Mr. Dakdduk's suggestion, the Committee asked the Staff to amend the issue summary to include a discussion of existing independence rules that might be applicable to alternative practice structures.

Mr. Pearlman suggested that the crux of the issue might be the proper extension of the definition of a "member" under the independence rules, and added that it appeared that the SEC Staff would include all of PublicCo. and its employees within the definition of a member. Mr. Turner responded that he did not think he went that far in his earlier comments.

The Committee decided to form a task force consisting of Mr. Kueppers, Mr. Dakdduk, and Mr. Barber to assist in expanding the issue paper to include a discussion of how the current independence rules might be applied to alternative practice structures. In addition, a representative from Century Business Systems agreed to give a presentation to the Committee on the safeguards his company employs to preserve auditor independence in alternative practice structures

created when the company purchases the non-attest business of a CPA firm. Other organizations involved in these structures will also be invited to speak to the Committee. The Committee will discuss these issues again at its meeting on October 13<sup>th</sup>.

## **Staff Report**

### Invitation to Comment (ITC 98-1)- Proposed Recommendation to SECPS - Annual Auditor Independence Confirmation

Mr. Siegel stated that the Staff had summarized the comments received on the proposed recommendation to SECPS that it require member firms to confirm their independence annually to the audit committees (or Boards) of their public company clients, and to offer to meet with the audit committee to discuss auditor independence. The proposal was intended to improve corporate governance and communication about auditor independence.

Comments received, which were generally favorable, were presented to the Board at its last meeting. The Board concluded that the confirmation should be enriched to include a more detailed discussion of independence matters, and directed the Staff to prepare and present a revised proposal at its November meeting. In response to a question asked by Mr. Horstmann, Mr. Siegel stated that comment letters on such matters were always welcome although the official comment period on the original proposal had expired.

### Formation of ISB Project Task Forces

Mr. Siegel reported that the broad-based ISB Project Task Forces had been formed to assist the Board in its conceptual framework, employment with clients, and family relationships projects. Members of the task forces had been formally approved at the Board's August 31st meeting, and the task forces were scheduled to hold their first meetings in October.

### Agenda Subcommittee Discussions

Mr. Siegel reported that the Agenda Subcommittee decided that the Committee should consider the level of assistance that the auditor can provide an audit client in implementing FAS 133, *Accounting for Derivative Instruments and Hedging Activities*. Mr. Horstmann will prepare an issue summary for Committee discussion at the October IIC meeting.

Mr. Horstmann stated that judging from the SEC comments and Tandy letters he had seen, it seemed as if the SEC Staff's quarrel with some of the in process R&D; valuations was one of quality in addition to auditor independence. Mr. Turner agreed. At Mr. Siegel's request, Mr. Bayless agreed to try to forward a sample of these reports, redacted if appropriate, to the ISB Staff.

### Staff Consultation Activity

At Mr. Siegel's request, Mr. Towers briefly summarized Staff consultation activity. He stated that approximately 48 informal inquiries had been received to date, and

summarized the 8 new inquiries received since the August 11<sup>th</sup> IIC Executive Session meeting as follows:

<b>By requester:</b>		<b>By subject:</b>	
Small firms	4	Family relationships	1
Registrants	2*	Bookkeeping	1
Other	<u>2</u>	Financial interests	1
Total	8	Former partners	1
		Other (2 re: broker-dealers)	<u>4</u>
		Total	8

\* Mr. Towers stated that these calls were from registrants, seemingly doing corporate governance due diligence before discussions with their auditor, which he considered to be a good sign. Mr. Towers encouraged these registrants to discuss these inquiries with their auditors as well.

#### Terms of Office for Committee Members

Mr. Siegel stated that the Board had set staggered terms of office, in accordance with the Board's Operating Policies, for Committee members. The Big Five firms had been assigned permanent seats on the Committee - individuals filling these seats would be approved by the AICPA's SEC Practice Section. The three other Committee members were randomly assigned terms expiring on December 31<sup>st</sup> of the following years:

Mr. O'Connell 1998  
Mr. Barber 1999  
Mr. Pearlman 2000

Mr. Siegel noted that members could be re-appointed for second, three-year terms.

#### **Task Force Reports**

##### Materiality Task Force

Mr. Horstmann reported on the activities of the Materiality Task Force, and stated that he had presented the Task Force's materiality paper to the ISB at its August 31st meeting. The purpose of the paper was to provide the Board with "advance thinking" to assist in developing a frame of reference for materiality considerations in independence matters. The paper evaluates how materiality might be assessed and applied in different situations.

Mr. Turner stated that he had read the paper and the SEC Staff's comments were forthcoming. He suggested, however, that the Task Force consider the investor's point of view, which may require additional research, as he believes that the paper was written from the auditor's perspective. Mr. Horstmann asked for

specific language suggestions, since the Task Force tried to have that perspective.

### Outsourcing Task Force

Mr. Dakdduk discussed his Task Force's activities on independence concerns surrounding outsourcing engagements. He distributed the current draft of the paper prepared by his Task Force that provides a definition of outsourcing, describes the functions or processes that are typically outsourced and the threats to independence that these may pose, and suggests how independence concerns might be mitigated.

Mr. Dakdduk stated that he would welcome any additional Committee input on the paper before it is finalized.

### **Other Matters**

Mr. Horstmann noted that the ISB, at its last meeting, decided to further investigate two research projects discussed at its February meeting - a focus group study of independence attitudes by various groups, and an empirical study of present and past disclosures of non-audit services. Mr. Horstmann asked if an IIC task force might be useful in assisting the Board with these projects, and Mr. Siegel said that he would consider the Committee's offer.

### **Next Meeting**

The Committee's next meeting will be held on Tuesday, October 13, 1998 at 10 AM, in the New York offices of the AICPA.

\* \* \* \* \*

Having no further business, the meeting was adjourned at approximately 2:45 PM.

Respectfully submitted,

Susan McGrath

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