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# Discussion memorandum: Evolving forms of firm structure and organization, October 1999; DM 99-2

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DM 99-2

# Discussion Memorandum

## Evolving Forms of Firm Structure and Organization

October 1999

Independence
Standards
Board

Independence
Standards
Board

# Discussion Memorandum

## (DM 99-2)

# Evolving Forms of Firm Structure and Organization

October 1999

Comments should be received by December 31, 1999, and addressed to:
Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: DM 99-2

Comments may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to DM 99-2).

Independence
Standards
Board

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**Date:** October 1999

**To:** Interested Parties

**From:** William T. Allen, Chairman

The mission of the Independence Standards Board (ISB or Board) is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets. Two of the founding precepts of the ISB are that (1) while many factors may affect the functioning of the capital markets, those markets will not function effectively unless investors have confidence in the information they use to make investment decisions, and (2) an independent audit is essential to providing that sense of confidence. If knowledgeable and reasonable investors believed that the independent auditor placed the interests of the auditing firm, the audit client, or any other person, over the interests of investors, then the value of the audit function would be impaired.

With this mission in mind, and while working concurrently on its project to establish a conceptual framework for auditor independence to serve as the foundation for principles-based independence standards, the Board has, in a limited scope and expedited project, studied certain independence concerns related to the evolving forms of audit firm structure and organization. The Board seeks comment on this Discussion Memorandum (DM) on Evolving Forms of Firm Structure and Organization, as described therein.

The operating policies of the ISB are designed to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue.

The ISB is seeking specific input on the questions posed throughout this discussion memorandum. In addition, we

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Web site: www.cpaindependence.org

welcome comments and suggestions on any other aspect of the firm structure issue. The Board appreciates the time that respondents are taking to study this discussion memorandum, and recognizes that the document is lengthy and the issues complex. It is not necessary for each respondent to respond to every question raised, although we certainly encourage that. We do call your attention specifically to the general questions (Q1 – Q4) following paragraph 14, and would appreciate answers to all of these.

Your responses, which must be received by December 31, 1999 may be sent via:

1. mail Independence Standards Board
   6th Floor
   1211 Avenue of the Americas
   New York, NY 10036-8775
2. fax (212) 596-6137
3. e-mail isb@cpaindependence.org

Please reference DM 99-2 in your correspondence.

ISB Discussion Memoranda explore auditor independence issues in an effort to solicit debate and public comment. They do not in any way modify existing auditor independence requirements.

All responses will be available for public inspection and copying for one year at the offices of the Independence Standards Board and at the library of the American Institute of Certified Public Accountants at Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey.

## Evolving Forms of Firm Structure and Organization

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## Evolving Forms of Firm Structure and Organization

## Executive Summary

1. This memorandum is the first step in a process that will culminate in the issuance of formal guidance to preserve auditor independence when auditors are involved in new firm structures.

2. The memorandum discusses:

   a. evolving forms of audit firm structure and organization;

   b. the new relationships with persons and entities (Related Parties[1])that these structures create for the auditor;

   c. relationships that Related Parties may have with the auditor's audit clients;

   d. potential threats to auditor independence that Related Party relationships with audit clients may pose;

   e. the potential need for restrictions on Related Party relationships with audit clients to protect auditor independence; and

   f. safeguards that may be available to eliminate or mitigate such threats to auditor independence.

3. Rules requiring auditors to be independent of their clients seek to protect the integrity of the financial reporting process. The form and content of these rules were originally developed at a time when all audit firms were relatively small partnerships concentrating on audit,[2] tax, and accounting services, with partners managing all Firm[3] operations and sharing in firm profits. These rules generally prohibit certain relationships between members of such firms and the

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[1] Related Parties is defined to mean all of the organizations and individuals with which the auditor has a financial, employment or other relationship resulting from firm structure developments. A Related Party may include the auditor's corporate employer, Sister Firm, Non-Auditor Owner, or investee.

[2] In the DM, the term "audit" is often used in place of the more technical term "attest," defined in the auditing literature to mean services where the auditor provides assurance on a range of representations including those contained in historical financial statements.

[3] The term Firm is being used to mean an entity that conducts audits of the financial statements of clients. It could be a partnership, a sole practitioner, or a corporation, and could also engage in significant other activities.

firm's audit clients that are thought to impair, or create a sufficient risk of impairing, the auditor's independence.

4. In the mid-1900s, the executives of audit firm clients began to look to their auditors as business advisors able to provide useful advice on important issues facing their businesses. Business consulting services expanded rapidly, and as the use of computers increased, audit firms expanded into computer systems consulting. As merger and acquisition activity increased, audit firms provided due diligence, strategic planning, valuation services, financing advice, tax planning, and other services related to these activities. Audit firms have also expanded into other activities including human resource consulting, investment and broker-dealer services, outsourcing of business functions, risk management, and legal services. For many firms, consulting services now rival or exceed audit and tax practices in terms of revenue. See Appendix A for a more complete listing of the various services offered by public accounting firms today.

5. Public accounting firms have expanded not only in the breadth of services they offer, but also in terms of the magnitude of their revenues, number of employees and partners, and number of locations both in the United States and worldwide. The larger firms have thousands of partners and tens of thousands of employees both domestically and overseas. All of the larger firms have entered into international marketing and cost sharing agreements with public accounting firms in other countries. These agreements allow the firms to maintain some autonomy in their management and business operations, while adopting a common branding, marketing, and service-delivery approach. These arrangements advanced and continue to evolve as a result of the need for public accounting firms to provide services on a global basis to their global clients. Smaller accounting firms have also been faced with increasing competitive pressures to provide their clients with the services they desire on a global basis.

6. In both large and small firms, capital is needed to expand both the consulting and audit businesses. In addition, some firms and their partners may want to realize or monetize the value of these operations, either through private placements, public offerings of stock, or a complete sale. The issuance of stock to the public also can create an additional means of compensation for partners and employees. In addition, economies of scale may be one objective driving the current consolidation of small to mid-size firms either through "roll-ups" or acquisitions by corporations. Finally, some public accounting firms have large unfunded pension obligations, and need capital to meet these obligations.

7. These worldwide competitive forces have led audit firms to engage in a wide variety of businesses beyond the traditional audit service mentioned previously, and some firms have organized these practices in structures quite different from the simple partnership model. Consideration must be given to whether the conflicting incentives created by having publicly-traded stock or by providing audit clients with non-audit services through these alternative business structures create pressures on auditors that could impair their independence or investor confidence in their integrity. Firms have represented

that they have developed or are developing quality controls (or safeguards) to ensure the firm's independence under these alternative practice structures. Some believe these safeguards adequately address the additional conflicts and pressures on independence that are created as a result of these alternative forms of practice. Others believe that the incentives that are creating the conflicts of interest and pressures on independence are greater than the incentives to establish and maintain compliance with safeguards implemented, thus negating their effectiveness.

8. In these new structures Related Parties may own part of the firm or otherwise be in a direct or indirect position to exert influence or control over it. Because of a relationship with an auditor's audit client, a Related Party may try to influence the outcome of the audit. Or, because of the auditor's relationship with the Related Party and his or her knowledge of the Related Party's interests in the audit client, the auditor may be biased in the conduct of or conclusions reached on the audit. Such new relationships with Related Parties and their potential relationships with audit clients were not contemplated by existing rules, and both the application and the adequacy of existing rules need to be re-examined in connection with the issues raised by these new relationships.

9. This discussion memorandum describes salient new structures that have emerged. Chiefly these include (a) the sale of the non-audit practice to a third party (in a private placement or initial public offering for example) and retention by the former partners of the audit practice, with some operational link between the two components and (b) the union of audit firms under single umbrellas (by combining them and selling some or all of the non-audit portion to a third party or to the public), or via formal associations and affiliations.

10. The sale to a third party of a portion of the non-audit practice may create a direct financial interest between the firm and an audit client which purchases the stock of the firm's subsidiary. In addition, the audit firm may have certain fiduciary responsibilities to its new shareholders, which may conflict with the duties of the auditor with respect to audit clients. The use of common names for the audit and non-audit businesses, and common leasing, cost-sharing, back-office, and international agreements also create financial interests between the audit firm and the publicly-owned non-audit business. These arrangements raise questions regarding whether the audit firm retains some degree of control over the public non-audit business, even if it holds only a minority interest in that business. In addition, public ownership may put additional pressure on the auditor to meet earnings forecasts, and therefore the auditor might be reluctant to stand up to an audit client providing the firm with consulting revenues and profits.

11. New forms of practice involving the purchase of the non-audit business by a corporation also raise potential conflicts that may impact the auditor's independence. In some cases, the partners of the remaining audit firm also become employees of the purchaser of the business, and may receive a direct financial interest in the purchaser through stock or stock options. As a result, their financial status is now affected by the financial performance of their new employer. In addition, those partners become subject to the budgetary and

performance goals of their new employer, and are evaluated on how they support those goals. The other professional employees of the audit firm may also become employees of the corporation, which leases them to the audit firm on a part-time basis. The corporation may also provide the audit firm with office space, marketing, and administrative services. The new corporate employer may have relationships with the audit firm's clients that create conflicts which may, in fact or appearance, affect the auditor's integrity, objectivity, and independence. Some ask whether investors, knowing the extent of the relationships between the employer and the audit firm, will have confidence in the integrity and objectivity of the auditor, if such employers are allowed to, for example, make loans or provide bookkeeping services to the audit firm's clients.

12. The memorandum depicts four types of Related Parties generated by these new structures that generally are absent in the typical partnership structure, including: (1) Dual Employment[4] situations; (2) Non-Auditor Owners;[5] (3) relationships with Sister Firms;[6] and (4) entities in which the Firm has a minority ownership interest. These Related Parties may desire relationships with audit clients that would ordinarily impair the audit firm's independence if they involved the audit firm directly. Examples of such relationships include lending money to the client, providing certain services to the client, and entering into other transactions that may lead the auditor to review the Related Party's work for a client, develop a mutuality of interests with the client, or participate as a part of client management.

13. The discussion memorandum raises a number of questions. Respondents are asked whether the Dual Employment of the auditor should subject the auditor's employer to some or all of the existing independence rules. If yes, respondents are asked whether those rules should apply to the employer as an entity and/or to certain personnel within it and whether they should apply to any shareholders of that other employer. With respect to Sister Firms, the discussion memorandum asks whether the independence rules should apply so that each firm must be independent with respect to the other's clients. To the extent rules are required, are there safeguards that might be developed and implemented to protect auditor independence in these various circumstances? Respondents are asked whether Firms should be allowed to audit the financial statements of companies that have relationships with the Firm's significant Non-Auditor Owners. Respondents are also asked to describe the circumstances under which an investee of the Firm (an entity in which the Firm holds a minority ownership interest) should observe restrictions on relationships with the Firm's audit clients. And finally, respondents are asked whether rules should consider independence impaired when an audit client

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[4] Dual Employment refers to the situation when the auditor is either a partner or employee of the audit firm as well as an employee of another entity not providing audit services.

[5] Non-Auditor Owners are shareholders of the Firm or its parent, subsidiary, or investee who are not actively employed by the Firm or its parent, subsidiary, or investee.

[6] Sister Firms refer to situations when two or more audit firms practice using the same trade name or have other attributes of common interest.

owns stock in the audit firm (i.e., the audit client is a Non-Auditor Owner) or in the auditor's employer, and whether the answer depends on whether that ownership interest is publicly traded, material or immaterial to the client or to the firm or employer, and so on.

14. In addition to the questions asked throughout the discussion memorandum, we particularly request comment on the general questions listed below.

## General Questions for Respondents

**Q1.** Do you believe that the traditional focus of accounting firms on professional standards and independence may be compromised by the types of relationships described above? Why or why not? Does your answer depend on the type of relationship?

**Q2.** Is it appropriate for a multi-disciplinary professional service firm (such as a "Big 5" accounting firm) to have public ownership in either the firm itself or in its parent, subsidiary, or investee?

**Q3.** Do you believe that the independence of a firm would be impaired if an audit client or one of its officers or directors owned stock in the audit firm or one of the audit firm's subsidiaries? Would your answer be different if the investment were not material to the investor, or the client-shareholder owned less than say 5% or 10% of the shares of the public entity?

**Q4.** When an audit partner is also an employee of a corporation, do you believe that the restrictions applied to the auditor and his or her firm on activities and relationships with audit clients should also be applied to the corporation?

# Evolving Forms of Firm Structure and Organization

## Background

15. Traditionally, audit firms have been organized as partnerships, with partners managing all firm operations and sharing in firm profits. Typically, individual partners had responsibility for the conduct and supervision of the audit engagements assigned to them, and for the decisions and judgment calls on accounting and reporting matters, although sometimes their judgments were informed through consultation with others in the firm. Engagement partners were assisted by other professionals of various experience levels, who were partners or employees of the firm.

16. Currently, most of the independence rules designed to protect auditor independence, and the restrictions they impose, run to "members." In general, members are defined as:

a. individuals providing professional services to the client,

b. managerial employees in an office participating in a significant portion of the audit engagement,

c. all partners in the firm,

d. the firm itself, and

e. entities controlled by one or more of the above.

17. Therefore, those providing professional services to the client, and the firm itself, may not, for example, own stock in the audit client, and those on the audit engagement cannot have close relatives in certain positions at the client. These restrictions are extended to others within the firm who do not have direct responsibility for the audit – to other managerial employees in the office and, in some cases, to all firm partners. This extension of restrictions may have been based on several factors, including recognition that the collegiality among partners and among other senior professionals working in the same office might allow relationships between these colleagues and the client to influence those on the engagement team. Or, perhaps known relationships between those higher up in the firm and the audit client might affect the objectivity of a member of the engagement team, or such a relationship might compel a senior partner to try to influence a subordinate on the engagement team.

18. New firm structures and relationships with other entities have raised questions as to the appropriate application of the restrictions designed to protect auditor independence. It is not clear to whom in these organizations or to which affiliated entities the independence rules should apply. In addition, some of these new structures raise the concern that individuals other than firm

partners may have significant influence or control over the audit firm (or its partners and staff).

19. This discussion memorandum (the DM) seeks to examine the auditor independence issues posed by these new firm structures, and to examine the pros and cons of various methods of applying the independence rules to the individuals and entities in these organizations. The DM attempts to identify threats to independence that are common to many different structures, so that solutions determined by the Board (restrictions that should be applied, or safeguards to protect the independence of the auditor) are linked to specific threats that may arise from one or more structures, rather than to specific structures themselves. In this way, the Board hopes to develop principles that practitioners, companies, and regulators can apply to the new structures that exist or are evolving today, as well as to those not yet contemplated.

## Evolving Forms of Structure and Organization

20. Several forms of firm structure and organization exist today or are evolving:

Traditional Partnership, often with Separate Auditing, Tax, and Consulting Divisions.[7]

21. The traditional partnership structure described previously has evolved. Some firms have grown quite large, with thousands of partners and professionals worldwide. These firms are multiline organizations with consulting divisions that rival or exceed the traditional audit and tax practices in size and revenue generation. Therefore, in some firms, professionals performing audits may no longer make up the majority of firm personnel. In addition, "partners" with direct engagement responsibility may be in substance salaried employees rather than equity owners sharing in firm profits, and many partners or partner equivalents are in the consulting division with little or no participation in audit engagements. Some argue that independence rules that apply certain restrictions to all partners in these large firms are no longer based on threats to auditor independence and may carry unintended costs.

22. This DM will not, however, examine the changes in the independence rules that might be warranted due to such changes in some traditional firms.[8] In addition, any new standards that may result from the Board's study of these

[7] A traditional firm with separate audit, tax, and consulting divisions is likely to be large. Professionals in smaller firms may be more likely to perform a variety of audit, tax, and consulting services. Business pressures on small and mid-size firms, and the structures that exist or are evolving to adapt to these pressures, are described in the subsequent paragraphs.

[8] The Board is currently working on a conceptual framework for auditor independence. After the framework is completed, the Board is likely to consider existing independence standards in light of conclusions reached in the conceptual framework project.

issues would apply only to evolving forms of firm structure, and are not intended to be applied to traditional firms by analogy.

Corporate Purchase of the Non-Audit Business of one or more Traditional Firms.

23. Some small or mid-size firms believe that they could improve their service delivery and prospects with additional capital to improve audit methodologies, keep abreast of and invest in technology, and develop expertise in particular lines of business or specialties required by their clients. The attraction and retention of qualified professional staff is described as one of the biggest challenges facing the profession. And while many firms are enjoying a high demand for professional services and record growth and profits, unfunded partner retirement obligations threaten future cash flows. These needs have caused some firms to sell their non-audit practices to another entity, often a public corporation, which can provide the business with needed capital, provide enhanced employment opportunities and benefits to firm professionals, and assume retirement obligations.

24. In these transactions, the audit business often remains in partnerships owned and run by the original partners, who are now also employees of the corporation (state laws and regulations require CPAs to have at least majority ownership of firms providing audit services). The audit firm typically leases employees and facilities and purchases administrative services from the corporation. In some cases, the audit firm may retain its employees, and lease them to the professional services subsidiary of the corporation to perform non-audit services. A typical alternative practice arrangement might be constructed as follows (see the attached organizational chart – Exhibit A):

a. A company, which may be publicly-owned (Public Co.), buys the non-audit portion of a CPA firm practice (e.g., financial and computer consulting, tax advisory services, etc.) from the firm's partners for cash or stock, or a combination of both. Part of the consideration received by the partners often is based on the future profitability of the sold business, pursuant to "earn-out" arrangements.

b. Public Co. may have subsidiaries such as a bank, an insurance company, or a broker-dealer, and a professional services subsidiary that offers clients non-audit public accounting and consulting services.

c. As a condition of the sale of the audit firm's non-audit business, partners and employees may become employees of Public Co. (or one of its subsidiaries), providing clients with non-audit public accounting and consulting services under the Public Co. name.

d. The original firm's audit practice remains intact (Audit Firm), and continues to be owned by some or all of its original partners (who are now also employees of Public Co. – a Dual Employment situation).

e. The Audit Firm provides its services by leasing staff below the partner level from Public Co. and pays administrative fees for the use of office space and equipment, and for administrative services and advertising performed by Public Co. on behalf of the Audit Firm. Alternatively, the Audit Firm may retain its own employees, who are leased to Public Co. to perform non-audit services. The Audit Firm partners supervise the audit work and the audit reports are signed in the partnership name. The partnership is legally and financially responsible for this work.

f. This transaction may be replicated so that there are several Audit Firms affiliated with, but not owned by, Public Co (Sister Firms). Or, these firms may be merged into a single audit firm.

25. In this situation, Public Co. management directly supervises the owners of the Audit Firm (in their work and role as Public Co. employees), and some believe that Public Co., through this employment relationship and its employee leasing and administrative agreements, may in effect control the Audit Firm.

Roll-Up Transactions.

26. A number of firms may be assembled under a holding company (Public Co.) that is sold to the public. Firm partners may receive a combination of cash and stock for the sale of their firms to Public Co. The underlying firms may or may not be merged together in conjunction with the initial public offering. Former partners and other professionals may now be shareholders and employees of Public Co. (creating Dual Employment situations), sharing in the profits of the combined firms. Public Co. may also have subsidiaries such as an insurance company, a broker-dealer, or a bank (Exhibit A).

27. Because of state laws requiring at least majority ownership of audit firms by CPAs, the audit practices of these firms are placed in separate partnerships owned and run by the firms' original partners. The facilities, employee leasing, and administrative arrangements between the audit firms and Public Co. may be similar to those described in paragraph 24.e. above. The motivations behind these transactions are often similar to those described in paragraph 23 above.

Public Ownership of an Interest in the Non-Audit Practice of a Traditional Firm.

28. A traditional public accounting firm may place all or part of its non-audit business in a subsidiary, a portion of which is sold to the public or private investors. The firm may continue to hold either a majority or minority ownership share in the subsidiary. Despite a minority percentage of ownership, the firm may retain control or significant influence over the subsidiary through common management, and use of or control over a common name, and office leasing and other administrative agreements. Motivation for these arrangements may include access to capital for growth and expansion, the ability to use stock and options for incentive compensation, the need to fund large pension obligations, and sharing the risk and rewards of the business with others.

Associations.

29. Networks of independently-owned firms within the U.S. or internationally that are linked for certain purposes, such as shared training and marketing, or to fill gaps in special expertise or geographical presence (see the attached organizational chart - Exhibit B).

30. Many associations provide members with:

a. geographic reach, enhanced service offerings, and opportunities for specialization.

b. client referrals.

c. a cost effective way to provide training to staff.

d. opportunities to benchmark firm results, and the results of client and employee satisfaction surveys, with peers.

e. a forum to share practice management techniques.

f. marketing assistance through sharing of best practices, firm and service brochures, current event newsletter material, etc.

g. access to technical materials via lending libraries, accounting bulletins, etc.

h. software and other product discounts.

31. Member firms are financially independent and practice under their own names, but may note their membership in the association on their letterhead or websites and in other marketing material. Member firms do not engage in profit-sharing, although member firms may receive "correspondent fees" (fees for the referral of or participation in work, arranged directly by the firms involved, rather than by the association). In addition, member firms pay fees to the association, but these are not normally large enough to be construed as profit-sharing. The typical association does not exercise any direct or indirect management control over the professional or administrative functions of its member firms, and does not usually perform any professional services other than those it provides to its member firms or affiliates.

32. A few associations are "anchored" by one large firm. These associations provide member firms with large firm resources, and extend the reach of the anchor firm to areas where it does not have local offices.

Affiliations.

33. These are networks of firms under common management, or participating in some level of profit or expense sharing (Exhibit B). All of the larger firms have affiliates throughout the world that practice under the umbrella organization's name. While the degree of independence of the member firms varies – some may be closer to one global firm, while others are structured as looser federations – all the larger firms support a global infrastructure and management that harmonizes, to some extent, procedures and policies throughout the world. Standard manuals, technology, and training are developed. The global organization may conduct market research on a worldwide basis, so that member firms can agree on a global identity and marketing strategy. The global organization may also fund the initial costs of opening new member firms in countries where the firm lacks but desires a presence.

34. These international networks operating under one name are not new structures – all of the very large traditional firms are organized more or less along these lines. The Board has been advised that the SEC Staff's position is that foreign affiliates must be independent with respect to the U.S. firm's audit clients.

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35. The foregoing series of descriptions is intended to be illustrative rather than exhaustive. It is designed to stimulate identification of the types of potential threats to independence that changes in the traditional firm structure may pose. This intention reflects recognition that other structures also are emerging or are likely to emerge. Some may amount to variations on those described above, while others may be very different.

## Potential Threats to Auditor Independence

36. A set of threats to auditor independence may result from relationships between auditors and other individuals and entities, who in turn have relationships with the auditor's audit clients. These other individuals and entities may include the auditor's corporate employer (or the employer's officers, directors, or shareholders), Sister Firm, Non-Auditor Owner, or investee (a Related Party). The threats to auditor independence posed by Related Party relationships with audit clients are not necessarily new but arise in new contexts, and may include the following:

a. A Related Party could attempt to influence the auditor to allow a client favorable accounting treatment or to deliver an inappropriate auditors' report (e.g., the absence of a going-concern opinion), because of:

i. a loan to or a personal or corporate investment in a firm audit client;

ii. a personal or corporate business venture with a firm audit client; or

iii. a family relationship with someone at a firm audit client.

b. Even without direct attempts to influence them, audit professionals may become sufficiently concerned about the impact of their audits on the business or family members of a Related Party that their judgment could be affected.

c. A Related Party may provide:

i. bookkeeping services to an audit firm client, resulting in the audit firm auditing the work performed by staff of a Related Party (current independence rules for public companies prohibit audit firms from providing bookkeeping services themselves to audit clients);

ii. other services to the audit client that the auditor could not provide directly, which may result in the auditor and client developing an inappropriate "mutuality of interests;" or

iii. other services that put Related Party personnel in the position of audit client management.

d. The auditor might end up auditing the results or value of a product or service a Related Party sold to a client – a product or service that the auditor would be prohibited, under the independence rules, from providing directly to the audit client.

37. In addition to the threats to auditor independence of Related Party relationships with audit clients, some believe that some of these new structures in and of themselves put additional stress on the auditor's independence. This group believes that with public ownership of the consulting practice of an auditor's firm, the firm (and its auditors) will be under additional pressure to meet earnings forecasts, and therefore be reluctant to stand up to an audit client providing the firm with consulting revenues and profits. The sale of a firm's non-attest business to a corporation can generate similar concerns when consulting arrangements with audit clients are part of the sale, and the partners' consideration on the transaction is subject to earn-outs.

38. The evolving forms of firm structure and organization bring new relationships to the auditor and the audit firm that may pose threats to auditor independence. Currently, relationships that others within the firm (e.g., firm consulting staff) can have with audit clients are restricted, as are relationships between audit clients and entities that the audit firm controls. The purpose of most of these restrictions is to prevent the auditor from:

a. auditing the books, records, or values produced by the auditor or his or her colleagues (the threat of "self-review"). For example, some worry that the auditor may be biased in assessing the materiality of a

bookkeeping error made by a firm colleague. They would assert that the "second look" that the audit provides – a second review of the books and records by an impartial and objective professional – is fundamental to auditing.

b. developing an unacceptable "mutuality of interests" with the client. For example, current rules prohibit audit firm professionals from preparing income projections for a publicly-held audit client, on the basis that the auditor might be biased in auditing the client's results during the projection period. Or, the audit team may not exhibit the requisite skepticism in auditing the client's investment results if the firm also acted as investment advisor to the client.

c. acting in the capacity of management. The current rules prohibit the auditor from making decisions or taking actions on behalf of the client that result in the auditor acting in the capacity of management. The independence rules have deemed the hiring and firing of employees, for example, as functions of management inappropriate for the auditor to assume.

39. The question posed by emerging forms of firm organization and the new relationships that these imply is to whom should these restrictions apply? What sorts of safeguards, if any, would be necessary or adequate to address these potential threats to independence? To evaluate these questions, it seems useful to isolate a few specific circumstances in which these threats are more or less clearly implicated – (1) Dual Employment of the auditor; (2) Sister Firms; (3) significant Non-Auditor Owners; (4) minority investment by the Firm in other entities; and (5) client holdings of firm or employer equity securities.

**Dual Employment of the Auditor**

40. In structures where audits are performed by entities owned by CPAs who are also employees of another entity (as a result of a roll-up transaction or the corporate purchase of a firm's non-audit business – see the descriptions of such arrangements in paragraphs 23-27), some question whether the independence rules should allow that entity to have relationships with, or perform services for audit clients that the CPA firm itself would be prohibited from having or doing. In other words, should the "Dual Employment" of the auditor by the audit firm and another entity ("the employer," which may be a corporation with a professional services subsidiary for which the auditor works) draw that other entity under the independence rules? If so, they ask whether all independence restrictions that apply to the audit firm should also apply to the other entity and all of its subsidiaries (*entity, or corporate* independence restrictions), and to what extent *personal* independence restrictions should apply to the other entity's officers and employees. Furthermore, under what circumstances should the independence rules apply restrictions to the other entity's stockholders?

41. Some believe that virtually all of the employer's *corporate* investments in or business ventures with audit firm clients should be prohibited, as if they were owned or conducted by the audit firm itself, to protect auditor independence. They would prohibit the employer and its subsidiaries from entering into certain proscribed business relationships with any of the audit clients of the audit firm. Similarly, if the employer has, or in some cases, has had during the period under audit any prohibited relationship or activity with a company, the audit firm could not accept that company as an audit client. Prohibited business relationships with an audit firm client might include:

a. Loans or other extensions of credit.

b. Deposit relationships (some would be less restrictive here, and only prohibit deposits with the employer that were not fully insured by an agency of the federal government).

c. Retirement plan management (investment and custody of plan assets, payment of benefits, etc.).

d. Investment advisory and / or broker-dealer services.

e. Beneficial ownership by the employer of an audit client's securities, except perhaps immaterial investments owned indirectly, such as through mutual funds owned but not managed by the employer.

f. Joint ventures and similar business relationships between the employer and an audit firm client.

g. Personal trust services for an audit firm client, or its officers or directors, or significant shareholders.

h. Bookkeeping, recordkeeping, payroll services, or executive recruiting.

42. Note that these prohibitions do not address *personal* investments and business ventures by officers and employees of the employer in or with audit firm clients, which others suggest are also necessary and are discussed below.

43. Those who believe in the necessity of restrictions on the relationships between the auditor's audit client and the auditor's employer point out that in a traditional firm, restrictions currently apply to the entire audit firm and its "members," and not just to the engagement team. This extension of restrictions is presumably in recognition that the firm and certain professionals within the firm may be able to exert influence over the engagement team, or that the engagement team may be influenced by firm or colleague relationships with an audit client. Since the rules in these areas extend restrictions beyond those actually performing the audit, some argue that they should be similarly extended to the employer-employee relationship, because it is one that may bear on the auditor-employee's independence. They worry that pressure from an employer may influence the auditor, or that even in the absence of overt

pressure, the auditor might be biased by his or her employer's relationships with an audit client.

44. In addition, the auditor-employee in many of these structures often has significant holdings in the employer's securities (i.e., significant to the auditor). Therefore, some believe, the auditor might be further tempted to preserve the employer's business interests with the client, to protect the value of his or her investment. This inclination might be present to some degree even if the effects of the business relationship were immaterial to the employer. It is the same impulse that drives the Coca-Cola investor to choose Coke over Pepsi in a restaurant, even though the investor's choice cannot possibly affect the stock price of Coke. Employers often capitalize on this instinct when they encourage employees to own stock in the company, believing that employees will work harder and "think like owners," even though the extra efforts of an individual employee are not likely to significantly affect the company's performance or stock price. On the other hand, in some cases, audit firm partners may have a significant ownership interest in the corporate employer (i.e., both significant to the corporation that has a relationship with the audit firm audit client, and significant to the audit firm partners). Therefore, their actions with respect to the audit, if they have a negative impact on the audit client's relationship with the corporation, may affect the value of their investment in the corporation. Or, the individual audit firm partners may collectively own sufficient shares in the corporation to give them significant influence. Some believe that a corporation that can be influenced by the partners of an audit firm (or several audit firms) acting in concert should observe independence restrictions with respect to audit firm clients.

45. This group also points out that in many of these structures, the corporate employer provides all the professionals and resources to perform the audit. They ask whether investors, knowing the extent of the relationships between the employer and the audit firm, will have confidence in the integrity and objectivity of the auditor, if such employers are allowed to, for example, make loans or provide bookkeeping services to the audit firm's clients.

46. Others respect the separate legal structures and identities of an audit firm and the auditor's corporate employer in these structures, and do not believe that auditor independence is impaired by certain relationships between the auditor's employer and his or her audit client. Recognizing the size of some large, multiline corporations that have entered into these alternative practice structures, they would limit restrictions to those individuals and subsidiaries within the employer that have close contact with audit firm personnel or serve in the supervisory "chain of command." In addition, they argue, traditional firms may have close relationships with other service providers who may provide products and services to their audit clients. There are no specific rules proscribing these relationships, although this group believes the potential

threats to the auditor's independence may be similar to those arising when the auditor's employer provides the audit client with products and services. [9]

47. Some also argue that these structures can benefit the independence of the auditor. When a significant portion of the income of the audit firm partner comes from employment with a large corporation, he or she may feel less pressure to acquiesce to the demands of a single audit client. In addition, the enhanced employment and benefit opportunities for professional staff provided by these structures may increase the caliber of professional performing audit firm engagements. Better staff, they believe, will be better able to understand, appreciate, and comply with the independence requirements and ideals of the profession, and to perform more effective audits – the immediate goal of the auditor independence rules. They believe that independence standards placing unnecessary and burdensome requirements on the corporate employer in these arrangements may lead to a decline in the quality of professionals performing audits.

Independence Rules of the American Institute of Certified Public Accountants (AICPA)

48. Recent amendments to the AICPA's rules extend restrictions to the corporate employer and its officials as follows:

a. direct supervisors of audit firm partners and managerial employees located in an office participating in a significant portion of an engagement must observe all independence restrictions currently applied to "members."

b. subsidiaries and other entities over which direct supervisors exercise significant influence must observe all independence restrictions currently applied to "members."

c. indirect supervisors (those one or more levels up the chain of command from direct supervisors) and other employer entities are precluded from having relationships with audit firm clients that are material to the indirect supervisors or the consolidated financial statements of the employer. In addition, indirect supervisors and other employer entities can not have financial relationships that would allow them to exert significant influence over audit firm clients, and no employer entity or employee can act as promoter, underwriter, voting trustee, director, or officer of audit firm clients.

[9] Under current rules, auditors cannot accept commissions or referral fees from product or service providers such as insurance or investment companies for *audit client* referrals. Some audit firms have relationships with these providers, however, and earn fees and commissions on sales to or referrals of *non-audit clients*. The rules do not preclude audit client referrals – only the acceptance of commissions and fees for these referrals.

d. other employer entities over which indirect supervisors have direct responsibility cannot have a financial relationship with an audit firm client that is material in relation to the separate entity's financial statements.

49. Some question whether the AICPA's rules are restrictive enough when it comes to audits of publicly-traded companies.[10] They note that the AICPA approach could permit a multiline employer with a bank subsidiary to make a loan to an affiliated firm audit client, if the loan were not material to the bank subsidiary. Some worry, in this situation, that the auditor would be influenced by the effect his or her audit might have on the collectibility of the employer's loan. Proponents of the AICPA rules believe that restricting relationships to those that are not material reduces the risk of inappropriate auditor influence to a sufficiently low level, in part because they believe that indirect supervisors would not be sufficiently motivated to attempt such influence in the face of the presumed integrity, objectivity, and strength of character of CPAs involved in the engagement. Finally, since the audit firm partners are financially responsible ("at risk") for firm operations and professional liability, proponents believe there is minimal risk that they would jeopardize the firm's well being or their own to protect a relationship that was not material to an employer.

50. Critics of the AICPA rules, however, believe that the auditor could be unduly influenced by the business relationships of an employer's subsidiary with an audit client even if that relationship is not material to the financial statements of the subsidiary. They note that the term "not material" as used in these restrictions is not the same as "immaterial,"[11] and believe that managers and employees are frequently evaluated, praised, criticized, and rewarded for profit and loss contributions that are quite immaterial to the financial statements of one operation or subsidiary of their employer. They believe that the auditor's employer should not be allowed to provide services to or have financial interests in the auditor's clients that the audit firm could not have or provide directly.

Length of the Employment Contract and Other Agreements

51. Another nuance to the employer – auditor employee relationship (Dual Employment) may be the length and nature of an employment contract, and any other employee leasing, or administrative agreements. For example, suppose an audit firm sells its non-audit business to a corporate entity (Public Co.), and the firm's original partners continue to own and manage the audit firm. Several audit firm partners are given three-year employment agreements with Public Co., and are expected to spend less than half of their time during this period working on Public Co. business. The pay they receive from Public Co. will reflect a pre-negotiated salary multiplied by the proportion of their time spent on Public Co. business, subject to a floor, and can only be terminated for

[10] The SEC Staff has not accepted the AICPA's rules on this topic as sufficient for auditors of public companies.

[11] *Webster's Ninth New Collegiate Dictionary* (Merriam-Webster, Inc., 1987) defines "immaterial" as "unimportant," or "of no substantial consequence." "Material" is defined as "having real importance or great consequences."

cause. Audit firm partners will not be eligible for Public Co. bonuses or other incentive compensation. The employment contract is meant to provide enough time to transition non-audit business clients to permanent Public Co. employees. The audit firm will also lease employees from Public Co. at a fixed rate per hour, and rent space and receive other administrative services for a fixed fee set at the beginning of the three-year contract term. After the three-year transition period, all ties between Public Co. and the audit firm will be severed (employment contracts, employee leasing agreements, space lease and administrative services agreement will expire and will not be renewed).

52. Some would argue that in this scenario, the audit firm's relationship to the corporate employer has been adequately managed to protect auditor independence during the three-year transition period. The auditor's compensation and other financial arrangements with the corporate employer are short-term, and fixed as to rate per hour, minimum hour commitments, and fees for services. They contend that in these facts and circumstances, the auditor has even less incentive to compromise his or her independence to protect employer relationships with an audit client.

53. Others contend that the close working relationship the auditor has with the corporate employer and the leased employees and other corporate personnel may be such that the auditor would be unduly influenced when auditing the results of services performed by employer personnel for an audit client, or knowing that the employer or its officers and directors had some financial interest in the audit client. They also point out that there is no legal obstacle to subsequent renewal of agreements that were initially intended as short-term arrangements. This group would require that the auditor's employer and its officers and directors observe independence restrictions with respect to firm audit clients for the duration of the employer – audit firm agreements.

54. There could be other variations of these "Dual Employment" or "temporary Dual Employment" agreements. For example, in a sale of a firm's non-audit business, some of the partners and other professionals may become permanent employees of the purchaser, while others remain with the audit firm. There may be temporary employment contracts between these former firm partners and employees, and the audit firm, to transition audits in an orderly manner. The questions raised under these agreements are similar to those discussed above – should the "Dual Employment" of the professionals performing the audits, albeit temporary and with fixed compensation, compel the other entity and its officers and directors to observe independence restrictions?

55. Or, perhaps an audit firm merely leases professional employees from another entity, at market rates on a "non-exclusive" basis (i.e., the audit firm is free to lease professional employees from someone else, and can cancel the employee leasing agreement at any time without penalty). Some have compared this situation to leasing professionals from a temporary agency such as "Accountants on Call" or "Accounttemps." Existing practice is that professionals leased from these services must follow the independence rules with respect to firm audit clients, but the rules and their restrictions are not extended to the agencies themselves (or to officers or directors of the agency).

Others suggest that standards should impose independence restrictions on the agency if the use of agency professionals is frequent and / or extensive. In some of the employee leasing arrangements arising from new firm structures, the audit firm leases all or virtually all of its professional staff from the corporate entity.

Potential Safeguards[12]

56. Some suggest safeguards to protect auditor independence in these Dual Employment situations, such as:

a. management of the corporation's professional services subsidiary by a majority of CPAs. Those who suggest this safeguard believe that CPAs are more likely to understand the AICPA's *Code of Professional Conduct*, and work to preserve the professionalism (and independence) of the CPA-auditor. In addition, CPA managers in the corporation may offer some protection against an attempt by another corporate officer to influence the outcome of an audit by pressuring an employee-auditor.

b. separate CPA management of the audit firm and the corporation's professional services subsidiary. Recognizing the benefits of CPA management of both the audit firm (generally required by state law), and the corporate subsidiary employing the audit firm professionals, some would further suggest that these management teams be comprised of distinct groups of individuals. They believe that top management of the audit firm should not have top management responsibility for promoting the financial well-being and interests of the corporation's professional services subsidiary, to avoid conflicts of duty when the objectives of the corporation collide with independence restraints imposed on the audit firm by professional standards.

c. separate names, logos, and marketing for the audit firm and the corporation's professional services subsidiary, to preserve the appearance of independence. In addition, when the entities serve joint clients, some would insist on separate engagement letters and billing.

d. employee leasing and administrative agreements that preserve the right of the audit firm to hire its own staff or develop in-house administrative capability, or to purchase these services from other providers. In addition, such agreements between the corporation and the audit firm should, some suggest, obligate the corporation to provide the level of services requested by the audit firm, so that the corporation cannot withhold needed services or staff in an attempt to influence the audit firm. Fees charged under leasing and administrative agreements should be at market rates, so as not to constitute profit-sharing.

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[12] See Appendix B for a comprehensive list of firm and profession policies, procedures, and safeguards which protect auditor independence.

e. adoption of quality assurance policies by the professional services subsidiary so that all employees closely associated with the audit firm understand the auditor's independence requirements.

57: Others, however, are generally skeptical about the effectiveness of safeguards to protect auditor independence when conflicts arise between the interests of the firm or the auditor's corporate employer, and the auditor's professional standards or obligations to the public. It is their experience that safeguards have not been sufficient to overcome the pressures on auditors to benefit from impermissible investments in and business opportunities with clients (see SEC Accounting and Enforcement Releases 994, 1098, and 1134). They believe that the employer's relationships with audit clients should be restricted in the same way that a traditional firm's relationships with audit clients are restricted.

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**Questions for Respondents**

**Q5.** To what extent do you believe that relationships between the auditor's employer and the audit client pose a threat to the independence of the auditor? Do you believe that the auditor's employer should be required to observe any of the *entity* independence restrictions required of the audit firm with respect to audit clients (e.g., prohibitions against firm loans to and investments in audit clients, firm bookkeeping for audit clients, firm-provided investment advisory services, etc.)? Why or why not?

**Q6.** Would your answer to question 5 change if the audit firm's partners owned a significant portion of the employer's common stock, and the investment were significant to the audit firm's partners? If so, why? If the partners collectively own sufficient shares in the corporate employer to allow them significant influence, should that corporate employer observe independence restrictions with respect to audit firm clients? Why or why not? Does it matter if individual audit firm partners across several Sister Firms collectively own sufficient shares in the corporate employer to allow them significant influence? Why or why not?

**Q7.** Should materiality be applied when determining whether the employer's relationships with an audit client impair the auditor's independence? Why or why not? If so, how should materiality be determined?

**Q8.** To what extent do you believe that relationships between the officers and directors of the auditor's employer and the audit client pose a threat to the independence of the auditor? Do you believe that the officers and directors of an auditor's employer should be required to observe any of the *personal* independence restrictions with respect to audit clients imposed on "members" (e.g., prohibitions against investments in an audit client, certain loans from an audit client, business relationships with audit clients, etc.)? Why or why not? If so, how would you define officers?

**Q9.** Should materiality be applied when determining whether relationships between the officers and directors of the employer and audit clients impair the auditor's independence? Why or why not? If so, how should materiality be determined?

**Q10.** Would your answers differ if the audit firm had other relationships with the employer, such as leasing of staff and office space, and other administrative arrangements? If so, how would they differ? Do you believe that the independence of the professional staff is affected by whether they are employed by the audit firm and leased to the professional services subsidiary versus situations where the primary employment and leasing arrangements are reversed? If so, why are these situations different and how do they affect the independence of the professional staff?

**Q11.** If independence standards should impose restrictions on the auditor's employer, should these restrictions vary based on the frequency, projected length, or scope of relationships between the audit firm and the other employer? For example, should restrictions be applied when the employment relationship is temporary (with respect to the employer or the audit firm), and compensation from the employer or the audit firm is fixed? Should independence restrictions extend to an organization and its officers and directors that lease professional staff to an audit firm on a non-exclusive basis?

**Q12.** Are there circumstances in which a controlling shareholder of the auditor's employer should observe some or all of the independence restrictions? If so, what are the circumstances and which restrictions should be observed? Are there circumstances in which a significant shareholder of the auditor's employer should observe some or all of the independence restrictions? If so, what are the circumstances and which restrictions should be observed? How would you define significant shareholder? Should materiality be applied in assessing whether these relationships between a shareholder and an audit client impair the auditor's independence?

**Q13.** Are there safeguards that would be effective in protecting auditor independence in these "Dual Employment" situations? If so, what are they and how would they operate?

**Q14.** Do some of these structures resulting in the dual employment of the auditor serve to promote auditor independence? If so, how?

**"Sister Firms"**

58. An audit firm may have "Sister Firms" related by common ownership, common corporate employment of firm partners and other professionals, or joint membership in an association or worldwide federation (an affiliation). (Associations are networks of independently-owned firms within the U.S. or internationally that are linked for certain purposes, such as shared training and marketing, or to fill gaps in special expertise or geographical presence – see

paragraphs 29-32. Affiliations are networks of firms under common management, or participating in some level of profit or expense sharing – see paragraphs 33-34.)

59. Some believe, for example, that marketing a firm under an association name (i.e., ABC Firm, a member of the XYZ Network) creates a link between Sister Firms in the minds of the auditor and the public, and therefore each should be independent with respect to the other's clients. They would ask, for example, whether the auditor would be impartial when auditing the investment results of a client where an associate firm acts as investment advisor. Or whether an auditor would be viewed as objective when auditing a company where a fellow association member was a significant investor.

60. Similarly, some suggest that the common employment of Sister Firm partners and other professionals by a financial or professional services corporation is a tie that should compel firms to observe the independence rules with respect to each other's clients. For example, if an auditor is precluded from auditing the client's books and records maintained by a firm colleague, why should the rules allow the auditor to audit such records produced by a corporate colleague?

61. Others believe that if there is no profit or significant expense sharing, or sharing of staff between these Sister Firms, the independence rules should not require the observance of independence restrictions with respect to Sister Firm clients. They point out that the auditor, in these cases, would have no financial incentive to protect the interests of the Sister Firm, while having a compelling reason to protect his or her own reputation and that of his or her firm. Therefore, the auditor would have the requisite objectivity needed to identify and correct errors made by the Sister Firm in, say, the bookkeeping engagement, or to impartially audit the investment results of a client where an associate or affiliate firm acts as investment advisor.

62. Others would argue, however, that the reputation of Sister Firm partners and professionals in the business community might very well carry over to the entire association or federation, or in the case of a common corporate employer, to that employer and other firms associated with it. Most firms prominently advertise their association membership, and a professional embarrassment for one firm could embarrass them all. Worldwide federations often practice under the same umbrella firm name. They would argue that in each of these situations there is enough incentive to protect the reputation of the other audit firms in the group to warrant extending the independence rules to all related firms.

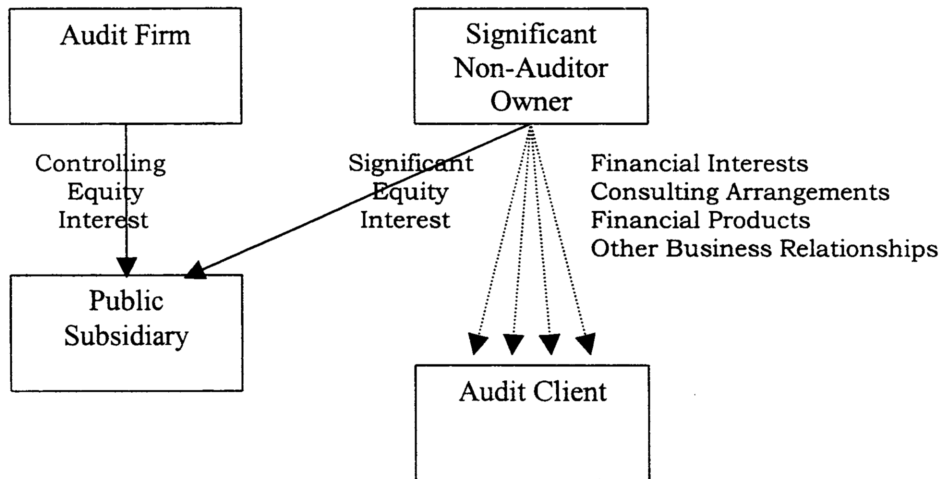
## Questions for Respondents

**Q15.** Are there circumstances when Sister Firms in associations or affiliations should observe independence restrictions with respect to Sister Firm clients? Does you answer depend on whether the firm advertises its membership in the association, or practices under an umbrella firm name, or whether there is

significant profit and expense sharing or a centralized management structure? Are there other criteria you would use to determine whether members should observe such independence restrictions? If so, what are the criteria?

**Q16.** Should Sister Firms united by the common corporate employment of their partners or other professionals (e.g., resulting from the corporate purchase of the non-audit business of the firm, or roll-up transactions, where firm partners and professionals also become employees of the purchaser) observe independence restrictions with respect to Sister Firm clients? Why or why not?

**Significant Non-Auditor Owners**




63. A traditional firm may place all or part of its non-audit practice in a subsidiary, and sell a minority interest to the public, retaining control of the subsidiary (see paragraph 28). Few would contest that the subsidiary and its professionals should observe the independence restrictions that they were required to observe prior to the transaction (under current rules, controlled entities must observe the independence restrictions with respect to firm audit clients).

64. Such public ownership of an accounting firm subsidiary may, however, allow a significant Non-Auditor Owner to pressure the auditor because of a relationship with an audit client, particularly when the public subsidiary is large in relation to the audit firm. Some would suggest that standards are needed extending some or all of the independence restrictions with respect to firm audit clients to significant Non-Auditor Owners (either those that own a 5 or 10% interest in the subsidiary or affiliate, or to Non-Auditor Owners with "significant influence" – generally more than 20% of the voting stock). Others might "draw the line" at Non-Auditor Owners able to exercise significant

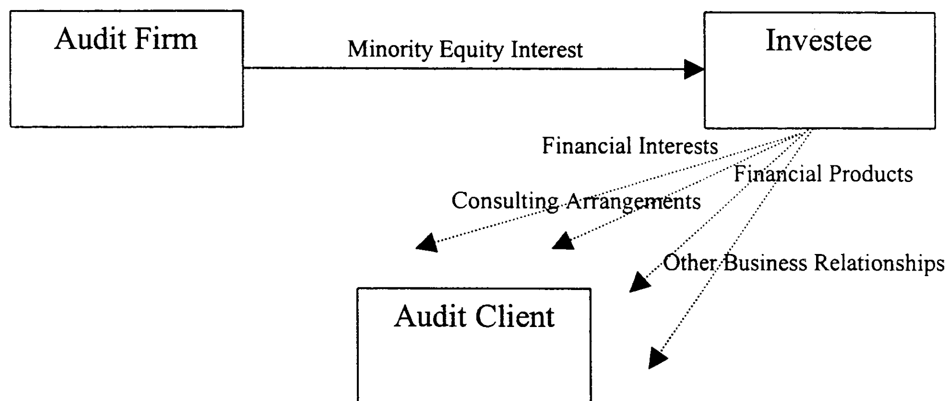
influence over the public subsidiary, *and* whose relationships with firm audit clients are material to the Non-Auditor Owner. They believe that a Non-Auditor Owner, despite the ability to exercise significant influence over the audit firm, would have no incentive to attempt to influence the outcome of an audit, if the Non-Auditor Owner's relationship or interest in the audit client were immaterial to the Non-Auditor Owner. Others argue that minority Non-Auditor Owners may come and go, and it is not practical or desirable to identify and sever relationships that these Non-Auditor Owners might have with audit clients, or to rotate audit firms where prohibited relationships cannot be terminated. This group might argue that safeguards, such as firm consultation and disclosure to the client's audit committee, would effectively protect auditor independence if someone in the firm gets an inappropriate phone call from a significant Non-Auditor Owner.

65. For example, few would argue that a Non-Auditor Owner with the ability to exercise significant influence over a firm's public subsidiary – a subsidiary that is material to the audit firm – should be allowed to retain the firm to audit the Non-Auditor Owner's financial statements, or that the firm should audit the financial statements of a publicly-owned company that such a Non-Auditor Owner controls. Some would argue, however, that safeguards may be effective in protecting auditor independence when a Non-Auditor Owner has a significant equity interest in the audit firm and a significant equity interest in one or more of the firm's audit clients – an equity interest that does not allow the Non-Auditor Owner, however, to control the firm audit client. Safeguards might include discussion with and disclosure to both the firm and client audit committee, and special internal inspections of the audit engagement.

## Questions for Respondents

**Q17.** In situations where an audit firm sells an interest in some or all of its non-audit business to the public, but retains control over the non-audit subsidiary, should independence standards extend restrictions with respect to firm audit clients to significant Non-Auditor Owners of the non-audit subsidiary? Why or why not? How would you define "significant Non-Auditor Owner?" Should restrictions consider the materiality of the relationship between the significant Non-Auditor Owner and the client, and the significance of the publicly-owned subsidiary to the audit firm and the Non-Auditor Owner? Do you believe there are circumstances when safeguards could effectively protect auditor independence when a significant Non-Auditor Owner has a material relationship with an audit client? If so, what are those circumstances, what would those safeguards include, and how would they work?

**Minority Investments by the Firm in Other Entities**




66. Some believe that minority interests by the audit firm in other entities that have relationships with audit clients may pose threats to auditor independence. The investee's relationships with firm audit clients that the audit firm itself could not have may include:

- provision of certain services, such as assuming responsibility for the maintenance and operation of a client's computerized records (for example, in an outsourcing engagement);
- business relationships such as joint ventures and alliances;
- financial interests, such as owning the client's stock, or loans to or from the audit client;
- sales of financial products, such as insurance, mutual funds, and other investments.

67. They believe that if such relationships exist, the auditor may be more lenient in conducting the audit in an effort to protect the investee's business interests and ultimately, the value of the firm's stock in the investee. This group therefore thinks that restrictions should be placed on the relationships that an investee could have with the firm's audit clients. Restrictions could vary based on the level of the firm's investment in the investee, or the materiality of the investment to the firm.

68. Beyond equity ownership, there may be other ties between the audit firm and the investee. The investee may, for example, be the former consulting practice of the firm, in which the majority interest was sold in a public or private offering. This consulting company may, however, continue to share the firm's name, operating under a franchise agreement that allows the firm to control many of the consulting company's activities. The audit firm might also refer its clients to the consulting company on a substantially exclusive basis, and vice versa, and the firm may perform back-office and marketing services to the company under administrative agreements. If the consulting unit were spun-off to the public, the separation agreement between the firm and its

former consulting practice might stipulate earn-outs or profit-sharing for some period of time following the transaction.

69. Current rules extend all independence restrictions to entities that the audit firm or its partners control (controlled entities are considered "members" in the current independence literature, and therefore all restrictions on activities with audit clients apply to them). Evolving firm structures may result in situations where the firm does not have voting control of another entity, but can exercise *effective* control or "significant influence" over that entity. Effective control may stem from a large minority voting interest combined with some or all of the agreements described above and the absence of another party or organized group of parties with a significant voting interest. For accounting purposes, under generally accepted accounting principles, a company is presumed to have significant influence over another if it holds 20% or more of the voting stock. In these cases, some believe that some or all of the restrictions on firm relationships with audit clients should apply to the investee.

70. Others believe that restrictions based on the level of influence that a firm can exert over an investee are really a proxy for measuring the closeness of the relationship between the two, and the degree of alignment in their interests. This closeness and alignment can exist even when the level of the firm's ownership interest in an investee is 20% or less, and may still threaten auditor independence. For example, they argue, an investee sharing the same name with the audit firm, or which is understood in the business community to have some operational link to the firm, might perform the bookkeeping for the firm's audit client under an outsourcing arrangement. The firm's equity interest in the investee may be small. An auditor's objectivity, however, could be affected when assessing the materiality of bookkeeping errors made by the investee, if insisting on an immediate correction could embarrass the investee and therefore the firm, even if the effect of such an embarrassment on the value of the firm's stock in the investee were immaterial. A similar concern might exist if the investment were material to the firm, even if the percentage ownership were small, because of concern about the value of the investment.

71. Another example of a firm's close alignment of interests with an investee might arise from frequent client referrals between the two. If the investee had business relationships with the firm's audit client, for example, the auditor's objectivity might be impaired if the outcome of the audit would somehow jeopardize those relationships with the audit client (e.g., the investee might have a loan to an audit client, whose collectibility would be jeopardized if the auditor issued a "going concern" opinion on the audit client's financial statements), endangering the firm's client referral arrangements with the investee. In these examples, the threat to auditor independence may stem from a combination of factors – concern about the value of the firm's stock holdings in the investee, concern about other business relationships between the firm and the investee, as well as concern for the reputation of the firm itself.

72. Others argue that audit firms currently have alliances and business relationships with other companies that may have relationships with firm audit

clients – relationships that independence standards prohibit the firm itself from having with audit clients. In these situations, the firm may have similar incentives to protect the business interests of the alliance or business partner, which may affect the auditor's objectivity. Yet there is no evidence, they argue, that these alliances and business relationships with third parties have led to audit failure, or even audit weakness. In addition, this group points out that the individuals on the audit team may have minority investments in companies that have relationships with audit clients, and there is no evidence that these have led to audit problems.

73. Some argue that if standards were to extend independence restrictions to investees, then the nature and extent of these restrictions should vary based on the level of the firm's ownership of the investee, *and* the materiality of the investment to the firm. They contend that it does not make sense to impose all restrictions of investee relationships with audit clients, even when the firm has a large minority ownership interest, if that interest is not material to the firm and therefore could not influence the auditor's objectivity.

74. In addition, some might restrict the relationships that the investee could have with an audit client if the audit firm's ownership percentage were high and the investment were material to the firm, but they would not extend restrictions to the *personal* relationships that investee officers and employees could have with audit clients. In other words, they would say that the investee should not own stock in the audit client, but its officers and employees could. They would argue that an auditor might be reluctant to damage the firm's relationship with an investee, or impinge on an investee's business interests with an audit client, but there would not be compelling reason to compromise professional standards to protect the value of stock held by individuals officers or employees of the investee, even if they knew about such investments.

75. Still others dispute the need for any restrictions on investee relationships with audit clients when the audit firm does not have voting control of the investee. They believe that the size and complexity of some firms have introduced many *potential* conflicts between the firm, its audit clients, and other entities. Independence standard-setters cannot extend restrictions to cover all of these entities and relationships, nor do the threats to independence that these pose warrant such extensions. They argue that restrictions should not be expanded based on "worst case" scenarios – a series of hypothetical facts and circumstances, all as unfortunate as the mind can conjure up – leading to a loss in auditor independence. They believe that firm safeguards, such as discussion with the audit committee of relationships between the investee and the audit client, would be sufficiently effective in protecting auditor independence.

**Questions for Respondents**

**Q18.** Are independence standards required to restrict investee (entities in which the firm owns a minority of voting stock) relationships with firm audit clients? Why or why not?

**Q19.** If restrictions are required on investee relationships with firm audit clients, how would you impose them? Should entities the audit firm effectively controls observe restrictions? Is there a threshold level of ownership in the investee that should trigger restrictions, such as the ability to exercise significant influence (generally considered to exist at a 20% ownership level)? Would you consider the materiality of the investment to the firm in imposing restrictions? Are there other facts and circumstances you would consider? Would you restrict the relationships that the investee's officers and employees could have with audit clients in addition to the relationships the investee could have? Why or why not?

**Q20.** Could safeguards effectively protect auditor independence when the audit firm's investee has relationships with audit clients? If so, what would they be and how would they work?

**Client Investment in Firm or Corporate Employer Securities**

76. A potential threat to auditor independence in many of these structures is that the auditor might end up auditing the value of an investment held by a client in his or her audit firm (or the firm's parent, subsidiary, or investee) or corporate employer (collectively referred to as "firm or employer securities" in this section).

77. Some believe that standards should treat client investments in firm or employer securities as an impairment of auditor independence. They argue that audit clients cannot make loans to their audit firms, presumably to prevent the client from giving the firm or its professionals favorable terms or loan extensions in exchange for lenient treatment on the audit, and to spare the auditor from the necessity of auditing the value of such a loan. They believe that similar risks exist when the client buys firm or employer securities, particularly if the block purchased is large, or the stock is not publicly-traded.

78. Few, if any, believe that an audit client should be allowed to own large investments in firm or employer securities – investments that are material to the audit client or large enough to allow the client to control or to exert significant influence over the firm or corporate employer. The Board is not seeking comment on this question at this time. Some argue, however, that client ownership of small amounts of publicly-traded firm or employer securities does not pose a threat to auditor independence. These securities would be carried at market value on the client's balance sheet, and the auditor could easily audit the value by reference to published market prices. If the block were immaterial to the firm or employer, the client would not have any influence over the auditor or over the market value of the securities.

79. Others point out that determining the materiality of client holdings in firm or employer equity securities may not always be easy. For example, the value of the investment might be immaterial to the client's balance sheet, but an "other than temporary decline in value," which would be recorded in the income statement rather than in "other comprehensive income," requires judgment to determine and might be significant to a client's annual or quarterly earnings. Allowing even small client holdings of firm or employer stock, they believe, could put the auditor in the awkward position of arguing for a write-down of his or her firm's or employer's equity securities.

80. On the other hand, some believe a "zero tolerance" rule – a rule prohibiting even the most immaterial client investments in firm or employer equity securities - would be difficult to enforce and fail a cost/benefit analysis. Unlike a loan to the firm or employer from the client, the granting of which requires the participation of both parties, the purchase of firm or employer equity securities on the open market, by the client or its officers and directors, is a unilateral action beyond the control of the firm or employer. If a zero-tolerance rule were enacted, firms would presumably spell-out the consequences of client, officer, or director purchases of firm or employer equity securities (impairment of the audit firm's independence) in the audit engagement letter. Some believe that inadvertent purchases are bound to occur, however, because of the potentially large number of people involved for whom compliance would be required – many unschooled in the CPA's *Code of Professional Conduct* and in other independence rules and regulations.

81. A zero tolerance rule may preclude audit firm clients and their officers and directors from investing in many mutual funds that may, in turn, invest in firm or employer securities. In particular, index funds that mirror their holdings on the entire stock market or some segment of the market might be prohibited if a zero tolerance rule were enacted. Many argue that such a restriction is unnecessary when the client has no direct control over the investments of the mutual fund, the value of the fund as reported on the client's balance sheet is easily verified, and the client's "indirect shareholder status" does not provide any opportunity to influence the audit firm.

82. In addition, some contend that there are high costs associated with firm and client monitoring of compliance with a zero-tolerance rule – costs that exceed uncertain benefits. The firm could easily verify that the audit client did not hold any firm or employer securities at year-end. A change in auditors, however, compelled by an inadvertent and immaterial investment in firm or employer securities at year end, might present problems if a timely and thorough audit is to be conducted. In addition, verifying that there were no purchases and sales of the securities during the year might be considerably more difficult than reviewing year-end balances, especially for companies with large portfolios that are actively traded. If rules extended to them, the audit client would have to poll its officers and directors at least annually (or more often to avoid problems late in the audit), requiring confirmation that they did not own audit firm or employer securities at any point during the period.

83. Some believe the consequences of minor violations of a zero-tolerance rule are even more troublesome. Audit firm rotation, with the disruption, inefficiencies, and increased audit risk some believe this involves, may not be justified when the value of the securities held was immaterial, or the holding was temporary, and therefore they believe there was no threat to auditor independence. This group suggests that the ultimate purpose of auditor independence standards is to enhance the quality of financial reporting, and that a rule requiring audit firm rotation because an audit client or one of its officers or directors owned an immaterial amount of firm or employer stock would be counter-productive. They believe that audit firm rotation, in many cases, reduces audit quality, and that such a measure is unwarranted when the risk to auditor independence is dubious. If an inadvertent, isolated, or immaterial breach of a zero-tolerance rule were discovered, some contend that safeguards, such as audit committee discussion and disclosure, and internal inspection of the audit, would be a more effective way to ensure the quality of financial reporting.

84. Others believe that permitting even limited investment in equity securities while prohibiting loan relationships poses troubling questions concerning hybrid instruments. Should convertible debt instruments be treated as loan instruments or as equity securities, for example?

**Questions for Respondents**

**Q21.** Do you believe that immaterial client, or client officer or director, holdings of the audit firm's equity securities (or those of an audit firm's parent, subsidiary, or investee) threaten the auditor's independence? Why or why not? If not, please describe how you would assess materiality.

**Q22.** Do you believe that immaterial client, or client officer or director, holdings of the equity securities of the auditor's corporate employer threaten the auditor's independence? Why or why not? If not, please describe how you would assess materiality.

**Q23.** Would your answer to questions 20 and 21 differ if the securities were not publicly-traded, such that fair value were less easily determinable?

**Q24.** If you believe that the auditor independence rules should prohibit client investment in firm subsidiary or employer securities, do you believe the rules should permit client investment, or investment by the client's officers and directors, in diversified mutual funds that may invest in firm or corporate employer securities? Why or why not?

**Q25.** If you believe that the auditor independence rules should prohibit client investment in firm subsidiary or employer equity securities, what consequences do you believe are appropriate for immaterial, isolated, or inadvertent violations of the rule? Is replacement of the audit firm required, or can safeguards such as second partner review and disclosure to the audit committee function to protect auditor independence in such instances?

## Potential Safeguards[13]

85. Various safeguards and quality controls are employed today to mitigate threats to independence in traditional firms. Some of these safeguards and controls have already been discussed in the DM, as procedures that some believe might effectively protect auditor independence in certain evolving structures and organizations. Many of these existing safeguards and controls could be adapted to focus specifically on threats to independence posed by any of these new structures. For example, concurring reviews by second partners could include specific procedures to be performed or inquiries to be made in the event of client investment in firm securities. In Dual Employment situations, required discussion with the audit committee of relationships between the auditor's employer and the audit client may focus both the auditor and company management on potential conflicts, thereby mitigating threats to auditor independence. Internal consultation could be required when a significant Non-Auditor Owner in the firm has a significant relationship with an audit client, and internal firm communications could alert professionals to the independence risks raised by new structures, and reiterate firm commitment to uncompromised professional values. Firm compliance with these policies and procedures could be tested in peer review. Rather than extending existing restrictions to additional persons and entities with a relationship to the auditor by virtue of a new firm structure, some believe existing safeguards and controls could be successfully adapted to cover the threats to independence raised by new firm organizations.

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## Questions for Respondents

**Q26.** Do you believe that traditional safeguards and controls such as concurring review, internal consultation, audit committee disclosure, training in firm culture and professional values, and peer review could effectively protect auditor independence in new structure situations? Why or why not? Are there other safeguards not traditionally employed by audit firms that may be useful in mitigating threats to independence raised by new structures? If so, please identify and evaluate these potential safeguards.

**Q27.** Are you aware of other firm structures not mentioned in the foregoing that may raise potential threats to independence of a kind not otherwise discussed in the DM? If so, briefly describe the structures and the potential threats to independence they pose. How should standards treat these threats?

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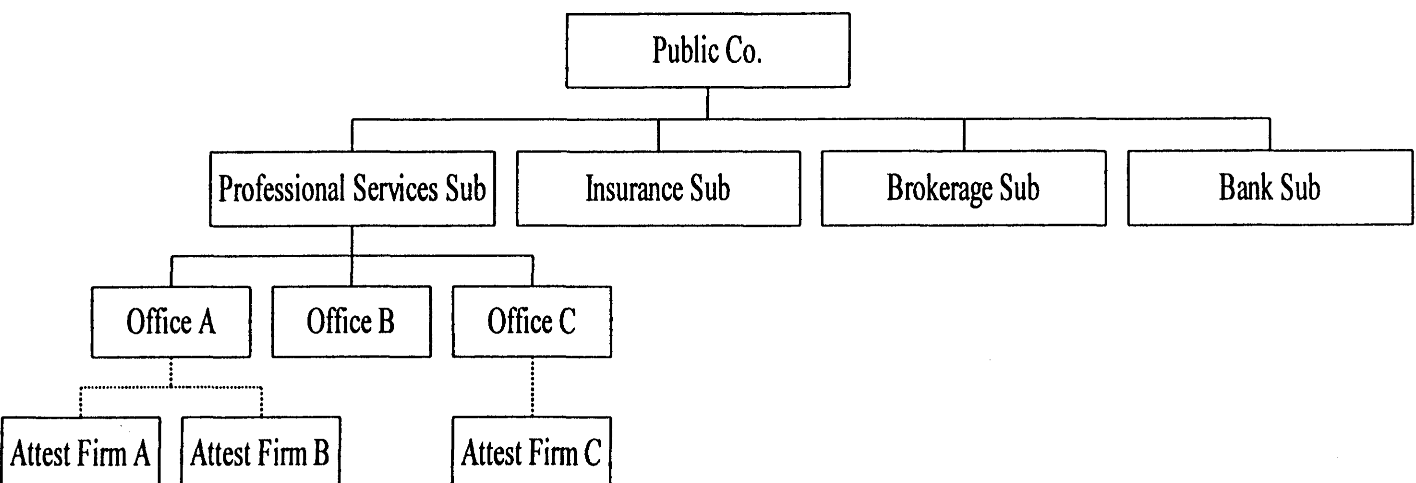
[13] See Appendix B for a comprehensive list of firm and profession policies, procedures, and safeguards which protect auditor independence.

**Exhibit A**

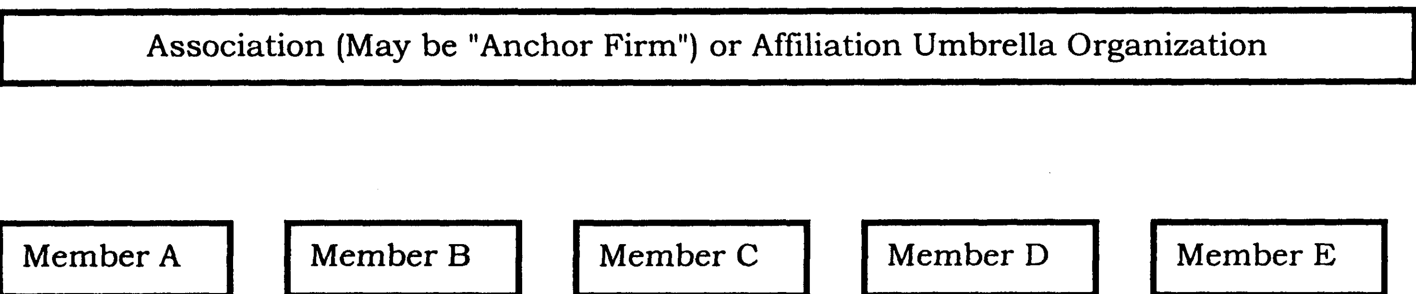
# Example Alternative Practice Structure




This structure can result from the corporate purchase of the non-attest business of several traditional firms, or from a roll-up transaction.

**Exhibit B**

# Practice Structure
# Associations and Affiliations




The terms "association" and "affiliation" capture a range of practice structures that exist along a continuum depending on a variety of characteristics such as resource sharing, ownership links, profit and loss sharing and so on.

**Appendix A**

## Services Offered by Professional Accounting Firms[14]

### Accounting and Auditing Services

1. Year end audit. This may include assisting the client in calculating the amount of the income taxes owed, valuing stock options and other stock compensation arrangements under FAS 123, and drafting and typing the financial statements.
2. Review of interim (monthly, quarterly) financial statements.
3. Compilation of financial statements.
4. Bookkeeping services (some firms offer this as a computer bookkeeping service).
5. Valuations of derivatives at fair market value for accounting purposes.
6. Assistance in preparation of and review of filings with the SEC, including initial public offerings.
7. Underwriter comfort letters for SEC and non-SEC filings.
8. Audit of Management's Discussion and Analysis in SEC filings.
9. Agreed-upon procedures engagements (the client and auditor agree to procedures the auditor is to perform with respect to tasks such as testing a royalty arrangement or compliance with a loan agreement, and the auditor then issues a report on his or her findings).
10. Audit or review of financial forecasts or projections. This includes such documents included in offering memoranda.
11. Providing advice on how to interpret new accounting pronouncements, including providing sample journal entries.
12. Audits of financial statements of pension plan financial statements.
13. Director examinations of financial institutions.
14. CPA WebTrust - an engagement to review the security of a company's website that is conducting electronic commerce over the internet.
15. Assisting international companies in conforming their financial reporting to U.S. financial reporting practices (GAAP conversions).
16. Technical opinions on accounting matters to clients of other accounting firms.

### Business Controls

1. Ethics and Responsible Business Practices – a service that helps clients address the sources of internal wrongdoing and eliminate barriers to responsible business practices.
2. Evaluation, design and implementation of internal accounting and financial reporting controls, policies and procedures.

[14] Under the current independence rules, auditors may face restrictions in performing some of these services for public company audit clients.

3. Evaluation, design and implementation of management and business controls over various business functions such as management reporting systems, research and development, etc.
4. Examinations of internal controls.
5. Business Fraud and Investigation Services - helps companies identify, manage and minimize integrity risks, such as suspected management or alleged employee fraud.

**Tax Services**

1. Preparation of federal and state individual income tax returns.
2. Preparation of federal and state corporation tax returns.
3. Individual and corporate tax planning (including federal, state, and local taxes).
4. Personal financial planning for individuals including client employees and executives.
5. Income tax planning for executives including employee compensation and benefit plans (see below).
6. Investment planning.
7. Programs for planning for college.
8. Retirement planning programs.
9. Estate planning including preparation of wills, trusts, etc.
10. Representation of clients in tax negotiations and disputes with the IRS.
11. Review of property tax assessments.
12. Succession planning.
13. Serve as or provide tax advice to executors and trustees.
14. Tax credit reviews to determine maximum allowable credits (e.g., research and development credits).
15. Trade and customs services - ensures compliance with trade laws and regulations while trying to avoid, reduce, or defer overall customs duties.
16. Transfer pricing studies and evaluation, documentation, and modification of existing policies.
17. Valuation services.
18. VAT Services.

**Financial Services**

1. Treasury management services including design, development and implementation of policies and procedures.
2. Credit management services including design, development and implementation of credit policies and procedures.
3. Design and structuring of financial instruments.
4. Assisting investment banking firms with the designs of financial instruments and financing transactions.
5. Assistance with finding/identifying equity parties or financial parties.
6. Identification and selection of banks.
7. Assistance with or preparation of financing and loan applications.
8. Loan review services.

9. Regulatory advisory services.

**Information Systems Technology**

1. Selection of new hardware and software systems. This may include activities such as performing a "needs analysis," preparation of a request for proposals, and overseeing, assistance with, or performance of demonstrations.
2. Implementation of new hardware and software systems. This may include:
   - Full on-site team to perform all implementation services.
   - Project administration of another consulting team.
   - Development of necessary manual and computer control systems.
   - Providing necessary computer programmers.
   - Software design and programming.
   - Ongoing support functions.
3. Consulting on Y2K issues such as:
   - Inventory of Y2K system problems.
   - Development of Y2K remedial program.
4. Development of IT management and/or strategic plans.
5. Evaluation and selection of telephone systems.
6. Business continuity planning and information security services.
7. Application controls consulting.
8. Electronic commerce services.
9. Reporting on the Processing of Transactions by Service Organizations.

**Employee Benefit Programs**

1. Designing and developing employee compensation programs including:
   - stock option programs.
   - retirement plans.
   - executive compensation arrangements.
   - deferred compensation and bonus arrangements.

**Business Reengineering**

1. Benchmarking of best practices including business and financial reporting practices.
2. Reengineering of business processes including:
   - manufacturing processes.
   - research and development processes.
   - review of spending levels (e.g., for general and administrative expenses).
   - plant layout and design.
3. Review of manual processes that feed into computerized information systems.
4. Staff reduction programs.

**Outsourcing**

Outsourcing of such client functions as:

1. Information systems. This may include outsourcing the management or the entire data processing and information systems group.
2. Internal audit function.
3. Tax department.
4. Office of the Chief Financial Officer.
5. Accounting department.
6. Human resource department.
7. Risk management function.

**Corporate Finance**

1. Deal due diligence.
2. Candidate targeting.
3. Preparation of offering memorandums.
4. Lead advisor for private placements.
5. Merger transaction advice on:
    - Structuring of transactions.
    - Tax implications.
    - Sourcing capital.
    - Preparation of pro forma financial statements and projections.
    - Reengineering acquired businesses.
    - Cost reduction and synergistic studies.
6. Appraisal and valuation of target assets, including receivables, inventories, property, plant and equipment, intangible assets, and in-process research and development.
7. Fairness opinions.
8. In some foreign jurisdictions, the firms act as stock transfer agents.
9. "Turnaround" business advisors.

**Marketing and Distribution**

1. Evaluation of marketing and distribution channels.
2. Development of marketing and distribution channel plans and consulting on the implementation of such plans.

**Legal Services**

1. Corporate and commercial legal services to national and international companies worldwide.
2. Assistance to law departments and general counsel to enhance and measure performance.

**Litigation Support**

1. Case management.
2. Expert accounting and financial reporting witnesses.
3. Damages experts and witnesses.
4. Environmental litigation experts.
5. Securities litigation experts.
6. Antitrust services.
7. Construction disputes.
8. Analysis of detailed data to provide cost-effective, proactive strategies and solutions to complex business disputes.

**Other**

1. Government Contract Consulting - helps companies understand and address business risks associated with negotiating, contracting with, and performing under contracts for the sale of goods or services with U.S. federal, state, local and foreign governments.
2. Advise government entities that are privatizing on commercialization, restructuring, competition, changing organization attitudes, customer satisfaction and policy adjustment; provides other grant-aided work in emerging markets.
3. Real estate - provides advice about increasing the profitability of real estate assets through the acquisition, development, management and disposition of single assets or portfolios of properties. Services also include strategic planning, consolidation studies, surplus property planning, valuations, and outsourcing consulting.
4. Services for middle-sized companies - includes cash management, payroll needs, business relocation services, and shareholder meetings.
5. Insolvency/executory services - acting as receivers, liquidators, bankruptcy trustees, or advisors to debtor or creditor groups.
6. Specific services for health insurers and other health care organizations.

**Appendix B**

## The Profession's Policies, Procedures, and Safeguards To Protect Auditor Independence

The firms and the profession have instituted various policies, procedures, and safeguards to meet the dual goals of achieving quality audits and enhancing public perceptions of and confidence in the professional practice of auditing. The purpose of many of these practices is to safeguard the independence of the auditor, while others are targeted to other quality control objectives but may also indirectly protect independence.

- The profession has a code of professional conduct requiring ethical behavior by its members, which includes standards on auditor independence (*AICPA Professional Standards: Code of Professional Conduct,* American Institute of Certified Public Accountants). The code describes the meaning of independence, the related values of integrity and objectivity, and the profession's obligations to the public. The code and its interpretations proscribe many financial, business, and other relationships between the auditor and audit client to protect auditor independence.

- The AICPA also imposes quality control standards – standards for designing and maintaining systems of quality controls over auditing services, including, for example, the systems of hiring, training, promoting, and compensating professional personnel. The AICPA's quality control standards also require audit firms to design and implement appropriate quality control policies and procedures related to independence. Firms are required to communicate their independence policies and procedures to appropriate personnel, and to monitor compliance with them.

- The Independence Standards Board recently issued a standard requiring annual communications between the auditor and the audit committee regarding relationships that, in the auditor's professional judgment, may reasonably be thought to bear on independence, as well as written confirmation that the auditor is independent of the company within the meaning of the Securities Acts (ISB Standard No. 1, *Independence Discussions with Audit Committees*). Such discussions with the audit committee are likely to sensitize both auditors and company management to these issues, making independence impairments less likely. In addition, involvement of the audit committee in independence matters may compel the committee to reiterate the company's commitment to fair financial reporting, emphasizing that attempts to intimidate the auditor will not be tolerated.

- In 1977, the AICPA established the SEC Practice Section (SECPS) as a voluntary membership organization within the AICPA with the objective of improving the quality of practice of CPA firms before the SEC. In 1990 the

AICPA made SECPS membership mandatory for those member firms that audit one or more SEC clients. Virtually all of the firms auditing U.S. - headquartered public companies today are members of the SECPS. In addition, approximately 500 firms that do not audit SEC registrants have joined the SECPS. The Public Oversight Board (POB) oversees the activities of the SECPS.

- Members of the SECPS must participate in peer review – a process in which another SECPS member reviews the firm's quality control policies and procedures every three years. The review team evaluates whether (1) the reviewed firm's quality control system is appropriate, (2) the firm's policies and procedures are adequately documented and communicated to its personnel, (3) the firm is complying with such procedures so as to provide reasonable assurance of conformity with professional standards, and (4) the firm is in compliance with the membership requirements of the SECPS. At the completion of the peer review, the review team provides the reviewed firm with a formal report and, if applicable, a letter of comments on matters that may require action by the firm.

- Firms are required under SECPS membership rules to rotate engagement partners at least every seven years, and in the normal course of business usually do so for other engagement professionals. Engagement partners are prohibited from returning to in-charge status for a minimum of two years. Otherwise, engagement partners and professionals can become too close to a client and lack the requisite skepticism in assessing management's representations. In addition, the knowledge that a replacement partner or staff member will have the opportunity to second-guess decisions may encourage conservatism in decision-making.

- Firms are also required under SECPS membership rules to assign a concurring review partner to audit engagements to objectively review significant auditing, accounting and financial reporting matters. The concurring review partner may not have served as audit engagement partner for at least two prior annual audits. The concurring review can serve to balance perspective when the audit team may be too close to the client, lacking the requisite skepticism, or has been persuaded to accept an inappropriate accounting treatment.

- In addition, firms are required under SECPS membership rules to ensure that their foreign associated firms have adopted policies and procedures regarding U.S. accounting, auditing and independence standards with respect to certain filings by SEC registrants. The policies and procedures include a review by a person knowledgeable in accounting, auditing and independence standards generally accepted in the U.S. and discussions with the audit partner in charge of the engagement with regard to any significant auditing, accounting, financial reporting, and independence matters. The membership rule also requires that the policies and procedures include the review of a sample

of these audit engagements as part of the firm's internal inspection program.

- The SECPS maintains a Quality Control Inquiry Committee (QCIC), which investigates allegations of audit failure against SECPS member firms. The review determines whether the firm needs to strengthen its quality control systems or address personnel deficiencies. The QCIC's work may also raise questions that suggest the need to reconsider or interpret professional standards, or identify audit practice issues where practical guidance would benefit practitioners. The QCIC refers such matters to those bodies responsible for issuing professional guidance.

- The SECPS also operates a Professional Issues Task Force that distributes practice alerts to members on various professional practice issues. For example, the Task Force recently issued Practice Alert 99-1, *Guidance for Independence Discussions with Audit Committees.* This Practice Alert provided members with guidance on implementing the ISB's first standard.

- The profession and its regulators, including the SEC and the state boards of accountancy, have a disciplinary system in place to deal with violations of the profession's behavioral (including independence), technical and quality control standards. In addition, firms often take disciplinary action against individuals who fail to comply with professional standards.

- Firms produce manuals describing firm and professional standards governing independence that are updated periodically and are distributed to all professionals to educate and aid them in understanding the requirements. Training in these requirements is also provided to all professionals.

- The ISB Staff answers questions and issues interpretations on the application of the independence rules to specific facts and circumstances involving public company audit clients. The AICPA's Professional Ethics Division Staff provides a similar function for private companies and their auditors.

- Firms typically require all professionals to confirm annually, in writing, that they do not own any prohibited investments in audit clients, and that they comply with all independence rules and regulations. Some firms monitor and track all of their professionals' personal investments, requiring the professionals to notify the firm of all purchases and sales in their personal portfolios.

- Firms have client acceptance and continuation policies designed to prevent association with unsavory clients, and to encourage the termination of relationships with clients that are not committed to fair financial reporting, or whose tactics of persuasion include intimidation of the auditor. While there are other reasons to reject or terminate a client relationship,

concerns related to client integrity frequently are factors in these decisions. In addition, in determining whether to accept a new client, the auditor is required under professional standards to communicate with the predecessor auditor. This communication must include specific questions regarding management's integrity, the existence of any disagreements over accounting, auditing, or reporting matters, and the predecessor's understanding of the reason for the change in auditors.

- Firms also have acceptance policies and procedures covering new service lines. Firm partners specializing in independence typically review each proposed new service to determine whether the service should be restricted to non-audit clients.

- Many firms have separate, centralized consultation functions staffed with experts in accounting, auditing, and reporting matters. These specialists assist the engagement team in assessing issues where guidance is unclear, the issues are highly technical or require a great deal of judgment, or where there are disagreements with the client. These professionals can protect auditor independence when the engagement team is being unduly pressured by a client.

- Similar to the peer review program, firms conduct internal inspections, usually on an annual basis, of selected audit engagements. These reviews are generally quite comprehensive, and a great deal of resources are spent on them. The objective of the reviews is to identify weaknesses in audit quality and areas where quality controls should be strengthened, and to monitor compliance with firm policies. Verification of compliance with independence policies and identification of audit weaknesses that could result from a lack of independence would be part of these reviews. The results of these reviews are generally taken quite seriously, and a bad review can jeopardize a professional's career or result in dismissal.

- Firms carefully analyze litigation experience and allegations of audit failure to identify weaknesses in audit quality and to assess whether changes are needed in the audit process, firm policies, or firm personnel.

- Auditors are subject to continuing professional education requirements imposed by state boards of accountancy, state societies, and the AICPA. The purpose of these requirements is to increase the professional competence of CPAs. While there is latitude in the educational programs that an auditor can chose to fulfill these requirements, many qualifying courses undoubtedly contribute to the professional's understanding of the auditor's unique role in protecting the public interest, and of the profession's standards of independence, integrity, and objectivity.

- Many state boards of accountancy require CPA candidates to pass an ethics exam in order to obtain licensure.

- Finally, firms that are members of the AICPA must retain financial responsibility for the attest work performed by the firm. In addition, the threat of litigation and/or damage to the firm's reputation, its greatest asset, serve to protect auditor independence and promote compliance with all professional standards.

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**Independence Standards Board**