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DM 99-1

Discussion Memorandum

Employment with Audit Clients

March 12, 1999

Independence
Standards
Board

Independence
Standards
Board

Discussion Memorandum
(DM 99-1)

Employment with Audit Clients

March 12, 1999

Comments should be received by June 18, 1999, and addressed to:
Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: DM 99-1

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 99-1).

Independence
Standards
Board

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Date: March 12, 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. 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 is studying the independence concerns related to audit firm personnel going to work for audit clients. As such, the Board seeks comment on the issues described in this discussion memorandum.

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.

While the ISB welcomes comments and suggestions on any aspect of the employment with audit client issue, input is specifically being sought on the following questions:

1. Does the discussion memorandum identify all the potential threats to auditor independence posed by auditors going to work for their audit clients?

2. In protecting auditor independence in employment with audit client situations, which is a more cost-effective solution — firm-implemented safeguards or a mandatory "cooling-off" period?

3. If a safeguard approach is the best way to protect auditor independence when firm personnel go to work for audit clients, would the safeguards described in the discussion memo be effective, or are there additional safeguards that could be implemented to accomplish the goal of protecting the independence of the auditor?

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4. If a cooling-off period is the best way to protect auditor independence in employment with audit client situations, how should the applicability and length of the cooling-off period vary with regard to the level and position of the professional joining the client, the circumstances of his or her departure (resignation versus termination versus retirement), and the position assumed at the client?

5. Is there a better mechanism for protecting auditor independence than either safeguards or a mandatory cooling-off period?

6. When a partner joins an audit client, current rules require that the partner's capital balances and retirement benefits be settled in full prior to the commencement of the audit engagement. Some have questioned the relevance of this "full-payout" requirement in situations where the capital account and retirement benefit balances are de minimus to the firm. When balances due to the former partner are immaterial and there are no extenuating circumstances such as financial distress on the part of the audit firm combined with unfunded benefits, do these financial interests in the firm pose a threat to auditor independence? If so, should the "full-payout" rule extend to senior, non-partner employees assuming positions of responsibility at the client?

Responses should be addressed to the Independence Standards Board, 6th Floor, 1211 Avenue of the Americas, New York, New York 10036-8775, Attn: ITC 99-1. Responses may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to ITC99-1). Comments must be received by June 18, 1999.

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 AICPA at Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey.

Employment with Audit Clients

Discussion of Issues

Background and Executive Summary

1. Partners and other professionals have been leaving their firms to join audit clients for many years. Turnover at public accounting firms has always been high, and in more recent years, partners have begun to resign from firms with increased frequency, with others retiring in their late 50's to start second careers.

2. Contributing to the current concerns regarding audit professionals joining clients have been several, well publicized financial scandals where alumni of the audit firm held positions of responsibility at the client. Although cause and effect may not have been established, the media frequently report the fact that former employees or partners of the audit firm are in positions of responsibility at the company, with an inference of causation. This is reinforced by the frequent use of the term "revolving door" to describe such employment - a reference to the common practice of officials from the private sector going to work for the government for a few years and then returning to their former employers. In fact, it is rare that someone in public accounting leaves and then at a later date returns to the audit firm.[1] But the revolving door treatment in the media reinforces the appearance issue.

3. Much has been written about this topic over the years, and proposed solutions generally run along one of two lines: (1) the institution of additional safeguards or mitigating controls in the audit firm to better protect auditor independence when professionals join audit clients; or (2) a mandated "cooling-off" period – a prohibition against public companies hiring their auditors for some period of time, or a restriction placed on the CPA firm or its professionals (as opposed to the client) by deeming such a hiring to impair the independence of the auditor.

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

   a. That members of the audit team, who may have been friendly with, or respectful of a former partner or professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client's

[1] The independence issues which arise when a client official joins an accounting firm (or when accounting firm personnel join clients and later return to the firm) will not be explored here because they are of a different character.

proposed accounting without exercising appropriate skepticism or maintaining proper objectivity.

b. In situations where partners or other audit team members resign to accept positions with audit clients, questions may be raised regarding whether the individuals exercised an appropriate level of skepticism during the audit process prior to their departure.

c. That the departing partner or professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent its design.

5. At times, the profession has endorsed a mandatory cooling-off period. The Board of Directors of the American Institute of Certified Public Accountants, in a 1993 report entitled "Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession," called on the SEC and other regulatory bodies to prohibit public companies (and other organizations with public accountability) from hiring the partner responsible for their audit for one year after the partner ceases to serve that client. A similar suggestion was included by the Chairmen of the Big Six accounting firms in a 1993 statement of position issued in response to the Public Oversight Board's report entitled "In the Public Interest – Issues Confronting the Accounting Profession." The reports of the Big Six firms and the AICPA Board came in the wake of some highly publicized business failures, and they recommended several other changes to solidify trust in the financial reporting system.

6. In November 1996, the AICPA's SEC Practice Section Executive Committee appointed a task force to study these issues. The task force drafted both proposed SECPS membership requirements and "best practices" guidance relating to professional staff and partners that are offered employment, are considering employment, or have accepted employment with a client whose engagement requires independence. These proposed requirements called for new procedures intended to prevent or detect any inappropriate actions taken by the departing professional, or that result from the lack of appropriate skepticism by the audit team because the former professional is now with the client. Safeguards rather than a mandatory cooling-off period were advanced as cost-beneficial procedures that would be effective in preventing or detecting abuses.

7. The SEC Staff, in response to the proposed SECPS membership requirements, indicated that they continued to believe that, based on the facts and circumstances of a particular case, a period of separation might be appropriate when a former partner, or in some circumstances a senior manager, provided professional services to a public company and then assumed a role in the company's senior management or on the board of directors.

8. Also in 1996, the European Contract Group, composed of representatives of the eight largest international networks of accounting firms, studied ways in which the accounting profession in Europe might respond to the "expectation gap" – the gap between the role and responsibilities of the profession, as seen

by the users of financial statements, and their views as to the profession's performance in meeting those expectations. The Group concluded that a prohibition on partners (or staff) joining their audit clients was unrealistic or impractical, but that care must be taken to ensure the appearance of objectivity in these circumstances. The Group suggested safeguards consistent with those proposed by the SECPS.

9. In January 1998, the International Federation of Accountants released a revised *Code of Ethics for Professional Accountants.* In employment with audit client situations, the guidance suggests safeguards with respect to a former partner's financial interests in the firm, and prohibits the participation or appearance of participation in firm business or professional activities.

10. In July 1998, the Federation des Experts Comptables Europeens released core principles on auditor independence and objectivity for the guidance of the European profession. The guidance suggests a safeguard approach to protect independence when partners or senior employees of the audit firm join the audit client.

11. A cooling-off period could be applied in several ways:

- c. A prohibition against companies hiring from their audit firms;
- c. A rule calling for a replacement of the audit firm when certain firm professionals join an audit client; or
- c. Employment contracts between firms and their professionals describing the conditions that would have to be satisfied before a professional could go to work for an audit client.

12. However, in 1994, the SEC staff stated that "it would be difficult, if not impossible.....for the Commission administratively to prohibit a company from hiring anyone, including the individual that the company believes is the most qualified candidate for any position within the company"[2]) (the application described in 9a. above). Instead, most proponents of the cooling-off period believe that the requirement to hire a new audit firm would discourage most companies from hiring professionals from their current firm, which the proponents believe would be a positive development. In those cases where the client did hire from the audit firm, proponents of the cooling-off period believe that the risks to audit quality described in paragraph four should require replacement of the audit firm.

13. Those in favor of safeguards contend that a cooling-off period rule carries a cost to the profession, industry, and the public interest. They believe that limiting the career opportunities of accountants will make the profession less attractive to the most promising recruits, and limiting the ability of companies to hire qualified people will, in some cases, reduce the quality of financial reporting - and that these costs ultimately impinge on the degree of confidence investors can place in the securities markets. While they recognize that there

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[2] Staff Report on Auditor Independence, Office of the Chief Accountant, Securities and Exchange Commission, March 1994.

have been some instances where former audit professionals engaged in preparing false financial statements shortly after leaving the audit firm and joining the client, a lack of auditor independence resulting from the hiring of the audit firm personnel was rarely alleged or established. Advocates of safeguards also believe they reduce the risk of abuses to an acceptably low level. And although safeguards may not be a fail-safe solution to perceived problems, they believe that a mandated cooling-off period is also far from fail-safe, because its objectives can be evaded.

14. Advocates of the mandatory cooling-off period believe that the proposed safeguards approach would be ineffective in addressing the problems set forth in paragraph 4 above. The proponents of a cooling-off period are also concerned that when evaluating whether an engagement team member should be replaced because of a strong relationship with a former boss or colleague now at the client, firms may sometimes be liberal in the application of the safeguard. Firms have an interest in maintaining strong relationships between engagement teams and clients, and judgments in these matters may be difficult to "second guess," because of the difficulty in assessing the strength of personal relationships. In addition, advocates of the mandatory cooling-off period assert that the preservation of both the fact and appearance of auditor independence is of primary importance.

15. Some also question the relevance of existing guidance on severing financial ties with former partners and professionals in employment with clients situations. They believe the threats to auditor independence posed by these financial interests seem far-fetched when the benefits or monies held by the firm are immaterial to the firm. Others question whether, from an investor's perspective, the firm's failure to sever financial ties with former partners and professionals who accept employment with audit clients creates an appearance of a lack of independence for the auditor's former firm. They also believe that materiality is hard to assess in many cases, and that any financial ties between the audit firm and the client encroaches unnecessarily on the appearance of independence.

16. This paper seeks to analyze the issues surrounding employment of partners and professional staff by audit clients, and discuss the "pros and cons" of proposed alternatives. Rather than restricting the scope of the paper to an examination of issues as they relate to a particular group of professionals joining audit clients, the Discussion Memo covers the issues and their variations as they apply to a wide range of individuals and situations. For example, the concerns one would have when a partner leaves a firm to join a client would exist, to a lesser extent, when professionals with lower levels of responsibility leave and go to clients. These concerns would presumably diminish as the level of the departing professional decreased (both proponents of safeguards and of the mandatory cooling-off period would adapt the proposed rules to account for the seniority or role of the departing professional). The language of any rules must be sufficiently flexible to contemplate these intentions, especially as the structure of the firms change, and more professionals are given new responsible, non-partner roles in firms. In addition, the issues may vary for active versus retired partners, those leaving

the firm voluntarily versus those terminated, and engagement partners versus partners having little or no direct prior professional relationship with the client.

Discussion of Issues

Proponents of the Mandatory Cooling-Off Period

17. Advocates of a mandatory cooling-off period emphasize that such a measure is necessary to ensure that both the fact and appearance of auditor independence are preserved to maintain investor confidence in the audit process. As such, certain safeguards should be applied to the individual's relationship with his or her audit firm, which include a cooling-off period. They believe that a former partner or professional should not be in a position to exercise any influence over the auditing firm or individual members of the firm. In addition, the audit partner or professional may be less likely to be accommodating to a client as the likelihood of a job offer decreases, and presumably, the likelihood of a job offer would decrease if, in extending an offer, the company was compelled to change audit firms. For these reasons, they would require that a reasonable period of time elapse between retirement or resignation and acceptance of a responsible position with the client of the firm (any influence a former partner or professional may have is perceived to diminish with the passage of time and changes in the personnel of the firm). In implementing a cooling-off period, decisions would have to be made regarding the length of period and whether it would be limited to either certain levels (e.g., partners and managers), or just those providing audit services, based on some other criteria, or applied to all professionals in the audit firm.

18. At times in the past, the SEC Staff has informally suggested two years, one year, or at least one audit season as a "rules-of-thumb" to apply in determining a reasonable cooling-off period. The SEC Staff believes that the decision on whether a cooling-off period is warranted and the determination of a reasonable separation period should depend on the facts and circumstances. Factors that might be considered include:

a. The services that the former partner or professional provided to the company while he or she was with the audit firm. Generally, advocates of a cooling-off period believe that a period of separation may be warranted for the audit partner or senior audit personnel, tax partners, concurring reviewers, and others closely involved with the audit of the client. A cooling-off period may also be warranted for nationally-prominent partners even if not directly involved with the engagement.
b. The seniority, stature, and authority within the firm of the new engagement partner compared to that of the former partner or professional when he or she was with the firm.
c. Previous personal or professional relationships between the former partner or professional and the new partner or senior personnel on the audit engagement.
d. The number of firm alumni currently occupying positions as officers or directors of the client.

e. Whether the former partner or professional negotiated or sought employment from the client during any part of the audit engagement (current AICPA rules require that the individual remove himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought).
f. The current responsibility or ability of the former partner or professional to interact with, or make representations to, the auditors.
g. Whether the former partner resigned voluntarily, was terminated, or retired and joined the client.

19. The factors enumerated above illustrate the complexity of the issues involved, and the degree of judgment that would have to be exercised to apply what appears to be, at first glance, a simple rule (i.e. a mandated cooling-off period). For example, whether the former partner or professional resigned voluntarily, was terminated, or retired might influence the determination of an appropriate cooling-off period. Firms often maintain formal and periodic communications with retired partners, and it seems logical that a retired partner may have stronger ties to his or her firm, and vice versa, than someone who left the firm in mid-career for what he or she believed was a better opportunity. These differences, if any, would seem to diminish as the length of time the person was with the firm increases.

20. Some also believe that the risk of a "terminated" partner or professional having undue influence over the remaining engagement team is less than in resignation or retirement situations, particularly when the fact that the former partner or professional was terminated is widely-known. On the other hand, a partner or professional anticipating termination may be less rigorous in challenging a client's accounting in the hopes of obtaining future employment with the client. How would a mandated cooling-off period be adapted to fit these varied circumstances? Some would say that the length of an appropriate cooling-off period might be more difficult than safeguards to appropriately adapt, as the requirement is based on preserving the appearance of independence, and facts of individual departure situations are unlikely to be known to others, and a consensus on what would be appear appropriate to a group of investors may be hard to determine.

21. Others have suggested a derivative of the mandatory cooling-off period to address the concern that the remaining engagement team might be influenced by their relationship with or by the stature of the former partner or professional. They would allow partners and other senior professionals to join clients in some non-audit-sensitive role for some period of time before they could move into a role where they would have dealings with the auditors (again, the influence that the former partner or professional has over the engagement team is presumed to decrease as time goes on). Proponents of this view believe that this solution may make a mandatory cooling-off period less onerous in that companies could hire the best person for the job, even if that person happened to be from their audit firm, without having to replace the audit firm. However, some believe that this alternative is contrived, and may be costly and impractical in that the company has to carry the individual in a role other than the one they intend for the person (and the intended position may be vacant).

Detractors also point out the proposal does not address the concern that the partner or professional may not have exercised an appropriate level of skepticism during the audit process.

The Cooling-Off Period – A Cost / Benefit Analysis

22. A mandated cooling-off period for partners and professional staff who want to accept employment with an audit client (or a rule that would otherwise impair the firm's independence), may seem to some to be a more fail-safe deterrent of impropriety or abuse, and may also better preserve the appearance of independence. Supporters of a cooling-off period believe it would be more effective in preventing fraudulent financial reporting. They point out that the losses to investors from the inevitable market value drop when fraud is revealed is a major cost that needs to be considered. However, critics of this alternative argue that the cooling-off period is ineffective in preventing fraud or collusion. And while a mandated cooling-off period would *eliminate* the risk that the audit team could be unduly influenced by a former colleague (at least during the term of the cooling-off period), critics believe that the costs of the requirement exceed it benefits. Critics of the cooling-off period believe that the benefits to society and the profession of allowing professionals and partners to accept employment with audit clients, without fear of jeopardizing the former firm's independence, outweigh the costs – even if the mandatory cooling-off period promotes the appearance of independence more completely.

a. The attraction of future employment opportunities draws talented and ambitious recruits to the profession. Turnover at public accounting firms can be quite high, and many recruits do not intend to stay long enough to be promoted to partner. Many join public accounting firms because of the broad experience they expect to gain at the firm, and the contacts they expect to make in industry. In addition, turnover within the partner ranks has increased in the last few years. If the future employment prospects of recruits were limited by a mandated cooling-off period, some argue that the caliber of professional attracted to public accounting would decline.

b. Companies benefit from the ability to hire staff at all levels from their audit team, as an auditor who has worked for several years on an engagement is often thoroughly familiar with the company's systems, and knows most of the company's people and their responsibilities. Beyond familiarity with the hiring company, the auditor brings broad experience "to the table" from working at a variety of companies, and sometimes in a variety of industries. In addition, partners and professionals in public accounting firms are generally recognized as experts in accounting, financial reporting, and internal control matters – skills needed by companies with financial reporting responsibilities to investors.

c. A mandated cooling-off period might force a company to choose between its audit partner and its audit firm, knowing that if the partner

were hired, the audit firm would have to be replaced. It should be recognized that replacement of an audit firm carries costs to firms, companies, and investors. There is a learning curve on a first year audit; auditors spend a lot more time and resources on them (developing audit programs, familiarizing themselves with the system of internal controls, etc.), and company personnel spend more time answering the auditors' questions and producing documentation previously provided to the prior auditors. And because audits are strengthened by institutional continuity, rotation of auditors and the increased risk that the first-year audit poses carries a cost to investors. It is a significant benefit to be well acquainted with a client's business, operations, and controls. Experience shows that problem audits occur much more frequently when the auditor lacks a solid base of experience with the client's business, operations, and systems – when a firm is in its first couple of years as a company's auditors.[3,4,5,6] (Some have suggested, however, that companies that misstate their financial results or position may be more likely to change auditors, which may contribute to the higher incidence of audit failure among auditors new to engagements.)

Proponents of the cooling-off period counter the "learning curve" argument by noting that a fresh look by a new audit team may carry some benefits that cannot be achieved with the same audit team and approach year after year.

d. A restriction on hiring former engagement partners or other professionals may be a heavier burden to smaller corporations in need of the inside accounting expertise provided by someone familiar with their business and industry, and to smaller firms. Smaller corporations may be at a disadvantage in recruiting personnel when competing with larger companies with strong national or regional name-recognition. Restricting these smaller companies from hiring directly from their audit firm (from among those who know the company well) may hurt them disproportionately.

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[3] Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies, SEC Practice Section of the American Institute of Certified Public Accountants, 1992.

[4] The Quality Control Inquiry Committee of the SEC Practice Section analyzed 406 cases of alleged audit failure that were considered between 1979 and 1991. This analysis showed that allegations of audit failure occur *almost three times as often* when the audit firm is performing its first or second audit of the company.

[5] In its 1987 report, the National Commission on Fraudulent Financial Reporting (Treadway Commission) stated that "the Commission's review of fraud-related cases revealed that a significant number involved companies that had recently changed their independent public accountants..."

[6] The independent Commission on Auditors' Responsibilities (1974-78), chaired by former SEC Chairman Manuel Cohen, stated that "....in the Commission's study of cases of substandard performance by auditors, several of the problem cases were first or second-year audits. While not conclusive, this indicates the higher peril associated with new audit clients. Once an auditor becomes well acquainted with the operations of a client, audit risks are reduced. If a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users."

Personnel from smaller accounting firms may face the same difficulties when competing in the job market with people from large, well-known firms. A rule that impairs the ability to go from an audit firm directly to a client, where management knows you and you have had a chance to demonstrate your abilities, may be more of a burden if you work for a smaller firm.

Proponents of Safeguards

23. Proponents of safeguards believe that effective mitigating controls already exist or can be put in place to prevent and detect threats to independence when partners or other professionals join audit clients.

24. Proponents of safeguards believe that firms should have formal policies which require immediate notification of the managing partner (or another appropriate partner) in any situation involving potential employment considerations or negotiations while participating on an audit engagement. If a professional is considering a potential employment opportunity while participating on an audit engagement, either through seeking or having been offered a position, the individual should be removed from the engagement until employment is no longer being sought or until the employment offer is rejected, as applicable (this is an existing AICPA ethics rule). Any audit procedures performed prior to this time should be immediately documented in a separate memorandum, if not already evident in the working papers. Firms should periodically remind professionals of these independence requirements concerning job negotiations.

25. Where a professional accepts employment with an audit client after having participated in the engagement, the engagement partner should determine if the individual's work should be reviewed by someone at least one level higher in the firm to assess the objectivity and impartiality of the professional on the most recent engagement within some predefined prior period, usually within one year of the date of departure from the firm. If the professional joining the client is the engagement partner, a partner not involved with the engagement team should perform an in-depth review of the previously issued audit report, financial statements, and working papers (an "in-depth review") as soon as possible after the individual announces the intention to join the audit client. In addition, the next annual audit following the partner's acceptance of employment should be subjected to such an in-depth review either prior to report issuance, or under the firm's next annual inspection procedures, with a view towards monitoring compliance with policies related to independence, integrity, objectivity, and engagement performance.

26. A policy of reviewing an individual's work after the announcement that he or she is joining the audit client, and of reviewing the engagement team's work on the subsequent audit is expected to have a deterrent effect; knowing that their work will be reviewed, individuals will most likely be more sensitive or aware of appearing to have acquiesced to a client's aggressive or incorrect accounting, and will be more likely to refrain from doing so.

27. The safeguards outlined above would be adapted to fit the facts and circumstances. For example, if the tax partner assigned to the engagement left to join the client, another tax partner should review the former tax partner's work; the entire engagement would not have to be reviewed. Similarly, if a consultant or specialist who performed work on an audit engagement joined the client, only his or her work would have to be reviewed to fulfill the requirements of the proposed safeguard.

28. Some have expressed concern that there may be situations where the departing partner or professional is familiar enough with the firm's general audit approach, or the planned audit approach and testing strategy for the particular company, so as to be able to circumvent their design, if desired. For example, specific locations for inventory counts or other test work may have already been selected, or areas of audit emphasis may have already been decided prior to the professional's departure (note, however, that on many engagements this information appears in the audit plan that is distributed to the audit committee and others within the organization prior to the start of fieldwork). Nevertheless, the new engagement team should review the audit plan and strategy to determine the risk of circumvention, make modifications if deemed necessary, and maintain a heightened sense of awareness during the audit for the threat of circumvention.

29. Another concern with partners or professional staff joining clients is that the remaining audit team members, because of their past relationship with the professional now in a position of importance with the client, may be reluctant to challenge the decisions or positions taken by the former partner or other professional.

30. Public accounting often generates close relationships among people who work closely together in a firm. Despite the structural changes in firms over the past few years, such as the growth of consulting practices, the appearance of "direct-entry" partners, and increasing focus on experienced hires as opposed to college recruits, the majority of partners and senior professional staff on the audit side of the business today, at least in the largest firms, started with their firms right out of college. When long-term colleagues are paired up in an auditor-client relationship, the risk of impaired objectivity may increase. For example, it's conceivable that the auditor's judgment regarding materiality could be swayed when determining whether a friend/CFO's aggressive accounting should be reversed, if the auditor's insistence on such a reversal would reflect badly on the friend/CFO. In addition, professionals at firms often develop respect for their colleagues and leaders; when a former associate joins a client, auditors may make the mistake of assuming that the former associate's perspective is still that of an auditor. These threats are specific to certain facts and circumstances; for example, because of the sheer size of some firms, the current and former firm professional may not be close at all, even if they worked together on some engagements or came from the same office.

31. The magnitude of these concerns also varies with the degree of interaction the former partner or professional is expected to have with the remaining

engagement team. Proponents of safeguards believe that the managing partner should review the relationships between the former partner or professional, and the remaining engagement members, and replace engagement team members who may have too close a relationship with the former partner or professional.

32. Similarly, in situations where a nationally-prominent partner joins an audit client in a position where he or she will interact with the auditors, proponents of safeguards believe the managing partner should review the appropriateness of the assigned engagement and concurring review partners, and consider the need to involve other partners with appropriate experience and stature to ensure that an appropriate level of professional skepticism is maintained. The concern here is that a less experienced engagement team may be unduly influenced by the statements of a former industry leader or senior technical partner of their firm. In addition, the next annual audit following the partner's acceptance of employment should be subjected to an in-depth review either prior to report issuance, or under the firm's next annual inspection procedures, with a view towards monitoring compliance with policies related to independence, integrity, objectivity, and engagement performance.

33. Another layer of safeguards could be imposed via a recommendation to the AICPA's SEC Practice Section that its Peer Review Committee explicitly require that at least a sample of these engagements be selected for review as part of its peer review program. The peer reviewer would verify firm compliance with the proposed safeguard approach, as well as evaluate the effectiveness of the safeguards performed.

34. Beyond providing "after-the-fact" assurance that independence was not impaired when professionals join audit clients, safeguards are expected to have a deterrent effect on behavior that lacks the requisite skepticism. A partner or professional who has joined a client presumably would have been more careful to ensure that the work performed and the decisions made during his or her tenure on the audit engagement were above criticism, if the professional knew that the work would be reviewed after he or she left. In addition, the skepticism of the remaining engagement team when evaluating the statements of a former colleague or leader may be higher if a special review of the current engagement were certain.

35. In addition, open discussion of employment with audit client situations with the audit committee or board of directors can serve as an effective safeguard. Airing, "in the sunshine," the potential threats to independence posed by these situations, and the safeguards employed to protect auditor independence, is likely to sensitize those involved (both the former firm professional now with the company and the remaining audit team) to these issues, and make independence impairments less likely. While auditors are responsible for upholding their own professional standards, including those related to independence, the audit committee can "set the tone at the top," and emphasize the proper separation between management and the auditor. Proponents of safeguards would encourage or mandate discussion of these employment situations with the audit committee, understanding the role that effective corporate governance can play in protecting auditor independence.

36. Some believe that mitigating procedures to prevent and detect abuses outlined above are more effective than a mandated cooling-off period. The SEC, in its 1994 staff report on auditor independence, evaluated the feasibility of a one-year ban on auditors joining attest clients, and stated that

> ".....it would appear that the time for the greatest risk to investors is while a compliant or conspirator engagement partner remains with the accounting firm and in control of the audit of the company's financial statements. Once the partner leaves the engagement and joins the company, a new engagement partner, with a fresh view of the company, may be more willing to challenge corporate management. In other words, if management and the engagement partner have the intent to perpetuate a fraud, the partner may remain with the firm rather than risk turning the audit engagement over to another individual who may uncover the conspiracy. In addition, if management wants to compensate the engagement partner for his or her role in a fraud, a ban on hiring the engagement partner for a certain period of time may not prohibit the company from providing payments to the partner, after he or she resigns from the accounting firm, through consulting contracts or other means."

37. The thought here is that a mandated cooling-off period would be ineffective against fraud or collusion between the auditor and client. And if the auditor, while still with the firm, were biased in his or her evaluation of the client's accounting, existing safeguards, such as the concurring review requirement, as well as the proposed safeguards, such as an in-depth review of the prior audit report, financial statements, and working papers, should be effective in addressing this concern. Note that the performance of these safeguards would be subject to both internal and peer review. (The 1994 SEC Staff report, however, also stated the Staff's position that an independence problem "may exist when the former partner was closely associated with the provision of services to a client within a short period of time (two years) prior to accepting a position with, or substantial ownership interest in, the client.")

38. In support of the argument that a mandatory period of separation is ineffective in deterring fraud or collusion, and in the wake of several highly-publicized savings and loan failures, Richard Breeden, then Chairman of the SEC, testified in 1993 to Congress that the mandated cooling-off period "would be a very bad idea." He stated that

> ".....the burden would fall on all the honest guys. If Charlie Keating wants to pay off somebody in an accounting firm, if you say that the person in the accounting firm can't take direct employment with him, well, the person will go out and form an independent company and then he can enter into a consulting contract with him. There are a million ways in which he could funnel money to that person. Why stop with accounting firms? The same thing would be true with lawyers. Don't let lawyers in an outside firm go to work for the client for an extra year. I think the burden of that would just fall on the honest guys, not on the crooks."

Financial Interests and Benefits

39. When a partner joins an audit client, SEC rules currently require that the partner's capital balances and retirement benefits be settled in full prior to the commencement of the audit engagement. In addition, any benefits that would create the appearance of a continuing influence such as free office space and secretarial services, or a continued listing as an active or retired partner in firm directories or on firm letterhead, would be viewed as impairing the accounting firm's independence. Since retirement benefits, even when fixed or independent of firm revenues, are generally paid out over time (and taxed to the recipient when received), current allowable practice is to place the present value of the projected benefits into an irrevocable trust that pays the normal retirement annuity benefit, so that the former partner avoids the onerous tax consequences of a lump-sum settlement.

40. The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the accounting firm are that such a financial interest:

a. may create the appearance that ties between the audit firm and the partner / professional have not been severed – that the accounting firm has placed its "own man" (or woman) at the client, functioning as management, and is in effect performing the bookkeeping that it will subsequently audit.

b. If the former partner or professional's retirement benefits vary based on the firm's profits, and the fees paid by the client to the firm are material to the firm, then the former partner or professional may be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). These threats may be mitigated by having audit fees approved by senior management, or by the audit committee or board of directors. In addition, the firm may be less rigorous in its scrutiny of the client's accounting policies if its fees are overly rich.

c. If the former partner or professional's unfunded retirement benefits or other monies held by the firm are material to the firm, and / or the firm is experiencing cash flow problems, and the former partner or professional has the right to call for settlement of these balances, the firm may be less rigorous in its scrutiny of the client's accounting policies in exchange for forbearance on the amounts owed to the former partner or professional.

41. Some have questioned the relevance of the "full-payout" requirement in situations where the capital account and retirement benefit balances are de minimus to the firm. They argue that the time and expense required to establish the trust exceed the questionable benefits of severing financial ties that are inconsequential to the firm. Others might argue, however, that the materiality to the firm of capital accounts and retirement benefit balances may

be difficult to determine in some cases, and a "bright-line" rule avoids questions of judgment and preserves the appearance of independence. In addition, pay-out requirements that are based on materiality relative to the firm may provide relief to large firms only. Former partners receiving benefits from their firms may also feel stronger ties to these firms, raising questions as to whether the firm and the client personnel are one and the same. And while the current rules speak to partner finances only, what, if any, settlements are appropriate when senior, non-partner employees assume positions of responsibility at the client? Should existing or new standards be extended to former employees accepting employment with a client on a facts and circumstances basis?

Independence
Standards
Board