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Exposure draft: statement of independence concepts - a conceptual framework for auditor independence, November 2000; ED 00-2

Independence Standards Board

ED 00-2

Exposure Draft

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

November 2000

ISB

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Standards
Board

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Exposure Draft
(ED 00-2)

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

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Comments should be received by February 28, 2001 and addressed to:

Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: ED 00-2

Comments may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to ED 00-2).

ISB

Independence Standards Board

Date: November 2000

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. One of the Board's most fundamental projects since its establishment has been the development of a conceptual framework for auditor independence to help the Board issue principles-based independence standards for auditors of public companies.

After considering comments received on its Discussion Memorandum covering issues integral to the development of a framework for auditor independence, the Board is soliciting comment on this Exposure Draft (ED) of a proposed framework. A separate list of Questions for Respondents follows for your convenience. It would be particularly helpful to the Board in its future deliberations if you would respond to those questions and include in your comments the reasoning behind your responses. We also welcome comments and suggestions on any other aspects of the proposed framework.

The Board gratefully acknowledges the contributions made to the development, content, and writing of this Exposure Draft by the Director of the Conceptual Framework Project, Henry R. Jaenicke, C. D. Clarkson Professor of Accounting at Drexel University, and by the Associate Project Director, Alan S. Glazer, Professor of Business Administration at Franklin & Marshall College.

Any individual or organization may obtain one copy of this Exposure Draft (ED 00-2), without charge, by contacting the

ISB. The ED is also available on the ISB website at www.cpaindependence.org.

Your responses, which must be received by February 28, 2001, 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 ED 00-2 in your correspondence.

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

Thank you in advance for your time and effort.

Exposure Draft

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

SUMMARY

This Statement describes a conceptual framework for auditor independence to be used:

- as a foundation for developing principles-based independence standards,
- as a guide for resolving independence issues in the absence of standards or other rules, and
- as a resource to help investors, other users of financial information, and other interested parties better understand how the independence of auditors contributes to audit quality.

The framework contains four interrelated components: a definition of auditor independence, a goal of auditor independence, concepts, and basic principles.

The Statement defines auditor independence as freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions. Compliance with rules and regulations governing auditor independence is necessary, but not sufficient, for an auditor to be considered independent under the definition. An auditor also must be free from all pressures and other factors that compromise, or that well-informed investors and other users of financial information can reasonably expect to compromise, an auditor's objectivity.

The Statement states that the goal of auditor independence is to support user reliance on the financial reporting process and to enhance capital market efficiency, rather than focusing on independence as an end in itself.

The concepts of auditor independence described in the Statement comprise a risk model for auditor independence:

- Threats to auditor independence are sources of potential bias that may compromise, or may reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions. The Statement discusses five types of threats to auditor independence—self-interest, self-review, advocacy, familiarity (or trust), and intimidation—that may be posed by various activities, relationships, or other circumstances.

- Safeguards to auditor independence are controls that mitigate or eliminate threats to auditor independence. The Statement provides examples of the wide range of safeguards that exist in the present audit environment or that can be put in place in response to threats to auditor independence.

- Independence risk is the risk that threats to auditor independence, to the extent that they are not mitigated by safeguards, compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.

- The significance of a threat is the extent to which the threat increases independence risk and the effectiveness of a safeguard is the extent to which the safeguard decreases independence risk. The Statement provides examples of factors that affect the significance of threats and the effectiveness of safeguards.

The basic principles serve as guidelines to assist individuals and organizations that make independence decisions in analyzing independence issues in a wide variety of circumstances. The Statement specifies that only a very low level of independence risk should be considered acceptable because only such a level—one that implies a very small likelihood of compromised objectivity—is consistent with the definition and goal of auditor independence.

The first two basic principles direct independence decision makers to assess the level of independence risk by considering the types and significance of threats to auditor independence and the types and effectiveness of safeguards and to determine whether the level of independence risk is at an acceptable position on the independence risk continuum.

The third and fourth basic principles describe constraints that may affect the independence decision-making process. The third basic principle states that independence decision makers should ensure that the benefits resulting from reducing independence risk by imposing additional safeguards exceed the costs of those safeguards.

The fourth basic principle states that independence decision makers should consider the views of investors, other users, and others with an interest in the integrity of financial reporting when addressing issues related to auditor independence and should resolve those issues based on the decision makers' judgment about how best to meet the goal of auditor independence.

Exposure Draft

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

Questions for Respondents

This proposed Statement of Independence Concepts describes the components of a conceptual framework for auditor independence. The Board welcomes comments and suggestions on all matters relating to the conceptual framework, particularly on the following issues. Please discuss the reasoning behind any comments you make.

DEFINITION OF AUDITOR INDEPENDENCE

1. The proposed conceptual framework defines auditor independence as "freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions." The definition and the basis for the Board's conclusions are discussed in paragraphs 3–7 and 37–46. The other components of the conceptual framework are intended to help independence decision makers apply the definition to a wide variety of auditor independence issues. Is the definition appropriate? If not, what changes would you suggest, and why?

GOAL OF AUDITOR INDEPENDENCE

2. The proposed conceptual framework states that the goal of auditor independence is "to support user reliance on the financial reporting process and to enhance capital market efficiency." The goal and the basis for the Board's conclusions are discussed in paragraphs 8–9 and 47–48. Is the goal appropriate? If not, what changes would you suggest, and why?

CONCEPTS AND BASIC PRINCIPLES OF AUDITOR INDEPENDENCE

3. The proposed conceptual framework contains basic principles related to four concepts of auditor independence: threats, safeguards, independence risk, and significance of threats/effectiveness of safeguards. The concepts, basic principles, and the basis for the Board's

conclusions are discussed in paragraphs 10–32 and 49–60. The concepts and basic principles contained in the proposed framework are intended to serve as guidelines for independence decision makers to analyze and resolve independence issues. Are the concepts and basic principles appropriate and sufficiently operational? If not, what changes would you suggest, and why?

4. Paragraphs 49–53 describe the elements of a risk model for auditor independence in which independence risk is a function of the significance of threats to auditor independence and the effectiveness of safeguards to auditor independence. What are your views on the appropriateness of the independence risk model? Is there research that the Board should be made aware of that would be helpful in expanding the model or otherwise making it more useful for independence decision makers? If so, please describe that research.

OTHER ISSUES

5. Are there other issues in connection with the proposed conceptual framework that the Board should consider? If so, what are those issues, and how would you advise the Board to resolve them?

Exposure Draft

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

Contents

Statement of Independence Concepts

A Conceptual Framework for Auditor Independence

INTRODUCTION—SCOPE AND CONTENT

1. This Statement describes a conceptual framework for auditor independence. Its principal purposes are:

   a. to help the Independence Standards Board (ISB or Board) meet its responsibilities to set sound and consistent standards by providing direction and structure for resolving independence issues;

   b. to assist other *independence decision makers*[1] in resolving questions about independence in the absence of ISB standards and other independence rules;

   c. to help investors, other *users* of financial information, and other interested parties understand the nature, significance, and limitations of auditor independence; and

   d. to focus debate and serve as a boundary for discussions about auditor independence issues, thereby helping interested parties contribute to the development and application of, and better understand the rationale and process underlying, ISB standards.

2. This Statement of Independence Concepts does not establish rules for auditor independence, which are issued by the ISB as Independence Standards. Rather, it specifies various components—a definition, a goal, concepts, and basic principles—that together form a conceptual framework. This framework serves as a foundation for principles-based Independence Standards and provides a basis for evaluating existing and proposed rules and practices. Appendices to this Statement describe the major steps in developing the conceptual framework and the basis for the Board's conclusions.

DEFINING AUDITOR INDEPENDENCE

3. *Quality audits* improve the *reliability* and enhance the *credibility* of the financial reporting process, thereby contributing to its usefulness and to the efficient functioning of the capital markets, which serves the public interest. The quality of audits depends on many factors, including the personal attributes that individual auditors bring to an engagement, the policies and procedures of the auditing firms in which they work, and the attitudes and actions of the management of those auditing firms, sometimes referred to as the "tone at the top." In addition, various self-regulatory and public regulatory bodies help ensure audit quality. The independence

[1] Words and phrases defined in the Glossary are set in *italic type* the first time they are used in the Statement.

of auditors and the controls that help ensure their independence are only one source, albeit an important source, of quality audits.

4. **Auditor independence is freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.**[2] This definition is not intended to imply that an auditor must be free from all pressures and all other factors that may affect an auditor's decision-making ability. The definition means that, to be independent, an auditor must be free only from those factors that are so significant that they rise to a level where they compromise, or can reasonably be expected to compromise, the auditor's ability to make audit decisions without bias—that is, that the pressures and other factors compromise, or can reasonably be expected to compromise, the auditor's *objectivity.* The level at which the auditor's ability to make unbiased audit decisions is, or can reasonably be expected to be, compromised represents a threshold that distinguishes between when the auditor is independent and when the auditor is not. Reasonable expectations refer to rationally based beliefs of well-informed investors and other users of financial information.

5. Pressures and other factors that can compromise or can reasonably be expected to compromise an auditor's objectivity may arise from a wide variety of activities, relationships, and other circumstances as well as from various personal qualities and characteristics of auditors that may be sources of bias. Regulatory and standard-setting bodies issue rules that limit or proscribe certain activities and relationships because they believe that those activities, relationships, and other circumstances represent potential sources of bias for auditors generally, even though some individual auditors may be impervious to the pressures that arise from those activities, relationships, and other circumstances. Those rules apply to all auditors because the regulatory and standard-setting bodies believe that it is reasonable to expect audit decisions to be biased in those circumstances. Accordingly, noncompliance with those rules might not preclude a particular auditor from being objective, but it would preclude the auditor from claiming to be independent.

6. The definition suggests that auditor independence is more than just compliance with the rules, because not every pressure or other factor that may be a source of bias can be identified and covered by a rule. To be independent, an auditor must be able, and be reasonably expected to be able, to overcome pressures and other factors that would prevent unbiased audit decisions. Accordingly, the absence of a rule violation does not mean that the auditor is independent. Even if a rule permits, or no rule limits or forbids, a particular activity, relationship, or other circumstance—for example, auditing a company in which the chief financial officer is the auditor's friend—an auditor would not be independent if his or her ability to make unbiased audit decisions was, or would reasonably be expected to be, compromised as a result of that activity, relationship, or other circumstance. Compliance with the rules is a necessary, but not a sufficient, condition for independence.

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[2] The components of the conceptual framework are set in **boldface type**.

7. Assessing the independence of auditors requires independence decision makers to consider:

a. the pressures and other factors that might result in, or might reasonably be expected to result in, biased audit decisions—defined in this Statement as threats to auditor independence;

b. the controls that may reduce or eliminate the effects of those pressures and other factors—defined in this Statement as safeguards to auditor independence;

c. the significance of those pressures and other factors and the effectiveness of those controls; and

d. the likelihood that pressures and other factors, after considering the effectiveness of controls, will reach a level where they compromise, or may reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions—defined in this Statement as independence risk.

These concepts related to auditor independence are discussed in paragraphs 10–20 of this Statement. Resolving auditor independence issues also requires independence decision makers to consider how best to meet the goal of auditor independence. That goal is discussed in the next section. Paragraphs 21–32 discuss basic principles concerning how independence decision makers should analyze independence risk and consider the benefits and costs of auditor independence and the views of interested parties.

GOAL OF AUDITOR INDEPENDENCE

8. **The goal of auditor independence is to support user reliance on the financial reporting process and to enhance capital market efficiency.** The focus of this goal is on independence as one aspect of quality audits—audits that improve the reliability and enhance the credibility of the financial reporting process. Reliable and credible financial information, in turn, help ensure that users have confidence in that information. Those outcomes are in the public interest because they help ensure that investors, creditors, and other capital market participants make appropriate resource-allocation decisions, an important element contributing to the efficiency of the capital markets.

9. The independence of auditors helps ensure that auditors are sufficiently free from bias and are reasonably expected to be sufficiently free from bias. This suggests that independence decision makers should make decisions that help ensure that investors and other users reasonably believe that auditors are independent. If auditors are sufficiently free from bias but investors and other users do not believe that they are, audits may not enhance the credibility of financial information, and, as a result, investors and other users may place less reliance on audited financial information. The basic principle set forth in paragraph 30 of this Statement describes how the ISB and other independence decision makers should incorporate the views of investors, other users, and other interested parties in their decisions.

AUDITOR INDEPENDENCE CONCEPTS

10. This section describes four concepts related to auditor independence:

a. threats to auditor independence;
b. safeguards to auditor independence;
c. independence risk; and
d. significance of threats and effectiveness of safeguards.

These concepts, together with the basic principles of auditor independence described in a subsequent section of this Statement, are intended to help independence decision makers analyze auditor independence issues.

Threats to Auditor Independence

11. **Threats to auditor independence are sources of potential bias that may compromise, or may reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.** Because threats may, or may reasonably be expected to, compromise an auditor's ability to make unbiased audit decisions, independence decisions makers should identify and analyze the effects of threats that are sources of potential bias.

12. Threats are posed by various types of activities, relationships, and other circumstances. Identifying the types of threats posed by specific activities, relationships, or other circumstances should help independence decision makers understand the nature of those threats and their potential impact on auditor independence.[3] The following list provides examples of the types of threats that may create pressures and other factors that can lead to biased audit decisions. Although the list is not mutually exclusive or exhaustive, it illustrates the wide variety of threat types that independence decision makers need to consider when analyzing auditor independence issues.

a. self-interest threats—threats that arise from auditors acting in their own interest. Self-interests include auditors' emotional, financial, or other personal interests. Auditors may favor, consciously or subconsciously, those self-interests over their interest in performing a quality audit. For example, auditors' relationships with *auditees* create a financial self-interest because auditees pay the auditors' fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor's spouse and an auditee.

b. self-review threats—threats that arise from auditors reviewing their own work or the work done by others in their firm. It may be more difficult to evaluate without bias one's own work, or that of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat may arise when auditors review judgments and decisions they, or others in their firm, have made.

[3] Although different methods of describing types of threats could be developed, the description used in this Statement is similar to the systems in use and under development by standard setters in various places outside the United States, including the United Kingdom (Institute of Chartered Accountants in England and Wales [ICAEW]), Europe (Federation des Experts Comptables Europeens [FEE]), and internationally (International Federation of Accountants [IFAC]).

c. advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee's position or opinion rather than serving as unbiased attestors of the auditees' financial information. Such a threat may be present, for example, if an auditor or others in the auditor's firm promote an auditee's securities.

d. familiarity (or trust) threats—threats that arise from auditors being influenced by a close relationship with an auditee. Such a threat is present if auditors are not sufficiently skeptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long-standing personal or professional relationship with an auditee; and

e. intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. Such a threat may arise, for example, if an auditor or an auditing firm is threatened with replacement over a disagreement with an auditee's application of an accounting principle.

Safeguards to Auditor Independence

13. **Safeguards to auditor independence are controls that mitigate or eliminate threats to auditor independence.** Safeguards include prohibitions, restrictions, disclosures, policies, procedures, practices, standards, rules, institutional arrangements, and environmental conditions. Because safeguards help ensure that auditors make unbiased audit decisions in the presence of threats to auditor independence, independence decision makers should consider existing safeguards as well as new safeguards that could be put in place to mitigate or eliminate those threats.

14. Safeguards exist in the environment in which audits are performed or can be mandated by independence decision makers in response to threats posed by various activities, relationships, and other circumstances. One way in which safeguards can be described is by where they reside:

a. safeguards that exist in the environment in which audits are performed. Examples include:

1. the value auditing firms and individual auditors place on their reputations;
2. peer review programs that assess firm-wide compliance with professional standards and regulatory requirements regarding independence;
3. general oversight by auditees' audit committees and boards of directors concerning compliance with the regulatory requirement that an auditee's financial statements be audited by auditors who are independent;
4. other aspects of corporate governance, including an auditee's "tone at the top," that support the issuance of reliable financial information and auditor independence;
5. rules, standards, and codes of professional conduct governing auditors' behavior issued by public regulatory bodies, such as the Securities and Exchange Commission (SEC) and state boards of accountancy, and by self-regulatory bodies, such as the ISB and the American Institute of Certified Public Accountants (AICPA);

6. disciplinary actions, and the possibility of such actions, by the SEC, state boards of accountancy, the AICPA, and others; and

7. the legal liability faced by auditors and other participants in the capital markets.

b. safeguards that exist within auditing firms as part of an auditing firm's quality controls. Examples include:

1. maintaining a "tone at the top" in the auditing firm that stresses the expectation that auditors will act in the public interest and the importance of quality audits and auditor independence;

2. maintaining a professional environment and culture in the auditing firm that supports behavior of all firm personnel that is consistent with auditor independence;

3. quality assurance programs that include policies, procedures, and practices directly related to maintaining auditor independence;

4. other policies, procedures, and practices, such as those concerning auditee acceptance and retention, the rotation of engagement management, concurring partner reviews, and requirements for internal consultation on technical issues; and

5. personnel hiring, training, promotion, retention, and reward policies, procedures, and practices that emphasize the importance of auditor independence, the potential threats posed by various circumstances that auditors in the firm may face, and the need for auditors to evaluate their independence with respect to a specific auditee after considering safeguards in place to mitigate or eliminate those threats.

15. Another way of describing safeguards is by their nature:

a. safeguards that are preventive—for example, an orientation program for newly hired auditors that emphasizes the importance of independence;

b. safeguards that relate to threats arising in specific circumstances—for example, prohibitions against certain employment relationships between auditors' family members and auditees;

c. safeguards that are designed to deter violations of other safeguards by increasing the likelihood that they will be discovered—for example, reviews of auditors' securities portfolios to detect prohibited investments; and

d. safeguards whose effects are to deter violations of other safeguards by punishing violators—for example, revocations of auditors' licenses by state boards of accountancy.

16. A third way in which safeguards can be described is by the extent to which they restrict activities or relationships that are considered threats to auditor independence:

a. absolute prohibition—for example, prohibiting auditors from having any direct financial investment in any auditees;

b. permitting the activity or relationship but restricting its extent or form—for example, a restriction that auditors cannot have material indirect financial interests in auditees;

c. permitting the activity or relationship but requiring other policies or procedures that eliminate or mitigate the threat—for example, the mandatory rotation of an engagement partner after the partner has spent a certain period of time on a specific audit engagement; and

d. permitting the activity or relationship but requiring the auditor to disclose information about it to the auditee's management, audit committee, board, or others—for example, disclosure to an auditee's audit committee of the nature of all services provided by the auditor to the auditee and the fees received for such services.

17. Safeguards may work either singly or in combination to mitigate or eliminate threats. Different safeguards may mitigate or eliminate different types of threats, and one safeguard may mitigate or eliminate several types of threats simultaneously. For example:

a. self-interest threats may be mitigated or eliminated by, among other safeguards, prohibitions against certain financial interests and family relationships between auditors and auditees, restrictions on the percentage of total firm fees earned from one auditee, and auditing firm disclosures to the audit committee of all services provided to the auditee;

b. self-review threats may be mitigated or eliminated by, among other safeguards, concurring partner and peer reviews and prohibitions against auditors acting in the capacity of auditee management;

c. advocacy threats may be mitigated or eliminated by, among other safeguards, prohibitions against and limitations on auditors providing certain non-audit services for auditees that involve advocacy roles;

d. familiarity threats may be mitigated or eliminated by, among other safeguards, mandatory rotation of engagement partners and restrictions on certain employment relationships between auditors' family members and auditees; and

e. intimidation threats may be mitigated or eliminated by, among other safeguards, concurring partner reviews, internal consultation requirements, and an appropriate "tone at the top" in both auditing firms and auditees.

Independence Risk

18. **Independence risk is the risk that threats to auditor independence, to the extent that they are not mitigated by safeguards, compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.** Independence risk increases in the presence of threats to auditor independence and can be mitigated or eliminated by safeguards. Independence decision makers should determine whether additional safeguards are necessary to reduce independence risk created by particular threats and, if they are, should decide which safeguards will reduce such risk to an acceptable level.

Significance of Threats and Effectiveness of Safeguards

19. **The significance of a threat to auditor independence is the extent to which the threat increases independence risk.** The significance of a specific threat depends on many factors, including the nature of the activity, relationship, or other circumstance creating the threat; the force with which pressure is exerted or felt; the importance of the matter that is the subject of the

activity, relationship, or other circumstance; the position and level of responsibility of the persons involved; and the strength of the integrity of the persons involved. Independence decision makers should evaluate these and other factors when assessing the threats to auditor independence posed by various activities, relationships, and other circumstances.

20. **The effectiveness of a safeguard to auditor independence is the extent to which the safeguard decreases independence risk.** The effectiveness of a safeguard depends on many factors, including whether it is suitably designed to meet its objectives, how it is applied, the consistency with which it is applied, by whom it is applied, and to whom it is applied. Independence decision makers should evaluate these and other factors when assessing safeguards that exist or can be put in place in response to specific activities, relationships, and other circumstances that pose threats to auditor independence.

BASIC PRINCIPLES OF AUDITOR INDEPENDENCE

21. This section discusses four basic principles of auditor independence:
    a. assessing the level of independence risk;
    b. determining the acceptability of the level of independence risk;
    c. considering benefits and costs; and
    d. considering the views of investors and other interested parties when auditor independence issues are addressed.

The basic principles serve as guidelines for independence decision makers to analyze independence issues in a wide variety of circumstances.

Assessing the Level of Independence Risk

22. **Independence decision makers should assess the level of independence risk by considering the types and significance of threats to auditor independence and the types and effectiveness of safeguards.** This basic principle describes a process by which independence decision makers should identify and assess the level of independence risk that arises from various activities, relationships, or other circumstances.

23. The level of independence risk can be expressed as a point on a continuum that ranges from "no independence risk" to "maximum independence risk." One way to describe those endpoints, the segments of the independence risk continuum that fall between those endpoints, and the likelihood of compromised objectivity to which the endpoints and segments correspond is as follows:

Level of Independence Risk

No independence risk	Remote independence risk	Some independence risk	High independence risk	Maximum independence risk
Compromised objectivity is virtually impossible	Compromised objectivity is very unlikely	Compromised objectivity is possible	Compromised objectivity is probable	Compromised objectivity is virtually certain

Likelihood of Compromised Objectivity

Although it cannot be measured precisely, the level of independence risk for any specific activity, relationship, or other circumstance that may pose a threat to auditor independence can be described as being in one of the segments, or at one of the endpoints, on the independence risk continuum.

Determining the Acceptability of the Level of Independence Risk

24. **Independence decision makers should determine whether the level of independence risk is at an acceptable position on the independence risk continuum.** This basic principle describes the need for independence decision makers to evaluate the acceptability of the level of independence risk that arises from specific activities, relationships, and other circumstances. That evaluation requires them to judge whether safeguards eliminate or adequately mitigate threats to auditor independence posed by those activities, relationships, or other circumstances. If they do not, independence decision makers should decide which additional safeguard (including prohibition) or combination of safeguards would reduce independence risk, and the corresponding likelihood of compromised objectivity, to an acceptably low level.

25. Given certain factors in the environment in which audits take place—for example, that the auditor is paid by the auditee—independence risk cannot be completely eliminated and, therefore, independence decision makers always accept some risk that auditors' objectivity will be compromised. Nevertheless, in the presence of threats to auditor independence, independence decision makers should consider only a very low level of independence risk to be acceptable. Only such a small likelihood of compromised objectivity is consistent with both the definition and the goal of auditor independence.

26. Some threats to auditor independence may affect only certain individuals or groups within an auditing firm, and the significance of some threats may be different for different individuals or groups. To ensure that independence risk is at an acceptably low level, independence decision makers should identify the individuals or groups affected by threats to auditor independence and the significance of those threats. Different types of safeguards may be appropriate for different individuals and groups depending on their roles in the audit.

Considering Benefits and Costs

27. **Independence decision makers should ensure that the benefits resulting from reducing independence risk by imposing additional safeguards exceed the costs of those safeguards.** Although benefits and costs are often difficult to identify and quantify, independence decision makers should consider them when they make decisions about auditor independence issues.

28. The benefits of auditor independence are efficiencies and other positive direct and indirect effects that accrue to various parties. For example:

a. for investors and other users of financial information, auditor independence helps ensure quality audits and the reliability of the financial reporting process, which also may lead to increased confidence in that reliability. These benefits, in turn, help improve investors' and other users' resource-allocation decisions and, ultimately, the overall efficiency of the capital markets, an outcome that is in the public interest.

b. for auditees, auditor independence helps reduce their cost of capital by reducing the premium that investors and creditors demand as compensation for assuming the risk that they will make incorrect decisions because the financial information used in making those decisions contains material misstatements or omissions.

c. for auditees' boards of directors, audit committees, and senior management, auditor independence helps ensure the reliability of financial information prepared by lower-level management.

d. for auditees and auditors, auditor independence may help reduce litigation and related costs resulting from alleged and actual situations involving unreliable financial information; and

e. for individual auditors, auditing firms, and the auditing profession as a whole, independence may help enhance their reputational capital.

29. Various parties bear a variety of costs of maintaining auditor independence. Some of those costs relate directly to developing, maintaining, and enforcing safeguards, including the costs of auditing firms' independence-related quality controls and costs related to the systems of public regulation and self-regulation of auditor independence. Other, indirect costs of maintaining auditor independence, sometimes called "second-order effects" or "unintended consequences," also may exist. Those costs relate to possible reductions in audit quality or other negative outcomes that may result from safeguards that prohibit or restrict auditors' activities and relationships. For example, restrictions on auditor investments and on employment of an auditor's family members by auditees may reduce the attractiveness of auditing firms as employers and thereby lead to reduced audit quality. The direct and indirect costs of maintaining auditor independence may be affected by many variables, including the number of individuals in a firm who will be affected by a safeguard. Because the independence of auditors is important not only in its own right but also in helping ensure that broad public interest objectives are met, independence decision makers should consider second-order effects or unintended consequences that go beyond the direct impact of their decisions on the independence of auditors.

Considering Interested Parties' Views in Addressing Auditor Independence Issues

30. **Independence decision makers should consider the views of investors, other users, and others with an interest in the integrity of financial reporting when addressing issues related to auditor independence and should resolve those issues based on the decision makers' judgment about how best to meet the goal of auditor independence.** Because of its responsibility for issuing independence standards for all auditors of public entities, the ISB's process of considering interested parties' views is somewhat different from that of other independence decision makers.

31. In recognition of its broad responsibilities, the ISB's operating policies provide for extensive participation by various parties in its standard-setting process. By keeping informed about the views of various types of individuals and groups, the ISB gains insight into reasonable expectations about auditor independence, an important aspect of the definition and goal of auditor independence described in this conceptual framework. The ISB considers the views of interested parties in deciding what standards are necessary to help ensure that auditors are free from pressures and other factors that compromise, or can reasonably be expected to compromise, auditors' ability to make unbiased audit decisions. Effective communication of ISB decisions, and of the reasoning that underlies them, also may help ensure that the ISB's constituents believe that auditors who comply with ISB decisions are free from such pressures and other factors. The basic principle described above is consistent with the ISB's broad responsibilities to gather information about the views of interested parties on auditor independence issues and to consider those views. The process of considering the views of interested parties described in the basic principle does not, however, abrogate the ISB's responsibility to exercise its own judgment in setting independence standards that are consistent with both the definition and the goal of auditor independence.

32. Independence decision makers other than the ISB also should find this basic principle useful when they consider independence issues in the absence of specific standards or rules. It should help ensure that they appropriately consider how their constituencies might view their decisions. In order to achieve the goal of auditor independence described in this framework, all independence decision makers, including the ISB, should be sensitive to the likely views of investors, other users, and other interested parties, and the impact their decisions may have on those views.

APPENDIX A—GLOSSARY

33. This appendix contains definitions of certain terms or phrases used in this Statement.

Auditees

Entities whose financial information is being audited.

Credibility

The quality of information that makes it believable.

Independence decision makers

Individuals, groups, and entities that make judgments about auditor independence issues. Independence decision makers include:
- the ISB and other independence standard setters
- auditing firms in adopting independence policies and procedures in the absence of existing rules or standards
- individual auditors in assessing their own independence and in making decisions when faced with situations for which there is neither authoritative guidance nor firm policy
- the management, audit committees, and boards of directors of auditees in meeting their responsibilities to retain auditors who are independent
- regulators in meeting their responsibilities to ensure the independence of auditors.

Objectivity

In the context of an audit, the ability to make unbiased audit decisions.

Quality audit

An audit performed in accordance with generally accepted auditing standards.

Reliability

"The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent."[4]

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[4] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (Stamford, CT: FASB, 1980), "Glossary of Terms."

Users

Investors, creditors, and others who use audited financial information in making investment, credit, and similar decisions.

APPENDIX B—BACKGROUND INFORMATION

34. The ISB was formed in 1997 to establish standards governing the independence of auditors of public entities. As part of its initial charge, the Board was given the task of developing a conceptual framework for auditor independence on which future independence standards could be based.

35. Discussion Memorandum (DM) 00-1, *A Conceptual Framework for Auditor Independence*, was prepared with input from a broad-based project task force consisting of representatives of investor groups, audit committee members, attorneys, regulators, other independence standard setters, members of the auditing profession, corporate executives, and academics specializing in ethics, accounting, auditing, and other business-related fields. A Board oversight task force provided further direction and assisted in reviewing the DM. The DM was considered by the Board at meetings on January 14 and February 17, 2000 and was released in February 2000 for a public comment period that ended on May 31, 2000. Comments also were solicited directly from specific individuals and groups in the academic, standard-setting, and investor communities. Twenty-two comment letters were received. After considering these letters, and with further assistance from the oversight and project task forces, this Exposure Draft (ED) of a proposed Statement of Independence Concepts was developed.

APPENDIX C—BASIS FOR CONCLUSIONS

36. This appendix discusses the issues that the Board considered most important in arriving at conclusions about the components of the proposed conceptual framework. It describes the Board's reasons for accepting certain views and for rejecting others.

Defining Auditor Independence

37. A definition provides a common language for all parties to debate auditor independence issues. The definition of auditor independence discussed in paragraphs 3–6 is based on a personal attributes approach. It defines auditor independence in terms of freedom from pressures and other factors that lead to biased audit decisions—a personal attribute that helps ensure that auditors perform quality audits. Paragraph 5 notes that those pressures and other factors may arise from certain activities, relationships, and other circumstances. That is, auditors who are free of external indicators of pressures and other factors—by not undertaking certain activities, having certain relationships, or facing certain circumstances—are more likely to perform a quality audit because they are more likely not to face pressures that compromise their ability to make unbiased audit decisions. Accordingly, the definition also is compatible with the activities and relationships approach described in DM 00-1.

38. The Board considered alternative definitions of auditor independence based solely on an activities and relationships approach. The Board acknowledges that there are many who believe that those definitions are more useful to independence decision makers because they include observable external indicators of a lack of independence. The Board, however, decided not to adopt an activities and relationships approach in developing a definition of auditor independence because it believes that a definition based on that approach describes how independence can be demonstrated (i.e., by an auditor not participating in certain activities or having certain relationships) rather than specifying what independence is (i.e., freedom from pressures and other factors). Nevertheless, the Board recognizes that investors, users, and other interested parties ordinarily cannot obtain information about pressures and other factors that may affect a specific auditor's ability in a specific audit engagement to make unbiased audit decisions. They rely on independence decision makers to identify and analyze various activities, relationships, and other circumstances that are sources of pressures and other factors that can reasonably be expected to lead to biased audit decisions, and to adopt appropriate safeguards, if necessary, to reduce independence risk to an acceptably low level.

39. The phrase "that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions" in the definition in paragraph 4 implies that independence does not require complete freedom from all pressures that an auditor may face—that is not possible. Biases arise from an individual auditor's background, education, and experiences and are part of human nature; they can be either conscious or subconscious and can be either in favor of or against specific individuals, groups, organizations, ideas, or principles. Nevertheless, pressures and other factors posed by certain activities, relationships, and other circumstances may endanger the quality of audits if they compromise an auditor's ability to make unbiased audit decisions. The definition of auditor independence in paragraph 4 suggests

that only pressures and other factors that rise to a level that prevents, or can reasonably be expected to prevent, an auditor from making unbiased audit decisions and that are not adequately mitigated or eliminated by controls would preclude an auditor from being independent.

40. The Board believes that the term "compromise" in the definition means that the auditor is unable to make unbiased audit decisions. The Board considered using the term "impair" instead of the term "compromise" in this context, but believes that "compromise" more clearly implies that the pressure or other factor must rise to a level where an unbiased audit decision cannot be made. That is, auditors can be affected by pressures and other factors that do not bias audit decisions. The Board believes that, in those circumstances, an auditor's ability to make unbiased audit decisions may be considered to be impaired (i.e., affected to some degree) but it is not compromised.

41. The Board considered whether the definition in paragraph 4 could be interpreted to mean that independence is unconditional or absolute—that is, that independence requires an auditor to be completely free from pressures. The Board believes, however, that the definition describes a state that an auditor can attain, namely, the ability to make unbiased audit decisions. As indicated in the preceding paragraph, the term "compromise" means that the pressure must rise to a level where an unbiased audit decision cannot be made. Accordingly, the Board believes that the approach in this Statement is useful for independence decision makers. That approach includes a definition that specifies the attainable attribute that the Board believes most clearly describes the independence of auditors. The other components of the framework provide guidance for independence decision makers in applying this definition when they examine potential indicators of pressures and other factors, assess the risk that those pressures and other factors compromise, or can reasonably be expected to compromise, the auditor's objectivity, and analyze whether that risk is acceptably low.

42. The definition in paragraph 4 focuses both on what auditor independence is and on investors' and other users' reasonable expectations about auditor independence. The Board believes this is consistent with its mission: "to establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets" (Operating Policies, Article 1).

43. The Board included the phrase "or can reasonably be expected to compromise" to incorporate investors' and other users' reasonable expectations in the definition of auditor independence. The Board acknowledges that there are many who believe that expectations, beliefs, views, and perceptions should not be a major focus of decisions on auditor independence matters and, therefore, should not be an element in the definition. In the Board's view, however, independence decision makers should consider investors' and other users' reasonable expectations about an auditor's ability to make unbiased audit decisions because such consideration is necessary to ensure that the goal of auditor independence is achieved—a goal that includes helping to support user reliance on the financial reporting process.

44. The Board believes that incorporating in the definition the notion of rationally based expectations of well-informed investors and other users helps make it operational. Instead of describing auditor independence purely as a state of mind that cannot be observed, measured, or

evaluated, a definition that incorporates the expectations of well-informed investors and other users provides independence decision makers with an objective way to assess when auditors possess the personal attribute of independence.

45. The Board considered including a phrase in the definition of auditor independence that would specify which interested parties' expectations are to be considered, such as "a reasonably informed person who has knowledge of all relevant facts." Such a phrase would serve to clarify that "reasonable expectations" result from a good faith determination by independence decision makers about how well-informed investors and other users might view an issue, not from a poll of the decision makers' constituents. The Board believes, however, that even "reasonably informed" investors and other users are likely to have divergent views about specific independence issues. The Board decided, therefore, that instead of specifying explicitly in the definition whose beliefs are to be considered, it is more useful to include in the conceptual framework a basic principle (see paras. 30–32) that describes how the views of interested parties should be considered in addressing auditor independence issues.

46. The Board decided not to include the phrase "independence in fact" in the definition. Including that phrase would have emphasized the notion that it is auditor independence itself, irrespective of anyone's expectations about independence, that helps ensure reliable financial information. The Board believes that, although the phrase has been widely used in the literature, it can easily be misinterpreted because it suggests a level of certainty or measurability about the existence of auditor independence that neither independence decision makers nor others can achieve. The Board also believes that including a phrase such as "independence in fact" in the definition would be inconsistent with the personal attributes approach adopted by the Board. That is, whether an auditor is, or can reasonably be considered to be, free from pressures and other factors is not a fact that can be objectively determined.

Goal of Auditor Independence

47. A goal of auditor independence serves as a guide for the Board in setting standards. It also assists other independence decision makers in analyzing auditor independence issues when ISB standards or other rules do not address particular circumstances that may compromise an auditor's objectivity.

48. The goal in paragraph 8 does not focus on independence as an end in itself but on independence as a means to support investor and other user reliance on the financial reporting process and to enhance capital market efficiency. Those broad purposes help make the goal aspirational, and the Board believes that an aspirational goal will be helpful to both the Board itself and other independence decision makers when making decisions on auditor independence issues. The goal also provides a basis for the Board and other independence decision makers to consider the benefits and costs associated with both reliable financial information and capital market efficiency. For example, allowing auditees to hire their former auditors in certain situations—that is, subject to certain safeguards—may increase independence risk, but the skills of those former auditors also may enhance capital market efficiency by helping auditees generate

more reliable financial information and by increasing the attractiveness of the profession to high-quality individuals.

Auditor Independence Concepts

49. Paragraphs 10–20 describe four concepts relevant to auditor independence decisions:
    a. threats to auditor independence;
    b. safeguards to auditor independence;
    c. independence risk; and
    d. significance of threats and effectiveness of safeguards.

These concepts are elements of a risk model for auditor independence that the Board believes will assist independence decision makers in understanding and analyzing auditor independence issues. In this model, independence risk is a function of the significance of threats and the effectiveness of safeguards. An auditor is independent when independence risk is at an acceptably low level, as determined by a particular independence decision maker. As indicated in paragraphs 27–32, the costs and benefits of auditor independence and the views of interested parties should enter into independence decision makers' considerations of auditor independence issues; however, they do not affect the level of independence risk.

50. The model acknowledges the importance of materiality by incorporating the concepts of the significance of threats and the effectiveness of safeguards. Assessing independence risk requires analyzing the significance of threats to auditor independence posed by a specific activity, relationship, or other circumstance and the effectiveness of the safeguards that are, or could be put, in place to mitigate or eliminate specific threats. Because of the large number of potential threats and safeguards that are not susceptible to quantification—for example, the impact of family relationships—the Board concluded that it is preferable to use the more general terms "significance of threats" and "effectiveness of safeguards," rather than "materiality," which is more frequently associated with quantitative measures or guidelines. Some threats and safeguards are susceptible to quantification, however, and independence decision makers may determine that their significance and effectiveness can be evaluated, in whole or in part, by reference to numeric benchmarks.

51. Cost–benefit considerations and the views of interested parties in auditor independence are not part of the independence risk model, but they are constraints that may affect the independence decision-making process. The basic principles related to costs and benefits and the views of interested parties that are described in this Statement should be considered by independence decision makers when they determine whether the level of independence risk posed by specific activities, relationships, or other circumstances is acceptable.

52. The Board believes that
    a. it is appropriate for independence decision makers to think in terms of independence risk rather than in terms of the existence or nonexistence of independence;
    b. considering the level of independence risk requires analyzing threats to auditor independence and the effectiveness of various safeguards in the face of those threats; and

c. when evaluating the acceptability of the level of independence risk, independence decision makers should consider related benefits and costs and the views of interested parties.

Basic Principles of Auditor Independence

Assessing the Level of Independence Risk

53. Under the basic principle described in paragraphs 22–23, independence decision makers' judgments about the level of independence risk can be expressed as a position on a continuum that extends from one endpoint, at which compromised objectivity is virtually impossible, to another, at which compromised objectivity is virtually certain. Because an auditor's objectivity cannot be directly observed, independence decision makers must rely on judgment to assess independence risk in various situations. When faced with identical threats and safeguards, the likelihood that an auditor's ability to make unbiased audit decisions will be compromised depends, in part, on the individual's personal attributes, such as integrity. In addition, the judgments of different independence decision makers about the level of independence risk posed by specific activities, relationships, and other circumstances also are likely to differ as a result of differences in judgment as to the significance of the threats posed and the effectiveness of alternative safeguards. Because of the extent of judgment involved in assessing auditor independence, the Board believes that it is useful for independence decision makers to view independence risk as a continuum and the level of independence risk as a position on that continuum. After considering all of the relevant facts and circumstances, independence decision makers should assess the level of independence risk in a particular situation and then reach a conclusion about whether that level is such that an auditor's ability to make unbiased audit decisions would be, or would reasonably be expected to be, compromised—that is, whether the auditor would not be independent.

Determining the Acceptability of the Level of Independence Risk

54. The Board believes that a principle based on achieving the "no independence risk" endpoint of the independence risk continuum for all threats to auditor independence is unrealistic and, in some circumstances, may be undesirable. Such a principle would mandate that independence decision makers adopt safeguards that provide "absolute assurance" of auditor independence, a level of assurance that audits themselves are not designed to provide. The Board believes that no safeguard or set of safeguards can be completely effective in eliminating all independence risk. The Board also believes that, in some cases, the costs (both direct and indirect) of attempting to get closer to the "no independence risk" endpoint on the continuum may exceed the benefits of reducing independence risk. The Board concluded that the basic principle described in paragraphs 24–26, which establishes an objective of reducing independence risk to a very low level, will help independence decision makers decide whether additional safeguards are necessary to mitigate threats to auditor independence.

Considering Benefits and Costs

55. The Board believes that, if independence decision makers judge that additional safeguards are necessary in order to reduce independence risk to an acceptably low level, they often will be faced with choices among alternative safeguards and with different ways of applying particular safeguards that vary in terms of benefits and costs. Although the Board recognizes that those choices require independence decision makers to exercise judgment, the Board believes that the guidance provided by the basic principle described in paragraphs 27–29 will help independence decision makers make such choices. The Board recognizes the difficulty of identifying and measuring many of the benefits and costs of auditor independence, especially the "second-order effects" or "unintended consequences" of maintaining auditor independence. Nevertheless, the Board believes that independence decision makers should, to the extent possible, weigh both the direct and indirect benefits and costs of safeguards they are considering. In many cases, independence decision makers may not need to consider the total dollar amount of benefits and costs of a particular safeguard, but rather only the incremental benefits and costs of that safeguard as compared with others.

Considering Interested Parties' Views in Addressing Auditor Independence Issues

56. The Board considered three alternative approaches to a basic principle concerning how beliefs about auditor independence should be included in its standard-setting process: develop standards that reflect the views of all interested parties; develop standards that reflect the likely views of reasonable, fully informed investors or some other group or groups of interested parties; or be informed by interested parties' views but base standards on the Board's judgment about how best to meet the goal of auditor independence. The Board believes that adopting either of the first two alternatives as a basic principle would inappropriately restrict it in making independence judgments, especially if those judgments differed from the short-term views of some interested parties. In addition, because different individuals and groups are likely to have diverse views on auditor independence issues, basing decisions on those views is often impossible or impractical.

57. The Board believes that a basic principle based on the process described in the third alternative emphasizes that the Board itself—whose members come from diverse constituencies and are chosen to represent the public interest based on their experience and integrity—is in the best position to establish appropriate independence standards. The Board's due process includes a thorough evaluation of all available information, including obtaining input from interested parties through its task forces, reviewing all responses to documents issued for public exposure, and in various other ways. Under the basic principle described in paragraphs 30–31, the Board should neither ignore interested parties' views nor base its decisions solely on those views. Instead, the Board should solicit the views of all interested parties about the issues and consider the potential impact of alternative decisions on those views.

58. The Board believes that effective communication with all interested parties can help inform them about its agenda, the process it uses to promulgate independence standards, and the reasoning underlying its standards. The Board provides a variety of opportunities for interested parties to furnish timely input to it—for example, Board task forces and working groups include representatives from many organizations, and the Board distributes discussion memoranda and exposure drafts widely to encourage interested parties to share their views with it. At various stages in its standard-setting process, the Board communicates its views on the nature of the threats that it believes are posed in the circumstances under consideration and the reasons why it believes that certain safeguards are the best solution in those circumstances. The Board also explains the bases for its conclusions, both in ISB standards and through other media. These and similar efforts by the Board to ensure effective communications with all interested parties should help increase their confidence in the organizations and processes involved in ensuring auditor independence as well as in the reliability of the financial reporting process and in the independence of auditors generally.

59. The Board believes that when other independence decision makers address auditor independence issues, they also should consider the views of interested parties. Those independence decision makers should ask, in their own informed good faith views, whether well-informed investors and other users would reasonably consider the activities, relationships, or other circumstances in question as precluding independence.

Independence
Standards
Board