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Independence Standard No. 1

**Independence Discussions
with Audit Committees**

January 1999



**Independence
Standards
Board**

Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*

Standard

1. This standard applies to any auditor intending to be considered an independent accountant with respect to a specific entity within the meaning of the Securities Acts ("the Acts") administered by the Securities and Exchange Commission. At least annually, such an auditor shall:

- a. disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
- b. confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts; and
- c. discuss the auditor's independence with the audit committee.

Effective Date

2. The above communications are required with respect to audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged. Auditors and audit committees of first-time registrants shall have these communications prior to the company's initial offering of securities to the public. These communications shall cover all audits of financial statements for periods subsequent to the effective date of this standard, included in a registration statement for an initial public offering of securities, whether performed by the current or a predecessor auditor.

Official Comment

3. In adopting this standard, the Board does not intend that an isolated and inadvertent violation of the standard's requirements would constitute a *per se* impairment of the auditor's independence, provided that the auditor is in compliance with all other independence rules. The Board believes, however, that in such circumstances the auditor must remedy violations of the standard's requirements promptly upon discovery.

Background and Basis for Conclusions

4. In May 1998 the ISB issued an Invitation to Comment (ITC 98-1) regarding a proposed recommendation to the Executive Committee of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants. The proposed recommendation would have required audit firms that are members of SECPS to confirm annually to the audit committee (or board of directors) of each public company audit client, each year, that the firm was independent of the client. In the confirmation the auditor would also offer to meet with the audit committee to discuss independence matters.

5. The Board received twenty-six letters in response to the ITC. Most of the letters were supportive, but some urged the Board to go further and require communication to the audit committee of the important matters considered in each particular situation in reaching a conclusion that independence was maintained.

6. After deliberation, the Board concluded that it agreed with those who suggested that the proposal be expanded, and it also decided that it would itself address the matter as a proposed standard, rather than ask the Executive Committee of SECPS to do so. Consequently, the proposal was converted from an Invitation to Comment to an Exposure Draft of a Board pronouncement. In addition, the Board decided that the discussion about independence between the auditor and the audit committee should be required, rather than encouraged by the auditor's written communication.

7. The revised proposal was re-exposed as an Exposure Draft of an ISB standard. Comment was specifically solicited from those that had responded to the initial invitation to comment, and from several groups representing investors. Twenty-two comment letters were received, and most supported the proposal. The Board believes that the proposed pronouncement will improve corporate governance by affording to audit committees a mandated opportunity to deepen their understanding of auditor independence issues. Companies are required by the Acts to engage "independent" accountants, and this proposal will assist directors in satisfying themselves that the company has met that requirement. The Board also believes that a mandate that audit firms describe and discuss the judgmental matters that might impact on independence will bring more focus within firms on this important issue.

8. Some suggested that the Board provide guidance on how an auditor could "cure" a failure to comply with the standard. The Board did not believe it was appropriate to comply with that request, but it did add the "Official Comment" to clarify its intent in the event of an isolated and inadvertent violation.

9. Some respondents objected to the provision in the exposure draft that would seem to have imposed a requirement on audit committees to discuss independence with the auditor, on the basis that the Board did not have such

authority. Without concluding on that question, the Board decided that it would revise the provision to impose the discussion requirement solely on the auditor. The Board recognizes, however, that the auditor could withhold his or her audit report until such discussion took place with the audit committee so that the auditor was in compliance with this professional requirement.

10. The Board considered whether to require that the discussion between the audit committee and the auditor take place before any substantive audit procedures had begun. There are clear benefits to the audit committee to obtaining satisfaction about independence before the audit is started. The Board recognizes, however, that many audit committees have established meeting schedules which would not accommodate such a discussion before the audit begins, and it concluded that imposing such a requirement was not essential to achieving the objectives of this pronouncement.

11. The Board recognizes that every additional requirement imposes costs, but the Board believes that the costs to implement this pronouncement would be small when compared with the benefits.

12. This standard was adopted unanimously by the members of the Board.

Members of the Independence Standards Board

William T. Allen, Chair
John C. Bogle
Stephen G. Butler
Robert E. Denham

Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon
James J. Schiro

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