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Independence Standards Board - Minutes of Meetings, Meeting of January 8, 1999: Public Session

Independence Standards Board

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**Independence Standards Board
Minutes
Meeting of January 8, 1999
Public Session**

A public meeting of the Independence Standards Board (ISB, or the Board) was held in the offices of the American Institute of Certified Public Accountants on January 8, 1999.

The meeting was attended by:

Board Members

William T. Allen, Chairman
John C. Bogle
Stephen G. Butler
Robert E. Denham
Manuel H. Johnson
Philip A. Laskawy
Barry C. Melancon
James J. Schiro

Others Present by Invitation

Arthur Siegel, Executive Director, ISB
W. Scott Bayless – Associate Chief Accountant, SEC
Susan McGrath – ISB Staff
Richard I. Miller – General Counsel & Secretary, AICPA
~~Rick Towers – ISB~~ Richard H. Towers – ISB Staff
Lynn E. Turner – Chief Accountant, SEC
Gerald W. Ward – Chair, IIC Family Relationships Task Force

The meeting was called to order by Chairman Allen at approximately 9 AM.

ED 98-1, Independence Discussions with Audit Committees

At Chairman Allen's request, Ms. McGrath summarized comments received on Exposure Draft 98-1, *Independence Discussions with Audit Committees*. She stated that the Exposure Draft had been posted to the website for a thirty-day comment period, its issuance announced in a press release, and hard copies were mailed to interested parties on request. In addition, the Staff had actively solicited input from those who had responded to the original Invitation to Comment, and from groups representing investors.

Ms. McGrath stated that twenty-two comment letters were received, and all but five expressed general support for the proposal. She then summarized the Staff's recommended changes to the original proposal based on comments received.

The SEC Observer stated that the SEC staff believes that the auditor's decision whether to bring matters to the attention of the audit committee should be based on whether the matter would be important from the perspective of a reasonably informed investor.

The Board discussed the consequences of a failure to comply with the proposed standard's requirements, and agreed to add an "Official Comment" to the document as follows:

"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."

A motion was made to issue the revised proposal as the ISB's first independence pronouncement, subject to the insertion of the above language reflecting the Board's intentions regarding the consequences of an isolated and inadvertent violation of the standard's requirements. The motion was seconded and passed unanimously.

Family Relationships

At Chairman Allen's request, Mr. Ward and Mr. Towers reported on the Board's family relationships project.

Mr. Ward reported that the broad-based, project task force on family relationships between personnel in audit firms and audit clients held its first meeting on October 9th. Mr. Laskawy of the Board's oversight task force also attended the meeting. The task force appeared to support the Board's instruction to prepare an exposure draft on a new standard for public comment, rather than an initial, neutral discussion memorandum.

Mr. Ward and the Staff, with input from the task force, had prepared a new standard on family relationships between the auditor and the audit client for Board deliberation and possible public exposure. The draft standard follows the direction indicated in the family relationships paper prepared by Mr. Ward's Independence Issues Committee (IIC) Family Relationships Task Force, presented to the Board at its May 26th meeting. Mr. Ward explained that the proposed standard would place additional restrictions on family relationships for those "on the engagement," which would include all those performing work for the client, as well as those in the "chain of command." These individuals were perceived as having the ability to influence the outcome of the audit. The

proposal would remove absolute restrictions for all others, imposing instead firm safeguards and likely audit committee disclosure for certain family relationships involving those not on the engagement.

Mr. Towers summarized the current SEC and AICPA independence rules as alternatives to the proposed standard, and analyzed their differences. He also stated that a subgroup of the task force had been formed to investigate potential research on independence and family relationships, and that this subgroup and Ms. Schipper, the Board's research consultant, had concluded that research would not be meaningful in this area.

Mr. Bogle, recalling an informal luncheon he held with analysts last April, thought that family relationships were only in the periphery of their concerns.

Mr. Turner stated his belief that the proposed restrictions for those "on the engagement" should be extended to all partners in the office performing the engagement. Mr. Ward explained that the proposal would not ignore relationships between others in the office and the audit client, but would impose firm review and resolution of these issues to protect auditor independence.

The Board resolved to obtain public comment on the "on the engagement" versus "in the office" question, as well as other generic family relationship issues, and directed the Staff to prepare a document which includes the proposal and well as a neutral discussion of family relationship issues. Mr. Turner agreed to prepare an alternate proposal based on his "in the office" criteria. The Board's Oversight Task Force on Family Relationships will review these documents and advise the Board on how to proceed.

Employment with Audit Clients

At Chairman Allen's request, Mr. Siegel discussed the draft discussion memorandum, for public comment, on independence and employment with audit clients. Mr. Siegel stated that the broad-based task force formed to advise the Staff on the discussion memo had concluded that it contained a comprehensive and neutral treatment of the issues. He stated that a research subgroup, which included Ms. Schipper, had concluded that research would not be meaningful in this area.

Mr. Turner was asked by Mr. Laskawy whether the "cooling-off" period was a practical solution to employment with audit client situations, and whether it would likely pass a cost/benefit analysis. Mr. Turner noted there were differing viewpoints on this issue. He then described the procedures that his former firm had followed when he left to join a firm audit client as Chief Financial Officer.

A motion was made, seconded, and passed unanimously to expose the discussion memorandum for public comment (a 120-day comment period), pending some clarifications, including a better description of alternative mechanisms by which a cooling-off period could be imposed. The Board authorized its Chairman and the

Oversight Task Force to approve any editorial changes to the document prior to public exposure.

Staff Report

IIC Activities

Mr. Siegel reviewed IIC activities for the Board. He stated that the Committee and Staff were deadlocked on the issue of the appropriate independence restrictions to apply in “alternative practice structure” situations, but stated that he was hopeful that the Committee could reach a consensus at its February meeting. Mr. Siegel stated that the IIC had been close to a consensus on the nature and level of support that auditors could provide their clients in implementing Statement of Financial Accounting Standards No. 133, *Derivatives and Hedging Activities*. At the Committee’s last meeting, however, the SEC Staff requested that the IIC cease study of the issue, while recommending that the Board take on the broader issue of valuations and fairness opinions in general. Mr. Siegel pointed out that the role of the IIC is to provide timely guidance on emerging independence matters within the framework of the existing literature. He stated that guidance from the IIC would be useful to practitioners in the immediate future, even if the Board later decided to undertake its own project.

Consultation Activity

Mr. Siegel asked Mr. Towers to summarize Staff consultation activity. Mr. Towers stated that the Staff had completed 82 informal independence consultations – 23 since his last report at the November 3rd meeting, which he categorized by both requester and subject. He noted that consultation activity was increasing. In addition, two formal consultations can be found on the ISB’s website, and one additional request had been received which likely will generate a public, written response in the next few weeks.

Conceptual Framework Project

Mr. Siegel briefly described recent progress on the conceptual framework project. He stated that the project directors, Professors Jaenicke and Glazer, had completed drafts of two sections of a discussion memo for public comment on the objectives of audits and auditor independence. The project task force is scheduled to meet on February 5, 1999 to provide comment on these draft documents.

Other Matters

Definitions of Independence

At Chairman Allen’s request, the Board considered several definitions of independence, compiled by the Staff, as candidates for a “working definition” to guide the Board in considering issues prior to completion of the conceptual framework project. The Board

concluded that it was premature to choose such a definition, but may consider the matter again in the future.

SEC Comments Regarding Possible Disclosure of Consulting Fees

Mr. Schiro asked Mr. Turner to address comments in a recent newspaper article indicating that he might favor a return to some form of required disclosure of certain consulting fees. Mr. Turner responded that the article was not accurate and that the SEC staff was not considering asking the ISB to implement the type of disclosure formerly included in ASR 250.

Letter from SEC Staff Regarding ISB Agenda Suggestions

Chairman Allen stated that he had received, on the previous day, the letter from Mr. Turner discussed at the last meeting suggesting topics for ISB study. The letter had been distributed to the other Board members and will be considered at a future meeting. In Executive Session, after discussion, the Board directed the Staff to provide an expanded list of possible projects, in the Staff's order of priority, together with resources that would be needed to deal with at least the top few issues.

Research Recommendations

Mr. Bogle, as Chairman of the Board's Research Task Force, discussed the profession's recommendations regarding research mentioned at the Board's last meeting. He stated that a telephonic meeting was held to discuss these proposals – he and Chairman Allen, Mr. Robert K. Elliot (representing Mr. Butler), Ms. Schipper, and the Staff participated. The Task Force concluded that the proposal from the Law & Economics Consulting Group to study the question of whether disclosure of non-audit services affects stock prices should not be pursued. Mr. Bogle expressed concern about studies involving earnings momentum regression analysis, and believes that the validity of the study results would be suspect. The Board concurred with the conclusions of the Research Task Force.

Mr. Bogle also reported that the group viewed favorably the focus group proposal. The Chairmen of the Board and of the Research Task Force will interview some researchers as focus group leader candidates, before deciding how to proceed.

Next Meeting

The Board's next meeting will be held on April 8, 1999 at 10 AM in the AICPA's New York offices.

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The meeting was adjourned by Chairman Allen at approximately 12:10 PM.

Respectfully submitted,

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Susan McGrath
