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Independence Standards Board

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## **Alternative Practice Structures – An Analysis of How the Current Independence Rules for Auditors of Public Companies Might be Applied (An Addendum to Issue Summary 98-2)**

Under the current independence rules, presumably written with only traditionally-structured accounting firms in mind, all “Members” (as defined), are precluded from having most loans to and from, and any direct or material indirect financial interest in, attest clients. In addition, in all but a few limited circumstances, auditors are precluded from providing bookkeeping and certain other services to public attest clients. Loans and direct financial interests, as well as the provision of certain services, are generally prohibited without regard to materiality under the current rules.

In general terms, a “Member” is defined as the firm, all of its partners, those providing professional services to the client, and those managerial employees in an office participating in a significant portion of the engagement.

### **Fundamental Concept**

In trying to apply the current independence rules to alternative practice structures (APS), the fundamental question is whether one believes that the AttestFirm and PublicCo. are separate, independent operations.

If one were to look through the separate legal ownership of PublicCo. and AttestFirm, and the measures taken to separate effective control of AttestFirm from PublicCo. management and to enhance the individual identities of the two in the public’s eye, concluding that these efforts were (1) more *form over substance*, and that (2) the dual employment status of AttestFirm partners, and the administrative and employee leasing arrangements between PublicCo. and AttestFirm, effectively negate most of the separation and distinctness afforded by the legal structure of the two, then it seems that in applying the current rules, PublicCo. would be precluded from having loans to and from, and direct and material indirect financial interests in attest clients. In addition, PublicCo. could not perform bookkeeping and certain other services for attest clients, and could not have any of the business relationships or contingent fee arrangements with attest clients barred to traditional firms (i.e., PublicCo. would be deemed a “Member”). In determining the financial interests and other relationships, if any, that PublicCo. officers and employees could not have with AttestFirm clients, the definition of “Member” might also have to be further revised to describe those PublicCo. officers and employees that would be equivalent to the partners and managers of a traditional firm.

On the other hand, if one were to respect the legal separation and the measures intended to enhance the operational and distinctness of the two entities, believing that these efforts

were effective in isolating the operations and control of AttestFirm, then you would not prohibit many relationships between PublicCo. and AttestFirm clients. Proponents of this view, however, concede that the dual employment status of AttestFirm partners poses some special risks to auditor independence. They would apply certain restrictions to PublicCo. and certain of its managers to protect the auditor from undue influence arising from his or her concurrent PublicCo. employment.

In addition, PublicCo. / AttestFirm relationships have been structured in different ways, and any application of the rules to these alternative practice structures would have to be adapted to fit the particular circumstances. For example, we understand that there have been instances where AttestFirm partners have joined PublicCo., severing their ties and financial relationships with AttestFirm, and leaving behind one or more partners to own and manage AttestFirm. These remaining AttestFirm partners do not become employees of PublicCo., although the AttestFirm has administrative and employee leasing agreements with PublicCo. similar to those in the traditional model. As neither the current nor the former partners of AttestFirm have dual employment status (i.e., they are not both owner-employees of AttestFirm and employees of PublicCo.), any threat of PublicCo. influence over AttestFirm partners would be mitigated. AttestFirm partners might still be influenced by PublicCo. if, in the course of performing an audit, PublicCo.'s interests in or relationships with an attest client were jeopardized, and PublicCo. could restrict access to needed employees or services – employees and services that possibly could not be acquired elsewhere on a timely basis. In addition, leased staff may be influenced by their PublicCo. employment. However, it would seem that the employment independence of these AttestFirm partners would at least mitigate many of the threats to independence posed by PublicCo. relationships with AttestFirm clients.

The following describes several views put forth to apply or adapt the independence rules to alternative practice structures. These views were not necessarily developed with the primary aim of applying the existing independence rules for auditors of public companies to alternative practice structures. Any consensus on an appropriate application could, of course, contain elements of one or more of the following proposals. As in the original issue summary, since we are only concerned with the independence of auditors of SEC registrants, assume that all discussion relates to AttestFirm's *public* clients.

#### **View A**

Proponents of View A would restrict virtually all PublicCo. relationships with and financial interests in AttestFirm clients that would be prohibited between a traditional firm and its audit clients. They would prohibit PublicCo. loans to AttestFirm clients, deposit relationships, investment advisory and broker/dealer services, ownership of AttestFirm client securities, bookkeeping and payroll services, receipt of contingent fees, etc. Although prohibiting most corporate relationships that a traditional firm could not have with an attest client, View A proponents have not suggested restrictions on PublicCo. managers' personal investments in and relationships with AttestFirm clients.

View A proponents have not addressed whether PublicCo. products (e.g., insurance policies) should be sold to AttestFirm clients.

In effect, View A proponents have “swept” PublicCo. and its subsidiaries into the definition of “Member,” concluding that the separation between PublicCo. and AttestFirm is artificial and insubstantial, but have not included any of its officers or employees, which differs from the approach taken by View B and View C proponents.

## **View B**

View B proponents respect the legal separation and the measures intended to enhance the operational and perceived distinctness of the PublicCo. and AttestFirms in an alternative practice structure. However, they would impose additional restrictions of the activities and relationships that PublicCo. and certain of its managers could have with AttestFirm clients, in recognition of threats to independence posed by AttestFirm partners’ PublicCo. employment. They suggest that the definition of “Member” be extended to include those individuals in PublicCo. who directly supervise AttestFirm partners when they perform work on behalf of PublicCo., the managers working in offices participating in a significant portion of the engagement, and the entities within PublicCo. in which such immediate supervisors work. Because these supervisors, subsidiaries, and managers would now be deemed “Members” under the auditing literature, they too would be precluded from having financial interests, loans, direct business relationships, etc. with AttestFirm clients.

This lack of personal interests and relationships with AttestFirm clients might prevent direct supervisors from attempting to exercise control over or influencing the audit partners whom they supervise. These disinterested supervisors might also act as a buffer between audit partners and PublicCo. upper management members that may have personal interests in or be responsible for corporate relationships with AttestFirm clients.

In addition, proponents of this view would prohibit PublicCo., its subsidiaries, and individuals who indirectly supervise, indirectly control, or could be perceived as influencing a Member from having a *material* relationship with an AttestFirm client, or an investment that would allow the investor to exercise significant influence over the AttestFirm client. They define materiality with respect to the individual’s net worth and PublicCo.’s consolidated financial statements (but not with respect to the attest client). These additional individuals and entities also could not be connected with an AttestFirm client as a promoter, underwriter, voting trustee, director, or officer.

View B proponents would not consider the owners of one AttestFirm “Members” with respect to the attest clients of another AttestFirm, unless the owners of one performed services in another. For example, if owners of AttestFirm A performed services in AttestFirm B, such owners would be considered owners of both AttestFirms for purposes of applying the independence rules. View B proponents would not restrict the services or

relationships that one AttestFirm could provide to another's attest clients, as long as the owners of the individual firms only provided services from within their separate firms.

### View C

Others might argue that, without the liberty to change existing independence standards, the expanded "Member" definition suggested by View B proponents does not go far enough; they would say that all normally prohibited business relationships and investments between PublicCo. officers and management and AttestFirm clients impair the auditor's independence. They point out that under the current independence rules, every partner is precluded from investing in or having certain business relationships with his or her firm's attest clients – even if the partner resides on the opposite side of the country from where the attest engagement is being performed, and regardless of the materiality of the investment or relationship to either the partner or the client. Following the logic of the current rule, they would ask why even an immaterial business relationship between, say, the PublicCo. CEO and an AttestFirm client would not impair the auditor's independence.

In addition, while the expanded definition of "Member" (View B) proponents would restrict the financial interests of other individuals and entities within PublicCo. that could have indirect control or influence over the auditor, they would allow PublicCo. entities and employees outside of the expanded Member group to perform services that the auditor would be prohibited from providing directly (e.g., bookkeeping and asset custody services), or enter into contingent fee arrangements with AttestFirm clients.. Proponents of View C say that the auditor's employer should not be allowed to provide services to or have relationships with the auditor's clients that the auditor could not provide or have directly, even if the auditor performs the audit under the auspices of a firm not owned by his employer.

View C proponents might equate the people and entities in the "Member" definition to PublicCo. as follows:

<b>Personnel and Entities in the Current Member Definition</b>	<b>PublicCo. Equivalent</b>
Firm	PublicCo., its subsidiaries, <sup>1</sup> and affiliated AttestFirms. <sup>3</sup>
Partners	Upper management (all PublicCo. managers at the attest partner's level or higher). <sup>2</sup>
Managerial employees in offices participating in a significant portion of the engagement.	Managerial employees in offices participating in a significant portion of the engagement.
Professional employees assigned to the engagement.	Professionals assigned / leased to participate on the engagement.

<sup>1</sup> Inclusion of the firm within the current definition of “Member” addresses permitted versus prohibited corporate financial interests, business relationships, services provided, etc. The current definition as applied to an accounting firm may include the entire worldwide firm depending on its structure / management and profit-sharing provisions, even though the firm may have several distinct divisions or units based on geography (organized by region or nation), function (audit, tax, and consulting), or profit center (perhaps organized by industries served). We’ve included all of PublicCo. and its subsidiaries in the expanded “Member” definition, to reflect the broad application of the rule to the traditional firm. The implied conclusion here is twofold: (1) that the auditor’s employer should not have relationships with or provide services to the auditor’s clients that the auditor could not provide directly, even if the auditor performs the audit under the auspices of a firm not owned by his employer, and (2) that if the current independence rules apply to the entire traditional firm, ignoring the separateness of national units and the separation between the audit and consulting practices, for example, then the rules should apply to PublicCo. and all of its subsidiaries.

<sup>2</sup> The current rules specify that all partners are “Members” when determining personal independence restrictions, even if they are in the consulting or tax practices, and far removed from an attest partner’s office and profit center. The current definition captures the attest partner’s colleagues, direct supervisors, and all more senior people in the firm (colleagues include a partner at the same level or junior to the attest partner). Direct supervisors and more senior management are included to prevent the risk that personal financial interests or relationships with attest clients would enable them to exert influence over the attest partner (or the attest partner’s judgment would be affected, knowing senior management’s interests in the attest client, even without overt attempts to influence the attest partner). Presumably, the partner’s contemporaries and those more junior are included because of the collegiality that the partnership structure engenders, because of appearances, and perhaps even administrative ease in applying the rule.

With regard to personal investments and relationships, the solution proposed here, to include all PublicCo. personnel at the attest partner’s level and higher in the definition of “Member,” is similar to the group included in a traditional firm. In applying this rule, for practical purposes, PublicCo. would have to designate some minimum level of management as the floor for determining those included as “Members.”

<sup>3</sup> Note that the current definition of Member would already pick up the other attest partners at AttestFirm that also work at PublicCo. (as well as PublicCo. personnel working on the engagement). The solution proposed here would also pick up attest partners from other AttestFirms affiliated with PublicCo. (assuming that they would fall within the definition of “upper management” as used here), but does not address what relationships AttestFirms could have with each other’s clients. If we conclude that Attest Firm and PublicCo. should be considered one and the same for purposes of applying the independence rules, then it would seem that AttestFirms, affiliated by virtue of the shared PublicCo. employment of their owner-managers, should not have normally prohibited relationships with each other’s clients. Indeed, if this were allowed, a national firm might

argue that its individual offices should be allowed to have relationships with each other's clients that would normally impair independence under certain circumstances – if, for example, partners were compensated based on office profitability rather than a firmwide, or divisional calculation, and other measures were taken to enhance the separateness of office units.

## **Other Issues**

### **PublicCo. Shareholders**

The proposals described thus far do not address whether restrictions on the activities of PublicCo. shareholders with respect to AttestFirm clients are necessary or feasible. If restrictions were placed on the relationships that PublicCo. senior managers could have with attest clients, should these restrictions extend up to PublicCo. shareholders? Certainly the owners of a traditional firm are subject to these restrictions.

One important distinction is that the owners of a traditional firm are, or have been, actively involved in its operations and management (independence restrictions extend to retired partners, who are receiving retirement benefits that vary based on current earnings as opposed to fixed benefits – these retired partners could be likened to passive shareholders, except that retired partners have a long history of active participation in the day-to-day operations of the firm, and most likely have some close ties to current management). Some would argue that this distinction is significant enough to justify leaving PublicCo. shareholders out of the “Member” definition. They would point out that inclusion of shareholders is not feasible, and the threat to auditor independence is not clear in a widely-held PublicCo., where ownership is not concentrated in any one individual or group. Should restrictions apply, however, to a PublicCo. shareholder that has a twenty or thirty percent ownership interest? Some would argue that auditor independence might be compromised, if such a shareholder also had, say, a significant interest in an AttestFirm client.

### **AttestFirm Client Stock Investments in PublicCo.**

Another issue not yet addressed is whether restrictions are appropriate on the stock investments AttestFirm client has in PublicCo., a situation not covered in the current literature. However, loans by an attest client to the audit firm are prohibited, and it would seem that equity investments would be prohibited for the same reasons. The threats to auditor independence are twofold:

- that the AttestFirm client, as a significant shareholder of PublicCo., could exert influence over an AttestFirm partner to obtain a favorable accounting treatment.
- that the AttestFirm partner would not be objective in assessing the value of equity investments that were not publicly-traded, or in evaluating the need for or magnitude of a charge for an other-than-temporary decline in value.

- that an AttestFirm client's holding of PublicCo. stock would create an unacceptable "mutuality of interests" between the client, PublicCo., and the AttestFirm partner.

It would seem that those who believe that PublicCo.'s financial interests in AttestFirm clients should be restricted would also believe that AttestFirm clients' financial interests in PublicCo. should be restricted. The potential threat to auditor independence does not seem imposing if the client is an insignificant shareholder of PublicCo., and if the client's holdings are immaterial to the client. However, materiality has not been considered in the current literature on direct financial interests between auditors and clients.

### Commissions

Under the current rules, the acceptance of commissions by the auditor for referring attest clients to brokers, insurance agents, bankers, etc, is prohibited, presumably because the auditor could end up auditing the value or financial consequences of a product or service that he or she was paid to recommend. Some would argue that the AttestFirm partner's independence may be impaired if he or she referred attest clients to PublicCo. for products, as salary increases or bonuses could be used to compensate the AttestFirm partner for these referrals. Others might argue, however, that it's not the act of being paid for these referrals that would impair the auditor's independence per se, but the ill-fated recommendation itself that causes a problem (which could be exacerbated by the client's knowledge that the auditor was paid for the referral). The fact that the auditor advised the client might cause the auditor to be overly optimistic in auditing the results or consequences of that advice. Uncompensated referrals, however, are not necessarily prohibited.