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1999 Annual Report

Independence Standards Board

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ISB

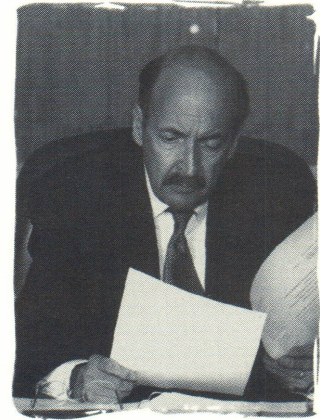
I n d e p e n d e n c e S t a n d a r d s B o a r d



1999 Annual Report

Chairman's Letter

The past year has been one of great activity and substantial progress for the Independence Standards Board. The Board's most basic task, the development of a conceptual framework for creating and critiquing independence standards, has been addressed by a large expert task force and that work has resulted in the soon-to-be-released Discussion Memorandum on a conceptual framework for auditor independence. In addition, the ISB, its staff and the members of the public who serve on its various task forces have made real progress on six separate standard setting projects. These include projects to modernize rules respecting family relationships, auditing mutual funds, and most basically, the evolving business structures within which audit services are offered to SEC registrants. These projects — most especially the conceptual framework project and the project treating evolving firm structures — involve issues of fundamental importance to capital market participants, and the Board has been gratified by the willingness of institutional investors as well as others with an important interest in the functioning of these markets to invest time and effort in participating through their comments on Board proposals or discussion documents.



William T. Allen

The process of giving mature consideration to proposed standards is a time-consuming one. This year the Board completed its public deliberation respecting its first standard — ISB Standard 1 — which treats the important topic of auditor–audit committee relations and disclosure. Our second standard addresses the special independence concerns that arise in the audit of mutual funds and has recently been completed.

This year the Board received results from its first sponsored research. That project, completed for the ISB by Earnscliff Research and Communications, dealt with the perceptions of a variety of groups on auditor independence issues. The results of this research is now publicly available (see our Web site) and was quite helpful in informing the exercises of judgment that Board members must make. The ISB currently has under consideration the sponsorship of additional research.

This Annual Report describes all of our accomplishments and ongoing projects in further detail. For more information respecting the work of the Board, please visit our Web site or address inquiries to the Board's expert staff.

The difficult foundation-laying work that the Board had to undertake at its founding is now well on its way to completion. It is realistic, I think, to hope that within the next eighteen months the Board will have completed not only its conceptual framework, but its project on firm structures and will thus have put in place an ability to deal with independence safeguards in a modern and principled manner. This work is complex, and time consuming, but important. We are grateful for the good cooperation and support the Board receives in this work from its Staff, from the Securities Exchange Commission and its Staff and from the accounting profession.

William T. Allen
December 1999

The Board



Top (from left) — P. Laskawy, R. Denham, J. Schiro
Bottom (from left) — M. Johnson, B. Melancon, W.T. Allen, S. Butler



John C. Bogle

William T. Allen, Chairman

Director, Center for Law and Business,
New York University

John C. Bogle

Senior Chairman, The Vanguard Group

Stephen G. Butler, CPA

Chairman and CEO, KPMG

Robert E. Denham

Partner, Munger, Tolles & Olson LLP

Manuel H. Johnson

Co-Chairman and Senior Partner,
Johnson Smick International

Philip A. Laskawy, CPA

Chairman and CEO, Ernst & Young LLP

Barry C. Melancon, CPA

President and CEO, AICPA

James J. Schiro, CPA

Chief Executive Officer,
PricewaterhouseCoopers

The **Independence Standards Board** (the ISB, or Board) is composed of eight members — four from the public and four from the accounting profession. Public members must be prominent individuals of high integrity and reputation, who understand the importance of investor protection, the U.S. capital markets, and the accounting profession.

Board members, with the exception of the President of the American Institute of Certified Public Accountants (AICPA) or his or her designee, can serve a maximum of two consecutive three-year terms (except that initial Board members may serve more than two consecutive terms as long as their service does not exceed seven years). The Board elects its Chairman from among the public members.

The Board's operating policies also specify that Commissioners of the Securities and Exchange Commission (SEC), the SEC's Chief Accountant, or his or her designee, and the Chairman of the AICPA have "privilege of the floor" at all Board meetings.

This year, the terms of Messrs. Denham, Johnson, Laskawy, and Schiro expired, and all agreed to serve an additional three-year term.

The operating policies of the ISB are designed to permit thorough and open study of issues involving auditor independence, and to encourage broad public participation in the process of establishing and improving independence standards. As such, ISB and Independence Issues Committee (IIC, or the Committee) meetings are conducted "in the sunshine" — the public is invited to attend or listen in by telephone.

ISB and IIC meeting minutes, comment letters received on exposure drafts, consensus reached by the IIC, and certain other materials are available for public inspection and copying at the ISB offices in New York and in the library at the AICPA's New Jersey offices. Much of this material is also available on our Web site.

While the ISB is funded by the AICPA's SEC Practice Section, it sets its own budget and operates autonomously.

The operating policies
of the ISB are designed
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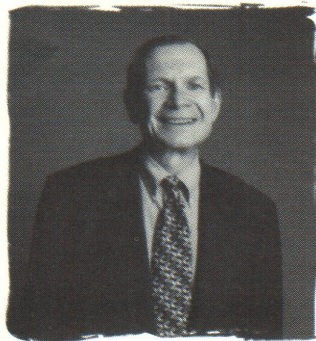
Web Site

The ISB Web site www.cpaindependence.org is our primary vehicle for communicating with interested parties and providing discussion memos, exposure drafts, final standards and interpretations to the public. The Web site also contains:

- Our operating policies and general information about the Board
- Public meeting notices and agendas
- ISB and Independence Issues Committee meeting minutes
- Speeches delivered by Board members and the ISB Staff
- Membership listings for project task forces
- A calendar showing the expected timetable for major milestones in each Board project
- A vehicle for submitting an independence inquiry or feedback on ISB activities
- Formal independence consultation interpretations issued by the Staff

Interested parties can also subscribe to our “document express” service, which alerts users to new Web-site postings via e-mail. All of our Web-site services are free of charge.

The ISB Staff



Arthur Siegel

Arthur Siegel has served as Executive Director of the ISB since his retirement from Price Waterhouse in October 1997. This year, we added two professionals to the Staff in response to the Board's addition of five standard-setting projects to its agenda.

The Staff supports the Board in all of its projects, which are described in more detail on the following pages. In addition, the Staff fields independence inquiries on the application of the existing independence rules to specific facts and circumstances. (See the section on ISB Staff Consultations.)

The Staff is active in making presentations to various groups with an interest in auditor independence to keep them up-to-date on ISB activities and to encourage comment on Board documents.

ISB Staff

Arthur Siegel, Executive Director

Susan McGrath, Director

Christine D. Bricker, Assistant Technical Director

Richard H. Towers, Technical Director

William J. Cashin, Jr., Director

Susan J. Lange, Administrative Assistant

Conceptual Framework for Auditor Independence

One of the Board's most significant charges is to develop a conceptual framework for auditor independence, which will then provide the foundation for principles-based independence standards.

A conceptual framework for auditor independence should serve several purposes. The framework should help the Board meet its responsibilities to set sound and internally-consistent independence standards by providing direction and structure for resolving independence issues and questions.

Both the framework itself and standards emanating from the framework should serve the public interest by increasing the confidence that investors, creditors, and other stakeholders in auditor independence have in the audit process and in the reliability of financial statements. The framework should help stakeholders understand the significance of auditor independence and the various processes that are in place to ensure it. The conceptual framework should also narrow the gap between the expectations that various stakeholders may have of auditor independence and an auditor's ability to achieve complete independence.

The new framework is not intended, by itself, to resolve auditor independence issues. Rather, the framework should focus discussion and provide a common language for those engaged in independence debates, thereby assisting stakeholders in contributing to the development of independence standards. Finally, the conceptual framework should enhance stakeholders' understanding of independence standards issued by the Board and assist them in applying the standards in specific situations.

Last year, the Board engaged Professor Henry Jaenicke of Drexel University to direct, draft, and provide thought-leadership on the conceptual framework project. Professor Jaenicke is assisted by Professor Alan S. Glazer of Franklin & Marshall College.

A broad-based project task force, consisting of individuals from a wide variety of backgrounds, has been formed for this project. This task force includes auditors, audit committee members, academics, state board of accountancy representatives, analysts and other users, corporate executives, and other interested parties. Representatives of international standard setters were also invited to join the task force so that the Board can keep abreast of international developments, and benefit from the work and thinking of those in other countries.

With the assistance of this task force and the ISB Staff, Professors Jaenicke and Glazer are close to completing a neutral discussion memo on the issues that are integral to the development of the framework. Review and consideration of the draft is on the agenda for the Board's January 2000 meeting. At that time, the Board will determine whether to issue the document for public comment.

The discussion memo is expected to cover such subjects as the purpose of the audit and of auditor independence, the environment in which audits are conducted, alternative definitions for auditor independence, and such concepts as independence risk, threats and safeguards to independence, and the private and social benefits and costs of independence.

The Board will consider comments received on the discussion memo and, after deliberation, issue for public comment an exposure draft of a conceptual framework for auditor independence. After considering public input, the Board will issue the final conceptual framework document. Messrs. Allen, Denham, Melancon and Schiro serve on the Board Oversight Task Force.



The ISB Standard Development Process

As the ISB completes its first full year of operations, the Board is studying several issues for possible standard setting, while working concurrently on its conceptual framework project. These issues have some urgency, and the Board was reluctant to wait until the conceptual framework was completed before developing at least some interim solutions. In addition, the Board believed its examination of specific auditor independence matters would enhance its understanding of the broader issues, and help in the development of a conceptual framework for auditor independence that leads to comprehensive standards.

Potential Board projects — topics of importance to public investors and to auditor independence — are identified and suggested by the Staff, the Independence Issues Committee, the SEC Staff, and others. The standard development process begins when the Board approves the addition of a project to its agenda, following the review of a project prospectus prepared by the Staff. At that time, the Board will also give the Staff general guidance concerning the scope and direction of the project.

To develop these projects in a comprehensive manner, a “task force” approach is used to obtain the input of a wide variety of interested and experienced parties. The Project Task Force performs an important advisory service for the Board by helping to ensure that Board documents, such as discussion memorandums (DMs) and exposure drafts (EDs), consider all relevant matters, are comprehensive and balanced, and clearly provide the guidance intended by the Board. To attain these objectives, Project Task Forces are structured to consider the unique requirements of each project and include about 12 to 15 individuals with a wide variety of backgrounds. Typical areas of expertise reflected in the task force membership may include auditing, academics, investment management, law, regulatory matters, audit committee participation, and other specialties that may be germane to the topic. A representative of the Office of the Chief Accountant of the SEC is invited to attend all Project Task Force meetings. Academic members are asked to identify or suggest helpful research related to the topics under study.

In addition to the broad-based Project Task Force, a Board Oversight Task Force is formed to oversee each project. These task forces usually consist of two Board members — one representing the public and one representing the auditing profession. The role of this group is to act as the Board’s liaison with the Project Task Force and to provide direction to the Staff in-between meetings of the full Board.

While a task force is being formed, work usually begins on the preparation of a DM — a neutral document designed to both stimulate discussion and debate and to ensure that all key issues are fully considered. The Staff typically drafts the DM and then obtains input from the Project Task Force. The DM may contain background information indicating why the issue was placed on the Board’s agenda, a review of current independence regulations, possible risks and threats to auditor independence, proposed safeguards that may mitigate possible risks, and an analysis of possible alternative solutions. Also included in the DM is a series of “Questions for Respondents,” which are designed to encourage thought and facilitate comment from the public and other interested parties.

After the Board Oversight Task Force reviews the DM, the full Board normally considers it at a public meeting, instructs the Staff to make revisions, and authorizes the issuance of the document pending clearance of the revisions by the Board Oversight Task Force. Comment periods are normally between 60 and 90 days long.

The Staff summarizes comments received and the Project Task Force reviews this summary to ensure its accuracy and completeness. Both the summary and copies of all comment letters are forwarded to the Board members. The Board reviews these responses to the DM, deliberates on alternatives suggested by the Staff and others, and then directs the staff to prepare an exposure

draft of a new standard. The draft ED contains a detailed explanation of the Board's basis for conclusions and another set of questions for respondents to encourage comment on the document. The sequence of events for the preparation, exposure, and analysis of comments received is the same for an ED as it is for a DM, except that the full Board must clear the final issuance of an ED. After deliberation and possible revisions to the proposed standard based on public comment, the Board would vote formally to approve the new independence standard and authorize its publication.

Occasionally, the Board may feel more confident in the appropriate direction for a new standard. If so, rather than issuing a DM seeking general input on the issues at hand, the Board may issue an invitation to comment on one or more alternative proposals, or it may proceed directly to an ED of a proposed standard.

The Board seeks the widest possible public participation in its activities, and believes these documents for public comment represent a very important and significant phase of the process. Press releases are issued announcing the release of these documents, and copies are mailed to investor organizations, institutional investors, and other groups with an interest in financial reporting and the capital markets. All documents for public comment are available on our Web site. Registered users may elect to receive e-mail notification of the release of a document for public comment.

The ISB regards the setting of auditor independence standards as its foremost responsibility. The Board believes that its process, which provides for public participation and extensive input, analysis and comment, will result in standards that are appropriate to protect the public interest and provide relevant guidance to audit firms, and to the management and directors of publicly-owned companies.

The Board currently has seven standard-setting projects in various stages of development:

- Employment with Audit Clients
- Family Relationships
- Evolving Forms of Firm Structure and Organization
- Legal Services
- Mutual Funds
- Appraisal and Valuation Services
- Outsourcing

See page 15 for a timetable for all Board Projects.

A detailed copy
of the Board's
Operating Policies
may be found
on its Web site.



ISB Standard No. 1

Independence Discussions with Audit Committees

In January 1999, the Board issued its first standard, which requires auditors subject to its rules (1) to disclose, at least annually and in writing, all relationships between the auditor and the audit client that may reasonably be thought to bear on independence, and (2) to confirm independence. Under the standard, the auditor must also meet with the audit committee (or the Board of Directors) to discuss the auditor's independence.

The Board believes that the new requirements are a cost-effective way of fostering additional attention on independence issues by audit committees and auditors. Companies are required under the Securities Acts to engage "independent" accountants, and the standard will assist directors in satisfying themselves that the company has met the requirements. The Board also believes that audit committees have an important role to play in protecting the independence of the auditor. The audit committee can set the "tone at the top," emphasizing the company's commitment to fair financial reporting, and that attempts to intimidate the auditor will not be tolerated. In addition, a mandate that audit firms describe and discuss judgmental matters that might impact independence will bring more focus within firms on this important issue.

The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees endorsed the standard. The Committee recommended that listing rules require that audit committee charters specify the audit committee's responsibility for ensuring that it receives the written communication from the auditor, and for actively engaging in the discussion required under the standard.¹

The standard is effective with respect to audits of companies with fiscal years ending after July 15, 1999, with earlier application encouraged. Copies of the standard are available on the ISB's Web site.

ISB Interpretation 99-1

Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)

The ISB issued its first Board interpretation on the application of existing independence rules in March of 1999. The interpretation provides guidance on independence issues when auditors assist clients in implementing the Financial Accounting Standards Board's Statement of Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Board believed there was an immediate and pressing need for guidance on permitted versus prohibited activities, as audit firms are likely to find themselves responding to many types of client requests as a consequence of the complexity and implementation challenges inherent in adopting the statement.

Most of the underlying work in developing this interpretation was performed by the IIC, and the Board is grateful for the Committee members' efforts to develop guidance for practitioners in a timely fashion.

The interpretation is available on the ISB's Web site.

¹1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Report and Recommendations*, New York Stock Exchange and the National Association of Securities Dealers, pg. 14.

Projects Leading to Standard Setting

Employment with Audit Clients

This project relates to the range of independence concerns that surface when audit firm professionals are employed by audit clients. These issues have been discussed by the SEC and the profession for several years, as the frequency of partners and other senior professionals leaving their firms to join audit clients has increased.

In March, the Board issued a discussion memo, for public comment, examining the issues from different viewpoints. Comments received showed strong support for a safeguard approach (firm controls, procedures, and monitoring) when audit professionals join firm audit clients, versus a "mandatory cooling-off period" (a requirement to change audit firms if certain firm professionals are hired for certain positions at the audit client).

The Board deliberated these issues, considered public input, and decided to release proposed new standards for public comment, requiring safeguards in these situations to protect auditor independence.

An exposure draft of new standards was recently issued for public comment, and new standards are expected in the second quarter of 2000. Mr. Butler and Mr. Johnson serve on the Board Oversight Task Force.

Family Relationships

Another issue that the Board is studying for potential standard setting is family relationships between audit firm and audit client personnel. The independence concern here is that emotional and financial considerations arising out of these relationships could impair the auditor's objectivity. In recent years, the practical problems of applying the existing rules to protect auditor independence in these situations have intensified, for several reasons, including mergers among audit firms and between audit clients. In many respects, however, the rapid growth of audit firms and the increase and success of women in business, and in accounting firms in particular, have brought the issue to a head. The relatively large proportion of young people in CPA firms, an increase in marriages between audit firm staff, the high staff turnover rate, and the fact that CPA firm staff will often leave to join audit clients contribute to large numbers of spouses of auditors in client financial management positions, creating family relationship conflicts. At the same time, the increase in the size of some firms has often created the separation between the engagement team and the firm professional with the family relationship that some believe is necessary to protect auditor independence.

Shortly before its fiscal year-end, the Board released an Invitation to Comment on these issues (ITC 99-1, *Family Relationships Between the Auditor and the Audit Client*). The ITC included a proposal that would change current rules to focus independence restrictions on a broadly defined "on the engagement" group of firm personnel. Two alternative definitions were offered for this restricted group — one was largely limited to those providing services to the client and in the "chain of command," while the other also included all partners and managerial employees in any office performing a significant portion of the audit work. Comments were sought on a variety of related questions, including whether a new standard on family relationships should also address financial interests in clients arising from the client-relative's employee benefit plans.

The Board hopes to expose a new standard on family relationships in the first quarter of calendar-year 2000, under the supervision of Board Oversight Task Force members Mr. Bogle and Mr. Laskawy, leading to a final standard in the second quarter.

Evolving Forms of Firm Structure and Organization

In October 1999, the Board issued a discussion memo (DM 99-2) covering the auditor independence issues raised by changes in firm structures. For example:

- Some audit firms have sold the non-audit portion of their businesses to corporations. The original partners continue to own and manage the audit business, while also becoming employees of the buying corporation and performing non-audit work under the corporation's name.
- Other firms are contemplating separate incorporation of their consulting practices, and capitalizing these entities through initial public offerings (or private placement) of securities, with the retention of a controlling or minority interest in the consulting practice.
- Still other firms may acquire a minority interest in another non-accounting entity.

These new structures bring new relationships to the auditor — for example, relationships with corporate employers, shareholders, and investees (Related Parties). These Related Parties may have relationships with the auditor's audit clients, and therefore, may have an incentive to attempt to influence the outcome of the audit. The DM asks whether standards should extend restrictions on relationships with audit clients to these Related Parties to protect the independence of the auditor.

The DM also asks under what circumstances "sister firms" — firms belonging to a common association or affiliation, or whose owners also work for a common corporate employer — should be independent with respect to each other's clients. In addition, the DM explores the potential threats to independence posed by an audit client's investment in the securities of the audit firm, or of a firm parent, subsidiary, or investee.

The DM's comment period ends on December 31, 1999. Because the existing guidance cannot be easily applied to these new structures, this project has been given a high priority, and the Board has sought to actively encourage responses from institutional investors and investment managers. The Board will consider the comments received on the DM, and deliberate on these issues in the first quarter of calendar year 2000.

Lawrence A. Cunningham, Professor of Law and Director of the Samuel and Ronnie Heyman Center on Corporate Governance of the Cardozo School of Law at Yeshiva University, has been engaged to serve as Project Director. Msrs. Allen, Denham, Laskawy, and Schiro serve on the Board Oversight Task Force.

Mutual Funds

In September 1999, the Board issued an exposure draft entitled, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*. This project is limited in scope, with the intention of addressing certain specific practice issues in an expedited manner. The Board discussed comments received on the ED at its November meeting and plans to issue a final standard shortly after calendar year end.

The standard will require the audit firm, certain of its retirement plans, the audit engagement team (broadly defined) and certain others, when auditing mutual funds, to be independent of all "sister funds" (other mutual funds in the complex that have the same investment advisor as any fund audited by the firm) and all related non-fund entities. In addition, when auditing a non-fund entity, the entities and individuals mentioned above would have to be independent of all funds in the mutual fund complex.

On the other hand, the standard would permit:

- direct investment in non-audit client sister funds by all other partners and employees of the firm; and
- investment through an employee benefit plan in mutual fund audit clients by spouses and dependents of partners, other than those of the engagement team or in a position to influence the audit.

The standard will be effective with respect to audits of financial statements for periods beginning after June 15, 2000, with earlier application encouraged. However, in certain respects, current rules of the AICPA and the SEC are more restrictive than the provisions of this standard, and these more restrictive rules must be followed until the AICPA and the SEC revise their rules. Mr. Bogle and Mr. Butler serve on the project's Board Oversight Task Force.

Appraisal and Valuation Services

Also in September 1999, the Board issued a discussion memorandum for public comment on auditors providing appraisal and valuation services for audit clients (DM 99-3, *Appraisal and Valuation Services*). The Board recently focused on these services in conjunction with the interpretation it issued on assisting clients in implementing FAS 133 on derivatives and hedging. In addition, the SEC staff expressed concerns related to auditors assisting their clients in allocating the purchase price of an acquired business to its individual assets and liabilities in conjunction with a purchase business combination.

This attention clarified the need for general guidance as to the extent of assistance that auditors can provide audit clients in valuing assets (or liabilities) while preserving their independence. In addition, focus on these services highlighted several inconsistencies or anomalies in the existing rules.

The discussion memo covers:

- the current rules governing provision of appraisal and valuation services by audit firm professionals to audit clients;
- professional standards governing appraisal and valuation specialists;
- threats to auditor independence that the provision of these services may pose;
- possible criteria that the Board might use in setting standards governing these services; and
- safeguards that some suggest may be effective in protecting independence when firm professionals perform these services for audit clients.

Readers were asked to respond to a variety of questions, including whether there are distinctions among offered services that the Board could use in standard setting. Comments were due by November 30, 1999. The Board will consider the comments received on the DM, and deliberate on these issues in the first quarter of calendar year 2000. Mr. Johnson and Mr. Melancon serve on the Board Oversight Task Force.

Legal Services

In its project on legal services, the Board seeks to determine whether independence standards should allow audit firms to provide legal services, or certain types of legal services, to publicly-held audit clients. International audit firms have been rapidly developing large networks of affiliated law firms in Europe, South America, Australia, and other parts of the world. In addition, the

American Bar Association appointed a Commission on Multidisciplinary Practice to evaluate whether the current ban on fee-sharing between lawyers and non-lawyers should be retained.

There are currently certain independence restrictions on audit firms performing legal services for audit clients. Some of these restrictions are based on the belief that a lawyer's advocacy may lead to a commonality of interests with the client which, in turn, could result in a loss of objectivity and thus impair the auditor's independence.

With the assistance of the project task force, the Staff drafted a discussion memorandum covering these issues that was considered by the full Board at its November meeting. The DM was released in early December, and the comment period ends on February 29, 2000. Mr. Denham and Mr. Schiro serve on the Board Oversight Task Force.

Outsourcing

The Board also authorized a project to study the independence issues related to outsourcing engagements performed by audit firms for their audit clients. The project will explore the nature of outsourcing services that accounting firms might offer, the threats to independence that these may pose, and whether safeguards may be effective in mitigating those threats. The project will build on the work previously performed by the IIC's Outsourcing Task Force, which prepared a paper outlining these issues. The project may consider whether standards restricting outsourcing activities should distinguish between engagements covering the audit client's core versus ancillary functions, audit-sensitive operations versus those without a direct financial statement impact, and material engagements versus those that are inconsequential to both the auditor and client.

A project task force has been appointed, and the Staff has begun to draft a neutral discussion memo covering these issues for public comment. Mr. Butler and Mr. Johnson serve on the Board Oversight Task Force for this project.

Research and Consulting Arrangements

In fiscal 1999, the Board embarked on a research project involving public perceptions of auditor independence. The Board engaged Earncliffe Research and Communications to conduct this study, which involves solicitation of perceptions on family relationship, employment with audit clients, and non-audit service issues, as well as more general independence concerns. Approximately 130 audit committee members, both buy and sell side investment analysts, experienced engagement partners from audit firms, regulators, CEOs, and CFOs from around the country were interviewed in the study. The Board received the final research results in November 1999. The project yielded insights into the concerns of various groups with an interest in auditor independence, and will likely influence the Board's future agenda-setting. The report has been posted to the ISB's Web site.

The Board has a consulting arrangement with Katherine Schipper, the L. Palmer Fox Professor of Business Administration in Accounting at the Fuqua School of Business at Duke University. Ms. Schipper assists the Board in evaluating researchers and research proposals and in ensuring that research methodologies are sound. She is also available to consult with the Board and the Staff on general auditor independence matters.

The Board also engaged Thomas W. Dunfee, the Joseph Kolodny Professor of Social Responsibility at the Wharton School of the University of Pennsylvania, to advise the Board on ethical matters. Professor Dunfee is also director of the Zicklin Center for Business Ethics Research at Wharton. He has been actively involved in the Board's project to develop a conceptual framework for auditor independence.

The Independence Issues Committee

Arthur Siegel, Chairman

Kenneth E. Dakdduk

PricewaterhouseCoopers LLP

Barry Barber

Grant Thornton LLP

John M. Guinan

KPMG LLP

Robert Bowen

Hansen, Barnett & Maxwell

Charles A. Horstmann

Arthur Andersen LLP

Edmund Coulson

Ernst & Young LLP

Robert J. Kueppers

Deloitte & Touche LLP

Larry Shapiro

BDO Seidman, LLP

The Independence Issues Committee is composed of eight members of the profession who are knowledgeable of the existing independence literature and are in a position to be aware of emerging independence issues as they develop. Art Siegel serves as the Committee's non-voting Chairman, and the SEC's Chief Accountant or his designee serves as an observer. The Committee also operates in public.

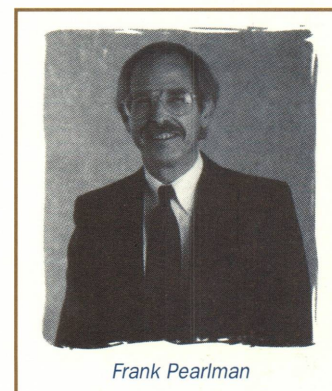
The Committee's charge is to address and develop consensuses on emerging issues within the framework of existing literature. In other words, the IIC provides guidance on independence issues not clearly addressed in the literature. Its consensus interpretations become authoritative when ratified by the ISB.

The Committee also performs "practical" research in support of the Board's missions, providing statistics and information about firm operations, service offerings, and more.

In the first half of the fiscal year, the IIC developed a consensus on the assistance that auditors could provide audit clients in implementing FAS 133; the consensus formed the basis for a Board interpretation on the issue. The IIC also studied the independence issues raised by alternative forms of firm structure and organization prior to the Board's addition of the project to its own agenda. The Committee has been largely inactive in the second part of the year, pending resolution of questions regarding the appropriate scope of its activities. The Board is expected to address these issues in the near future.

The Board, its Staff, and the IIC were saddened by the sudden death of Committee member Frank Pearlman, who passed away in August. Frank was a partner at BDO Seidman. A leader in the profession for many years, Frank was completing a three-year term as Chairman of the AICPA's Professional Ethics Executive Committee, while actively serving on the IIC and on the Board's firm structure and family relationship task forces. Frank will be missed by all, and his contributions to the profession will not be forgotten.

Robert Bowen, from Hansen, Barnett & Maxwell, replaced Edward W. O'Connell, from Wiss & Co., on the Committee. Gerald Ward, from PricewaterhouseCoopers, rotated off the Committee upon the merger of Price Waterhouse with Coopers & Lybrand, which resulted in two representatives from the merged firm. The Board welcomes Mr. Bowen to the Committee, and is grateful for the contributions of Mr. Ward and Mr. O'Connell. Mr. Ward led the charge in the early phases of the Board's family relationships project and continues to assist as a member of the task force. Mr. O'Connell has been involved in the Board's employment with audit clients project since its inception and continues to serve on the project task force.



Frank Pearlman

ISB Staff Consultations

As anticipated in our first full year of consulting operation, the pace of ISB Staff consultation has accelerated dramatically. Specifically, the Staff responded to 144 requests for informal consultation in fiscal 1999 — 55 in a comparable period to the 35 consultations reported last year after the SEC's Financial Reporting Release 50 recognized our processes.

In its consulting role, the ISB Staff answers independence questions from practitioners and others by interpreting the current rules. These consultations formerly were performed by the SEC Staff.

While informal inquiries can be made by telephone, official consultation requests must be submitted in writing to ensure that we have a complete understanding of and agreement on the facts. Only written requests and responses may be relied upon for SEC purposes and then only by the parties involved. The SEC staff will not treat the specific response as having substantial authoritative support, such that it can be relied upon by others, until ratified by the Board. Formal inquiries, along with their ISB interpretive responses (two each in 1999 and 1998), are posted to the Web site.

The detail, by subject, of informal inquiry responses follows:

SUBJECT	FISCAL 1999		FISCAL 1998	
	#	%	#	%
Bookkeeping	18	13%	5	14%
Financial interests	16	11%	5	14%
Family relationships	16	11%	1	3%
Former partners	14	10%	4	11%
Unpaid fees	10	7%	2	6%
Other services (consulting, valuation, outsourcing, etc.)	25	17%	10	29%
Other (business relationships, loans, mutual funds, broker-dealers, etc.)	45	31%	8	23%
Total	144	100%	35	100%

Expected Timetable for Board Agenda Projects

	1999 4Q	1Q	2000			2001 1Q
			2Q	3Q	4Q	
As of November 19, 1999						
Conceptual Framework	TF	DM		TF	ED	
Employment with Audit Clients	ED	TF	F			
Family Relationships	TF	ED	TF	F		
Evolving Forms of Firm Structure	DM	TF, ED	TF, F			
Mutual Funds	TF, F					
Appraisal and Valuation Services		TF, ED		TF, F		
Legal Services	DM		TF	ED	TF	F
Outsourcing		TF	DM	TF	ED	TF

KEY:

- TF Meeting of the Project Task Force
- DM Issuance of Discussion Memo for Public Comment
- ED Issuance of Exposure Draft for Public Comment
- F Issuance of Final Statement or Other Final Document





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