2000

Changes Needed to SEC Rulemaking Proposal to Reflect ISB Projects on Employment with Audit Clients and Appraisal and Valuation Services

Independence Standards Board

ISB

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August 18, 2000

Mr. Jonathan G. Katz
Secretary
U. S. Securities and Exchange Commission
450 5th Street N. W.
Washington, DC 20549

Dear Mr. Katz:

During the public hearings on auditor independence on July 26, Chairman Levitt asked ISB Chairman Allen for suggestions on how to make the Commission's proposed rules fully consistent with ISB documents. At the direction of Chairman Allen, I am enclosing a memorandum which contains such suggestions for ISB Standard No. 3 and with our proposed standard on appraisals.

Please contact me at 212-596-6141 if I can provide any additional information.

Sincerely,

Arthur Siegel
Executive Director

Enclosure

Copy - with enclosure

SEC Commissioners
Mr. Lynn Turner
ISB Board members

1211 Avenue of the Americas, New York, NY 10036–8775

Independence Standards Board

Changes Needed to SEC Rulemaking Proposal to Reflect ISB Projects on Employment with Audit Clients and Appraisal and Valuation Services

Employment with Audit Clients

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

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§ 210.2-01 Qualifications of accountants.

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(c)(2) Employment relationships. An accountant is not independent under the standard of paragraph (b) of this section if the accountant has an employment relationship with an audit client ~~or an affiliate of an audit client~~, such as the employment relationships specified in this paragraph (c)(2). An accountant is not independent when:

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(iii) Employment at audit client of former employee of accounting firm. A former partner, shareholder, principal, or professional employee of an accounting firm ~~is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client, unless the individual:~~ employed by the audit client could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.

~~(A) Does not influence the accounting firm's operations or financial policies;~~

~~(B) Has no capital balances in the accounting firm; and~~

~~(C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the firm) pursuant to a fully funded retirement plan or rabbi trust~~

An established program of safeguards including the following procedures, when conscientiously administered, is deemed to constitute steps that effectively eliminate the risk of independence impairment:

(A) Pre-change in employment safeguards:

(1) Firm professionals are required promptly to report to the firm conversations between themselves and an audit client respecting possible employment.

(2) Firm professionals engaged in negotiations respecting possible employment with an audit client are immediately removed from the audit engagement.

(3) Upon removal of a professional from the audit engagement as provided above, the firm reviews the professional's work to assess whether he or she exercised appropriate skepticism while working on the audit engagement.

(B) Post-change in employment safeguards:

(1) If a professional accepts employment with the audit client, the on-going engagement team gives active consideration to the appropriateness or necessity of modifying the audit plan to adjust for risk of circumvention.

(2) When a former firm professional joins an audit client and will have significant interaction with the audit team, the firm takes appropriate steps to provide that the existing audit team members have the stature and objectivity to effectively deal with the former firm professional and his or her work.

(3) When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the next following annual audit is separately reviewed by a firm professional uninvolved in the audit to determine whether the remaining engagement team maintained the appropriate skepticism when evaluating the representations and work of a former firm professional. The extent of this review should be tailored based on the position that the former professional has assumed at the audit client and other facts and circumstances that would heighten or mitigate threats to independence.

(4) The firm requires the prompt (1) liquidation of all capital balances of former firm partners who become employed by an audit client; (2) settlement[1] of all

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[1] In the United States, the payment of retirement benefits to the individual would immediately subject such benefits to income taxes. In some cases, this tax liability can be deferred by transferring the remaining retirement benefits to an Individual Retirement Account or similar vehicle, in which case the amounts become taxable only when paid to the individual. In other cases, the amount can be transferred to a "Rabbi Trust" which also serves to defer such income taxes. A Rabbi Trust is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met; however, such assets are subject to the claims of creditors in the event of the firm's bankruptcy or insolvency. To meet the requirements of this rule, such a trust can only be used if the amounts are fixed as to amount and timing of payment (i.e., the

retirement balances[2] of former firm professionals who become so employed that are not both immaterial to the firm and fixed as to amount and timing of payment; and (3) settlement of retirement balances of any firm professional, regardless of the financial immateriality of such balances to the firm, when, within five years of disassociating from the firm the identity of such former firm professional as an officer or employee of the audit client is required to be disclosed in the audit client's proxy statement or annual report.

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(d) Quality controls. An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

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(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence. For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934, a quality control system will not provide such reasonable assurance unless it has at least the following features:

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(vi) Written policies and procedures ~~requiring all firm professionals to report promptly to the firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and~~ regarding employment with audit clients as specified in (2) (iii) (A) and (B) above; and

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Commentary

The ISB's standard requires additional safeguards to address the concerns that the remaining engagement team may be either too close to the former firm professional now at the audit client, or lack the necessary stature to effectively challenge his or her decisions, thereby accepting the client's proposed accounting without exercising appropriate skepticism. Procedures are also required under the ISB standard to address the concern that the departing professional, because of his or her familiarity with the audit approach and testing strategy, may be able to circumvent its design.

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benefits do not fluctuate based on firm results, and the present value of benefits due to the departing professional can be calculated and placed in the trust), and the bankruptcy of the firm is considered remote.

[2] Retirement balances as used in this rule do not include a professional's benefits under the firm's defined contribution plan, such as a 401(k) plan, if the firm has no obligation to fund the individual's benefits after he or she disassociates from the firm.

The ISB standard's financial settlement provisions also differ from those in the SEC proposal, particularly in that the ISB's rules apply whenever retirement balances owed are not both immaterial to the firm and fixed as to amount and timing of payment, regardless of the former firm professional's position at the client (the SEC proposal would allow firms to have outstanding obligations to former firm professionals at audit clients – obligations that are material to the firm and possibly based on firm profits - as long as the professionals were not in accounting or financial reporting oversight roles).

The SEC's proposal requires settlement of retirement balances for former firm professionals in accounting and financial reporting oversight roles, unless they are fixed and fully funded, regardless of materiality and the length of time that has elapsed since the professional left the firm. The ISB standard would require settlement of immaterial balances only for a select group of positions at the audit client, and only if the former firm professional in one of these positions left the firm within the last five years. This five year settlement window recognizes that immaterial obligations cannot be used to influence the firm, and that the appearance of a close relationship between a former firm professional and the firm diminishes over time.

Appraisal and Valuation Services

(4) Non-audit services. (i) Even if the audit client accepts ultimate responsibility for the work that is performed or decisions that are made, an accountant is not independent under the standard of paragraph (b) of this section when the accountant provides certain non-audit services to an audit client or an affiliate of an audit client, such as:

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(C) Appraisal or valuation services~~, fairness opinions, or contribution-in-kind reports~~. Any appraisal or valuation service[3] for an audit client ~~or an affiliate of an audit client, or any service involving a fairness opinion or contribution-in-kind report where it is reasonably likely that, in performing an audit in accordance with generally accepted auditing standards, the results will be audited by the accountant~~ unless such services in the aggregate have only an immaterial[4] effect, whether direct or indirect, on the audit client's financial statements.[5]

[3] The terms "appraisal" and "valuation" are used interchangeably, and are meant to include the process of valuing assets, both tangible and intangible, and liabilities.

[4] *Webster's Ninth New Collegiate Dictionary* (Merriam-Webster, Inc., 1987) defines "immaterial" as "unimportant," or "of no substantial consequence."

[5] This rule does not apply:

a. when a firm valuation expert reviews and reports on the work of another specialist, employed or engaged by the audit client, who provides the primary support for the balances recorded in the client's financial statements;

b. to appraisals and valuations performed as part of the audit;

c. to situations where firm actuaries value a firm audit client's pension, other post-employment benefit, or similar liabilities; or

d. to valuations performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance purposes.

If a firm provided appraisal and valuation services to a company prior to it becoming an audit client (e.g., in new client or firm merger situations), and the auditor will be relying on, as audit evidence, an other-than-immaterial valuation that his or her firm performed, then the auditor shall obtain a review of that report[6] from another expert not connected to the firm.

Commentary

The ISB's proposed standard does not explicitly prohibit fairness opinions and contribution-in-kind reports, as these reports cannot be issued by the auditor if they are supported by appraisal and valuation work that is prohibited under the standard (i.e., prohibiting the reports in these cases is in a sense redundant). On the other hand, there may be instances where the report conveys the audit firm professional's conclusions regarding the work of another valuation specialist. As the ISB standard does not prohibit reviewing and reporting on the work of another specialist, these reports would be permitted in those limited circumstances.

The ISB's proposed standard prohibits audit firm professionals from performing appraisals unless they could only have an immaterial effect on the financial statements of the audit client. Similarly, the SEC proposal prohibits this work unless the results are not likely to be audited by the auditor. We believe that the SEC proposal would therefore permit immaterial appraisals, since the auditor is unlikely to focus on immaterial financial statement balances. While we think the language in the two proposals would lead to the same result, it is better to explicitly permit immaterial work if that is what is intended.

[6] Standards applying to appraisal and valuation experts provide for engagements to review and report on the work of another expert, without necessarily performing a second, full-scope valuation.