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## Presentation to 27th Annual AICPA Conference - Current SEC Developments

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Independence Standards Board

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**Independence Standards Board  
Presentation to  
27th Annual AICPA Conference - Current SEC Developments  
Arthur Siegel  
December 8, 1999**

It is a pleasure to be here today give you an update on the activities of the Independence Standards Board. I must remind you, however, that my remarks reflect my own personal views, and not necessarily those of the ISB or of individual Board members.

The Board's research project on perceptions of auditor independence and objectivity was recently completed. Earncliffe Research & Communications conducted the study, which consisted of interviews with 131 key individuals. The interviews covered many issues, but I will try to summarize a few of the highlights of the research results:

- With very few exceptions, interviewees felt that the standard of financial reporting in the US is excellent, and that auditors are currently performing audits which meet a high standard of objectivity and independence.
- Most believe that the future will present greater challenges to auditor objectivity and independence, and that a *perception problem* is likely to develop if the current trends continue. They believe that the evolution of accounting firms to multi-disciplinary business service firms represents a challenge to the ability of auditors to maintain the reality and the perception of independence - there was a feeling that firms' focus on auditing services had diminished.
- With regard to non-audit services, many felt that clearer guidance was needed on acceptable vs. inappropriate services for audit clients, acceptable practices for selling and bidding on non-audit assignments, and audit partner compensation and the role that an audit engagement partner should play in securing and managing non-audit work.
- I expect the research to have some impact on the Board both in terms of agenda-setting and in informing its decisions. A copy of the report will be available on the ISB's website shortly.

In January 1999, the Board issued its first standard, which requires auditors subject to its rules 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 to confirm its independence. Under the standard, the auditor must also meet with the audit committee to discuss its independence.

Last month the Board agreed to issue an interpretation stating that the standard's requirements run to the primary auditor, but not to auditors of subsidiaries or investees, unless those entities are themselves SEC registrants.

The Board has several other standard-setting projects in process. 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.

For each of these projects, we have formed a broad-based task force consisting of individuals from a wide variety of backgrounds, including academics, analysts, audit committee members, attorneys, financial statement preparers, regulators, and members of the profession. The role of the task force is to assist in ensuring that all documents produced, such as discussion memoranda and exposure drafts for public comment, are balanced, comprehensive, and understandable.

Let me briefly describe each one.

1. Evolving Forms of Firm Structure and Organization is one of the Board's most important projects, as the structure of the profession in the U.S. is changing rapidly. For example:

- Some audit firms have sold the non-audit portion of their businesses to corporations.
- Other firms are contemplating a sale of a portion of their consulting practices.
- And still other firms are acquiring a minority interest in other entities.

These new structures bring new relationships to the auditor – for example, relationships with corporate employers, shareholders, and investees. These related parties may in turn have relationships with the auditor's audit clients. The Board recently issued a discussion memo covering the auditor independence issues raised by these changes.

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.

The DM's comment period ends on December 31, 1999. Because the Board will consider comments received on the DM at its January 14th meeting, it is imperative that respondents get their comment letters in on time! The Board has sought to actively encourage responses from institutional investors and investment managers.

2. We are about to issue an exposure draft of new requirements covering audit firm professionals going to work for firm audit clients. In its deliberations, the Board considered comments received on its discussion memo on this topic. Respondents

overwhelmingly favored a safeguard approach rather than a mandatory cooling-off period, and the ED mandates the application of certain safeguards when firm professionals accept positions at audit clients. It also deals with the settlement of capital and retirement accounts. The comment period on the proposed standard ends on February 29, 2000.

3. At its November meeting, the Board also approved the principles which will underly an exposure draft of a new standard on family relationships between audit firm and client personnel. The proposed new standard would prohibit any employment of the immediate family members of those on the engagement, and mandate the application of safeguards for relationships involving others in the firm who are not expected to have influence on the outcome of the audit engagement.

The proposed changes in the rules are in response to the rise in family relationship conflicts, due to a variety of factors, including the sheer size of some firms, and the increase in women in responsible positions at the firms and in corporations.

The Board will consider the ED at its January 14th meeting, together with an assessment of the threats such relationships create for auditor independence, and we hope that the ED will be available on our website shortly thereafter.

After considering comments received on its exposure draft, the Board approved a new standard that:

- requires the firm, certain of its retirement plans, the engagement team, and those in a position to influence the audit to be independent of the entire mutual fund complex - funds, investment advisors, and related entities - if the firm audits one or more funds or entities in the complex.
- and permits all other firm professionals to invest in *non-client* sister funds, and their spouses and dependents to invest in *client* mutual funds, but only via an employer-sponsored employee benefit plan.

The new standard will be effective when the SEC and the AICPA rescind their guidance that conflicts with the new requirements, which we hope will be accomplished before the end of the first quarter.

4. This project addresses the criteria that should be used to determine when it is inappropriate for audit firm professionals to provide appraisal and valuation services to audit clients.

A neutral discussion memo was issued on this topic, and we are currently summarizing comments received. The Board will consider these comments and deliberate on the issues at its January 14th meeting.

5. 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 its publicly-held audit clients. As you know, 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 the U.S. there are currently certain independence restrictions on audit firms performing legal services for audit clients, based on the threats noted on the screen.

A discussion memorandum covering these issues, for public comment, was just issued last week. The comment period ends on February 29th.

6. Outsourcing by corporate America has become very fashionable as companies focus on their “core competencies.” This project will explore threats to independence posed by audit firm provision of various outsourced services, and potential safeguards that could be used to protect auditor independence. The Board will also determine which, if any, services should be prohibited.

The project is on a somewhat slower track, however, so I can’t give you any sense of timing yet.

7. The Board’s most fundamental project is to develop a conceptual framework for auditor independence, that will lead to principles-based standards. We have engaged Professor Henry Jaenicke of Drexel University to act as project director in the conceptual framework project. Professor Jaenicke is assisted by Professor Alan Glazer of Franklin & Marshall College. They are just completing, with the help of a broad-based task force, a neutral discussion memo for public comment, on issues that are integral to the development of the framework. Some of the issues covered in the document include:

- the need for reliable and credible financial statements;
- the objectives of the audit and of auditor independence;
- and the relationship between independence and objectivity and integrity.

The document also discusses:

- whether a threat / safeguard analysis is appropriate in analyzing independence risk.
- whether costs and benefits should be considered in developing new standards, and how these should be measured.
- the role of perceptions in developing independence standards.

- and finally, the document considers whether independence restrictions on relationships with audit clients should apply to the firm, the engagement team, and all of the partners in the firm, or whether the application of restrictions should vary based on facts and circumstances. In other words, the document asks “who is the auditor?” That is, to whom in the firm should the independence restrictions apply?

- The Board will begin considering the conceptual framework document at its January 14th meeting, and we expect that the DM will be released for public comment sometime this winter.

Finally, I’d like to update you on our consultation activities. As you may know, in addition to assisting the Board in all of its projects, the Staff answers independence inquiries from practitioners, clients, and others. Inquiries can be formal or informal.

While guidance issued on an informal inquiry is not authoritative, we spend a fair amount of time discussing questions with practitioners and others, having answered about 150 inquiries in the last year.

As you can see, we are very busy, and we are juggling several projects in various stages of completion. Looking out over the horizon, for a moment, I would guess that the Board’s next areas of study may include the independence implications of auditors providing non-audit services to audit clients, and auditors owning stock in firm audit clients.

I encourage you to visit our website at [www.cpaindependence.org](http://www.cpaindependence.org), which contains a great deal of information about the ISB and its activities.

In addition, our site offers a helpful feature called “Document Express.” This feature allows you to select one or more categories of documents - and when a new document in a selected category is posted to the site, you receive notification via e-mail. Try it - I think you will like it - and it is free!

Thank you for your time and attention, and I look forward to the discussion period.