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1999

## Comment letters on Family Relationships Between the Auditor and the Audit Client

Independence Standards Board

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Independence  
Standards  
Board

TO:

DATE:

1-18-01

FROM:

Carolyn Richardson

PHONE:

(212) 596-6062

To: SIMMONA STEELE

---

Attached are  
Comment letters  
on ITC-99-1  
"Family Relationships"  
(26 Ltrs)

3/1/01

# VEDDER PRICE

VEDDER, PRICE, KAUFMAN & KAMMHOLZ  
805 THIRD AVENUE  
NEW YORK, NEW YORK 10022-2203  
212-407-7700  
FACSIMILE: 212-407-7799

DAN L. GOLDWASSER  
212-407-7710

A PARTNERSHIP INCLUDING VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.  
WITH OFFICES IN CHICAGO AND NEW YORK CITY

August 23, 1999

Independence Standards Board  
Sixth Floor  
1211 Avenue of the Americas  
New York, NY 10036-8775  
Attn: ITC 99-1

Re: Family Relationships Between the Auditor and the Audit Client

Gentlemen:

I am writing in response to your invitation to comment on parameters for a standard for determining audit independence with respect to relationships between a family member and the audit client. At the outset, I want to congratulate you on your approach to this problem which appears to be both reasoned and measured. I am particularly pleased that you appear to have embraced the concept that certain potentially impairing relationships can be cured through collateral safeguards. Such a concept is absent from current independence standards, with the result that unnecessary restraints are placed upon a large number of persons (particularly at the very large accounting firms) who have no relationship whatsoever with the performance of the audit.

As a general comment, I would like to point out that your Invitation To Comment does not address the period of disqualification; i.e., the document does not indicate the extent to which a relationship of a short duration will impact auditor independence. I suggest that the statement on family relationships address this subject.

Set forth below are my responses with respect to the various questions which you posed at the end of your Invitation To Comment.

1. Paragraph No. 1 strongly supports the concept that the independence rule should be graduated based upon the proximity of the individual to the conduct of the audit. Accordingly, I strongly favor stringent independence requirements with respect to those persons deemed to be involved in the engagement. Correspondingly, I strongly favor relaxing independence standards with respect to persons who are remote from the audit, such as family members of partners who work in offices that are far removed from those which are involved in

Independence Standards Board

August 23, 1999

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the audit process.

2. A. As long as independence in appearance is a part of the conceptual framework, I prefer Alternative B because it is more likely to provide the requisite level of assurance needed for the public to accept audit reports. Should the Independence Standards Board, as a part of its conceptual framework project, adopt other means to assure public confidence in audit reports, it could (and should) consider Alternative A if coupled with appropriate additional safeguards.

B. While I am generally in favor of limiting the scope of independence requirements, I do not believe that the public is likely to receive great comfort from the fact that the CFO of the client is the spouse of a partner who works in a different department within the physical office conducting the client's audit. Accordingly, I favor a geographic definition of office. In short, I am not convinced that close relationships between partners in different departments within the same office do not abound.

3. Although I believe that the Board should first adopt a conceptual framework before proceeding with the adoption of particular standards, I see one very important advantage to the Boards' proceeding expeditiously with the adoption of a standard on family relationships; and, therefore, would prefer the Board to postpone its consideration of financial interests which would undoubtedly delay the publication of the proposed standard. My preference is based upon my concern that the Securities and Exchange Commission may not support the Board's determinations if they depart significantly from prior standards endorsed by the SEC. Should the SEC reject the Board's position on this standard, all future efforts by the Board would appear to be without significance. Therefore, I believe that it is better to assess the SEC's support sooner rather than later.

4. The definition of a "close relative" as defined in the Glossary of Terms is somewhat confusing and appears to be overly broad. If I understand the definition correctly, it would include the in-laws of a non-dependent child, as well as the entire immediate family of the spouse of a non-dependent child. Not only is this definition overly-broad, but it is also largely unworkable. I would opt to have the definition of a "close relative" be limited to the spouse, co-habitants, dependents, non-dependent children, parent and siblings of a restricted person and their respective spouses.

5. The definition of "key position" as contained in the Glossary is generally adequate on the assumption that the phrase "in a sensitive financial position, or with significant influence

Independence Standards Board

August 23, 1999

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over financial or operating matters” refers only to an officer or employee of the client.

The final phrase “or other individuals with comparable responsibility” is overly broad and too vague and should be deleted. It would also be helpful if the Board provided greater guidance as to what constitutes “a sensitive financial position.” Presumably, a key position is intended to mean a person who is empowered to make operational or accounting decisions with respect to a significant portion of the client business. It should not include a bookkeeper or even a senior officer of an immaterial client subsidiary.

6. I believe that current independence rules impose restrictions to an absurd degree, although I am not opposed to prohibiting altogether an audit client’s employment of an immediate family member of persons who are directly involved in the engagement. Not only might the employment of immediate family members of a member of the engagement team be deemed to impair the appearance of the independence, in periods in which jobs are not easy to come by, it could impair independence in fact, irrespective of the nature of the job.

7. I strongly support a graduated system of restrictions designed to assure audit independence. Accordingly, any system which can be reasonably devised to safeguard the firm’s audit objectivity with respect to seemingly marginal relationships would be far superior to simply deeming the firm’s independence impaired. I am not sure, however, what is meant by “consulting;” and it would be helpful if the Board provided further guidance as to what is intended by this term.

8. A. From an independence perspective, an impairment at a subsidiary level could be cured by having that subsidiary audited by a separate firm. I do not necessarily favor this approach as it is my experience that the overall integrity of an audit is compromised when separate auditors audit parts of a consolidated group of companies. This would be particularly true if there are substantial transactions which take place between the subsidiary and other parts of a consolidated operation.

B. To be sure, an audit firm can build in additional safeguards to protect the integrity of the audit process. Indeed, in the vast majority of cases in which independence is deemed impaired, there is no impairment in fact. The question thus becomes whether the public will accept such additional safeguards as a substitute for lack of independence in appearance. My answer to this question is that the public’s confidence in the audit process can be maintained under such circumstances, particularly if those additional safeguards are subject to monitoring and reporting.

VEDDER PRICE

Independence Standards Board

August 23, 1999

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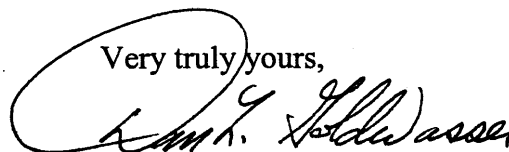
9. The questions raised with respect to death or divorce are largely issues of timing which the proposal does not address at all. Since it is my belief that current independence standards are largely overkill, I believe that death or divorce after a relatively short period of time would remove the impairment caused by the relationship between an in-law and an audit client. In the case of divorce, the impairment should be removed immediately; and in the case of death, there should be a short waiting period of approximately one to two years.

10. In the realm of family relationships, independence is rarely impaired as a matter of fact, but largely as a matter of appearance. Since no further impairing relationships come to mind, I must conclude that they do not even rise to the level of an apparent impairment and, therefore, the Board need not concern itself with them.

11. As noted above, family relationships largely present issues of the appearance of impaired integrity and, therefore, if the Board were to conduct any research, it should be to assess the extent to which users of financial statements would perceive an impairment under certain conditions. Until now, the independence rules dealing with family relationships have largely been built upon conjecture and without any empirical study as to when the public does perceive independence to be impaired. Such a study might even enable the Board to further pare down the rules which it is currently contemplating.

As I noted at the outset, I am deeply gratified by the Board's current efforts to put an end to the process of devising independence rules on a "worst case" basis. The Board's willingness to adopt a more flexible approach to independence standards certainly appears to be a move in the right direction; and my only hope is that the SEC will support the Board's efforts in doing so.

Very truly yours,



Dan L. Goldwasser

/mbb

Author: MIME:AHYBOO@ntu.edu.sg at INTERNET  
Date: 9/7/99 11:08 PM  
Priority: Normal  
TO: isb@cpaindependence.org at INTERNET, ISB at AICPA3  
Subject: ITC99-1

②

## Family Relationships Between the Auditor and the Audit Client

### Our Comments

We think that guidelines governing appropriate audit engagements should be broad enough to include all relationships (not just family relationships) that are likely to threaten auditor objectivity. The threat to auditor objectivity arises from the substance (closeness) of relationships rather than the form of relationships.

Close emotional ties could arise from other than family relationships, for example, close friendships and love relationships. They could have been established and nurtured from close proximity (e.g., neighbours), time spent together (e.g., ex-school mates), or a combination of other factors.

### Our Research Project

We are currently undertaking a research project that investigates, amongst other issues, the following two questions:

(1) do audit partners consider it appropriate to accept an audit engagement given the following relationship?

"Mr X is the Managing Director who owns 75% shareholding in Company XYZ. Mr X is the cousin of an audit partner, Mr Y. In their childhood days, Mr X and Mr Y grew up in the same housing estate and they have remained in close and frequent contact even after they have established their own families."

While the professional code in Singapore, PAB Rule 11 (Code of Professional Conduct and Ethics - Third Schedule) Section 2, does not specifically prohibit the above audit engagement, it is not clear whether accepting the engagement would be consistent with the spirit of the Code.

(2) would an engagement based on the above relationship significantly reduce auditor objectivity?

Yours sincerely

Hian Chye Koh (Associate Professor)  
El'fred Boo (Assistant Professor)

Nanyang Business School  
Nanyang Technological University



LOYOLA  
UNIVERSITY  
CHICAGO

SCHOOL OF BUSINESS ADMINISTRATION  
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September 15, 1999

Attn.: ITC 99-1  
Independence Standards Board  
1211 Avenue of the Americas  
New York, NY 10036-8775

This letter presents the comments of my Advanced Auditing class at Loyola University on ITC 99-1 titled "Family Relationships between the Auditor and the Audit Client."

While we share the Board's concern about the possible appearance of lack of independence that may be caused by family relationships between the auditor and the audit client, we believe the Board is embarked on a path that will cause much mischief and will not improve on present AICPA standards.

If the daughter of an audit partner "on the Burger King engagement" by herself obtains a job at a Burger King cooking hamburgers, the proposal would conclude that the firm is not independent. We believe this borders on ridiculous and that the current AICPA "audit sensitive position" rule is much more sensible.

We know that the Board's charge is to write rules for publicly held client situations. However, unless that AICPA's Ethics Division intends to conform its rules to the issuances of the Board, we believe that the profession may end up with three sets of independence rules:

- Rules of the AICPA Ethics Division (the AICPA Professional Standards ET Current Text).
- Rules for public companies published by the Independence Standards Board.
- Rules for public companies published by the SEC.

Some of the differences are likely to be very subtle and easy to overlook. For example, the Board proposes to add the spouse's brothers and sisters to the category of close relatives. (They are presently excluded specifically from ET 101.11.)



Another example of a subtle difference in the rules is that the definition of "managerial employee" does not include the "profit sharing" concept in ET 101.11.

We are also troubled by the Alternative A under the "on the engagement" definitions. It indicates a bias against smaller accounting firms. Moreover, it proceeds on the invalid premise that only "technical consultation" personnel should be added to the prohibited class. The fact is that a particular partner may often consult with a friend within the firm who is not designated for technical consultation. Alternative B is a more preferable alternative.

Finally, we are unaware of any case that should cause the current AICPA rules to be amended. Before you move on these new standards you ought to reply to the old adage: "if it ain't broke, don't fix it."

Cordially yours,

A handwritten signature in black ink, appearing to read 'C. Werner', with a long horizontal flourish extending to the right.

Charles A. Werner, JD, CPA  
Accounting Professor and Director of CPA Review

DeWitt F. Bowman, CFA  
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September 19, 1999

Independence Standards Board  
6th Floor  
1211 Avenue of the Americas  
New York, NY 10036-8775  
Attn. ITC 99-1

Dear Board Members:

I appreciate the opportunity to offer the following comments on family relationships for your consideration. As you observe, some of these issues are germane to the current work of the committee creating a questionnaire on auditor independence and also relate to the request for comment of the Public Oversight Board Panel on Audit Effectiveness sponsored by the SEC. In the final analysis I find it difficult to separate the issue of family relationships from the broader issue of the independence of the auditor and the question of whether the auditor is an individual or the firm of which the individual is member.

My personal view is that in reality the auditor of a large public corporation is the firm performing the audit and that the professional CPAs within that firm have a compromised independence which is well known and understood by investors. My suggestion to the Panel on Audit Effectiveness is that one way of achieving greater effectiveness would be some form of certification for firms preparing audits of companies whose securities trade on public exchanges. Certification would require application of rules relating to conflicts of interest and periodic examinations to determine if rules and procedures were being properly applied. In this situation relationships could be contained within regulations and their conflicts mitigated by approved procedures such as are currently applied to investment firms.

On a broader scope a better, tighter definition and more frequent updating of generally accepted standards would reduce the options available in the preparation of accounts and might lessen the need for an overly strict definition of auditor independence, including family relationships. As a practical matter conflicts arising from family relationships are probably of a greater concern in the audit of a small private company than of a larger public concern where investor interest is publicly focused on the result of an audit. This

suggests that some mitigation from a strict application of relationship rules might be made available in situations where other forms of control and oversight exist.

With these caveats I offer the following comments:

1. I support the changes proposed to apply the more stringent provisions to members "on the engagement" rather than the lesser restrictions on "members" as a whole. I suspect that in smaller auditing firms members would tend to be "on the engagement" in any event, while in larger firms easing restrictions on members not "on engagement" would better accommodate the wider diversity of operations of these firms.
2. I support alternative A. The suggested controls in paragraph 4 appear to be adequate to control the situation while still permitting greater flexibility of activity within the auditing firm.
3. I support deferring consideration of job related financial interests of relatives at this time, although I believe that the issue will need to be eventually addressed in connection with the whole question of financial interests as is suggested. Since the broad majority of those interests probably involve the securities of publicly traded companies, some lack of power of individual influence already exists under the condition of public scrutiny.
4. I believe the term "close relative" is well defined but I recommend adding "co-habitants" in the following manner to deal with the broadening definition of "marriage": "Member of the immediate family, nondependent child, parent or sibling and their respective spouses and co-habitants, and grandparents and grandchildren of the member and spouse or co-habitant".
5. Since neither "underwriter" or "promoter" are apt to be individuals, I would broaden the description to some extent. For example in the definition: "The individuals or firms performing in the following rules ....", and in paragraph 5: "... or has investments with the client or with someone or some firm in a key position with the client".
6. Consistent with my support of alternative A in question 2, I would support a more liberal application of rules permitting a firm to assess the likelihood of conflict and influence then to rely on the other controls. This suggests that prohibition of any employment at the client be limited to just those who provide audit services.
7. Paragraph 7 appears sufficient and the guidance appropriate.
8. I am generally opposed to the idea that having a different accounting firm audit a material subsidiary where family relationship conflicts exist is sufficient mitigation. Just the different methods or philosophy of a different firm might result in a less comprehensive audit unless closely coordinated, which would lessen the value of independence. Some

exception might be made for immaterial subsidiaries where the described device could be used as a mitigating measure.

The other mitigating factors can help although the use of "firewalls" should be confined to situations where some independent authority reviews the procedures and implementation, as the SEC does for investment firms. Disclosure and discussion with the audit committee are of limited value unless the board is truly independent.


To some extent reliance upon a general professional code of ethics which is enforced through evaluation and disbarment for violation can provide more effective control than a myriad of regulations which are difficult to know and keep current. Such measures could also better define the fiduciary responsibilities of auditors, although I recognize that the concept that auditors have a fiduciary responsibility to shareholders which can be legally enforced is controversial.

9. I would not support expanding the proposal to include death and divorce. Both events assume closure and subsequent relationships are subject to control of the courts. This would appear to me to be a sufficient safeguard.

10. & 11 I am aware of no other key criteria or research that should be considered in this study.

I am interested in your work on family relationships and look forward to incorporating the findings in the project on auditor independence.

Sincerely,

A handwritten signature in cursive script that reads "DeWitt F. Bowman".

DeWitt F. Bowman, CFA

22 September 1999

ITC 99-1

JM/lmb

**PRIVATE & CONFIDENTIAL**

Independence Standards Board  
6th Floor  
1211 Avenue of the Americas  
New York  
NY 10036-8775

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The Institute of  
Chartered Accountants  
in England & Wales



**Professional Standards Office**

Silbury Court  
412-416 Silbury Boulevard  
Central Milton Keynes MK9 2AF

Telephone: 01908 248100

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DX 31427 MK

www.icaew.co.uk

Dear Sirs

**INVITATION TO COMMENT ON FAMILY RELATIONSHIPS BETWEEN  
THE AUDITOR AND THE AUDIT CLIENT**

Thank you for the opportunity to comment on the above.

I am very shortly to leave on holiday, and I concluded with regret that it would not be possible for the UK Chartered Accountants Joint Ethics Committee to make a Committee response in the time available.

The following therefore represents essentially a personal view. However I believe that it is broadly in accordance with the position of CAJEC.

I am also copying this letter to FEE, who will, I understand, be making their own response.

**General - "the conceptual approach"**

Both of the bodies referred to above, together with the Institute of Chartered Accountants in England & Wales, have committed themselves to a conceptual approach, on issues of auditor objectivity and independence which is conveniently categorised as "The Framework". The member bodies of CAJEC (ICAEW, together with the Institute of Chartered Accountants in Ireland and the Institute of Chartered Accountants of Scotland) have been putting Framework-based guidance into practice over three-and-a-half years now, and have I believe demonstrated that it "can work"! 'Our' version of the approach is based on analysing the threats/risks to objectivity which arise in a particular situation, and weighing against them the generally-accepted safeguards, so as to reach a conclusion as to whether it is safe and prudent to proceed, or continue.



One major advantage of the Framework approach is that it does not, in general, require the 'spelling-out' of an infinity of possible situations and permutations.

It has however proved necessary to identify particular situations where the generally perceived appreciation of a threat or threats to objectivity is so great that it would not be in the interests of the public image of the profession for an audit to be accepted or continued, whatever actual safeguards might be available. Such situations are conveniently categorised as "prohibitions". When one is seeking to evolve 'framework-based' guidance, it is therefore necessary to set a "floor" of situations which are effectively prohibited. In all other cases the issues may be addressed by 'frameworking'.

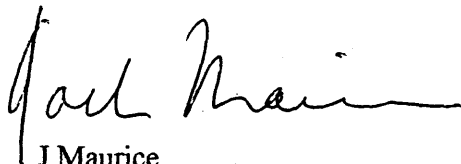
It follows from the above that the 'floor' should be set at a rational and realistic level. Situations which are only marginally different from a prohibited one will clearly require very special pleading by a firm which wishes to accept/continue appointment in those circumstances.

I now go on to attempt specific answers to the 11 questions posed in your Invitation to Comment. I should however warn that the responses will not be a great deal of use if they are taken entirely out of the context of what I have already indicated!

- A1. It would in my view go too far to prohibit *any* employment by a relation with the client. I would expect the significance of the particular employment to feature among the considerations to be dealt with conceptually.
- A2A. I suppose Alternative B, on the basis that the partner's spouse is not realistically going to decline the offer of a CFO role, whereas the firm, if it valued the services of the partner, could seriously consider allocating the partner to a different work office. That is based on my perception of what the public appreciation would be if the partner were to remain at the engagement office.
- A2B. These are issues which would be taken in by the conceptual approach.
- A2C. I don't believe that the public perception accepts 'isolation' procedures in small offices or practice units. Effectiveness of such procedures has also been the subject of unfavourable comment in our courts recently.
- A3. I do not believe that it is practical to have guidance which is 'partly concept-based' and partly not. I am therefore in favour of proceeding globally.
- A4. The definition is OK, insofar as definitions are necessary to a conceptual approach. There is always a danger of people asking about half-siblings, step-siblings, divorced spouses and so on. When the conceptual approach is fully appreciated, it should theoretically be possible to get rid of many definitions.
- A5. I believe that this definition *is* in danger of becoming too technical/specific. For instance could one not just refer to 'an individual having significant influence over financial or operating matters'?

- A6. I suspect that, on current public perception, the 'prohibitions' in paragraph 5 are probably necessary. My reasoning includes my appreciation of the public perception of what you call "firewalls", and what the UK used to call "chinese walls" - although more modish terms such as "cones of silence" are being floated!
- A7. Under the Framework approach, such issues would be under regular scrutiny, to decide whether or not it was proper to continue an engagement.
- A8A. This particular safeguard would, under the Framework approach, feature among a list of operational safeguards.
- A8B. This illustrates, in my view, the dangers of trying to get too specific- and the advantages of a conceptual approach.
- A8C. See previous response. There is a fair list of safeguards in the latest IFAC draft guidance.
- A9. This illustrates the danger of getting too technical - unnecessary with the Framework approach.
- A10. See A9.
- A11. Not that I am aware of.

Yours faithfully



J Maurice  
Head of Ethical Standards  
Direct Line: 01908 546283  
Direct Fax: 01908 546296  
E-Mail Address: JMaurice@icaew.co.uk

cc Saskia Slomp - FEE

G:\pcd\_inv\pcd11mb\JMletters\sept\isb219

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September 22, 1999



California  
Society  
Certified  
Public  
Accountants

William T. Allen, Chairman  
Independence Standards Board  
6th Floor  
1211 Avenue of the Americas  
New York, New York 10036-8775

Re: ITC 99-1

Dear Mr. Allen:

The Committee on Professional Conduct of the California Society of CPAs has reviewed your "Invitation to Comment" on "Family Relationships Between the Auditor and the Audit Client." The following material represents our answers to the questions posed at the end of the document.

1. We do not believe the changes are warranted. Even if independence is defined in terms of personnel "on the engagement," we believe that all partners of a CPA firm need to be included in the definition because all partners are responsible for the other partners. Partners, regardless of geographic location, still have the ability to actively influence an audit engagement. In an age of instant communication, geographic location of individuals is less critical in determining independence than other considerations, yet this proposal seems to make it more important.
- 2 A. Notwithstanding our answer to question 1, if "on the engagement" is the direction future independence definitions take, we support alternative B. Partners or managers in an office which works on the engagement can influence others who work on the engagement, even though they might not work on it themselves.
- 2 B. An "office" might be a practice unit, industry group or other grouping with a specific management person within the firm responsible for that unit.
- 2 C. Limiting the ability to influence to a small practice is irrelevant. In large firms partners also have the ability to influence.
3. The ISB can deal with the two issues separately, but needs to recognize that they may have to come back and deal with family relationships again later.



Mr. Allen  
Page 2  
September 22, 1999

4. The ISB should follow the SEC's lead in defining close relatives. The term should include a paramour.
5. The definition of "key position" is fine.
6. We believe that no family members of persons on the actual engagement should be employed by the client, in any position. Those on the engagement include those conducting any professional services to the client, including tax or consulting.
7. We believe all family relationships should be brought to the attention of the internal firm review board and client audit committee, regardless of their significance.
8. The proposal should not address this safeguard because it doesn't make it clear. It may remove the influence at the company member level but not at the firm level. We are only referring to partners.
9. This issue must be dealt with on an individual case basis and it depends upon many factors.
10. The definition of immediate family member should include paramour.

We hope this input is of value to you and hope we can offer additional help in the future.

Sincerely,



Mary Beth Armstrong, CPA, PhD  
Chair, Committee on Professional Conduct

cc: Committee on Professional Conduct  
Bruce C. Allen, Director, Government Relations

U. 201501

(7)

MASON & COMPANY, LLP

CERTIFIED PUBLIC ACCOUNTANTS

ELI MASON, CPA  
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CORRESPONDENTS IN PRINCIPAL  
U.S. CITIES AND ABROAD

September 22, 1999

Hon. William T. Allen, Chairman  
Independence Standards Board  
1211 Avenue of the Americas  
New York, NY 10036

Dear Judge Allen:

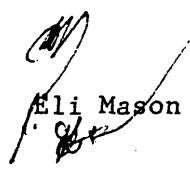
This is in response to ISB "Invitation to Comment, Family Relationships Between the Auditor and the Audit Client."

I believe that rules pertaining to auditors' independence should be concise with no room for subjective interpretation or diversification. I further believe that the idea of "conceptual framework" will lead to manipulation, interpretation by convenience and obfuscation. Perhaps, this is what some may wish and pursue.

Following are my terse and easily comprehensible recommendations for Family Relationships Between the Auditor and the Audit Client:

1. No partner of the firm, no manager of the firm, no staff member of the firm should have any financial interest in any client of the firm, direct or indirect.
2. Every firm engaged in the audit of publicly-held companies should maintain a current summary of security holdings by all partners, managers and staff of the audit firm.
3. The following paragraph should be added to the audit report signed by the independent auditor, as follows: "We are independent of XYZ Company in all respects and have no financial interest in the company, direct or indirect."

Very truly yours,

  
Eli Mason

EM:lf  
Copies: ISB

8

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**CIUNI & PANICHI**  
INC.  
CERTIFIED PUBLIC ACCOUNTANTS

September 27, 1999

Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, NY 10036-8775

Re: ITC 99-1

Ladies and Gentlemen:

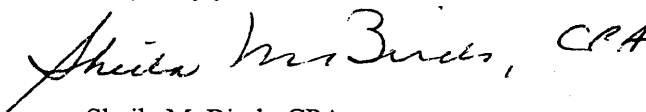
The following represents my comments regarding the above referenced proposal:

I am concerned that the systems-oriented approach to the resolution of independence questions as promulgated in paragraph 4 is immediately contradicted by the mandates of paragraphs 5 and 6. While I am appreciative of the attempt in paragraph 7 to bring clarity to the issue, the importance of the firm's own internal system of controls may be lost with the immediate juxtaposition of absolutes.

Having said that, however, the "on the engagement" alternatives as presented offer clear choices. I favor Alternative A because of the emphasis on the immediate practice environment. I do not think it is practicable to "isolate partners" or require additional reviews. To avoid the appearance of lack of independence, audits involving companies with the family relationships should simply be avoided.

As a side note, I frequently encounter discussions regarding independence that offer peer review as a way of catching violations. In my thirteen years of peer review experience, I find that to be rare. If a firm is not forthcoming about issues of independence, it is highly unlikely that the peer reviewers will stumble across them. My challenge to the Independence Standards Board: how will this be enforced?

Very truly yours,



Sheila M. Birch, CPA  
Co-Chair  
NASBA Ethics Committee

F:\cp\misc\indbrd.doc



*Nancy K. Ostrowski*  
*Bank of America Corporate Center, Suite 5400*  
*100 North Tryon Street*  
*Charlotte, North Carolina 28202*

September 28, 1999

Independence Standards Board  
Attention: ITC 99-1  
1211 Avenue of the Americas, 6th Floor  
New York, NY 10036-8775

Gentlemen:

Please find below my comments on ITC 99-1, Family Relationships Between the Auditor and the Audit Client.

Question 1:

Changes to independence requirements to allow appropriate flexibility for family relationships given today's social and economic factors is mandatory. However, the proposed "any employment" prohibition is far too restrictive.

Question 2A/B:

Alternative B is far too restrictive. Globalization increasingly demands personnel concentration in major markets, e.g. New York. This proposal would place one or the other spouse in a position threatening to their chosen career and possibly their marriage. It also adds extremely undesirable characteristics to the public profession of auditing at the highest levels of the Firms. Effectively, it decreases those firms' ability to retain top talent — it's Partners. In conclusion, alternative B should be soundly and overwhelmingly rejected.

Question 3:

There is no question that employment-related financial interests are sufficiently different from other financial interests that they should and can be addressed separately. In fact, bifurcating the issue is likely to leave many professionals in limbo until the Conceptual Framework Project is complete. Generally, many of today's rules, particularly those related to

direct financial interests in employment related situations were written when only beneficiaries of corporate stock options and the like were the top three to four executives and the number of major audit firms numbered above ten. The reality is that globalization increases specialization and the world becomes effectively smaller. Attracting top talent in a specialized marketplace demands leveraging corporate equity throughout the employee ranks. Direct financial interests are a way of life and, accordingly, need to be addressed in the same manner as Alternative A in Question 2. Controlling direct financial interests should be prohibited.

Question 4:

The definition of “Close Relative” is far too comprehensive particularly as used in paragraph five of the proposal. Considering the parents of a sibling’s spouse, their siblings and their respective spouses as close relatives is far too restrictive and, given today’s trends, not warranted. The standard would be improved by mandatory disclosure of all specified family relationships for internal firm evaluation and limiting mandatory compliance to members of immediate family — children (dependent or non-dependent), parents, siblings, siblings spouses, and sibling’s children.

Question 5:

The definition of the term “key position” appears reasonable in the circumstances.

Question 6:

It is not appropriate to prohibit immediate family members from holding non-sensitive client positions given consolidation trends and narrow markets. Mandatory disclosure of family relationships upon potential assignment should be assessed and client staffing addressed accordingly.

Question 7:

Paragraph seven of the proposal provides appropriate guidance.

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Question 8A:

I can think of few situations where a second firm would be needed to address an independence concern — certainly at any of the Big 5 considering their size and scale. I can think of no circumstances where this potential “safeguard” is warranted.

Question 8B:

Appropriate policies and processes for internal consultation are always appropriate.

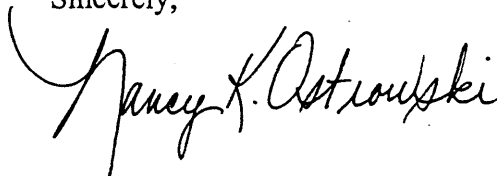
Question 9:

The guidance should not be expanded; rather consultative processes are warranted.

Questions 10 & 11:

The Board should avail itself of experts in the socioeconomic field and demographic trends to ensure its conclusions reflect not only today’s conditions, but those likely to be evolving. Additionally, were time available, a survey of AICPA members on family relationships might prove beneficial.

Sincerely,

A handwritten signature in black ink that reads "Nancy K. Ostrowski". The signature is written in a cursive style with a large initial "N" and "O".

Nancy K. Ostrowski

Author: MIME:badams@scsu.edu at INTERNET  
Date: 9/30/99 4:16 PM  
Priority: Normal  
TO: isb@cpaindependence.org at INTERNET, ISB at AICPA3  
Subject: ITC 99-1

The Auditing Class at South Carolina State University would like to submit the attached reponse to the Invitation to Comment ITC 99-1. This was a class project.

We appreciate the opportunity to have our comments considered.

Barbara L. Adams, Professor  
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SOUTH CAROLINA STATE UNIVERSITY  
DEPARTMENT OF ACCOUNTING  
ACCT. 425 - AUDITING CLASS

**RESPONSE TO INVITATION TO COMMENT (ITC 99-1)**

1. Do you believe changes are warranted to put more restrictions on those "on the engagement" by prohibiting any employment by the client?

**Response:** We do not believe that this restriction is warranted. The likelihood That a person who is not in a key position or has a material investment in the client would influence the audit is rare.

2. Do you believe that the added protection of independence provided by Alternative B's covering of this group is sufficient to warrant that extension, and if so, why?

If you support Alternative B, how would "an office" be defined, considering that a firm might have several locations in or around a large city? Does it matter if the "office" is managed on a "service-line" or an industry rather than a geographic basis?

If you prefer Alternative A, do you believe that approach provides appropriate guidance? Would it be effective instead to isolate partners or to require additional reviews in these circumstances, or must audits of the companies with the family relationships just be avoided?

**Response:** We support Alternative B and believe that "office" should be defined based on the structure of the hierarchy of the auditing firm. If the firm's hierarchy were organized geographically, an office would be defined in that manner. On the other hand, if the hierarchy of the firm is structured based on service or industry line, then the "office" should be defined in this manner. It would make a difference how the "office" is defined since a partner in a particular geographical location that does a significant amount of the work is unlikely to influence the audit if the assignments and hierarchy of responsibility is based on industry lines.

Alternative A is too restrictive. If this approach is adopted, it is believed that the firm should avoid audits of companies with the family relationships.



3. Should the Board expand the project to consider the inter-relationship of a relative's employment by a client and the financial interests that flow from that employment, rather than waiting to treat it as a separate issue?

**Response:** Yes, we feel that the Board should consider the financial interest and employment as one issue. If the relative's employment test fails, then the financial interest test should be applied immediately to avoid all "significant influence" violations.

4. Is the definition given for "close relative" comprehensive enough or too comprehensive? Comment.

**Response:** The definition given for "close relative" is comprehensive enough, but what about close friends ( for example, fiancé, etc.) that may have significant influence? We realize it may be difficult to establish a rule for such relationships, but some of these influences are as great or greater than a close relative.

5. Is the definition of the term "key position" (with a client) appropriate? If not, what would you change?

**Response:** No. In term of "other individuals with comparable responsibilities," what responsibilities would make a position a "key position?" Significant influence needs to be defined.

6. Is it appropriate to prohibit nonsensitive positions of immediate family members based upon a premise that if the job is not appropriate for the auditor, it should not be appropriate for the spouse?

**Response:** If a position would not be appropriate for the auditor, it should not be appropriate for the spouse either, because of the influence that a spouse or other immediate family may have. The financial gains of the spouse are direct interests of the auditor. On the other hand, we do not feel that a spouse or other immediate family member should be eliminated from having a nonsensitive position with a client. Thus, it should depend upon the type of position that the individual holds.

Do you think the prohibition of any employment by close relatives at a client should be restricted to those providing audit (attest) services? Why or Why not?

**Response:** We believe the prohibition of any employment by a close relative at a client should be restricted to just those providing attest services. Independence is not an issue with other types of services. Those who provide other professional services to the client are not likely to influence those on the audit team; therefore, they should not be restricted from having relatives employed by the client.

7. Do you believe the guidance provided on when formal consultation might be presumed for family relationships is appropriate? Are the examples helpful? Can you suggest additional examples?

**Response:** We believe the guidance is necessary and appropriate. The examples provided were helpful, but clarification is needed for point 2 under paragraph 7. Does the term "close relative" include immediate family members? There should be more examples.

When people think of a "relative" they think of family members. Non-relatives should also be included as well. For example, non-relatives who have significant influence on the auditor may be in key positions. This would require some mitigating controls.

8. Should the proposal refer to potential safeguards when family relationships exist at a client's subsidiary? If the use of a separate auditor should overcome an otherwise prohibition, under what criteria should that occur (e.g. only for immaterial subsidiaries or certain material ones as well)?

How much help are the safeguards or mitigating factors described in paragraph 15? Are there additional safeguards, which you believe are important?

**Response:** Yes, there should be safeguards when family relationships exist at a client's subsidiary. Safeguards should be established only when examining a subsidiary that the client has significant influence over, that is they own 20% or more of the subsidiary's stock. This restriction should be applied under the consideration of certain conditions. These conditions include, but are not limited to:

- Clients who have material subsidiaries in which a close relative is in a key position
- The auditor's close relative has a direct financial interest in the client's subsidiary

9. Should the proposal be expanded to provide guidance on the effects of death of or divorce by a relative? If so, what position should that guidance take? If not, why not?

**Response:** Yes. The proposal should provide guidance on the effects of death or divorce of a relative. The guidance should require that each firm to identify present or past relationship and refer them for consultation and recusal.

10. Are there other broad family relationship models or other key criteria and factors for evaluating relationships that should be considered?

**Response:** As indicated previously, we think some consideration should be given to models that include non-relatives such a fiancé', close friend, in-laws, etc. that may have significant influence over the auditor.

11. Is there research the Board should be made aware of or sponsor to assist in making informed judgements in these areas? If so, offer recommendations

**Response:** Determine what relationships and positions have caused the most problems with independence issues that resulted in lawsuits or had other damaging effects.



(11)

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New York, NY 10017

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September 30, 1999

Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, NY 10036-8775

Dear Sirs:

**Invitation to Comment (ITC 99-1)  
Family Relationships Between the Auditor and the Audit Client**

Body of letter.

We appreciate the opportunity to comment on the *Invitation to Comment: Family Relationships Between the Auditor and the Audit Client*. Prior to responding to the questions included with the Invitation To Comment, we have the following general comments.

1. The existing independence rules and interpretations regarding family relationships have led to restrictions on the families and relatives of many individuals employed by accounting firms that audit public companies. The existing independence rules for family relationships were developed during an era of single income families and traditional family relationships and do not adequately address the social and economic realities of today. It is our experience that these restrictions on family relationships have unnecessarily contributed to the migration of many very capable professionals away from the auditing profession. Therefore, we are supportive of an approach to independence in this area that gives an appropriate balance to the possible threats to independence and possible safeguards that may overcome or mitigate those threats.
2. While we believe that it would be most effective if family relationships issues could be addressed together with a conceptual framework on independence and other associated issues, we acknowledge that the clarification and improvement of the rules relating to family relationships



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cannot wait until the conceptual framework has been developed. However, the issues relating to family relationships often involve decisions that change the careers of family members or that involve family members that are not within the control of the auditor. Interim rule changes could create undue hardship for many individuals if the rules were changed again in the near future to conform to a conceptual framework or decisions made on other aspects of independence such as financial interests held by family members. Clear and consistent rules would be an improvement but must include appropriate transitional provisions to prevent undue hardship for families that previously made career decisions on the basis of rules in place at the time. Transitional provisions are particularly important when there is a risk that the rules will be changed again in the near future.

3. The proposed rules should address those aspects of financial interests that result from the employment of a family member by a client. Stock option plans, company sponsored retirement plans and other similar arrangements often are an integral component of compensation and impact career decisions. Accordingly, both employers and employees would benefit from the consideration and clarification of these issues.
4. The Invitation To Comment does not define employee or employment. Individuals can provide services to a single organization, or alternatively to several organizations, through a variety of full, part time or other arrangements. Accordingly, it is necessary to include definitions of these terms.

Our response to the specific questions asked in the Invitation To Comment are attached.

Very truly yours,

KPMG LLP

Attachments

Invitation to Comment (ITC 99-1)  
Family Relationships Between the Auditor and the Audit Client  
Responses to Specific Questions

Attachment

1. The Proposal makes a basic distinction between audit firm personnel "on an engagement" (broadly defined), and those who are uninvolved, when determining how family relationships affect auditor independence. Current SEC rules instead distinguish between "members" (defined as all partners, all managerial employees in offices performing a significant portion of the audit, and all individuals providing professional services to a client) and non-members in judging auditor independence. While the Proposal would limit the most stringent restrictions to those "on the engagement" - generally a smaller group than those considered "members" - it would strengthen the restrictions that apply to this group (by prohibiting any employment by the client, as discussed further in Question 6A), as these individuals are in the best position to influence the outcome of the audit. Do you believe these changes are warranted?

*The independence rules should focus on the relationships of individuals that are most able to influence the nature and extent of procedures, judgments and conclusions inherent in the completion of an audit. Accordingly, we concur with the proposed focus on those "on the engagement". Other comments on the definition of "on the engagement" are provided in response to other specific questions below.*

*We also believe that the restrictions should focus only on those employees that can influence the financial statements of a client. This would include the directors, officers and those in audit sensitive positions or capable of molding the financial statements.*

2. A. The definition in the Appendix of "on an engagement" includes those who are "likely to influence the audit" and is very important in applying the rule, and therefore merits significant consideration. Alternative B, while less inclusive than the existing rules, includes in its scope many partners and managerial employees of the work office not envisioned in Alternative A. For example, Alternative B would prohibit a partner whose spouse is CFO of an audit client being in an office performing a significant portion of that client's audit engagement, whereas Alternative A would instead require the firm to assess the likelihood of the partner who is the CFO's spouse influencing the audit and, if that did not result in prohibition, then to rely on the consultation, recusal, disclosure and other controls described in paragraph 4 of the Proposal. Do you believe that the added protection of independence provided by Alternative B's covering this group is sufficient to warrant that extension, and if so, why?

Invitation to Comment (ITC 99-1)  
Family Relationships Between the Auditor and the Audit Client  
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B. If you support Alternative B, how would "an office" be defined, considering that a firm might have several locations in or around a large city? Does it matter if the "office" is managed on a "service-line" or an "industry" rather than a "geographic" basis?

C. If you instead prefer Alternative A, it suggests that all partners in a small office or practice unit might be considered as being likely to influence the audit. Do you believe that approach provides appropriate guidance? Would it be effective instead to isolate partners or to require additional reviews in these circumstances, or must audits of the companies with the family relationships just be avoided?

*We recommend that the definition of "on the engagement" be based on Alternative A. We believe that Alternative A together with the additional limitations for managerial employees and the requirements for consultation, recusal and disclosure would provide adequate protection from threats to independence.*

3. Paragraphs 4 and 5 of the ITC describe the inter-relationship of a relative's employment by a client and the financial interests that flow from that employment. The Board, however, has tentatively chosen to defer consideration of job-related financial interests of relatives until the broader subject of financial interests can be reconsidered in its entirety. The basis for this tentative decision is that the question of permissible financial interests in a client is a major subject in its own right and has aspects broader than those of this project. Further, it is likely that resolution of that topic could benefit from the conclusions of the Board's in-process Conceptual Framework project.

The Board therefore asks whether a resolution of the employment issues raised in this Invitation to Comment, without dealing with the explicit financial interests that may come with that employment, will provide useful guidance. Alternatively, you may want to encourage the Board to expand the project, recognizing that doing so could delay issuance of any standard - and, of course, with no commitment as to how the Board would decide on such issues. Are the issues sufficiently different that the Board should now take up employment-related financial interests separately from other financial interests? Please describe the reasons for your conclusions.

*Our views on establishing independence rules family relationships in advance of the consideration of a conceptual framework or rules for financial interests are outlined in our covering letter.*

Invitation to Comment (ITC 99-1)  
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*Many employment arrangements potentially create financial interests such as through stock option and stock ownership plans, compensation for future periods and stock based retirement plans. Accordingly, we believe it is imperative to establish independence rules for employment related financial interests. Without such consideration, much of the guidance that would be developed with regard to employment positions would be inoperative in many family situations. We note that while the Invitation to Comment purports not to address financial interests, the proposed rules include reference to investments and other forms of financial interests in several paragraphs (e.g. paragraphs 6 and 7).*

4. "Close relative" is defined in the Appendix. Is that definition comprehensive enough, or too comprehensive?

*The definition of close relative should be limited to immediate family members, brothers, sisters, parents and grandparents. Possible threats to independence resulting from other relatives should be addressed through consultation, recusal and disclosure.*

5. Do you believe the definition of the term "key position" (with a client) is appropriate? If not, what would you change?

*We interpret the proposed definition of "key position" to be much broader than the corresponding concepts that currently exist and to be unnecessarily broad. We recommend that the definition of key position be limited to individuals that are involved in establishing policy, exercising judgements that affect the financial statements or comprise a substantive part of key internal control processes.*

*The definition of a "key position" should also be improved to clarify the following points:*

- Is it intended that the qualifier "sensitive financial position" be applied to both officers and employers or is it intended that all officers be considered to be in key positions?*
- What is the intended definition of an officer? We believe the definition for officers should focus on those that are required to be disclosed in the proxy and those individuals that have a direct effect on the financial statements. For example, we would not propose that all officers in a bank be included in the definition of officers affected by these rules.*



## Invitation to Comment (ITC 99-1)

Attachment

Family Relationships Between the Auditor and the Audit Client  
Responses to Specific Questions

- *Is it intended that underwriters be included as key positions only for those periods during which they served as underwriters, or for some other longer of time? We recommend that underwriters be considered to be in key positions only for the periods during which they served the client.*
  - *Is the reference to an underwriter intended to include just those employees of an organization that are directly involved in the provision of services to a client, or is it intended to include all employees of the underwriters? We recommend that the reference to underwriters should be clarified to include only those individuals that are involved in the services provided to the client.*
6. Under the Proposal's paragraph 5, the immediate family of those on the engagement would not be permitted to have any employment by the client. Under existing rules, employment of an immediate family member is permitted unless the position is either audit sensitive or capable of molding the financial statements. Would it be appropriate to prohibit nonsensitive jobs based upon a premise that if the job is not appropriate for the auditor, then it also should not be appropriate for the spouse? While all those who provide any professional service to the client are defined to be "on the engagement," some would suggest that it would be adequate for this extra prohibition of any employment at the client to be limited to just those who provide audit (attest) services. What are your views and why? (Note that the impact of any conclusion could vary significantly depending on your view as to Question 2A.)

*The limitations on employment should be limited to those positions that are audit sensitive or capable of molding the financial statements. Employment by family members in many non-sensitive positions would not create real threats to independence. We recognize that the issue of financial interests resulting from employment is equally applicable to non-sensitive positions and, accordingly, recommend these issues be addressed as part of this process.*

*The definition of "on an engagement" should include all individuals providing professional assurance services to the client or immediate family members of partners providing other professional services to the client.*

Invitation to Comment (ITC 99-1)  
Family Relationships Between the Auditor and the Audit Client  
Responses to Specific Questions

Attachment

7. Paragraph 7 of the Proposal provides guidance on when formal firm consultation might be presumed for family relationship situations. Do you believe this guidance is appropriate, and that the examples are helpful instances of when such consulting should occur? Are there other examples you believe should be included?

*We believe it would be an improvement to draw a bright line as to when formal firm consultation is required. For example, there should be required consultation when there is a potential threat to independence from the employment status of a close relative.*

8. A. Some believe that when certain family relationships exist at a client's subsidiary level, a significant safeguard can be provided by having a different accounting firm audit that subsidiary. This potential safeguard has not been described in the Proposal. Should the Proposal refer to this possible safeguard and, if so, how? For example, should that safeguard just be among those to be considered in the firm's overall evaluation of the family relationship or, in certain fact patterns, should its use be permitted to overcome an otherwise required prohibition? If the use of a separate auditor should overcome an otherwise prohibition, under what criteria should that occur (e.g., only for immaterial subsidiaries, or certain material ones as well)?

*We believe that the involvement of other auditors should provide adequate safeguards for relationships at a client's subsidiary level. The involvement of a separate firm of auditors would be a very effective "mitigating factor" for associated threats to independence.*

*If this concept is adopted, it would be necessary to consider whether a family relationship could exist, without impairing independence, with an individual at a parent company of the client as long as the parent is audited by a separate firm. Threats to independence could arise if the individual at the parent company was responsible for, or otherwise associated with, the performance of the subsidiary. However, employment in many other positions would not create threats to independence.*

*The rules should also provide concessions for immaterial subsidiaries in other countries and domestic immaterial subsidiaries that are operationally separate from the parent. Family relationships between an auditor of the parent company and an employee of a separate and immaterial subsidiary would not cause threats to independence that could not be addressed through consultation processes. Similar concessions should also be applicable for employees of other immaterial investees of the parent such as joint ventures and investments subject to significant influence.*

Invitation to Comment (ITC 99-1)  
Family Relationships Between the Auditor and the Audit Client  
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B. Of how much help are the other safeguards, or "mitigating factors," described in paragraph 15 of the ITC? Are there additional safeguards which you believe are important?

*The existing and proposed rules cast a wide net over all relationships that fall within certain definitions in an attempt to capture all circumstances that could cause potential threats to independence. We believe that consultation with appropriate professionals (not directly related to engagement and knowledgeable in independence matters) together with appropriate controls should provide sufficient safeguards against possible threats to independence in many cases, particularly for close relatives that are not immediate family members. We note that for such controls to be seen to be effective, the consultation and implementation of any controls would need to be completed as early as possible.*

*Consideration should also be given to many other "mitigating factors" embodied in existing professional standards such as concurring partner reviews and peer reviews.*

9. Paragraph 16 of the ITC discusses "the effects of death of, or divorce by, a relative," although these events are not currently mentioned in the Proposal. Should the Proposal be expanded to provide guidance in such situations? If so, what positions should that guidance take? If not, why not?

*We believe that the following principles should be adopted with respect to death and divorce.*

- A death or divorce of a spouse is presumed to terminate any associated close relative relationships. Any unique circumstances should be considered through the process of formal evaluation and consultation.*
- A divorce should be presumed to terminate any associated relationship with a spouse unless there is a continuing material financial interest such as through significant alimony or child support payments.*

Invitation to Comment (ITC 99-1)  
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10. Are there other broad family relationship models, or other key criteria and factors for evaluating relationships, which the Board should consider?

*We do not have any additional recommendations for models or criteria that assist in evaluating family relationships.*

11. Is there research that the Board should be made aware of or should sponsor to assist it in making informed judgments in these areas? If so, please offer recommendations.

*We are not aware of any research that the Board should be made aware of. We also are not aware of any research that establishes a significant correlation between alleged audit failures and family relationships.*

September 30, 1999

Independence Standards Board  
6<sup>th</sup> Floor  
1211 Avenue of the Americas  
New York, New York 10036-8775

ITC 99-1

Dear Board:

Below are my responses to the questions outlined in ITC 99-1, *Family Relationships Between the Auditor and the Audit Client*. I am responding as an interested party in the public accounting field and not on behalf of the firm at which I am employed. Thank you for the opportunity to share my thoughts on this proposal.

Sincerely,

W. Bryan Buckler  
CPA

1. Yes. All professionals on an engagement (“engagement professionals”) should be restricted as to any and all financial and personal (i.e., close relative) relationships with personnel at their client which might influence their judgment. However, a professional who is not on an engagement should not be limited as to the relationships he can have with employees of a client as long as he does not exert influence over engagement professionals (and thus impairing engagement professional’s judgment). As long as all relationships are clearly documented and understood by the firm, appropriate measures could be taken. It is very important that these measures include prohibiting the engagement professionals from being supervised, reviewed or mentored by the professional with the relationship.

2: A. No.

B. N/A – Alternative A supported

C. Certain offices are so small that the Partner would have to either be involved with the client or with other professionals on the engagement. In these cases, anyone in this office could be considered likely to influence the audit. The Board should consider determining the size of office thresholds. However, in a larger office, where professionals often do not even know other professionals within their unit or have contact with them on limited basis at firm-wide social or educational events, the requirement of additional reviews/controls would be appropriate and effective. In addition, the relationship should be documented by the firm, and boundaries periodically discussed with the Partner/Senior Manager in question and the engagement professionals. This discussion should be led by a senior partner designated by a firm’s national office.

Independent auditors and accounting firms are asked to make professional judgments all the time. In this case, it is also appropriate that the firms judge which relationships impair their independence (within certain boundaries set by the ISB).

3. Yes, the issues are sufficiently different that the Board should take up employment-related financial interests separately from other financial interests. The standards on financial interests currently provide enough guidance that should Alternative A be adopted, the Partner's immediate family member or close relative could take up employment and follow the current guidelines (i.e. the current financial interest guidelines do not in themselves make employment impossible and they appear to provide adequate limitations). Further, I believe that the financial limitations set by the board remain appropriate for immediate family members. If the Partner's spouse were to hold a *material* portion of the couple's joint net worth in equity of the Company, the Partner would then have a interest in the Company and not be independent.
4. The definition is appropriate, however, exceptions should be allowed for under certain circumstances as judged by the firm.
5. The definition is appropriate.
6. A professional should not be on the engagement of any client at which an immediate family member is employed. The engagement professional must be independent of his client. An immediate family member employed in any capacity might impair this independence. Furthermore, under Alternative A, the professional could be removed from the engagement but still be employed with the firm in that office.
7. Yes, the guidance is appropriate.
8. A. If said immediate family member was in a "key position", even at a subsidiary, then in no circumstances should it be permissible for an auditor to be on the engagement. This situation would not effect an auditor at a firm who had no ties to the engagement under Alternative A.  
  
B. No Opinion as Paragraph 15 could not be located.
9. I do not believe that the proposal should be expanded to provide guidance in such situations. However, each firm should have in place a control structure in which these situations are discussed and documented among the appropriate firm members to evaluate the independence of the auditor.
10. Not to my knowledge.
11. Not to my knowledge.

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Date: 9/30/99 7:13 PM  
Priority: Normal  
TO: isb@cpaindependence.org at INTERNET, ISB at AICPA3  
Subject: Comments on ITC 99-1

13

Art, Rick, and Susan:

Attached are my comments on ITC 99-1. Good luck as you continue to debate these issues.

Joe Carcello

Joseph V. Carcello, Ph.D., CPA, CMA, CIA  
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Date: September 30, 1999  
To: Independence Standards Board  
From: Joseph V. Carcello  
Subject: Response to ITC 99-1

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I have read ITC 99-1, "Family Relationships Between the Auditor and the Audit Client." Before responding to the questions posed at the end of the document, some general observations are in order. First, it was not clear to me that a problem exists. What evidence does the ISB have indicating that the existing independence guidelines in this area are inadequate? The problem might be that existing independence guidance in this area is too restrictive given the growth in dual-career families, and hence the possible rise in family relationships between the auditor and audit client. However, the motivation for tackling this issue was not clear to me and, in my view, providing such rationale for standards helps to engender confidence both in the standards and the standard setter.

I have recently co-authored a study on fraudulent financial reporting for COSO. Although not one of the objectives of our study, I cannot recall a single incident where there was a family relationship between the auditor and senior level personnel at the audit client. (Since we did not gather this information, I may be mistaken but, at a minimum, this was certainly not a pervasive problem.) There was a problem, however, in that family relationships between directors and/or officers were reasonably common among fraud companies. There was evidence of one or more family relationships (of the type just described) for almost 40 percent of the fraud companies for which we had access to proxy filings. Although I recognize that the ISB has no control over such relationships among boards and/or among senior management, this issue may need further study by other regulators and standards setters.

Question 1 addresses the tradeoffs implicit in the proposal outlined in ITC 99-1. The proposal would limit the most stringent rules to "those on the engagement," a smaller class of individuals than "members" (all partners, all managerial employees in offices performing a significant portion of the audit, and all individuals providing professional services to the client) as currently defined in SEC regulations. However, the proposal would strengthen independence requirements by prohibiting any employment with the client by family members of those individuals on the engagement.

In my view, the SEC's current definition of a member is too broad. I have difficulty

envisioning any independence-related threat if the child of a partner in a Big 5 firm in Seattle is the CFO of a Miami-based company audited by that same Big 5 firm. I just believe that the geographic scope and size of certain accounting firms is so large that to extend prohibitions on family relationships to all partners is too broad.

However, as discussed in my response to Question 6, I also do not favor prohibiting any employment with the client by family members of those on the engagement. I think such a prohibition is too restrictive and, in my view, an adequate case has not been made to tighten the rules that already exist in this area.

Question 2 addresses which of two alternatives is more appropriate for defining those individuals -- other than those who work directly on the audit -- who are likely to influence the audit. The essential difference between the two alternatives is that Alternative B would classify -- as those who are likely to influence the audit -- those partners and managerial employees who work in an office that performs a significant portion of the engagement. Alternative A would not classify such individuals as likely to influence the audit.

I struggled greatly with this issue. Good arguments can clearly be made in favor of both alternatives. I favor Alternative B. In my view, partners and managerial employees who work in an office that performs a significant portion of the engagement are potentially close enough -- both in proximity and, in some cases, based on relationships -- to influence those individuals who work directly on the audit engagement.

You also ask how to define the "office" if we support Alternative B. The office would be defined as the primary office in a city and any satellite offices that are essentially subsumed into the primary office by the firm's internal management system.

Question 3 addresses whether family relationships between the auditor and audit client can be effectively considered separately from financial interests that the auditor may have in the audit client. Although there clearly is some overlap between these issues, I believe that the issues are distinct enough to address employment-related family relationships separately.

Question 4 addresses the definition of a close relative provided in the document. The definition of a close relative is reasonable -- it is not excessively broad, nor is it too narrow. There are certainly instances where parents and (adult) children are not close, when siblings are not close, etc. There also are circumstances where an individual might be very close to an uncle or aunt (not considered a close relative per ITC 99-1). The factors that affect the "closeness" of human relationships are many and complex. As such, it would be impractical to try to capture all of these variables in some type of formula-based approach to measuring closeness that could lead to a general-purpose rule. The only reasonable alternative is the one adopted in ITC 99-1 -- that is, defining a close relative in a manner that would capture (albeit with some error) the family relationships that would normally be expected to be close.

Question 5 addresses the definition of a key person with the client. This definition is reasonable.

Question 6 addresses whether the prohibition against the immediate family of those on an audit engagement having any employment with the client is too strict. I believe that this aspect of ITC 99-1 is too strict.

As stated in ITC 99-1, under existing rules, employment of an immediate family member is permitted unless the position is either audit sensitive or could lead to a shaping of the financial statements. I believe that the existing rule is reasonable and adequate, particularly given the failure of ITC 99-1 to document significant problems with the independence rules that are already in place.

Question 7 addresses whether it is appropriate to handle situations that may be gray -- situations that are on the edge of being problematic -- via a requirement for internal firm consultation. I believe that this recommendation is adequate and prudent, and that the examples given of circumstances that would require consultation are reasonable.

Question 8 addresses whether a potentially problematic family relationship at a subsidiary could be resolved by having a different audit firm examine the subsidiary. I have no opinion on this recommendation.

Question 9 addresses whether the proposed guidance should address the independence-related effects due to the death of, or divorce by, a relative. Given the non-trivial rate of divorce in the U.S., I believe that it is important to incorporate such guidance into the final standard. The form such guidance should take is obviously more problematic. Factors that the ISB might consider include: (1) the length of the relationship before death or divorce, (2) whether children are part of the relationship terminated by death or divorce, (3) physical distance between the parties, both during the time of the relationship and currently. Other factors might be equally or more persuasive.



September 30, 1999

Mr. Arthur Siegel  
Executive Director  
Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, NY 10036-8775

Dear Mr. Siegel:

PricewaterhouseCoopers (PwC) appreciates the opportunity to comment on the Independence Standards Board's (ISB or Board) Invitation to Comment 99-1, *Family Relationships Between the Auditor and the Audit Client*, (ITC 99-1). The existing independence rules governing this subject have been in need of reexamination for some time. We welcome the opportunity to participate in the ISB's deliberative process in an effort to establish guidance that appropriately addresses the threats to independence that arise from family relationships between the auditor and the audit client.

The comments in this letter have been developed from the perspective of our firm as an ISB constituent. As you know, PwC's chief executive officer, James J. Schiro, is a member of the ISB. In carrying out his responsibilities as a board member, Mr. Schiro intends to fully exercise objectivity with a view to helping the ISB to reach conclusions on this project that are in the best interests of independence standard-setting and the investing public. The comments in this letter have been developed consistent with that goal but should not be viewed as necessarily indicative of Mr. Schiro's personal views and do not serve to bind him to any particular thought process in his role as an ISB member.

General Comments

The ISB has approached the subject of family relationships between the auditor and the audit client by analyzing the threats to independence that might arise from such relationships and proposing the development of guidelines to address those threats. Paragraph 11 of the Discussion section in ITC 99-1 sets forth the threats and provides, in part:

Specifically, the concerns are that independence could be considered to be impaired by an auditor

- effectively auditing his own (family's) work,
- having financial interests or other mutual interests in the outcome of the audit,
- conveying information to the client relative to compromise the firm's audit approach or ability to consult effectively, or
- receiving critical comments from the relative about an assigned staff person, the threat of which could weaken the staff person's effectiveness.

We believe that an assessment of potential threats is a useful way to approach this subject. In assessing the concerns described above, we do not believe that the last two are substantive. In particular, the threat of receiving critical comments from a relative regarding a staff person's performance does not seem substantially different from receiving the same type of comments from a non-relative. Critical comments received from a client (whether from a relative or non-relative) would, in our opinion, weaken a staff person's effectiveness to the same degree.

We agree with the ISB that a potential threat involving family relationships is encompassed in the first two bullets, i.e., auditing the work performed by the relative/employee and being in a situation in which the outcome of the audit would affect the financial interests of the relative/employee. We have summarized these threats below and believe that both condition (1) and either condition (2) (a) or (2) (b) must exist for auditor independence to be threatened:

- (1) the individual in the audit firm who is related to the relative/employee participates in the audit, and
- (2) (a) the relative/employee's work is subject to audit, would serve as audit evidence, or would otherwise be relied upon during the conduct of the audit,  
  
or  
  
(b) the relative/employee has a material financial interest in the audit client.

Paragraph 1 in the Proposal section of ITC 99-1 mentions a desire of the auditor to "protect a relative of a colleague" as a concern that also could exist. We question the validity of this notion. Accepting inappropriate accounting or ignoring an error that is attributable to a close relative of the auditor is a potential threat. However, the auditor who chooses this approach would do so at great risk to the client, himself<sup>1</sup>, and his firm. While he may be willing to accept that risk for a close relative, we find it difficult to

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<sup>1</sup> The terms "he," "him," or "himself" are meant to also connote the feminine "she," "her," and "herself."

imagine that he would be willing to do so for someone else's relative, even if that someone else is his partner.

The conditions we've outlined above contemplate that the "engagement" is the audit engagement. This would eliminate the need to provide guidance for situations in which an individual with the family relationship is not on the audit. If that person does not participate in the audit, condition (1) described above would not be met and thus the individual would not be in a position to evaluate the results of the relative/employee's work or influence the audit for the benefit of the relative/employee's financial interest. Accordingly, there should be no threat to independence as a result of a family relationship of an individual who is not on the audit.

We recognize that there can be instances in which it may not be readily apparent whether an individual in the firm is on the audit. One test that could be applied to make that determination is whether the individual's work will be relied upon in conducting the audit.

We also believe that any new rules in this area that are promulgated by the Board should apply prospectively with an appropriate transition period for individuals who may currently be in compliance with existing rules, but will need to take action to be in compliance with new rules that become effective. For instance, an independence impairment would exist under the Proposal where the brother of a managerial employee who is on the audit is employed by an audit client in a position that is not audit sensitive and does not enable him to mold the shape of the financial statements. Under existing rules, such an arrangement would be permitted. Companies in these situations would need a reasonable period of time to react to any changes that need to be made. Thus, we encourage the ISB to include in the Proposal a discussion of transition.

#### Questions for which Comments are Requested

Below are our responses to the specific questions for which the ISB has requested comments.

- 1. The Proposal would apply the most stringent restrictions to those who are "on the engagement" (generally a smaller group than those who are considered "members") and would apply more restrictive rules to that group by prohibiting any employment by the client of an immediate family member of someone "on the engagement" as these individuals are in the best position to influence the outcome of the audit. Do you believe these changes are warranted?*

We believe that threats to independence may arise when individuals who participate in the audit or have an ability to influence the conduct of the audit must audit the results of work performed by a relative/employee or audit an employer/client in which the relative/employee has a material financial interest. Accordingly, we believe those

individuals should be required to be independent of the audit client and we would support guidance that makes a distinction between those who are "on the audit" and those who are not. This is different from the proposal, which distinguishes between those who are "on the engagement" and those who are not and defines the term "engagement" broadly to include any professional services engagement, not just the audit. It is difficult to see how an individual providing non-audit services to the client could be among those who are "in the best position to influence the outcome of the audit." Thus, we disagree with a distinction based on such a broad definition and recommend that the proposal be revised to include only firm personnel providing audit or other attest services to the audit client. "On the engagement" should mean "on the audit."

We also recommend that the ISB eliminate the present approach contained in the proposal that would automatically apply more restrictive rules to those who are "on the engagement." Consistent with our general comments above, we believe that employment positions that potentially threaten auditor independence are those where the relative/employee's work is subject to audit, would serve as audit evidence, or would otherwise be relied upon during the conduct of the audit. Under the proposal, it is irrelevant what position an immediate family member holds with the auditor's audit client; any position would be sufficient to impair the auditor's independence if he is "on the engagement." We believe that a reasonable investor would conclude that an auditor's independence is not impaired simply because, for example, his son takes a summer job with the client working on the client's loading docks, or because his daughter works part-time as an assistant in the client's graphic arts department. Using the definition in the proposal of "on the engagement" makes the proposal even more difficult to understand. For example, under the Proposal, a firm's independence would be impaired if a first-year staff person in the firm's Management Consulting Services group participates on a consulting project for subsidiary X, an immaterial subsidiary of the audit client, and his spouse is a secretary in the human resources department at subsidiary Y. It is difficult to understand how this impairs the firm's independence. Even under the guidance proposed in the ITC, none of the concerns described in paragraph 11 would appear to exist in this situation.

We recommend that the Proposal provide for the firm to assess the nature of the work performed by the immediate family member of the individual who will participate in the audit. If the immediate family member's work would be subject to audit, serve as audit evidence, or otherwise be relied upon by the auditor in the conduct of the audit, then the individual should be precluded from participating in the audit.

*2. A. Do you believe that the added protection of independence provided by Alternative B, which would extend independence restrictions to many partners and managers located in the work office that would not be included in Alternative A, is sufficient to warrant that extension?*

We are not convinced that any added protection would result from such an extension. Unless the partner or manager with the family relationship is participating in the audit or has the ability to influence the audit by providing the audit team with consultation, supervision, quality control, or other oversight, we do not believe they are "likely to influence the audit" (even in a small office as contemplated by Alternative A). In fact, we assert that in most cases they would not even have the ability to do so. This would be especially true in large offices where partners of different disciplines are resident and there can be hundreds of partners in a single office. (However, refer to our response to Question 2B below regarding the definition of an office.) Moreover, we believe that the recusal provisions of paragraph 4 of the Proposal would adequately address situations in which a partner or manager with a family relationship is located in an office (large or small) that participates in a significant portion of the audit.

If the ISB believes that all partners and managers located in an office that participates in a significant portion of the audit are "likely to influence the audit," it will be important for the Board to set forth the basis for this conclusion so that we and other constituents can address it in subsequent communications. It also would be important to reconcile that with the recusal provisions in paragraph 4. It would seem that selection of Alternative B would significantly reduce the effectiveness of those provisions.

*2. B. If you support Alternative B, how would "an office" be defined considering that a firm might have several locations in or around a large city? Does it matter if the "office" is managed on a "service-line" or an "industry" rather than a "geographic" basis?*

We do not support Alternative B. As for the definition of "an office," we believe that the typical meaning of an office that is embodied in the existing rules (i.e., a physical location) should be supplemented by the structural safeguards that are inherent in how firms operate today, especially the larger ones. Many firms operate on a practice unit basis, which may be either service-line or industry based. Such units represent a subdivision of a firm's practice within which a team of partners and staff operate closely. In addition, personnel assigned to a practice unit will serve clients on a regional and sometimes national basis and are not confined to serving clients that are served primarily by the office they happen to be located in. In fact, they may never serve clients that are typically thought of as "X" office's clients." Moreover, some personnel are not even assigned to a physical office but work almost exclusively at client sites, various offices within a firm on a "hotelling" basis, or at home.

Thus, while an appropriate safeguard can still involve location in an office different than the one that performs the audit (depending on the facts and circumstances), we believe that safeguard is enhanced when that individual's practice unit responsibilities effectively distance him from the audit and the audit team. Such facts and circumstances should be considered as part of the consultation required by paragraph 4 of the ITC to determine the degree of threat that is posed by a family relationship.



*2. C. If you instead prefer Alternative A, it suggests that all partners in a small office or practice unit might be considered as being likely to influence the audit. Do you believe that approach provides appropriate guidance? Would it be effective instead to isolate partners or to require additional reviews in these circumstances, or must audits of the companies with the family relationship just be avoided?*

It would be helpful if the ISB defined what constitutes a small office or provided guidance to assist practitioners in making that determination. Without that guidance, a small firm with only one office could have difficulty determining whether they fall into the exception in Alternative A. Having said that, we support Alternative A except that we do not agree that all partners in a small office might be considered as likely to influence the audit. As stated in our response to Question 2.A., unless a partner is participating in the audit or provides the audit team with consultation, supervision, quality control, or other oversight, we do not believe he is likely to influence the audit. Moreover, in light of the ISB's approach of identifying threats that pose the highest risks to auditor independence, restrictions such as avoiding audits or isolating all partners in a small practice office may cause undue burden on audit clients and the relatives of the partners in that office. Although these situations should be highlighted, discussed with, and reviewed by appropriate individuals in the firm, it is difficult to justify why such relationships should be automatically prohibited based solely on the size of the office.

An effective way to address any threat that might arise in a small (or large) office situation is to apply the recusal provisions of the ITC. Under those provisions, firms would isolate the individual with the family relationship from any involvement with the client, including inappropriate contact with any individuals involved in the engagement. Although it is not clear what contact would be considered "inappropriate," we assume the Board contemplates assigning the individual with the family relationship to an engagement in which he will work with members of the audit team who serve the client where his relative is employed. However, we recommend the ISB provide examples or other guidance to assist practitioners in making this assessment and limit confusion over what is inappropriate.

*3. The Board has tentatively chosen to defer consideration of job-related financial interests of relatives until the broader subject of financial interests can be reconsidered in its entirety. The Board asks whether a resolution of the employment issues raised in this ITC, without dealing with the explicit financial interests that may come with that employment, will provide useful guidance. Are the issues sufficiently different that the Board should now take up employment-related financial interests separately from other financial interests?*

We strongly urge the ISB to address as part of this project family relationship issues involving financial interests in an employer/audit client that a relative may have as a result of such employment. It is quite common today for employees to own financial

interests in their employer. Such interests may arise from participation in profit sharing plans, stock purchase plans, stock option plans, 401(k) plans, and stock bonus arrangements. These plans and arrangements often are a normal part of how companies compensate their employees. In our view, that makes such interests sufficiently different from all other financial interests in audit clients that arise absent an employment relationship. Moreover, an inability to participate in these programs because of independence restrictions means that the relative/employee must forego a significant part of their compensation because most employers are usually not willing to substitute cash in lieu of such participation. Thus, addressing only whether the relative's position with the employer/audit client is problematic deals with only half of the issue that may arise when an audit client employs a relative.

We believe that if a partner or staff person is "on the audit," their relative/employee should not own material employment-related financial interests in the audit client. If the partner or staff person is not on the audit, their relative/employee should be permitted to own employment-related financial interests without regard to materiality.

While the Board's question pertains only to employment-related financial interests, we urge the Board to consider the independence implications of financial interests held by relatives in audit clients absent an employment relationship with the audit client. Under today's rules, there is a presumption of impairment of independence when certain nondependent close relatives of the auditor have material financial interests in an audit client. So, for example, if a partner knows that a relative owns a material financial interest in an audit client of his firm, independence is required to be safeguarded through the achievement of adequate geographic separation between the partner and the relative and the partner and audit team. This is without regard to whether the partner participates in the audit or otherwise influences the conduct of the audit. We believe that should be an important assessment prior to requiring any action to be taken to mitigate any threat. And, most would agree that a safeguard that is based entirely on how far apart the relatives are does little to address the threat, if any, that may exist in such situations.

*4. Is the definition of "close relative" comprehensive enough, or too comprehensive?*

We do not object to the comprehensiveness of the definition. However, the last part of the definition refers to "the member." We assume that this is not meant to connote "member" as defined in the SEC's independence rule. Clarification of this point could be made by changing the word to "partner or staff member."

*5. Do you believe the definition of the term "key position" (with a client) is appropriate?*

We believe that clarification is needed to ensure that readers will understand what is meant by "sensitive financial position." Is this meant to be similar to the AICPA's

We also recommend that the examples include an instance where an immediate family member is employed by the client and the related partner or staff person is not on the engagement.

In addition, use of the word "with" when discussing investments has the potential to be misread as investments "in" the client rather than "with" the client. The existing SEC rule, Section 602.02.h of the Codification of Financial Reporting Policies, uses "with" in a similar fashion<sup>2</sup>. We recommend revising paragraphs 5, 6, and 7 to clarify that the investment contemplated is one that is made together with the client (not in the client) as in a joint investment.

Finally, paragraph 8 refers to "direct or indirect control" of a client by a close relative of a partner or immediately family member of a staff person. We believe the Board should clarify what is meant by "direct or indirect control." This appears similar to the definition of control contained in SEC Regulation S-X. Thus, it might include instances in which a relative/employee owns greater than 50% of the voting stock of the client. However, because the Proposal has been written without regard to a relative/employee's financial interests in the employer/client, it may more appropriately contemplate control of the entity through contract or otherwise. Clarification and examples would be useful.

*8. A. Should the Proposal refer to the possible safeguard of having a different accounting firm audit a subsidiary where a family relationship exists? Should such a safeguard be considered in a firm's evaluation of the relationship or should its use be permitted to overcome an otherwise required prohibition and under what criteria should that occur (e.g., only for immaterial subsidiaries, or certain material ones as well)?*

We believe the Proposal should refer to the possible safeguard of having a different firm audit a subsidiary where a family relationship exists. We also believe that this safeguard should be considered in a firm's overall evaluation of the threats that may arise from such a relationship. Moreover, use of a different accounting firm in that situation should be permitted to overcome those threats, regardless of whether the subsidiary is material to the consolidated financial statements. In all situations, the other auditor who reports on the separate subsidiary should take full responsibility for the audit of the subsidiary's financial statements. Reference to that auditor should be made by the principal auditor when reporting on the consolidated financial statements, and the other auditor's report should accompany the statements. Under these conditions, we believe that financial statement users will clearly understand the degree of responsibility each auditor has assumed.

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<sup>2</sup> The first sentence of the second paragraph of 602.02.h states: "There would also be a presumption of impairment of independence when other close relatives of the accountant have material financial interests or business relationships or hold important positions with a client."

*8. B. How much help are the other safeguards, or "mitigating factors," described in paragraph 15 of the ITC? Are there additional safeguards that you believe are important?*

We believe that the safeguards described in the Proposal are helpful; however, they should be expanded. For example, the Proposal does not mention the safeguard that is inherent in the various levels of review that take place during an audit. The work of individuals on an audit is subject to a number of reviews by persons higher than the individual who performed the work. And, concurring review partners provide additional assurance that audits are performed in accordance with professional standards by providing an independent review of all significant audit issues. Consulting on difficult accounting, audit, or independence issues usually involves senior partners (in the large firms, these partners are typically national office partners) who are otherwise unaffiliated with the audit. Internal work inspections are performed annually by firm members who are not connected with either the office performing the audit or the audit itself. And, external peer reviews are performed by another firm triennially to independently evaluate the mechanisms in place to ensure audit quality. All of these control procedures serve as safeguards that mitigate perceived threats to independence that might arise from family relationships.

*9. Should the Proposal be expanded to provide guidance for situations involving death or divorce of a relative? What positions should that guidance take?*

We believe there is no critical need for guidance on this topic at the present time. As suggested in paragraph 16, the facts and circumstances of a particular case would need to be carefully analyzed to reach a judgment about whether such events eliminate the threats to independence that might arise from specific family relationships.

*10. Are there other broad family relationship models, or other key criteria and factors for evaluating relationships, which the Board should consider?*

The Board may wish to study various models presently employed in the federal government to enable government employees to avoid conflicts when carrying out their responsibilities.

*11. Is there research that the Board should be made aware of or should sponsor to assist it in making informed judgments in these areas?*

Mr. Arthur Siegel  
Independence Standards Board  
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It may be useful to sponsor research to test the tentative conclusions in a final proposal. For example, we have argued that we believe a reasonable investor would conclude that an auditor's independence is not impaired simply because his son takes a summer job with the client working on the client's loading docks. The Board may wish to test this (and other views) with investor groups and those who have fiduciary responsibilities to shareholders, such as audit committee members.

It also may be helpful to the Board to conduct research into the structure and operation of a practice unit versus a practice office to gain a more complete understanding of the inherent separation that occurs in a practice unit structure.

\* \* \*

We appreciate the opportunity to express our views and would be please to discuss them with you in detail. If you have questions, please contact Robert H. Herz (973-236-7217) or Kenneth E. Dakdduk (212-596-7140).

*Richard A. ...*

Investment Advisory Company

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# PNC advisors

September 30, 1999

William T. Allen, Chairman  
Independence Standards Board  
1211 Avenue of Americas 6<sup>th</sup> Floor  
New York, NY 10036

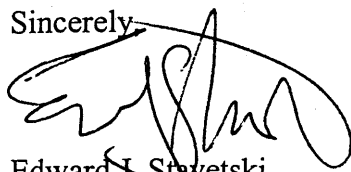
Attn: ITC 99-1

Dear Mr. Allen:

I have received the analysis of *Family Relationships between the Auditor and the Audit Client*. While I applaud the spirit of the effort to remove any appearance of impropriety, the complicated world we live in may make the attempt difficult to achieve the desired ends.

Specifically, I am referring to item (5.) on page (9) of the analysis. The term *immediate family and close relative* are subject to broad interpretations. Also, it does not mention or include "significant other, roommates, or close friends", who may have better relationships and communications than the actual family members. Additionally, there was no mention of ex-family and friends through the divorce process. With family units ill defined, focus may be placed in narrow areas, providing regulations with a false security.

Sincerely,



Edward J. Stavetski  
Chief Investment Officer

EJS/ejr

Enclosures



**MARGOLIN, WINER & EVENS LLP**

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS - ESTABLISHED 1946

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September 24, 1999

Independence Standards Board  
6<sup>th</sup> Floor  
1211 Avenue of the Americas  
New York, New York 10036-8775  
Attention: ITC 99-1

Gentlemen:

We are pleased to offer our comments with respect to Invitation to Comment (ITC 99-1) "Family Relationships Between the Auditor and the Audit Client" dated July 1999.

Question 1

We agree with the Proposal's basic distinction between audit firm personnel "on an engagement" and those who are uninvolved when determining how family relationships affect auditor independence. In many situations appropriate safeguards can effectively isolate uninvolved individuals with relationship issues from the client irrespective of their geographic location or partnership status. We do not believe geographic proximity or partnership status in and of themselves should be the determining factors. As an example, partners with relationship issues in large practice offices may in fact be more isolated from the client than managerial employees in small, but separate offices.

We do not agree that all employment by the client of an "immediate family member" of individuals "on an engagement" should be prohibited. Current SEC and AICPA rules do not proscribe certain employment of spouses and dependents. In the absence of evidence that employment of an "immediate family member" in a capacity other than a "key position" has resulted in impairment of independence, it does not make sense to strengthen the restrictions that apply to this group even if the definition of "on an engagement" results in a smaller group. Rather, we suggest that the ISB mandate that all employment by the client of an "immediate family member" of individuals "on an engagement" be disclosed to the Audit Committee.

Question 2

As indicated in our comments under Question 1, we believe no distinction should be made based on geographic location, accordingly, we prefer alternative A. We agree with the guidance in Alternative A concerning the immediate practice environment. If the Board decides that Alternative B is preferable, we suggest serious consideration be given to incorporating the guidance in Alternative A, which we believe can be equally applicable to multi-office environments. The Board should also consider changing the phrase "those likely to influence the audit", which is part of the definition of "on an engagement", to "those with the potential to influence the audit".

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Question 3

At this time, we believe it is appropriate to separate independence implications of family employment relationships from financial interests resulting from such employment. Current rules ascribe all financial interests of a spouse or other dependent to the member and we believe those rules should remain in effect until the broader subject of financial interests is reconsidered in its entirety. In that regard, we note that the guidance concerning financial interests of partners or staff not on the engagement in paragraphs 6 and 7 of the Proposal appear contradictory. Specifically, paragraph 6 gives the following example of family investments with respect to partners or staff not on the engagement that cause the firm's independence to be impaired:

- "With respect to individuals not on the engagement, a firm will not be considered independent if a member of the immediate family of any firm partner, or of a managerial employee in an office participating in a significant portion of the audit, has any investment with a client, or with someone in a key position at the client."

Paragraph 7 provides the following example of relationships that may be resolved with adequate mitigating controls:

- For firm partners and staff not on the engagement:
  - An immediate family member has a material investment with the client or with someone in a key position at the client.

Inasmuch as the guidance in paragraph 6 seems appropriate and is consistent with existing rules regarding financial interests, we suggest the last bullet in paragraph 7 be removed.

Question 4

Although the inclusion of brothers and sisters of the member's spouse within the definition of "close relative" is more restrictive than the AICPA's definition, it is consistent with the SEC's current policy and we have no objection. Accordingly, we agree with the definition of "close relative" in the Appendix.

Question 5

We believe the definition of "key position" is appropriate.

Question 6

The second paragraph of our response to Question 1 addresses this question and is repeated below.

We do not agree that all employment by the client of an "immediate family member" of individuals "on an engagement" should be prohibited. Current SEC and AICPA rules do not proscribe certain employment of spouses and dependents. In the absence of



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evidence that employment of an "immediate family member" in a capacity other than a "key position" has resulted in impairment of independence, it does not make sense to strengthen the restrictions that apply to this group even if the definition of "on an engagement" results in a smaller group. Rather, we suggest that the ISB mandate that all employment by the client of an "immediate family member" of individuals "on an engagement" be disclosed to the Audit Committee.

#### Question 7

We believe the guidance in paragraph 7 of the Proposal is appropriate with the exception of the last bullet, which we believe should be removed since it conflicts with paragraph 6 and conflicts with current rules regarding financial interests. The following is abstracted from our response to Question 3 which more completely addresses our concern.

The guidance concerning financial interests of partners or staff not on the engagement in paragraphs 6 and 7 of the Proposal appear contradictory. Specifically, paragraph 6 gives the following example of family investments with respect to partners or staff not on the engagement that cause the firm's independence to be impaired:

- "With respect to individuals not on the engagement, a firm will not be considered independent if a member of the immediate family of any firm partner, or of a managerial employee in an office participating in a significant portion of the audit, has any investment with a client, or with someone in a key position at the client."

Paragraph 7 provides the following example of relationships that may be resolved with adequate mitigating controls:

- For firm partners and staff not on the engagement:
  - An immediate family member has a material investment with the client or with someone in a key position at the client.

Inasmuch as the guidance in paragraph 6 seems appropriate and is consistent with existing rules regarding financial interests, we suggest the last bullet in paragraph 7 be removed.

#### Question 8A

This safeguard should not be permitted to overcome an otherwise required prohibition.

#### Question 9

We believe that the effects of death of, or divorce by, a relative should be addressed inasmuch as the definition of "close relative" encompasses the respective spouses of most relatives. We agree that death or divorce reduce, but may not eliminate, the existing family relationship with the remaining individuals, and that judgment must be applied after careful analysis of relevant facts and circumstances.

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Question 10  
No comment.

Question 11  
No comment.

Other Matters

Under the caption "AICPA Rules Applicable to All Auditors", DM 99-3 states that "In performing appraisals, all auditors must comply with the independence requirements of the American Institute of Certified Public Accountants (AICPA) (auditors of public companies must also comply with SEC rules where these are more restrictive)." If the ISB adopted the Proposal set forth in the Invitation to Comment, the auditor of a public entity could be in compliance with the independence requirements of the ISB but in violation of the requirements of the AICPA unless the AICPA changes its independence rules, since the rules of the AICPA would be more stringent than the rules of the ISB in certain specific circumstances.

We question whether the terms co-habitant and dependent should be defined. By co-habitant is the Proposal referring to individuals living together when not legally married, or is the Proposal referring to all instances of individuals living together (including roommates, nondependent children living with their parents, etc.). We believe that only co-habitants with a relationship akin to that of a spouse should be considered an "immediate family member", accordingly, we do not believe roommates or nondependent children living with parents should be considered "immediate family members". Further, is our understanding that the AICPA Professional Ethics Division considers IRS definitions in determining whether an individual is a dependent.

We would be happy to discuss the above comments at your convenience.

Very truly yours,



Michael R. Peress  
Partner

MRP:jwp

7

**Date:** 10/4/99 3:21 PM  
**Sender:** MIME:Shirley.Westcott@tfn.com  
**To:** isb@cpaindependence.org; ISB  
**Priority:** Normal  
**Subject:** Comments ITC 99-1

Attached please find ISS's comments on Family Relationships between Auditor and Audit Client, if you are still accepting commentary.

<<audit2.doc>>



AUDIT2.DOC

## Questions for comment

1. We believe the SEC definition makes more sense in terms of identifying true conflicts of interest. It looks for family members in key positions in the client company (those that could influence the financial statements). Someone's son working in the mail room, for example, is not likely to compromise independence. It also applies the definition to any partner of the audit firm or any employee of the audit firm providing services to the client company (say, consulting services). Extending the family relationship rule to consultants helps to preserve the "Chinese wall" between the provision of auditing and consulting services to the same client. The ISB proposal, on the other hand, only applies to persons actually involved in the audit but their family members cannot be employed in any capacity by the client, even in a low ranking position. Instead of such an absolutist solution, we believe the critical factor is adequate disclosure by the audit firm. Based on this, the client company board, which hires the audit firm, should ultimately decide whether a conflict of interests truly exists.
2. Alternative B offers greater protection since partners and managerial employees in the office conducting the audit could have an indirect influence on it. However, there are too many nuances of how "office" could be defined, depending on how the particular audit firm is structured. We defer to our response in Item 1, which advocates disclosure of family relationships to the client company to determine if there are conflicts of interest.
3. Financial interests relating to employment could be treated in conjunction with other financial interests as long as they don't play into the definition of what constitutes a "key position" with the client.
4. An aunt, uncle or cousin could also constitute a close relative. Because the strength of individual relationships may vary from family to family, no definition can be all-encompassing.
5. OK
6. See Item 1.
7. See Item 1.
8. A separate auditor for the subsidiary could be included as a possible control measure.
9. No
10. No
11. We are not aware of specific research on this.

# ARTHUR ANDERSEN



October 5, 1999

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Arthur Andersen LLP

Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, NY 10036-8775

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225 North Michigan Avenue  
Chicago IL 60601-7600  
312 782 0225

Re: ITC 99-1

Gentlemen:

We appreciate the opportunity to comment on ITC 99-1, *Family Relationships Between the Auditor and the Audit Client*. Our comments on the specific questions raised in the ITC are as follows:

1. We applaud the limitation of the most stringent restrictions to those "on the engagement". By so limiting, the proposed standard recognizes that the threats to auditor independence of family relationships between most members and the client are de minimus. The existing rule that sweeps within its scope all partners and managers in offices performing a significant portion of the audit is not warranted, given the size of accounting firms and the low probability that the family relationships of most members could impact the auditor's objectivity.

We strongly oppose the proposed proscription against any employment by the client of family members of those on the engagement. Our views on this issue are more fully explained in response to question 6.

- 2.A. We do not believe that the definition of "on an engagement" should be expanded as provided in Alternative B. In the case of large offices, the auditor's independence is not threatened because a partner or manager in the office has a close relative who is employed by the auditor's client. The auditor may not even know the partner or manager given the size of some offices and many of those partners and managers will be in different divisions (e.g., tax, consulting). Alternative A should provide adequate protection since it recognizes the need for the firm to be sensitive to the practice environment.

We strongly believe that the definition of "on an engagement" is too broad. We recommend that it be revised to include partners and staff directly involved with providing audit services to the client, as well as those likely to influence the audit (as defined in Alternative A), and, in most cases, partners and managerial employees directly involved with providing non-audit services to the client. It is important to note

# ARTHUR ANDERSEN

Independence Standards Board

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that our position is based on our conclusions regarding the definitions of "close relative" and "key position", as discussed below.

- 2.B. We do not support Alternative B. However, if an approach is adopted based on the office in which a person is located, the definition of "an office" should incorporate a number of factors, rather than relying on one factor, such as physical location. In today's environment, physical location has less relevance as employees are often assigned to locations that differ from where they reside and the number of employees telecommuting continues to rise. Some of the factors to consider include geographic location, the firm's organizational structure, the community served by the locations and the appearance to the public.

The definition should not be based on whether the office is managed on a "service-line" or "industry" rather than a "geographic" basis. Firms are structured and managed in many different ways. Consequently, a definition so based will result in inconsistency in the application of the rule.

- 2.C. As noted in paragraphs 3 and 4, firms should adopt policies and procedures on the independence implications of family relationships. These policies and procedures should address situations, such as small offices, where there may be a greater likelihood that the family relationship of another partner or manager in the office may appear to create an independence issue. The policies and procedures might include additional reviews; however, the standard should allow a firm the flexibility to adopt those quality control policies it deems appropriate in the circumstances.

3. We are supportive of the need to revise the rules applicable to family relationships between the auditor and the audit client. Changes in the work environment, as noted in the ITC, are such that the existing rules need to be revised if the accounting profession is going to continue to attract and retain the best people. However, many of the family relationships that would not present a problem under this proposal will continue to impair the auditor's independence because of the financial interests rules. Consequently, we believe that any revision to the family relationship rules should include the ancillary issues involving compensation arrangements and retirement plans offered by many employers today. We suggest such changes permit family members employed by audit clients to receive equity-based compensation provided the compensation is offered to similarly situated employees and the family member disposes of the financial interest when there are no longer significant penalties associated with the disposition.

# ARTHUR ANDERSEN

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4. We believe that the term "close relative" should include immediate family members and other individuals whose relationship with the partner or staff member on the engagement is such that there is a threat to independence. The group of "others" proposed is both over-inclusive and under-inclusive. For example, the spouse of the spouse's sibling is included. In some cases, the auditor may have no relationship with this person. Even for closer relatives, the auditor's relationship may be such that there is no threat to independence. Conversely, there may be cases where the auditor's relationship with a non-relative may create an independence issue. For example, the auditor may have a very close friendship with a person holding an important position with the client.

We appreciate that "bright line" rules may be easier to apply. However, they also may lead to arbitrary results that, in some cases, are ludicrous. An auditor may be deemed not independent because of a sibling living hundreds of miles away with whom the auditor has had little or no contact for years. Given changes in familial relationships in and the mobility of our society, these types of situations are not uncommon.

Consequently, we suggest that the family relationships that by their nature impair independence be limited to immediate family members. Other relatives, including those identified in the proposed definition of close relative, and non-relatives should be evaluated on a facts and circumstances basis, considering the threats to independence and the possible safeguards to mitigate any concerns that relationships between such individuals and those on the engagement would impair the auditor's independence.

5. We suggest several revisions to the definition of "key position". First, officers should be deleted. Some corporations name as officers many individuals who neither hold sensitive financial positions nor can significantly influence financial or operating matters. More importantly, the inclusion of certain designated employees and others should adequately cover those officers who would be deemed to hold key positions. These are the individuals who would potentially threaten the auditor's independence.

Second, we would replace the reference to "in a sensitive financial position" because it introduces a new and unnecessary term of art. The SEC's rules refer to persons who "appear to have the opportunity to mold the shape of the financial statements." AICPA Interpretation 101-9 refers to persons who can exercise significant influence over the entity's "primary operating, financial, or accounting policies". These concepts encompass the group of individuals who, if close to the auditor, would pose a threat to independence.

# ARTHUR ANDERSEN

Independence Standards Board

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If revised as recommended (and reflecting certain editorial changes), the definition of "key position" would be:

A key position held by an individual with respect to the client includes: director, underwriter, promoter, voting trustee, or employee, but only if the employee appears to have the opportunity to mold the shape of the financial statements or can exercise significant influence over the client's primary operating, financial or accounting policies. Other individuals may be deemed to hold a key position because their role and responsibilities are comparable to those of employees holding key positions.

6. In our view, the proposal to prohibit any employment by the client of the immediate family members of those on the engagement goes well beyond what is necessary to ensure the auditor's independence. The ITC identified four threats to auditor independence. None of these threats would exist if the family member were employed in a position that had no direct or indirect contact with the audit engagement team or association with the financial statements. For example, a spouse could be employed in a non-managerial sales position or a dependent child could take a summer job as a sales clerk. Positions such as these would not threaten the auditor's independence.

Prohibitions against employing immediate family members would place significant burdens on many within the firms. This is particularly true for those two-income families living in smaller cities, where the employment opportunities may be significantly more limited than those in larger cities. An unnecessary hardship is created by the proposal. Given this hardship, accounting firms will become a much less attractive employer and public accounting a less attractive career choice.

Immediate family members and close relatives (as defined above) of partners and staff on the audit engagement or involved in the audit (including, for example, the tax partner who participates in the accrual review) should be prohibited from holding key positions (as defined above) with the client. In addition, if positions are held by immediate family members and close relatives that do not constitute key positions, the positions should nevertheless be reviewed under the firm's policies and procedures and appropriate safeguards should be put in place, if necessary, to assure that any risks to independence are mitigated.

As noted in our response to Question 2.A., immediate family members and close relatives (as defined above) of partners and managerial employees on non-attest engagements should generally be prohibited from holding key positions (as defined



# ARTHUR ANDERSEN

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October 5, 1999

above). In cases where these partners and managers are assigned to the client and provide ongoing and in some instances recurring services, we believe it is appropriate to prohibit the close relatives of such partners and managers from holding key positions with the client. However, a partner and manager may work on a short-term project for a client and render few if any other services for the client during the course of a year. In the latter case, we do not believe the prohibition against employment of close relatives should apply to such partner and manager. This type of situation should be evaluated on a case-by-case basis to assess the threat to the auditor's independence of the family relationship. We do not believe it is necessary to extend this rule to staff below the manager level.

7. As drafted, paragraph 7 implies that the relationships included therein impair the auditor's independence unless adequate controls are employed. We do not believe it is appropriate to expand presumptively the scope of relationships that impair independence. The examples may be helpful in identifying the types of relationships that could raise independence concerns. However, the presumption should be deleted. As discussed above with respect to the definition of close relative, we believe all close relationships between members of the engagement team and persons in key positions should be reviewed to determine if the relationship threatens the auditor's independence. Blood ties, no matter how distant or indirect, should not be what drives the evaluation.
- 8.A. We believe the audit of a material or immaterial subsidiary by another firm should generally cure an independence problem that is created due to a family relationship that exists at the subsidiary's level.

In some cases, the auditor is engaged to audit a subsidiary, but not the parent. If a family relationship issue exists at the parent level, we do not believe that the auditor's independence is per se impaired. The auditor should assess whether the close relative would be deemed to hold a key position with respect to the subsidiary, i.e., whether the relative appears to have the opportunity to mold the shape of the financial statements or can exercise significant influence over the subsidiary's primary operating, financial or accounting policies.

- 8.B. When a family relationship poses a threat to the auditor's independence, the safeguards and mitigating factors identified in paragraph 15 of the ITC may be helpful in resolving the independence issue. We believe it is important to analyze the particular facts of each case and determine what safeguards are appropriate under the circumstances.

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9. The proposal should be expanded to cover the effects of the divorce by or death of a relative since it is not uncommon for independence issues to arise as a result of these events. The guidance should provide that these situations be dealt with on a case-by-case basis after considering the threats to independence and possible safeguards and mitigating factors. Examples should be included of the types of factors the auditor should consider in evaluating the impact of a divorce or death on independence. Some of the questions an auditor might ask include:
  - Who got divorced or died and when did the event occur?
  - How close was the auditor to the divorced relative?
  - If the auditor's spouse died, how close was the auditor to his or her spouse's family?
  - Where do the parties live?
  - How often do the relatives socialize?
  - Would the public perceive the relationship to be close, despite a death or divorce?
10. We do not believe there are other broad family relationship models or other key criteria for evaluating relationships the Board should consider.
11. We are not aware of research in this area.

We also offer the following comments on issues not specifically raised in the questions set forth in the ITC:

- The first bullet point in paragraph 5 of the proposal provides that immediate family members of any partner or staff member on the engagement are prohibited from have any investment with the client or with someone in a key position with the client. Similarly, paragraph 6 of the proposal provides that any firm partner, or a managerial employee in an office participating in a significant portion of the audit, is prohibited from having any investment with a client or with someone in a key position at a client. We believe that these prohibitions are more restrictive than necessary to protect the auditor's independence. We recommend that in each case, the prohibition be limited to material direct investments.
- The ITC notes that the proposal does not address the periods covered by the proposed rules. We believe that the standard should have an effective date that does not penalize individuals who made employment decisions based on current rules. Thus, for example, if the new standards prohibit any employment of immediate family members, spouses and dependents in positions permissible under existing standards would not be permitted to continue under the new rules unless the rules contain a "grandfathering" provision. In the

# ARTHUR ANDERSEN

Independence Standards Board

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interests of fairness, employment situations that were permissible should continue to be so under any newly adopted standard.

- Paragraph 3 of the proposal provides that each firm has responsibility for its independence. We fully concur that independence is the firm's responsibility and it is necessary for the firm to establish appropriate policies, procedures and processes to provide reasonable assurance that the auditor's independence is not impaired. The proposal also suggests that each firm implement an identification and notification system. We believe it is more appropriate for each firm to determine the means by which it will satisfy itself that partners and employees are complying with its independence policies. Firms might, for example, require all partners and employees to attend training sessions, require annual confirmations with respect to compliance with independence policies, establish communication channels to assure that independence issues get surfaced, and build into audit engagement acceptance procedures questions regarding family relationships.

\* \* \* \* \*

We appreciate the opportunity to comment on ITC 99-1 and would be pleased to discuss our comments with the Board or its staff. Please contact Charles A. Horstmann at (312) 507-3071 or Jean L. Rothbarth at (312) 507-2827 with any questions.

Sincerely,

*Arthur Andersen LLP*

September 30, 1999

Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, NY 10036-8775

Attn: ITC 99-1

Gentlemen:

The AICPA's Professional Ethics Executive Committee (PEEC) and SEC Practice Section Executive Committee (SECPS) are pleased to submit this comment letter to the Independence Standards Board with regard to ITC 99-1, *Family Relationships Between the Auditor and the Audit Client*.

With regard to the specific questions outlined in the Invitation to Comment, we have the following comments:

1. While we strongly support the "engagement team" approach, we do not agree with the proposal that would prohibit all immediate family members from having *any* employment with the client. For example, we fail to see the threat to independence imposed by a son of a member of the engagement team who is employed by the client on its assembly line. Clearly, such an individual could have no impact on the audited financial statements or influence the engagement team.
2. A. We support the Alternative A definition of "those likely to influence the audit" and do not believe the additional restrictions imposed by Alternative B are necessary.  
  
B. Although we do not support Alternative B, we would like to recommend several criteria that should be considered if the Board decides to define "an office". In determining whether an office is separate, one should consider physical location and geographic area, community served, organizational structure of the firm, quality control structure of the firm, and common staffing arrangements among offices.  
  
C. Although we agree that in a small firm, there may be a perception that all partners may be able to influence the audit, we believe adequate safeguards could be implemented by the firm to protect its independence. For example, an additional review by an outside firm, in the case where a partner of a small firm has performed the audit, could ensure that the audit engagement was performed with objectivity. In the case of a large firm, an additional review by a second partner would appear to mitigate any threat to independence.

In addition, we believe that the proposed definition of "on an engagement" should be limited to those individuals directly involved with the *audit* engagement, as well as those likely to influence the audit. Individuals directly involved with the audit engagement would include those individuals who provide support to the audit

In addition, we question whether it is intended that the reference to an underwriter include just those employees of an organization that are directly involved in the provision of services to a client, or is it intended to include all employees of the underwriter? We recommend the former.

We also believe that the term “key position” would be more appropriately defined if the language were revised as follows, “...or with significant influence over primary financial, accounting, or operating policies...”

6. As noted in no. 1 above, we are not in support of prohibiting all immediate family members from having *any* employment with the client. Specifically, those family members who are employed in positions that are neither audit sensitive nor allow for significant influence pose no threat to the independence of the firm. Accordingly, we recommend that this restriction not be included in any resulting standard
7. We agree with the guidance provided in paragraph 7 of the Proposal and believe it is appropriate for the firm to resolve other family relationship issues using a threats and safeguards approach on a case by case basis.
8. A. We believe that where certain prohibited family relationships are limited to a subsidiary level, the threats to independence are adequately mitigated by having a separate auditor audit the subsidiary. In addition, in the situation where the firm audits a subsidiary and a prohibited family relationship exists at the parent level, we believe independence would not be impaired provided a separate auditor audits the parent company and the close relative, through their position at the parent, cannot exercise significant influence over the subsidiary’s primary operating, financial or accounting policies.  
  
B. With regard to additional mitigating factors that should be considered, we offer the following:
  - ISB Standard No. 1, *Independence Discussions with Audit Committees* requires annual written and oral communications between the auditor and the audit committee
  - Internal firm communications and inspection procedures
  - Peer review program
  - Quality Control Inquiry Committee (QCIC) and oversight by the POB
  - Concurring partner review
9. We believe that the types of events described in paragraph 16 of the ITC, such as the death of, or divorce by, a relative are significant issues that should be addressed in the Proposal. We recommend that in such situations, it would be appropriate for the firm to consider the resulting family relationship and formally evaluate the situation using a threats and safeguards approach.

10. We are not aware of any other factors the Board should consider for evaluating family relationships.

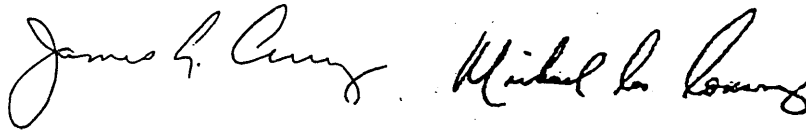
11. We are not aware of any prior research performed on this issue.

In addition to our responses to the specific questions set forth in the Proposal, we have the following comments:

- We believe that the first bullet of paragraph 5 of the Proposal should be revised to prohibit only “material closely-held” investments with the client or someone in a key position with the client and that the last sub-bullet of paragraph 7 should be similarly revised.
- We recommend that the proposed standard include a transitional provision in order to mitigate the negative impact on family members who made career decisions based on the rules that were in effect at the time. In other words, if the family relationship is permissible under the existing rules, it should be grandfathered under any new standard.

We appreciate this opportunity to comment. We would be pleased to discuss in further detail these comments and any other matters with respect to the Board’s Discussion Memorandum.

Sincerely,



James L. Curry  
Chair  
PEEC

Michael A. Conway  
Chair  
SECPS

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October 6, 1999

Mr. William T. Allen, Director  
Independence Standards Board  
1211 Avenue of the Americas  
6<sup>th</sup> Floor  
New York, NY 10036-8775

**Re: Invitation to Comment: *Family Relationships Between the Auditor and the Audit Client***

Dear Mr. Allen:

One of the objectives that the Council of the American Institute of CPAs established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective.

TIC has reviewed the above referenced Invitation to Comment ("ITC") and is providing the following comments and suggestions for your consideration.

***PARTNERS AND STAFF "NOT ON AN ENGAGEMENT"***

TIC members note that with respect to partners and staff "not on an engagement," page 9 of the ITC provides that "a firm will not be considered independent if a member of the immediate family of any firm partner, or of a managerial employee in an office participating in a significant portion of the audit, has any investment with a client, or with someone in a key position at a client."

TIC members believe that the appearance of independence cannot be maintained and that a firm's independence is therefore impaired if any firm partner that is "not on an engagement" has an immediate family member or close relative that is employed by the client.

***"THOSE LIKELY TO INFLUENCE THE AUDIT"***

The definition of the term "on an engagement" on page 11 of the ITC includes two alternatives for defining the phrase "those likely to influence the audit." Both of those alternatives indicate that "those likely to influence the audit" include individuals "who supervise or perform technical consultation, quality control or other oversight of the partners and staff members involved in the audit."

To ensure the proper application of the term "on an engagement," TIC members suggest that the final description of "those likely to influence the audit" include firm managing partners and regional managing partners as examples.

We appreciate the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

James A. Koepke, Chair  
PCPS Technical Issues Committee

JAK:lec

cc: PCPS Executive and Technical Issues Committees





INTERNATIONAL FEDERATION OF ACCOUNTANTS

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October 6, 1999

TO THE INDEPENDENCE STANDARDS BOARD

The Ethics Committee of the International Federation of Accountants appreciates the opportunity of commenting on the Exposure Draft analyzing issues related to Family Relationships Between the Auditor and the Audit Client. The Committee commends the Board and its staff for its thoughtful consideration of this issue. Our comments follow.

- 1. The definition of "on an engagement" needs further clarification as to the way it applies to those "likely" to influence the audit. Alternative B could be unduly restrictive because it would apply to persons who may not provide any services to the client; i.e., a partner who is a firm consultant on a particular industry would be subject to the rule even though that partner did not in fact provide consultation related to specific client. Alternative A needs additional clarification regarding how a firm can maintain its independence if a consulting or quality control partner who, in fact, is not on an engagement has such a relationship. "Informal" influence is too vague a description to be useful in applying such a principle.

Paragraph 4 recommends isolation as a control or safeguard to eliminate family relationship independence risks. Assuming an adequate isolation control as described is adopted by a firm, that would appear to satisfy the requirement in Alternative A.

Consideration should also be given to this factor in Paragraph 6. Could the isolated partner's immediate family or close relative retain a financial interest with the audit client, if in practice, isolation would remove the risk of appearance of a lack of independence?

- 2. "Key position" and "significance influence" should be more completely defined; definition is also needed for the phrase "other individuals with comparable responsibilities".
- 3. Of particular concern to IFAC as a representative of international professionals, is the definition of "immediate family member" which includes "co-habitant". In many countries family relationships have different patterns than the traditional U.S. "nuclear family". Households in many countries include numerous extended family relationships and can include many who would fall outside of even the "close relative" definition of this proposal. Even in the U.S. the term co-habitant could include those sharing a household with no financial or emotional ties, which appears to be more restrictive than warranted to protect the public interest. We believe therefore that a definition of "co-habitant" or a modification to specify that only dependent co-habitants would be considered to be immediate family members would be preferable.

TO THE INDEPENDENCE STANDARDS BOARD

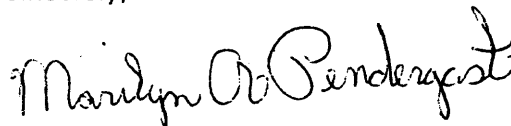
October 6, 1999

Page Two

4. A minor point regarding Paragraph 4 is that many of our members were not familiar with the term "recusal" so that for international users of the guidelines, it would be helpful to also define this term within the document.

Thank you for considering our comments.

Sincerely,

A handwritten signature in cursive script that reads "Marilyn A. Pendergast". The signature is written in black ink and is positioned above the typed name.

IFAC Ethics Committee  
Marilyn A. Pendergast, Chair



CHARLOTTESVILLE • HONG KONG

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October 8, 1999

**VIA E-MAIL AND FED EX**

William T. Allen, Chairman  
Independence Standards Board  
6<sup>th</sup> Floor  
1211 Avenue of the Americas  
New York, New York 10036-8775

**Re: ITC 99-1 Family Relationships Between the Auditor and the Audit Client**

Dear Mr. Allen:

The Association for Investment Management and Research (AIMR)<sup>1</sup> is pleased to comment on the Independence Standards Board's proposal regarding Family Relationships Between the Auditor and the Audit Client. AIMR's Advocacy Advisory Committee<sup>2</sup> (AIMR Committee) provides its comments below.

**Background**

The mission of the Independence Standards Board (ISB) is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets. To further its goals of improving independence requirements, the ISB is considering revising those requirements relating to family relationships. The primary purpose of these revisions is to develop principles-based standards to better address the threats to auditor independence raised by family relationship. The proposal focuses on circumstances where the ISB believes the risk is highest—for those on the engagement team and others who are likely to be able to influence the engagement. The ISB believes that threats to independence exist in situations involving family relationships where a reasonable investor, in possession of the relevant facts, would be concerned about the integrity and objectivity with which the audit was conducted, and therefore about the credibility of the underlying financial statements.

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<sup>1</sup> The Association for Investment Management and Research is a global, nonprofit organization of over 39,000 investment professionals from 91 countries. Through its headquarters in the U.S., and 89 Member Societies and Member Chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

<sup>2</sup> The Advocacy Advisory Committee coordinates the priorities of AIMR's Advocacy committees and reviews major new regulatory, legislative, and other developments affecting AIMR's global membership.

## AIMR Position

### **A. AIMR Code of Ethics and Standards of Professional Conduct**

AIMR strongly supports the fair treatment of the investing public and encourages high ethical and professional standards in the financial services industry. AIMR believes that an ethical and proficient industry is in the best interests of the investors who rely on professional financial services. Moreover, maintenance of such an industry is also in the best interests of financial service professionals who seek to compete fairly on the basis of their activities. Toward this end, AIMR requires its members, holders of the Chartered Financial Analyst (CFA®) designation, and CFA candidates to abide by the AIMR Code of Ethics and Standards of Professional Conduct (Code and Standards). The AIMR Committee is pleased that the proposed ISB standard promotes similar protections that ultimately work to enhance the efficiency and strength of the market. If adopted, the proposed standard will strengthen investor confidence in the investment industry by requiring auditors to honor a high standard of conduct in their dealings with the investing public.

AIMR promotes its goals of fostering and maintaining the integrity of the financial services industry and protecting the investing public by enumerating several fundamental ethical principles within its Code and Standards. The ISB seeks to promote the same fundamental ethical principles through its Family Relationships proposal. Both approaches are grounded in the principles of integrity, disclosure, conflicts of interest, and responsibility to the employer and the client.

### **B. Disclosing Conflicts of Interest**

The ISB proposal deals with a particular type of conflict of interest—family relationships between auditors and audit clients. Such a conflict of interest can have a negative impact on an auditor's independence, objectivity, and integrity in preparing credible financial statements. The ISB proposal addresses this issue by defining the existence of a family relationship that potentially gives rise to a conflict of interest and specifically recommends that audit firms disclose relevant family relationships and the possible implications to appropriate client management and the audit committee.

The AIMR Code and Standards recognize the possible deleterious effect of such conflicts of interest. Consequently, a fundamental principle of the AIMR Code and Standards is the disclosure of conflicts of interest that could potentially impair an AIMR member's ability to make unbiased and objective recommendations. Standard IV(B.7) specifically requires AIMR members to disclose such actual and potential conflicts to clients. Furthermore, Standard

IV(A.3) requires AIMR members to use reasonable care and judgment to maintain independence and objectivity in making recommendations that are unaffected by potential conflicts of interest or by circumstances that may adversely affect their judgment. The AIMR standards require all disclosures to be made in plain language and in a manner designed to effectively communicate the information to clients. Such disclosures should be made before any action is taken. Members must also take care to avoid even the appearance of a loss of independence and objectivity.

Applying these principles of disclosure of conflicts of interest and maintaining independence and objectivity to auditors helps to ensure that users of an enterprise's financial statements can have confidence that the audited financial statements and disclosures fairly represent the financial position, results of operations, and other key financial data of the audited enterprise. A formal disclosure procedure also ensures that there is written documentation of a family relationship and that these relationships are communicated to the enterprise's Board of Directors and audit committee.

### **C. Compliance Program**

The ISB recommends that the ultimate responsibility for maintaining auditor independence be placed on the audit firm itself. This would entail establishing a compliance program that would include written policies and procedures, education courses, and other appropriate forms of communication. The ISG also recommends that each audit firm implement certain safeguards and mitigating controls.

A goal of the Family Relationship standard is to assist audit firms in conducting their business in an ethical manner that promotes fairness and integrity. The AIMR Committee believes that conducting an ethical and compliant business in the investment industry requires ethical employee behavior. The AIMR Committee strongly supports, therefore, the recommendation that firms adopt a compliance program because an effective and visible compliance program serves as the cornerstone of an ethical business. It creates a common understanding of the organization's values and serves as a reference for individuals seeking guidance on what is expected business conduct. Furthermore, the AIMR Committee supports the proposed safeguards and mitigating controls as further protections that help to ensure the fairness and integrity of financial statements and related disclosures on which users of that information depend.

#### **D. Defining the Engagement**

The ISB proposes to define whether audit personnel are “on the engagement” to mean any partner or staff member who is directly involved with providing any professional services to the client, as well as those likely to influence the audit. Two alternatives are proposed to define those likely to influence the audit:

Alternative A: those who supervise or provide technical consultation, quality control, or other oversight of the partners and staff members involved in the audit.

Alternative B: those partners and managerial employees that perform a significant portion of the audit work, and also those persons who supervise or perform a technical consultation, quality control, or other oversight of the partners and staff members involved in the audit.

The AIMR Committee supports Alternative B for determining which audit firm staff should be considered on an engagement for purposes of applying the family relationship standard. However, the AIMR Committee believes that the language of this alternative should be made less ambiguous. This alternative includes supervisors and technical consultants, as required by alternative A. However, alternative B is comprehensive enough to include those individuals who are directly involved in valuing client assets and liabilities, assessing what values and data are reflected in the financial statements, and ultimately determining audit conclusions. The AIMR Committee believes that it is important to include these individuals as they can influence the information that is provided in an enterprise’s financial statements and related disclosures.

The AIMR Committee believes, however, that applying the family relationship standard to certain partners and managerial staff based on whether they perform a “*significant* portion” of the audit work is ambiguous. The AIMR Committee recommends a definition that is based instead on whether the task or function performed by the individual could affect the integrity of the audit. Such a materiality criterion helps to ensure objectivity. The AIMR Committee further believes that this alternative should be adopted without regard for the size of an audit firm.

**Conclusion**

The AIMR Committee appreciates the opportunity to comment on this proposal. Questions about the AIMR Committee's position may be directed to Philippa Hughes at 804.951.5332 or pbh@aimr.org.

Sincerely,

/s/ Deborah A. Lamb

Deborah A. Lamb  
Chair  
AIMR Advocacy Advisory Committee

/s/ Philippa P.B. Hughes, Esq.

Philippa P.B. Hughes, Esq.  
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October 12, 1999

Independence Standards Board  
1211 Avenue of the Americas, Sixth Floor  
New York, New York 10036-8775

### ITC 99-1—Comment Letter Family Relationships Between the Auditor and the Audit Client

We are pleased to submit this comment letter to the Independence Standards Board with regard to ITC 99-1, Family Relationships Between the Auditor and the Audit Client, and are supportive of the Board's attempt to develop principles-based standards to better address the threats to auditor independence raised by family relationships. The profession is in need of a more focused, realistic approach given the large number of working spouses in today's workplace and their participation in broad-based, compensatory employee incentive programs.

If it is to be effective, we think the project must address employment-related financial interests. In those situations where the professional's immediate family member is employed by a client (or employed by a nonclient whose benefit plan invests in clients) and the professional does not participate in the audit engagement and is not able to influence the audit, the immediate family member's participation in broad-based employee incentive programs (e.g., stock option plans, employee stock purchase plans, and 401(k) benefit plans—where participation is offered or required in the ordinary course of business, usually as a part of a compensation program) should be permitted, without regard to materiality (that is, there should be no mechanical materiality test).

If this issue is not addressed, we wonder whether the Board's effort is worthwhile. For example, under current rules, the spouse of a partner located in office X may not have a job as a consolidations manager with client Y, which is wholly serviced by office Z. Under the Proposal, the partner's spouse may have such a job (provided the partner is not in a position to influence the audit); however, if participation in a stock compensation program is a reasonable and customary aspect of the job, the partner's spouse is in the same position as under the old rules.

Accordingly, we are not in agreement with paragraph no. 6 of the Proposal as it relates to broad-based employee incentive programs with respect to individuals not on the engagement (as defined). However, if the Board determines that it will not address financial interests in connection with the family relationship Proposal, paragraph no. 6 should be clarified to address indirect financial interests as the current rules and practice permit immaterial indirect financial interests held by one's spouse as a result of employment (e.g., stock options).





Independence Standards Board

Page 2  
October 12, 1999

In addition, we have the following major comments about the scope of the Proposal.

It has been our firm's policy that professionals whose immediate family members are employed by a client should not participate in the audit engagement for that entity and we are supportive of this aspect of the Proposal. While we believe that there is little threat to independence when an immediate family member's employment is clearly not in a key position, we believe it is a good policy and a practical cut. However, the Board's Proposal would significantly expand the number of professionals covered by this policy.

The threats outlined in paragraph no. 1 of the Proposal and paragraph no. 11 of the Discussion appropriately deal with the "audit" and the "auditor" and as such we believe that the Proposal should be directed to those professionals participating on the audit engagement (providing attest services), as well as those in a position to influence the audit. The proposed rules should exclude those professionals providing other professional services to the client (for example, consulting services or other non-audit services). We believe that application of the rules to professionals who provide other professional services to the entity that are not audit-related are unnecessary and would require extensive monitoring procedures that would not be cost beneficial.

With respect to those in a position to influence the audit, we strongly support Alternative A—those who supervise or provide technical consultation, quality control or other oversight of the partners and staff members involved in the audit (chain of command approach). However, in this situation, we favor an approach that considers the employment position/job description of the family member. We do not agree with the Proposal that would prohibit all immediate family members from having *any* employment with the client. We believe that if the family member of those in a position to influence the audit is not employed in a key position (such as a nurse at a hospital audit client), there is no automatic impairment of the appearance of independence.

The distinction that we draw between the two approaches is that we can consciously not assign a professional to an engagement when that person has an immediate family member employed by the client. With respect to those in a position to influence the audit, their position cannot easily be re-assigned. Therefore, we believe the Proposal should be amended to allow for such situations to be resolved with adequate mitigating controls.

Paragraph nos. 5 through 7 of the Proposal refer in various ways to relatives having *any* investment or *any material* investment *with* the client or someone in a key position with the client. We believe that this is unclear and that the intent is to capture the existing rules dealing with joint closely held business investments. Thus, the Proposal should refer to "joint" investments. Further, we note that paragraph nos. 6 and 7 appear to be inconsistent. The second sentence of paragraph no. 6 refers to partners and managerial employees in an office participating in a significant portion of the audit (but not on the engagement) creating an independence problem if a member of the immediate family has any investment (presumably joint) with a

client. The last part of paragraph no. 7 says that for partners and staff not on the engagement that there is a presumption of a need for formal evaluation if an immediate family member has a material investment with a client. This inconsistency should be fixed, but in any case, we believe that only material joint investments should be a problem.

**Further Discussion Related to Questions for which Comments are Requested**

1. The Proposal makes a basic distinction between audit firm personnel “on an engagement” (broadly defined), and those who are uninvolved, when determining how family relationships affect auditor independence. Current SEC rules instead distinguish between “members” (defined as all partners, all managerial employees in offices performing a significant portion of the audit, and all individuals providing professional services to a client) and non-members in judging auditor independence. While the Proposal would limit the most stringent restrictions to those “on the engagement”—generally a smaller group than those considered “members”—it would strengthen the restrictions that apply to this group (by prohibiting any employment by the client, as discussed further in Question 6A), as these individuals are in the best position to influence the outcome of the audit. Do you believe these changes are warranted?

A change in the application of the rules from “member” to those professionals “on the engagement” addresses the threats and concerns of stakeholders, as these are the individuals who are in a position to influence the audit. In that connection, the definition of “on an engagement” in the glossary should be revised to make it operable by focusing on those that are “in a position to influence the audit,” not “likely to influence the audit.”

2. A. The definition in the Appendix of “on an engagement” includes those who are “likely to influence the audit” and is very important in applying the rule, and therefore merits significant consideration. Alternative B, while less inclusive than the existing rules, includes in its scope many partners and managerial employees of the work office not envisioned in Alternative A. For example, Alternative B would prohibit a partner whose spouse is CFO of an audit client being in an office performing a significant portion of that client’s audit engagement, whereas Alternative A would instead require the firm to assess the likelihood of the partner who is the CFO’s spouse influencing the audit and, if that did not result in prohibition, then to rely on the consultation, recusal, disclosure and other controls described in paragraph 4 of the Proposal. Do you believe that the added protection of independence provided by Alternative B’s covering this group is sufficient to warrant that extension, and if so, why?

B. If you support Alternative B, how would “an office” be defined, considering that a firm might have several locations in or around a large city? Does it matter if the “office” is managed on a “service-line” or an “industry” rather than a “geographic” basis?

C. If you instead prefer Alternative A, it suggests that all partners in a small office or practice unit might be considered as being likely to influence the audit. Do you believe that approach provides appropriate guidance? Would it be effective instead to isolate partners or to require additional reviews in these circumstances, or must audits of the companies with the family relationships just be avoided?

As noted above, we support Alternative A (as amended for our comments) and do not believe that the Proposal should be extended to automatically include employment of immediate family members or close relatives of other partners or managerial employees located in an office that performs a significant portion of the audit work when those individuals are by definition not involved in the audit or in a position to influence the audit.

Alternative A describes situations to which the firm must be sensitive. However, in applying the proposed rules in a small office situation where a partner not on the engagement has a family member employed in a key position at an audit client, such controls as isolation of the partner, an independent review partner from outside the office, additional reviews, discussion with the audit committee, could be effective controls. There should not be a presumption that independence is impaired; the firm would need to consider the specific facts and circumstances. In some cases, the firm may determine that the facts and circumstances suggest that the engagement should be declined.

3. Paragraphs 4 and 5 of the ITC describe the inter-relationship of a relative's employment by a client and the financial interests that flow from that employment. The Board, however, has tentatively chosen to defer consideration of job-related financial interests of relatives until the broader subject of financial interests can be reconsidered in its entirety. The basis for this tentative decision is that the question of permissible financial interests in a client is a major subject in its own right and has aspects broader than those of this project. Further, it is likely that resolution of that topic could benefit from the conclusions of the Board's in-process Conceptual Framework project.

The Board therefore asks whether a resolution of the employment issues raised in this Invitation to Comment, without dealing with the explicit financial interests that may come with that employment, will provide useful guidance. Alternatively, you may want to encourage the Board to expand the project, recognizing that doing so could delay issuance of any standard - and, of course, with no commitment as to how the Board would decide on such issues. Are the issues sufficiently different that the Board should now take up employment-related financial interests separately from other financial interests? Please describe the reasons for your conclusions.

As indicated above, we believe the board should address employment-related financial interests in conjunction with the project dealing with Family Relationships Between the Auditor and the Audit Client.

4. "Close relative" is defined in the Appendix. Is that definition comprehensive enough, or too comprehensive?

The proposed definition of close relative includes the "... spouse's parent, child, or sibling and their respective spouses. . . ." We believe that the inclusion of the spouse's sibling's spouse is overly restrictive and would recommend that such a relationship be evaluated by the firm using a threats and safeguards approach.

5. Do you believe the definition of the term "key position" (with a client) is appropriate? If not, what would you change?

The concept of "key position" as defined is generally appropriate. However, the reference to underwriter, promoter, and voting trustee should be clarified to indicate that this is only intended to cover situations where the relative is directly acting in such roles, and does not include situations where the relative is employed (say as a systems programmer) by a company that provides such services to a client, and the relative is in no way involved with that activity.

Further, "key position" as it relates to officers and employees of a client should be limited to those officers and employees that have the ability to exercise significant influence over the operating, financial, or accounting policies of the client. Employees in lesser positions do not pose sufficient threats to necessitate the proposed restrictions.

6. Under the Proposal's paragraph 5, the immediate family of those on the engagement would not be permitted to have any employment by the client. Under existing rules, employment of an immediate family member is permitted unless the position is either audit sensitive or capable of molding the financial statements. Would it be appropriate to prohibit nonsensitive jobs based upon a premise that if the job is not appropriate for the auditor, then it also should not be appropriate for the spouse? While all those who provide any professional service to the client are defined to be "on the engagement," some would suggest that it would be adequate for this extra prohibition of any employment at the client to be limited to just those who provide audit (attest) services. What are your views and why? (Note that the impact of any conclusion could vary significantly depending on your view as to Question 2A.)

See earlier comments.

7. Paragraph 7 of the Proposal provides guidance on when formal firm consultation might be presumed for family relationship situations. Do you believe this guidance is appropriate, and that the examples are helpful instances of when such consulting should occur? Are there other examples you believe should be included?

Proposed guidance is appropriate.

8. A. Some believe that when certain family relationships exist at a client's subsidiary level, a significant safeguard can be provided by having a different accounting firm audit that subsidiary. This potential safeguard has not been described in the Proposal. Should the Proposal refer to this possible safeguard and, if so, how? For example, should that safeguard just be among those to be considered in the firm's overall evaluation of the family relationship or, in certain fact patterns, should its use be permitted to overcome an otherwise required prohibition? If the use of a separate auditor should overcome an otherwise prohibition, under what criteria should that occur (e.g., only for immaterial subsidiaries, or certain material ones as well)?

If there was a family relationship issue at a subsidiary level and that subsidiary was audited by a different auditor, this should overcome any independence concerns. However, assuming the ISB is responsive to our comments raised earlier with respect to "on the engagement" defined as on the audit engagement or in a position to influence the audit, we would not have a professional "on the engagement" in this situation. Given the relative rarity of such situations, we do not believe it necessary to explicitly address this issue.

- B. Of how much help are the other safeguards, or "mitigating factors," described in paragraph 15 of the ITC? Are there additional safeguards which you believe are important?

There is available a broad range of existing safeguards that may be appropriate given the facts and circumstances of a particular situation. Our firm is a strong believer in a threats and safeguards approach to handling independence issues. In this connection, we believe the ISB should establish broad principles and require firms to implement appropriate policies, procedures, and controls to demonstrate compliance. We do not believe it is necessary or appropriate for the ISB to dictate these items and suggest that paragraph nos. 3 and 4 of the Proposal be revised accordingly. We note that this is consistent with the conclusion of the AICPA SEC Practice Section Independence and Quality Controls Task Force that has been dealing with the question of a membership requirement related to the tracking/monitoring of member investments.

9. Paragraph 16 of the ITC discusses "the effects of death of, or divorce by, a relative," although these events are not currently mentioned in the Proposal. Should the Proposal be expanded to

provide guidance in such situations? If so, what positions should that guidance take? If not, why not?

The Proposal should not be expanded to provide guidance in situations involving death and divorce. The judgment approach described in the ITC is reasonable. Such situations should be reviewed by firm independence or other technical specialists on a facts and circumstances basis. A similar judgment approach should be used in situations where the family relationship is strained and virtually non-existent as documentation of a "non-relationship" and discussion with the audit committee should alleviate concerns of the potential impairment of the firm's independence.

10. Are there other broad family relationship models, or other key criteria and factors for evaluating relationships, which the Board should consider?

Subject to our comments above, we believe the approach discussed in the Invitation to Comment is appropriate.

11. Is there research that the Board should be made aware of or should sponsor to assist it in making informed judgments in these areas? If so, please offer recommendations.

We are not aware of any.

We would be pleased to discuss our comments with the Board or its staff.

Sincerely,

*Ernst & Young LLP*

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October 15, 1999

The Independence Standards Board  
6<sup>th</sup> Floor  
1211 Avenue of the Americas  
New York, NY 10035-8775

Attention ITC 99-1

Gentlemen:

The Committee on Corporate Reporting of the Financial Executives Institute represents the dual perspective of preparers whose financial statements are audited by independent auditors, and executives who use and rely upon audited financial statements. An independent audit is very important to us and to the financial reporting environment.

We consider independence in fact to be of paramount importance in receiving a quality audit. Independence in appearance is less a concern to us, except for the important necessity that the audits we receive must be in full compliance with applicable SEC and auditing profession requirements.

We believe it is appropriate to reexamine and most likely liberalize the family relationship restrictions that are contained in the existing independence requirements. The prevalence of two wage-earner families and the wide variety of family and companion relationships that are present today largely did not exist in the era when most of the independence rules were developed.

We also think the consolidation of the larger audit firms has added an important dimension to this issue, in that it is more and more difficult to avoid circumstances where there will be professional, even senior, persons working in CPA firms who are married or otherwise related to persons in companies being audited by the CPA firm.

In our view, a family or companion relationship should not exist between persons who are direct participants in an audit engagement, and persons who are employed by the company being audited. We think this should be true from the top to the bottom of the chain of command, the top being the individual who signs the audit opinion or gives final approval to the audit findings and audit workpapers.

We think persons who are directly employed in the chain of command of an audit engagement and their next-of-kin family members and companions should not own stock in the company being audited, nor should they be in control of stock of that audited company held in another's name, whether that other party is an individual, a corporate entity, or an investment fund.

Starting from a blank slate, we believe investor needs and other public interest concerns do not warrant extending these types of restrictions beyond the chain of command that is directly involved in planning, conducting and signing off on the audit. For example, we do not think that other persons in a local office of a CPA firm or elsewhere in the larger CPA firm itself, who do not plan, conduct, review or sign off on the audit, should be subject to any family relationship restrictions. We think this should normally be true, even if these other individuals are involved in providing non-audit professional services to the company being audited, but with this caution: so long as the office is not so small, or the particular facts and circumstances so concerning as to create a potential conflict of interest.

The essence of our view is a general principle that any person who is judged to have some type of personal interest in a company should be excluded by the CPA firm from any involvement in planning and conducting the audit of that company. Once the need is satisfied to exclude from the audit any persons who have some family or other personal interest in the audit client, we see no reason to try to specify close and less-close relatives, companion relationships, and/or gather in others who are employed by the same CPA firm, whether in the same engagement office or elsewhere, but are not on the audit team, to be under similar restrictions.

For example, we do not think it should matter what level or type of job a spouse has, but should more directly be a matter of determining that, whenever there are primary or secondary personal or business interests present that could reasonably be ascribed to the member, and could reasonably be considered to constitute a conflict of interest, that member should not be a part of the audit team for that company's engagement.

With the consolidation of CPA firms and the variety of family relationships in the business marketplace, we believe that the focus for ensuring independence should be on the professional individual in charge - the person who decides, executes, or approves an audit - and the team of employees who actually conduct the audit. Another way to describe this is the person who is licensed as a certified public accountant and supervises the engagement and his or her audit engagement staff. This person should be held responsible to ensure that he or she is free from any conflict of interest, and that the audit is conducted in an independent and competent fashion, free of any potential conflict of interest among other members of the audit team.



We have noticed that the quality of audits we receive is most directly a function of the quality of the partner who is in charge of the audit, and this is where we think the emphasis for ensuring independence belongs. Of course, we think it is important and necessary that each CPA firm have internal control processes and strong administrative procedures to support independence in fact in audits, and an internal consulting organization to provide counsel and guidance in questionable cases.

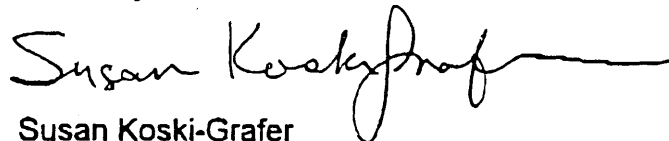
In regard to the numerous specific questions in the Invitation to Comment, our general view would take us to a different set of questions, so we will not attempt to address each item. It would follow, however, that in smaller modifications of present practice, we would look mostly to "service lines" rather than an entire local office, and to individuals who are involved directly in an audit, rather than to other partners or managerial or other staff working elsewhere in the local office or in the larger firm.

We also would not find it meaningful to attempt to make fine-grained distinctions and subsets of rules between one type of blood relative and another, and different in-law relatives, much less unmarried close companions. We would focus instead on requirements, strong admonitions, strong controls, and stringent penalties to ensure the fact of independence in an audit, requirements for processes that identify and remove individuals who may have conflicts of interests from the direct audit team.

Having penalties for an audit that is not independent in fact, penalties under law and in the marketplace, can provide the sanctions and motivation to ensure independence without the need for constant regulatory and professional rulings on narrow issues and a detailed compendium of rules.

We are pleased to provide our comments and would be willing to answer questions and participate in further discussions as needed.

Sincerely,



Susan Koski-Grafer  
Vice President – Technical Activities  
Financial Executives Institute



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September 27, 1999

Ms. Sheila M. Birch, CPA  
Ciuni & Panichi, Inc.  
25201 Chagrin Blvd. #200  
Beachwood, OH 44122-5633

Dear Sheila:

Thank you for the opportunity to participate in NASBA's process of responding to the Independence Standards Board (ISB) invitation to comment. There are, as always, difficulties with simple rules to complex transactions or situations in this document.

Some of our clients are very large and have many, many employees. For example, I am by definition, a member of the engagement team of a retail store chain with over 800 locations. This rule would prohibit my college student child from accepting a job as a part-time cashier at one of their stores, or the wife of any partner in our office from working in their advertising department. It seems to me that this is a bit extreme. Carved to an extreme, based on this rule, when I was in our National Office, I would have been on the U.S. Postal Service engagement and my dependent child could not have been a letter carrier. It is hard to rationalize any of these as situations that endanger independence of the firm conducting an audit.

I find the requirement to disclose "relevant family relationships" with the audit committee to be overly simplistic without further guidance. If, for example, we conclude that Ms. Smith, a junior accountant, cannot work on the audit of the XYZ Company because her mother is a secretary in the office of the client, do we need to disclose this decision to, and discuss this matter with, the Audit Committee? I hope not. Had we not removed Ms. Smith from the engagement team, that decision would be relevant to the Audit Committee. As the general propositions in ISB Standard No. 1 begin to mesh with specific standards such as these, it will be important for the ISB to try to provide additional discussion as to what is "relevant."

My comments should not lead you to believe that I believe the ISB's attention to this questions is ill-advised or incorrect. I am pleased that the ISB recognizes that there are differences based on family relationships and that some situations can be dealt with by mitigating controls. I have not seen NASBA's responses to other documents submitted to me for comment. I would appreciate learning how NASBA ultimately responds to this ISB proposal.

Ms. Sheila M. Birch, CPA

September 27, 1999  
Page Two

Thank you again for including me among the potential commentators on this proposal. Please feel free to contact me at (617) 859-6465 or by e-mail at robert.temkin@ey.com if you would like to discuss any of this further.

Very truly yours,



Robert H. Temkin  
Partner

RHT:jj

**FAX**

INSTITUT  
DER  
WIRTSCHAFTSPRÜFER


**IDW**

26


Datum 29.10.1999  
Date



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Ref.: Family relationships between the auditor and the client;  
invitation to comment (ITC 99-1)

Mit freundlichen Grüßen

*i.A. Steinmetz*

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INSTITUT  
DER  
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**IDW**

Independence Standards Board  
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New York

Düsseldorf, den 29.10.99  
333/408/335

Dear Sir or Madam,

**Ref.: Family relationships between the auditor and the client; invitation to comment (ITC 99-1)**

In its common core of principles on statutory audit independence and objectivity dated July 1998, to which the IDW contributed significantly, our European organisation FEE has developed the following requirements concerning personal or business relationships:

„Where a close relative is involved in senior management of the client company or is in a position to exercise direct influence on the preparation of the accounts or has a material financial interest, the threats of real or perceived lack of objectivity are in practice too high and too numerous to be over-ridden by possible safeguards. An individual statutory auditor should therefore not personally accept or continue an appointment in such a situation“.

In the light of these reflections we would like to take the opportunity to respond to the questions for which comments are requested.

### Add 1

We believe that the changes mentioned in question 1 are warranted. For judging auditor independence from the perspective of Informed third parties (independence in appearance) we take the view that restrictions have to be applied to those working "on an engagement" requiring independence.

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#### Bankverbindung:

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**Add 2:**

A. The IDW is of the opinion when defining those likely to influence the audit - that the definition provided by alternative B is more appropriate because it extends the scope of application to partners and managerial employees in an office who perform a significant portion of the audit work.

B. The answer depends on the structure of the audit firm. If all offices of a firm's branch in a large city are managed separately and act with separate staff, the definition of an office could be restricted to relatively small entities. If this is not the case it should include all offices belonging to the audit firm's branch.

**Add 3**

The proposal considers the independence implications of family employment relationships in all its ramifications. In our view the independence aspects of the explicit financial interests that may come with a relative's employment merit being deepened in the same way. This could be done separately without having a negative effect on the current Proposal.

**Add 4**

The definition of „close relative“ seems to be comprehensive enough.

**Add 5**

The IDW considers the definition of the term „Key position“ to be appropriate.

**Add 6**

We support the view taken in the Proposal's paragraph 5 that the immediate family of those on the engagement should not be permitted to have any employment by the client. From the perspective of independence in appearance the employment of an immediate family member can't depend on the question whether the position is either audit sensitive or capable of molding the financial statements.

**Add 7**

The guidance and the examples provided in Paragraph 7 of the Proposal seem to be appropriate.

**Add 8**

A. The potential safeguard mentioned in question 8 should be included in the Proposal. The use of a separate auditor should be accepted to overcome an otherwise prohibition irrespective of the size or the significance of the subsidiary for the entire group.

B. We consider the other safeguards described in Paragraph 15 of the ITC to be helpful. It should be noted that – generally speaking – from the view of third parties all safeguards are useful which contribute to transparency.

**Add 9**

The IDW takes the view that the Proposal should be expanded to provide guidance in the case of death and divorce. Given the fact that a general statement is very difficult we are of the opinion that death and divorce may reduce the existing family relationship but that these cases should not be treated in a different way.

**Add 10**

Other broad family relationship models or other key criteria and factors for evaluating relationships are not evident.

**Add 11**

Such kind of research does not seem to be available.

We would be pleased to discuss any aspect of this letter which you would like to raise with us.

Yours sincerely



Horst Karwinski

Executive Director



Independence  
Standards  
Board

TO:

Pat

DATE:

FROM:

Susan Lange

PHONE:

(212) 596-6134

Please include w/  
Comments from SMPF/  
Employment w/clients,  
Thank



October 18, 1999

Independence Standards Board  
1211 Avenue of the Americas, 6<sup>th</sup> Floor  
New York, New York 10036-8775

RE: Paragraph to be added to ED on Employment with Audit Clients

Gentlemen:

The AICPA's SEC Practice Section Peer Review Committee and Peer Review Board are pleased to submit this comment letter to the Independence Standards Board with regard to the paragraph noted below to be added to the Exposure Draft on Employment with Audit Clients.

*Firms that are members of an established peer review program, such as that offered by the AICPA's SEC Practice Section, should ensure that the scope of the peer review performed includes an evaluation of the firm's compliance with the provisions of this Standard. This would also require an assessment of the effectiveness with what safeguards were implemented by reviewing all or, if agreed to by an independent party overseeing the peer review program (such as the P.O.B.), a sample of the audit engagement subject to this Standard. Firms whose audit practices are not subject to at least tri-annual peer review must, at least every three years, engage another practitioner to assess compliance with these requirements and issue a report on the results of that assessment.*

While we believe that it would be appropriate for peer review to include testing of those elements of a firm's quality control system relating to insuring compliance with this proposed standard, however, we do not believe that peer review procedures for testing compliance should be dictated by standard setters or regulators. As you know, the existing peer review requirements include a number of specified tests to address the concerns of various regulators and we would be glad to consider amending our requirements to include required testing for this new standard. In that regard, we believe that the entire paragraph, except for the last sentence, should not be included in the exposure draft.

In order to change our membership requirements, we would need some clarification and guidance on how the requirement is going to be implemented by a firm. An example of an item needing clarification would be when a partner leaves a firm to go to work for a nonclient and a month later leaves that nonclient to go to work for a client. Would this type of situation come within the scope of the proposed standard? Also, what kind of tracking system would the ISB expect to be implemented at firms?

We appreciate this opportunity to comment. We would be pleased to discuss in further detail these comments and any other matters with respect to the paragraph to be added to the Exposure Draft on Employment with Audit Clients.

Sincerely,

W. Ronald Walton  
Chair  
SECPS Peer Review Committee

Walter H. Webb  
Chair  
AICPA Peer Review Board

American Institute of Certified Public Accountants

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