Comment letters Re: Statements of Independence Concepts

Indendence Standards Board

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WITH OFFICES IN CHICAGO, NEW YORK CITY, AND LIVINGSTON, NEW JERSEY

December 12, 2000

Independence Standards Board
1211 Avenue of the Americas, 6th Flr.
New York, NY 10036-8775
Attn: ED 00-02

Re: Statements of Independence Concepts

Gentlemen:

I wish to commend you for the excellent job you and your staff have done in formulating a conceptual framework for audit independence standards. Quite frankly, I would not change a single word (a recommendation I only infrequently make - see my comments dated July 16, 2000 on the SEC's independence proposal, a copy of which is attached hereto). Not only is this document a logical and clear statement of the factors which must be considered in formulating independence standards, it is sufficiently flexible to enable the Board to address the issue of the client's economic importance to the audit firm and audit team, an issue which has too long been ignored by the profession the professional literature. I, therefore, encourage you to adopt this statement even though it is not in accord with the current thinking of the Securities and Exchange Commission (the "SEC") as more fully discussed below.

The major problem with your Exposure Draft is that it is not wholly consistent with the SEC's newly adopted independence standards. Indeed, one of the reasons why I urged the SEC not to adopt its proposed independence rule was that it would impair the Board's ability to adopt a conceptual framework. Now, rather than designing the ideal structure for formulating independence standards, you are forced to design a structure that must accommodate the principles embodied in the SEC's new rule. This is truly unfortunate and I remain puzzled why the public members of the Board encouraged the SEC to proceed with the adoption of its proposal.

To be sure, there is much in the SEC's new rule which is consistent with the Board's proposed Statement of Independence Concepts. For example,

- The SEC has recognized that the primary goal of independence standards is to maximize the reliability of financial data and that independence standards are only a means to that end;

- The SEC has recognized that audit independence can never be perfect and that a certain degree of impairment can be tolerated; and

- The SEC has adhered to the principle of "independence in appearance" and has opted for a "reasonable man" standard to apply that principle.

On the other hand, there are three fundamental differences between the approach taken by the Board and the approach taken by the SEC, and those differences are discussed below.

Use of Safeguards

Fundamental to the Board's proposed conceptual framework is the concept of safeguards; i.e., that certain impairments of independence may be sufficiently mitigated by establishing safeguards that are likely to assure objectivity and integrity notwithstanding factors which either impair or are perceived to impair audit independence. The SEC's proposal does not evidence this concept and the Staff of the SEC has categorically rejected the safeguard approach. Although the SEC rule does provide for the mitigation of sanctions for certain violations of its independence rules if certain safeguards are in place, that provision is simply designed to encourage the use of safeguards without eliminating the violation. From a legal prospective, both the client and its auditors could be subject to civil liability claims as a result of the infraction. I consider to be an unfortunate choice on the part of the SEC.

The Disclosure Concept

The SEC, in dealing with the gray areas of independence impairments, has chosen to employ a disclosure concept. Thus, the SEC has mandated the disclosure of certain relationships which it believes might be perceived as impairing audit independence. Thus, the SEC considers such matters simply to be a "cost of capital" issue or a "business question" and not a "legal question." By requiring public companies to disclose the extent of the non-audit services being provided to it by its outside auditors, investors and creditors would be able to decide whether reliance upon the auditors' report entails added risk and their perception of that added risk will be reflected in an increase in the company's cost of capital. In this way, the company's board or audit committee will have to decide whether it is more beneficial for the company to employ its outside auditors to perform non-audit services or to refrain from doing so and possibly enjoy a lower cost of capital.

While this concept appears logical on its face and has the advantage of decentralizing the decision-making process, it is flawed in practice. As I pointed out in my letter to the SEC, disclosure of non-audit services does not really provide the reader with useful information. At best, this is secondary information as it provides the reader with no further understanding of the operations, assets or prospects of the subject company. It only addresses the reliability of the expertised financial information. Secondly, it does not provide the reader with sufficient information to make an informed judgment regarding the reliability of the financial information as it does not convey the extent of the audit testing performed by the auditors or the safeguards that are in place to assure objectivity and integrity. Equally important, it tells the reader little about the importance of the client to the audit firm and the audit team. Lastly, by providing this information, the reader is caused to doubt the entire regulatory scheme. Thus, if the reader believes that the performance of non-audit services will likely impair the auditors' objectivity and integrity, he will begin to wonder what the independence rules actually accomplish, if anything. Thus, the reader might not only regard the subject company's financial statements to be less than reliable, but also that all audited financial statements are suspect. In this sense, the disclosure concept will deter the public's willingness to rely upon audited financial information, not enhance that willingness. In short, it will be counterproductive to the whole purpose of having independence standards.

For these reasons, I have come to reject the disclosure approach and believe that the Board's safeguard approach is the best way to address the gray areas of audit independence.

The Carve-Out Concept

In the rule adopted by the SEC, there is an exemption from the limitation on internal audit services for companies with less than $200 million in total assets. This is clearly a compromise with respect to companies that are not likely to be able to afford their own internal audit functions. The Board's proposed conceptual framework does not appear to embrace such an exclusion, notwithstanding its flexible approach. On the other hand, to the extent that small public companies are less likely to be able to influence the objectivity of outside auditors than large public companies, this approach may not be inconsistent with the Board's approach. The problem, however, is that if a small public company is audited by a small CPA firm, the risk to audit independence may actually be greater. In short, it is not the size of the client, but rather the size of the client in relationship to the size of the audit firm that threatens audit independence.

The Board's Dilemma

In the final analysis, the Board must decide whether it wishes to adopt a conceptual framework which it believes is in the best interest of the public and the profession or whether it will modify its proposal to make it compatible with the rules adopted by the SEC. There can be no question that the SEC has the final word on such matters as the Board exists only at the pleasure of the SEC which is free to ignore any and all determinations which the Board might make. Nevertheless, I strongly urge the Board to stand by its convictions on this issue and not acquiesce to the SEC's position even if this may precipitate the Board's demise. I so urge the Board for two reasons:

(1) By altering its approach to audit independence, the Board will not be able to effectively address the issue of the client's economic importance which is the principal (if not the only remaining significant) independence issue; and

(2) The SEC's rule was not primarily aimed at audit independence, but rather was aimed at increasing the relative importance of the audit practices of the Big Five firms so as to make them effectively subject to regulation. Thus, the SEC's rule should not be considered of precedential value to the Board's determination.

The SEC's rule addressed the issues of when consulting and legal services, among others, impair audit independence. If also addressed the financial interests in clients and entities within a mutual fund complex and client employment issues. At best, these areas are now only subject to minor interpretation and hardly justify the Board's further existence. Indeed, considering the four "guiding principles" which the SEC has adopted, any such interpretation is likely to be a thankless task as these principles provide no useful guidance. Thus, if there is any reason to continue the Board's existence, it is to develop a standard for addressing the client's economic importance to the audit firm and audit team.

From my perspective, this cannot be achieved without some means of assuring audit objectivity and integrity when it passes beyond the limits of the reasonable man standard. In such cases, one would have to conclude that certain companies which are dominant in a given geographic area simply cannot receive an independent audit. For example, is there an audit team or audit office with such a broad spectrum of work that it could remain viable without the continued audit business of a Walmart, Caterpillar, Dupont, Kodak or Microsoft. Each of these companies is the dominant economic force in their community, and the loss of their audit business would be the death knell of the audit office servicing the account. Thus, the only way to maintain the objectivity of the audits of these companies is to have the audit determinations reviewed and approved by persons working in other offices whose compensation and continued employment by their firm would not be adversely affected by the loss of the client. Even if a disclosure concept works (which I do not believe is the case for the reasons discussed above), it would not be sufficient to offset this factor as no reasonable investor should give any more credence to an audit report rendered by an auditor whose continued livelihood depends upon the preservation of the client relationship than a set of financial statements published by the client alone. In such cases, knowledge only makes the user better aware of the problem, but does not serve to limit the risks faced by the user. It is for this reason that I believe that if the Board is to serve any further useful purpose it must adhere to the safeguard approach.

Secondly, I have concluded that the SEC proposed its new rule, not in an effort to establish clear and viable independence standards (as the Board was well on its way to achieving that goal), but rather to address a problem which the Board is not empowered to address; namely, the fact that the Big Five accounting firms are deriving a diminishing percentage of their revenues and profits from their audit practices. Thus, the day is not far off when such firms might simply decide to abandon their audit practices in view of their high potential for liability claims and their relatively low level of profitability. The decision of Andersen Consulting to sever its ties with Arthur Andersen underscores this possibility. Thus, I believe that the SEC was seeking to cause the Big Five firms to limit their consulting practices so that their audit practices would remain at the core of their operations. In this way, the SEC would avoid the nightmare of the Big Five firms' simply informing the SEC that they no longer wished to engage in a public company audit practice.

While this may sound implausible, it does explain many of the stranger aspects of the SEC's recent actions; to wit:

- It explains why the SEC chose to promulgate an independence standard which did not address the all-important economic importance issue:

- It explains why the SEC has devoted so much emotional and political capital to this issue even thought there was neither a public outcry for this action, one or more notorious cases of non-audit services leading to audit failures, nor statistical evidence supporting this conclusion;

- It explains a number of anomalies in the SEC's proposal such as why the SEC sought to prohibit legal advice but not tax advice;

- It explains why the SEC has pushed for independence investigations within the Big Five firms, but has taken no enforcement action with respect to even the serious violations that have been uncovered;
- It explains why the SEC has chosen to prohibit contingent fees and commissions but not regulate total fees;
- It explains why the SEC was willing to jeopardize the continued existence of the ISB when the ISB represents the best hope of addressing the economic importance issue;
- It explains why the SEC was so vehement in contending that its proposal does not affect non-Big Five firms when its proposal made no such distinction;
- It explains why the SEC chose to negotiate the final provisions of the rule with the Big Five firms rather than simply base its rule on the public submissions as is customary in agency rulemaking;
- It explains the very personal attacks by the SEC on the AICPA and its leadership and the SEC's efforts to divide them from the AICPA members who practice in small firms; and
- It also explains why the SEC was simultaneously lobbying for enhanced public participation in the POB and the AICPA's disciplinary processes.

Robert Elliott, the former Chairman of the AICPA, perhaps first identified this possibility when he characterized the SEC's independence proposal as a "solution in search of a problem." To be sure, the SEC perceived there to be a problem; however, it was one which the Congress had not empowered the SEC to address. For this reason, the SEC chose to address it with the only power it had -- its authority to define audit independence. Thus, the Board should not interpret the SEC's rule as one designed to assure audit independence, but rather one intended to prevent regulatory independence.

Conclusion

Again, I wish to commend the Board for its superb Statement of Independence Concepts and to encourage the Board to adopt it and to press forward with a statement addressing the overall economic importance of the audit client.

Very truly yours,

Dan L. Goldwasser

/mbb

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INDEPENDENCE STANDARDS BOARD
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

20 December 2000

RE: Exposure Draft: Statement of Independence Concepts.
Immediate Response.

Dear Board:

This is my immediate response to your Exposure Draft Statement of Independence Concepts. My remarks below address the definition of Independence.

Your standard needed a definition of Independence, and now you have one. Good. The definition includes an objective, reasonable person clause: "or can reasonably be expected to compromise." This is good.

The definition, however, still has a lot of deficiencies:

1. Generally, the ED definition is more imprecise than it could or ought to be. The words "pressure," "other factors," "compromise," and "ability" are too fuzzy. I am especially concerned that an essential element of the definition relies on the auditor's "ability" to make unbiased decisions. Arguments over what are persons' "abilities" will go on for ever.

2. The concept of risk ought be overtly in the definition because it is so essential to the meaning of auditor independence. Just look at how often the word "risk" appears in the ED. Put it in the definition if it is that important, which it is.

3. "Unbiased" is a modern day term: Instead use the term "impartial" because that was the term used during 1932-1934 lawmaking hearings which caused the independence requirement to be inserted into the bills eventually becoming the U.S. securities laws. I believe it is beneficial to liken the required impartiality of an auditor (accountant-examiner) to that of a judge. Using the word impartial or impartiality makes this connection better. I prefer an impartial judge to an unbiased judge. "Impartial" is a stronger term than "unbiased." We need judges and auditors who are impartial, not just "unbiased."

4. As I have stated before, I find it regrettable that the

ED makes no reference whatsoever to the state of affairs which gave birth to the U.S. securities laws and to the insertion of the independence provisions into those laws. These sources of the independence requirement cannot be legitimately ignored by any person or body charged with the duty of producing an authoritative definition of independence warranting any public support. One gets the impression that the Board so dislikes the legal system and the professionals who participate directly in it that the Board has purposefully chosen to ignore that system in producing an independence definition notwithstanding that that system is the mother of the modern day audit profession. This attitude toward the law is the profession's roadblock to meaningful progress, even when the job of making progress is handed to it on a silver platter as is the case of the SEC handing the job to the Board in this case. I have previously informed the task force and the Board where it might begin its acquisition of this knowledge; see Committe citation below.

5. The following definition of independence is a much better definition:

> Free from relationships that a reasonable person would expect to increase the risk of the accountant examiner losing judgment-making impartiality.

Committe, Bruce Edward, "Independence of Accountants and Legislative Intent," 41 Administrative Law Review 33, 53 (1989).

Sincerely,

Bruce Committe

Bruce Committe, CPA

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INDEPENDENCE STANDARDS BOARD
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

23 December 2000

RE: Exposure Draft: Statement of Independence Concepts. Extended Response.

Dear Board:

In a letter dated 20 December 2000 I sent my immediate response to the Exposure Draft on Statement of Independence Concepts: A Conceptual Framework for Auditor Independence (ED). Now I provide an extended response in the format of answering the five questions which appear on pages iii thru iv of the ED under the same headings I use below.

DEFINITION OF AUDITOR INDEPENDENCE

As I previously stated on 20 December 2000, the proposed ED definition of independence uses words and terms that are too fuzzy, indirect, and indefinite in their meaning ("other factors," "compromise," "unbiased," and "auditor's ability." Too, the definition appears to come out of thin air rather than from logical and orderly development of ideas using authoritative sources which would be, and are, the transcripts reporting 1932-1934 hearings leading to insertion of the accountant-examiner independence requirement into Congressional bills that eventually became The Securities Act of 1933 and The Securities Exchange Act of 1934. The failure of the ED even to make reference (much less make use of its content) to the one and only research report of Congress' 1932-1934 consideration of the accountant-examiner independence requirement is inexcusable and likely is best explained by the fact that too many Board members have a large indirect, but certain, financial interest in the outcome of its work, that is, in whether CPA firms can continue lucrative but conflicting consulting work along side their independent audit work otherwise pursuant to the requirements of the federal securities laws. See research report: Committe, Bruce Edward, "Independence of Accountants and Legislative Intent," 41 Administrative Law Review 33, 53 (1989).

The term "risk" should appear directly in the definition.

The following definition is based on the hearing transcripts referenced above, and the Board should adopt it instead of the one now proposed:

> Free from relationships that a reasonable person would expect to increase the risk of the accountant examiner losing judgment-making impartiality.

GOALS OF AUDITOR INDEPENDENCE

The goal is not to report reliance on any "process." Too, those who make, and others who do not make but are nevertheless interested in, wealth distribution decisions have more on their mind than just "market efficiency." The goal of auditor independence is to produce information that is trustworthy as to its content and useful to the public in making wealth allocation decisions, including, but not limited to, wealth allocation decisions made within the environment of what is now conceptually well known as the traditional and developing capital markets.

CONCEPTS AND BASIC PRINCIPLES OF AUDITOR INDEPENDENCE

The ED proposes four basic concepts of auditor independence: threats, safeguards, independent risk, and significance of threats/effectiveness of safeguards. These should be replaced with the following single concept: The auditor must eliminate and avoid risks to his or her independence by avoiding all relationships that a reasonable person would expect to increase the risk of the accountant examiner losing judgment making impartiality. Note how this basic concept and principal tracks the above quoted definition of independence. Whenever concerns of independence arise, determining the appropriate action to take requires merely asking and answering the question whether such stated risk is present given any set of facts. Simple is better.

RISK MODEL

Forget the model stuff. The risk model appears to be a back door way of inserting the concept of materiality into the proposed independence rule. The reasonable person concept in both the ED definition and my above proposed definition take care of any materiality factor relevant to a rule on independence. That is, the reasonable person idea subsumes the idea of materiality. Note that my above proposed definition of independence has the word "risk" built in; that is, there is no need for a side bar discussion of "threats," "safeguards," "cost-benefits," etc. Such matters are common sense, and do not deserve special mentioning. By mentioning them and not other relevant concepts they take on more importance than they should. Such side bar discussions merely detract from the definition.

Keep it simple. Human concepts like "independence" are best not reduced to models as humanity is too complex for such simplifications that might work well outside the social sciences. Models are useful devices for academic thought development within the social sciences, but they can are not useful in societal rulemaking the purpose of which is to describe behavior the violation of which is to be the basis for public sanctions.

OTHER ISSUES

If the Board still expects to produce its independence conceptual framework without any significant attention given to the independence idea developed and contained in 1932-1934 hearings eventually leading to insertion of the independence requirement into the statute, at the very least the Board ought to explain, in its proposed independence conceptual framework, why it has chosen to ignore such lawmaking authority.

To determine whether the definition of audit independence proposed in this letter is better than the one proposed in the ED I ask that the Board perform the following test: As a group, read both definitions aloud, one after the other, and let each Board member immediately after the reading aloud choose for himself or herself which one sounds better (seems more logical). Each writes his or her choice on paper. Then, let each Board Member reveal his or her choice and state the reasons why the one each selected sounds better (seems more logical). Those reasons can form the basis for fleshing out the conceptual framework beyond the mere defintion. If those participating in the test drop whatever agendas they bring to the table from those who sent them there, I believe the proposed definition that I have offered will be selected by most, if not all, members of the group.

The reason that my proposed defintion will seem more logical is because its source is collective experience (revealed in 1932-1934 Congressional hearings which focused on the problem that Congress planned, in part, for the independence requirement to solve), and experience, especially in the social sciences, is a very powerful (though not full proof) learning tool and guide post as to what makes sense (is more logical). Too, the definition that I propose is a simple collection of a lot of experience, and such simplifictions, or reductions, are usually more appreciated because of their immediately recognizable better utility.

CONCLUSION

The ED has ignored the circumstances, events, and therefore the purposes which have given rise to the legal requirement that accountant examiners be independent in performing audit services required by the U.S. and other securities laws. The ED appears to be a hodge podge of ideas very much influenced by those who have a desire to retain the current conflicts of interest which exist when public accounting firms provide both audit and non-audit services sometimes to the very same business entity; what other explanation could there be for ignoring the prelude to the legal audit independence requirement?

For all the reasons stated above, the ED should consist of the entire contents of Committe, Bruce Edward, "Independence of Accountants and Legislative Intent," 41 Administrative Law Review 33, 53 (1989) wherein the last sentence reports the definition of audit independence quoted above at the top of page 2 of this extended response letter.

Sincerely,

Bruce Committe

Bruce Committe, CPA

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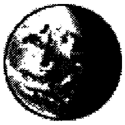

wallmans@foliofn.com (Steven Wallman)
12/25/00 05:44 PM
Please respond to wallmans

To: "Arthur Siegel (E-mail)" <ASiegel@cpaindependence.org>
cc:
Subject: Conceptual Framework ED

Arthur - Happy Holidays.

I read the November 2000 ED on independence and thought it was a great step forward. Congratulations on making progress. I hope 2001 is a good year for you.

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December 26, 2000

Dear Art:

This letter responds to you request of December 14, 2000 for comments on the Board's exposure draft of a "Conceptual Framework for Auditor Independence".

My major comment on the exposure draft relates to the impact of the SEC's recent revision of the Commission's Auditor Independence Requirements upon this project and the broader issue of the future role of the Board. It would appear that the SEC's rule amendments regarding auditor independence have preempted not only the proposed conceptual framework but most of the future work of the Board.

The definition of auditor independence in the draft would appear to be preempted by the Preliminary Note to Rule 2-01 and by Rule 2.01(b). Not only does the Commission set forth a general standard for auditor independence in Rule 2.01 but it also sets forth factors in the Preliminary Note that it will consider in determining whether a relationship or the provision of a service compromises independence. Moreover, the Preliminary Note in the Commission's rule further preempts the Board's work by going on to say that registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in Rule 2-01. The Commission makes no reference in Rule 2.01 to the future role of the Board - a Board which the Commission itself created.

If this action by the Commission were not enough to undermine the Board's work, the Chief Accountant, in his December 6, 2000 speech at the 28th Annual National Conference on Current SEC Developments, appears to reject the Board's entire conceptual framework because it does not incorporate the four basic principles in the Commission's Preliminary Note and the appearance concept in Rule 2.01.

As you know, the Commission over the past year has urged the profession to strengthen its self-regulation and it has praised the efforts of the Public Oversight Board to act as overseer of the various professional bodies, including the ISB, devoted to improving the quality of audits of publicly held companies. The majority of our Panel on Audit Effectiveness adopted this approach in its report by asking the SEC to exercise restraint in its rule making authority by delegating to the Board the determination of any services that audit firms may not provide to their clients. We also recommended that the Board identify factors to be considered by auditors, audit committees and client management in determining whether a specific non-audit service is appropriate.

It is unfortunate that the Commission rejected this approach but instead came forward with its own rule which in the end echoed the Panel's recommendations and followed the directions in which your Board appeared to be heading. In my view, this Commission, by choosing to regulate directly, has seriously weakened your efforts and the future efforts of the POB to act as a strong self-regulator for the profession.

I have not provided detailed comments on the conceptual framework, Art, because I think it is vital that the Board, working with the POB, first determine its future role and its relationship with the Commission. In my view, that relationship must be based on the principle that the auditing profession should regulate itself through a strengthened POB, as well as ISB, as recommended by the Panel on Audit Effectiveness. I think experience over the next several years will demonstrate the wisdom of that recommendation.

Sincerely,

Ken

cc: William T. Allen, Chairman
Independence Standards Board

Charles A. Bowsher, Chairman
Public Oversight Board

Shaun F. O'Malley, Chairman
Panel on Audit Effectiveness

Mr. Arthur Siegel
Executive Director
Independence Standards Board
1211 Avenue of the Americas
New York, NY 10036-8775

5

Tom Horton
<thorton@stetson.edu>

12/29/00 10:36 AM

To: isb@cpaindependence.org
cc:
Subject: Exposure Draft: Statement of Independence Concepts

Attention: Arthur Siegel, Executive Director

Dear Mr. Siegel:

This conceptual framework, in my opinion, strikes just the right balance. I have no suggestions for change.

Congratulations on the achievement of a difficult task.

Sincerely,

Thomas R. Horton
(Audit Committee Member)

University of Wisconsin-Madison

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January 20, 2001

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

Dear Board Members:

Please find enclosed a copy of a paper that we are submitting as part of the comment process for the Statement of Independence Concepts: A Conceptual Framework for Auditor Independence (ED 00-2).

The paper, "Antecedents and Consequences of Independence Risk: Framework for Analysis," presents a framework that examines how incentives that may increase independence risk interact with environmental and other factors to affect actual or perceived audit quality. We explore the combined effects of direct incentives (e.g., direct investments, potential employment), indirect incentives (e.g., interpersonal relationships), and judgment-based decisions (e.g., difficult accounting issues, materiality decisions, audit conduct decisions) on independence risk. We also explore factors that may mitigate independence risk, such as corporate governance, regulatory oversight, auditing firm policy and culture, and individual auditor characteristics. Where relevant, we discuss findings from academic research as they relate to the elements of our framework and provide an analysis of the effects of independence risk on various stakeholders. We conclude the paper with suggestions for future actions by the auditing profession, auditing firms, regulators, and academic researchers.

While the primary goal of the framework in our article is to provide direction for future academic research, we believe that it also may be useful to the Independence Standards Board for analyzing the issues identified during the Board's consideration of the Conceptual Framework Exposure Draft. Our comments, detailed specifically below, address your request for input with particular emphasis on your Question Four.

Question Four: "What are your views on the appropriateness of the independence risk model? Is there research that the Board should be made aware of that would be helpful in expanding the model or otherwise making it more useful for independence decision makers?"

We believe that you have developed a potentially useful independence risk framework and one that shares a number of similarities to the one presented in our article. For example, the threats and safeguards articulated in the Conceptual Framework correspond to our analysis of environmental conditions and mitigating factors relating to independence risk (see p. 25 in the enclosed paper).

However, while there is overlap between our frameworks, ours differs from yours in the following respects. First, our framework is more comprehensive in its discussion of factors that contribute to possible threats to auditor independence (paragraph 11 in the Conceptual Framework). For example, as discussed above, our framework includes a discussion of various judgment-based decisions that allow independence risk to affect audit quality (e.g., pressure on difficult accounting issues, pressure on materiality judgments, and pressure on audit scope and conduct). We believe that without a judgment-based decision, no mechanism other than compromised integrity enables the threats to auditor independence to result in reduced audit quality (see pp. 6 - 8 and p. 25 in the enclosed paper). We encourage the Board to consider adding this type of discussion to the Conceptual Framework to better communicate to all independence constituencies (auditors and non-auditors) the contexts in which threats to independence arise.

We believe that the Board's discussion of the safeguards to auditor independence is relatively complete and is consistent with our analysis of mitigating factors. We prefer the method whereby you categorize the safeguards according to where they reside (paragraph 14a of the Conceptual Framework) because it is from the perspective of these various independence constituencies that actions could be taken to respond to independence risk. We view the two perspectives outlined in paragraphs 15 and 16 as secondary in describing the nature of these actions and we believe that these should not be presented as alternatives to the discussion in paragraph 14.

We are particularly interested in the idea of audit firm culture with respect to important safeguards, and our paper proposes an audit firm culture continuum that you may wish to consider as you further develop the Conceptual Framework (see p. 12 - 15 and p. 26 in the enclosed paper). We believe that explicit and implicit auditing firm messages regarding appropriate conduct within the firm likely have a significant impact on independence risk. We propose an auditing firm culture continuum anchored by a "public duty culture" on one end (lowest independence risk) and a "client advocacy culture" on the other end (highest independence risk). This type of characterization may be helpful to the Board in clarifying "advocacy threats" (paragraph 12c of the Conceptual Framework).

Other Comments

In paragraph 23 of the Conceptual Framework, a continuum of independence risk is introduced as a way to characterize levels of independence risk that might trigger action by independence decision makers. While the continuum is useful for illustrating the range of independence risk, the discussion in paragraphs 24-26 may imply a higher level of precision in implementation than the Board intends. For example, based on the discussion in paragraph 25, it is unclear whether action will be triggered by independence decision-makers when independence risk is judged as at or below the remote level. Given that the Board introduces the continuum and notes specific points along it, explicit discussion of "trigger" points seems appropriate. Alternatively, it may be preferable to introduce the continuum by describing only its endpoints, avoiding concerns over unnecessary specificity. Another concern regarding the wording in the continuum is that the terms "remote" and "probable" are not unambiguously defined. We caution the Board that this type of wording may lead to implementation difficulties in the future.

With respect to the discussion of costs and benefits within the Conceptual Framework, one cost that is not discussed, but that is in our framework (see the section "How are stakeholders affected by independence risk?", p. 16), is the cost that other auditors, the broader profession, and capital markets may bear when an individual auditor assumes a level of independence risk that leads to a decline in audit quality. This can be viewed as one of the "second order" effects in that it represents an externality that arises when an individual auditor does not fully internalize the costs of his or her actions on the profession as a whole and on the efficient allocation of capital. The Board might consider adding such a discussion, because such externalities provide an important motivation for regulation and enforcement -- i.e., independence rules. As recognized in the Conceptual Framework, it is difficult to measure the costs and benefits of public goods such as financial statements and audit opinions. The Board may wish to refer to a similar discussion in this regard by accounting standard setters (see FASB Concepts Statement No. 2, paragraphs 133 - 140).

In addition to the above comments, you may find our summary of prior auditor independence-relevant research helpful (see footnotes 2, 3, 4, 5, 6, 7, 8, 9, 11, 12, and 13 in the enclosed paper).

Please feel free to contact any of us if you have questions about our paper.

Sincerely,

Karla Johnstone

Karla Johnstone
Assistant Professor
kjohnstone@bus.wisc.edu

Terry Warfield

Terry Warfield
Associate Professor
twarfield@bus.wisc.edu

Enclosure
Cc: Michael H. Sutton

ANTECEDENTS AND CONSEQUENCES OF INDEPENDENCE RISK: FRAMEWORK FOR ANALYSIS

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November 2000

Forthcoming, *Accounting Horizons*, March 2001

Acknowledgements: We thank practitioners and faculty who attended the 1999 Auditor Independence Conference at the University of Wisconsin - Madison, research workshop participants at the University of Wisconsin - Madison, participants at the 2000 University of Wisconsin - Madison Ph.D. Alumni Conference, and participants at the Boston Area Research Colloquium. We especially appreciate the comments of Jean C. Bedard, Karen Braun, Brian Mayhew, Larry Rittenberg, and two anonymous reviewers. The research assistance of Marie Nelson is also gratefully acknowledged.

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Thomas J Reilly Jr
Suite 2600
1601 Market Street
Philadelphia PA 19103-2499

Mr. Arthur Siegel
Executive Director
Independence Standards Board
1211 Avenue of the Americas
New York, New York 10036-8775

Re: ED 00-2

January 24, 2001

Dear Mr. Siegel:

The ED of the ISB's conceptual framework is well thought-out and comprehensive. After reading the ED I have only one comment/suggestion. This deals with the emphasis or relative importance of safeguards listed in paragraph 14.

My suggestions are based on 31 years experience with a Big 5 firm (including serving as internal quality control review partner for several U.S. and non-U.S. offices), two years as a member of an audit committee of a public company and four years as an "independent director" of three private companies.

I believe that the most important safeguard is the value that firms and individual auditors place on their reputations, followed very closely by the auditee's "tone at the top." Without very high personal integrity underlying those two safeguards, the remaining safeguards are of relatively little value. I therefore suggest a reordering of the safeguards in paragraph 14 to emphasize those two and would reorder the remainder based on my experience on both sides of the table (original #'s in parenthesis):

1	Value of reputations	(1)
2	Auditee's "Tone at the Top"	(4)
3	Legal Liability	(7)
4	General Oversight	(3)
5	Peer Review programs	(2)
6	Rules, standards, etc.	(5)
7	Disciplinary Actions	(6)

Sincerely,

By TJ Reilly
Thomas J. Reilly, Jr.
Retired Partner – Arthur Andersen LLP

Copy to: Dr. Henry R. Jaeniche, Drexel University ers

February , 2001

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

Dear ISB Members:

The comments below are offered in response to the release of ED 00-2. They bear on the ED's definition of Auditor Independence and the terminology employed for concepts of the Risk Model.

Yours truly,

Edward R. Scott

Independence Definition: -
Practitioner Reference:

As this exposure draft purports to provide a conceptual model for auditor independence it would seem that a better definition of auditor independence might be as follows:

Auditor Independence is the objective application of auditing procedures.

As stated in paragraph #33 objectivity is the ability to make unbiased audit decisions. Such a definition would be consistent with General Standard #2 requiring an independence of ***mental attitude*** on the part of the auditor.[i] As Carmichael observes "independence of mental attitude" has historically served as the conceptual definition of auditor independence:

> **There has been an official definition of audit independence since Generally Accepted Auditing Standards were first proposed in 1947 (Tentative Statement of Auditing StandardsTheir Generally Accepted Significance and Scope). Essentially the same definition exists today in AU section 220 of the AICPA's codification of auditing standards.**

This concept of "practitioner independence" is recognized in the classical treatise by Mautz and Sharaf when they say:

> **We can agree with those who contend that independence is basically a state of mind.** [ii]

In an empirical study of professional sanctions Moriarity in a recent study noted that sanctions against members of the AICPA for independence violations have increased at a lesser rate than have those for violations of auditing standards. Although no tests were conducted here to assess the likelihood of the sanctions being from populations of equal proportion or even opposite in magnitude these results would seem to suggest that the conceptual definition in use is providing appropriate guidance to members of the profession.[iii] In addition, Barry Melancon, the President of the AICPA, has noted that the SEC has never brought an action alleging a lack of auditor independence.

> **Even the SEC enforcement director has admitted the commission has never brought a case alleging that an audit failure occurred as a result of the accounting firm's lack of independence.** [iv]

Although, as ED paragraph #44 states, the auditor's state of mind can never be known by the independence decision maker, it is the auditor's state of mind that is if fact of particular relevance. Paragraph #6 makes clear that conformity to a set of rules alone is not sufficient when it states:

> **To be independent, an auditor must be able, and be reasonably expected to be able, to overcome pressures and other factors that would prevent unbiased audit decisions. Accordingly, the absence of a rule violation does not mean that the auditor is independent**

The "state of mind" criterion is also conceptually consistent with the personal attributes approach taken in the exposure draft.

Construction:

In addition, it conforms to the rules for the construction of connotative definitions which require that a definition be stated in the affirmative rather than negative. [v] [vi] **That is it stipulates the distinguishing property of independence which can exist although a lack of freedom from influences that might lead to bias may not.** Just as one may have fuel, oxygen, and heat without a fire the presence of a potentially biasing influence may be a necessary, but not sufficient, condition to actually result in bias. Also, the definition offered in the exposure draft requires a complete specification of the "pressures and other factors" to give it meaning whereas the above definition is complete in and of itself.

As noted in paragraphs #37-39 the personal attributes approach adopted places a focus on the individual auditor rather than an enumeration of the various relationships that might lead to a compromise of independence. The suggested definition is more consistent with the adopted approach. Efforts to combine an operational definition of independence with a "genus and difference" definition risks conflicting extensions of the definition itself. Thus, one may conclude that an auditor is independent by virtue of having none of the enumerated and prohibited relationships while an as yet unspecified relationship may be a substantial Bias Factor. Although ED #49 seems to sanction an operational definition of independence when it states:

> **An auditor is independent when independence risk is at an acceptably low level, as determined by a particular independence decision maker.**

such a definition seems more consistent with a rules approach to defining independence than to the personal attributes approach. This statement provides an operational definition of independence as opposed to a conceptual one. It is the equivalent of explaining a straight line as the result of placing a ruler on a page and drawing a pencil along one side.

Furthermore, as observed in the exposure draft complete freedom from potentially biasing conditions is an impossible state of affairs considering the client fee payment arrangement. As Mautz and Sharaf also observe the very institutional arrangements or environment in which the auditor performs his work contaminates his independence in the minds of users.[vii] These institutional factors may be as significant to the user's evaluation of auditor independence as any potentially compromising personal factors. The ED definition, therefore, is unattainable whereas the one suggested is at least conceptually achievable, a desired condition as stated in ED paragraph #41. In addition, a definition such as that suggested offers a concept to which anyone involved in any attest engagement, whether a public company or not, could subscribe. Although not the ISBs obligation internal consistency with other pronouncements and standards would, nevertheless, seem a desirable property.

Profession Reference:

Whether this pillar of the profession is significant to a user is a matter of argument. Conventional wisdom holds that it is independence of the audit that gives value to the auditor's opinion. The idea of auditor independence is so ingrained that it's significance is never examined. As Mautz and Scharaf note:

> **The significance of independence in the work of the independent auditor is so well established that little justification is needed to establish this concept as one of the cornerstones in any structure of auditing theory.**[viii]

However, **it may instead be that the value added by an audit opinion is derived from an existence of auditing standards as they apply to the application of auditing procedures coupled with the legal implications for failure to observe them.** Again, as Melancon notes the SEC has never brought an action for a lack of independence, only for substandard audit work.[ix] It should be observed that the mere presence of independence in and of itself is no defense against a failure to perform required audit procedures satisfactorily. Instead it merely asserts that in the absence of motive the auditor may be presumed to have performed his job for the benefit of the user. It hardly matters to a user that his loses were the result of an independent auditor doing his work poorly or from an auditor lacking independence doing his work poorly. Either way he will look to the legal system for a redress of grievances.

As useful as this presumption of independence may be for refuting legal claims it may not be as critical to the profession as conventional wisdom would lead one to believe. For example, investors have always committed large sums of money to investments on the basis of broker recommendations. However, it is well known that broker's have no requirement of independence.

Legal Dimensions:

Finally, a focus on "mental attitude" may preserve for the auditor a defense against a ***prima facia*** case established by a claimant arising from a difference in the risk assessment of a potentially biasing condition. The traditions of our legal system place the burden of proof on a claimant in cases of negligence. Violation of an auditor's professional duty to provide an objective application of auditing procedures should remain the standard of proof rather than a mere appearance of compromised independence resulting from a violation of an independence rule. An accidental or unknown violation could expose the auditor to liability when in fact he has performed a "quality audit."

Terminology:

"Threats" is a term filled with negative emotional implications. "Bias Factors" or some other term with a more benign connotation would be preferable. As Kemeny states, "A philosopher is supposed to be free of emotions, and hence philosophical discussions are supposed to avoid such words."[x] It would seem this same criterion ought to apply to any conceptual model developed by the ISB.

---

[i] Douglas Carmichael, CPA Journal, May 1999

[ii] Robert Mautz and Hussein Sharaf, **The Philosophy of Auditing**, American Accounting Association, 1961, p. 206

[iii] Shane Moriarty, "Trends in Ethical Sanctions Within the Accounting Profession," **Accounting Horizons**, December 2000.

[iv] Barry Melancon, "The Proposed SEC Rule on Auditor Independence and its Consequences", **Journal of Accountancy**, October 2000, p. 26 - 28. It should be noted that a lack of auditor independence may correlate highly with a substandard performance of audit procedures. Since evidence of the later may be more relevant to a proof of injury by a claimant than a lack of independence it may be that the quality of the audit has been the subject of SEC actions although the substandard audit may have stemmed from a lack of independence. There is currently no evidence to my knowledge to support either position.

[v] **Introduction to Logic,** 7th Edition, Irving Copi, p.161

[vi] Morris Cohen and Ernest Nagel, **An Introduction to Logic and the Scientific Method**, (Harcourt, Brace & World, 1934), pp. 223-244

[vii] Robert Mautz and Hussein Sharaf, **The Philosophy of Auditing**, American Accounting Association, 1961, pp. 210-211.

[viii] Mautz and Sharaf, p. 204

[ix] Barry Melancon

[x] John Kemeny, **A Philospher Looks at Science**, (D. Van Nostrand Co, 1959), p.5

9

Helene_Parent@fee.be

02/15/01 12:53 PM

To: isb@cpaindependence.org
cc:
Subject: FEE Ethics Working Party - Comment letter on your Exposure Draft ED 00-2: Statement of Independence Concepts ? A Conceptual Framework for Auditor Independence

Please see after the commenting letter from the Ethics Working Party of the European Federation of Accountants (FEE) on ED 00-2. A formal letter will also follow by post.

Best regards,
Hélène Parent
FEE Director of Regulatory Affairs

Brussels, 16 February 2001

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

Dear Madam, dear Sir,

Re: Exposure Draft ED 00-2: Statement of Independence Concepts ? A Conceptual Framework for Auditor Independence

The Federation des Experts Comptables Europeens (FEE) wrote to you on 6 June 2000 relating to the Discussion Memorandum you issued on the above subject and we are pleased to have the opportunity to submit our comments on the Exposure Draft.

We very much welcome the Board's work advocating the use of a conceptual framework in the determination of guidance on auditor independence. As we explained in more detail in our letter of seven months ago, the use of a conceptual approach underpins FEE's own Common Core of Principles, set out in 1998. The International Federation of Accountants and the European Commission, in the current drafts of their forthcoming papers on independence, have since adopted a similar approach. In an increasingly global economy, international harmonisation is an important goal and the consideration of the conceptual framework in the context of the U.S. auditor independence code will greatly assist in this process.

We set out below some general observations on key aspects of the paper, together with some specific comments following up some of our responses to the questions posed in the Discussion Memorandum.

General observations

Firstly, we wonder whether the four basic guidelines needed to implement the conceptual framework are best described as 'principles'. In our view, the principles are the underlying requirements that auditors perform their work with objectivity and professional integrity. The conceptual framework of assessment of threats and safeguards is a means to achieving those principles.

The section of the Exposure Draft on the consideration of costs and benefits raises an important question and your paper considers the nature of some of the costs and benefits likely to result from auditor independence. We entirely agree with the conclusion that costs and benefits should be considered: independence cannot be absolute and it is reasonable to consider costs and benefits when determining the level of independence that is acceptable. In this connection, the concept of proportionality should be observed. This concept when applied to law or regulation requires that the effect of the law or regulation on the market place should be "proportionate" to the objective of protecting the public interest. However, the analysis of costs and benefits should not be overcomplicated.

Another issue that we believe could usefully be developed further is who is best placed to apply the framework. We believe there are merits in considering the benefits of placing the responsibility for making the decision on whether to undertake the engagement on the auditor alone. This is considered further below.

In the context of international harmonisation, we suggest that the definitions and the terminology should be revisited and adapted so that there is as much consistency as possible with the definitions used by IFAC in its ED on Independence and the EU in its proposed recommendation on statutory auditors' independence. The latter paper can be found at:
http://europa.eu.int/comm/internal_market/en/company/audit/news/indintro.htm

Comments on the resolution of certain issues raised in the Discussion Memorandum (DM 00-1)

Introduction ? Scope and content

FEE is concerned that the conceptual framework is referred to, in paragraph 2 and several other contexts, as a tool for resolving independence issues "in the absence of ISB standards or other rules", or words to that effect. A reader could get the impression that all imaginable independence problems should ideally be covered by detailed rules, and that the conceptual framework is intended for use only in situations where such rules are not (yet) in place. For similar reasons FEE is also concerned over the definition of 'independence decision maker'. The definition includes individual auditors in assessing their own independence and in making decisions 'when faced with situations for which there is neither authoritative guidance nor firm policy'. As FEE noted in its response to the Discussion Memorandum, "the use of casuistic checklists may foster a mechanical attitude towards compliance with independence requirements. Auditors and supervisory bodies may get the false impression that if all the detailed prohibitions have been observed, independence issues need no more attention." In fact, this weakness of detailed rules is indirectly admitted in paragraph 6 of the ED.

In FEE's opinion the conceptual framework should serve the individual auditor as the main tool for resolving all independence issues. In the framework approach adopted internationally, the ability to cater for the infinite variety of individual circumstances that arise in practice is considered to be best served by placing the onus on the auditor actively to consider independence issues for each engagement. It goes without saying that the auditor must comply with any existing prohibitions, whether or not he finds them appropriate in the individual case. Such rules, however, should never be regarded as exhaustive. Even in a situation that is covered by detailed rules the auditor has to use an analytical approach in accordance with the framework model to identify any threats to independence that are not anticipated by the rules. In such circumstances, it must of course be incumbent on the auditor to be able to demonstrate that a responsible conclusion has been reached, assisting with the quality insurance that is necessary to retain public confidence. The regulator should complement the conceptual framework with detailed rules only to give guidance on the application of the general principles to specific situations, such as prohibitions where no other safeguard would be acceptable.

Goal of auditor independence

The Introduction to FEE's own Common Core of Principles notes that the statutory audit was introduced into the legal framework in Europe to protect the interests of shareholders and of other stakeholders in enterprises and, more generally, the public at large. We support the adoption of an outward-looking goal: independence is not an end in itself, but a means to an end.

Defining auditor independence

We agree that it is appropriate to consider independence of appearance as well as independence of mind. The draft European Union document Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, adopting a definition similar to that in the Common Core of Principles, considers that independence should address:

° "Independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand, but no others; and
° Independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that a reasonable and informed third party would question the Statutory Auditor's ability to act objectively."

We are concerned, that your definition will be taken to imply an unrealistic degree of absoluteness to independence: a fear that you express yourselves in Appendix C.

Basic Principles of Auditor Independence ? Analysing Threats and safeguards

In the section concerning the determination of the acceptability of the level of the independence risk, it is mentioned in paragraph 26 that 'independence decision makers should identify the individual or groups affected by threats to auditor independence and the significance of those threats'. To that end, FEE in its commenting letter on DM-001, categorised three groups of individuals in the audit firm whose ability to influence the outcome of the audit varies substantially. We consider that it would be helpful to introduce a categorisation of this sort into your document.

Basic Principles of Auditor Independence ? Considering Stakeholders' Perceptions

In FEE's response to the Discussion Memorandum, it was observed that whilst the importance of stakeholder perceptions is acknowledged, the paper did not deal enough with what their perceptions are. We welcome the further analysis and definitions of who these stakeholders might be in the ED, but regret that no additional comments are made on those perceptions.

Again, we suggest that ISB considers the new and radically different paradigms of stakeholder engagement in the emerging fields of social, environmental and sustainability reporting.

We would be pleased to be of any assistance to you in respect of this project and in particular, any issues raised by this letter.

Yours sincerely,

Dr. Harald Ring

Chairman,

FEE Ethics Working Party

THE INSTITUTE OF INTERNAL AUDITORS

William G. Bishop III, CIA
President

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February 16, 2001

Arthur Siegel, Executive Director
Independence Standards Board
1211 Avenue of the Americas, 6th Floor
New York, NY 10036-8775

Dear Art:

Thank you for the opportunity to comment on the Independence Standards Board's (ISB) Exposure Draft (ED) on *Statement of Independence Concepts – A Conceptual Framework for Auditor Independence (ED 00-2)*. The Institute of Internal Auditors (IIA) supports the development of a conceptual framework for auditor independence that will help the ISB issue principles-based independence standards for auditors of public companies. Our comments to the questions raised in the exposure draft are as follows:

1. Definition of Auditor Independence

The definition of auditor independence contained in paragraph four may be flawed in that "*freedom from those pressures*" seems to denote an absolute. The next sentence modifies the definition so as not to imply that an auditor must be free from all pressures. Paragraph six states that, "an auditor must be able, and be reasonably expected to be able, to overcome pressures and other factors that would prevent unbiased audit decisions." Clearly, the document states that the definition of independence cannot be the absolute freedom from pressures.

The *International Federation of Accountants* (IFAC) issued a draft revision to their Code of Ethics concerning independence. They do not define independence on its own (Section 8.3) because the definition can create misunderstandings. Rather they state (section 8.2) that the reporting accountant (auditor) must be both independent of mind and independent in appearance. They define both as follows:

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tel 407 830-7600
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email wbishop@theiia.org

- Independent of Mind – "The state of mind that permits the provision of an opinion without being affected by the influences that impair professional judgment; when used in conjunction with the **independence** required of a reporting accountant (auditor), it includes the qualities of integrity, objectivity and professional skepticism.

- Independence in Appearance- The ability to demonstrate that risks to independence of mind have been eliminated, or limited to such clearly insignificant matters, so that an informed third party (investors) would not reasonably question the reporting accountant's objectivity.

We recommend that a format and concept similar to IFAC's be used in place of the definition of independence exposed by the ISB.

2. Goal of Auditor Independence

We agree that the goals are appropriate.

3. & 4. Concepts and Basic Principles of Auditor Independence

We believe that the concepts and basic principles are appropriate and will provide a framework for evaluating auditor independence.

5. Other Issues

We do not believe there are other issues that should be addressed.

Established in 1941, the Institute of Internal Auditors is an international professional organization with world headquarters in Altamonte Springs, Florida. The IIA has over 70,000 members in internal auditing, governance, internal control, IT audit, education and security. Many of our members share membership with professional accountancy bodies throughout the world. With representation from more than 100 countries, the Institute is the acknowledged leader in standards, certification, education, research and technological guidance for the profession worldwide.

Again, thank you for this opportunity to provide the Institute's comments on this exposure draft. If the IIA can provide further assistance please feel free to contact me.

Sincerely,

William G. Bishop III, CIA

11

[ABA LETTERHEAD]

February 23, 2001

E-mail: isb@cpaindependence.org
Independence Standards Board
6th Floor
1211 Avenue of the Americas
New York, New York 10036-8775

Attention: ED 00-2

Re: Exposure Draft (ED 00-2) Statement of Independence Concepts, A Conceptual Framework for Auditor Independence (November 2000)

Dear Members and Staff:

We are pleased to submit this letter of comments on ED 00-2 on behalf of the Committee of Law and Accounting, Section of Business Law, American Bar Association. Our letter was prepared by a drafting group comprised of members of our Committee. Those other members of our Committee who reviewed drafts of our letter, which were widely circulated through our Committee's listserv, were in general agreement with our letter. However, our letter does not reflect the official views of our Committee, the Section of Business Law or the American Bar Association.

Introduction

We agree with the Board's conceptual goal "to support user reliance on the financial reporting process and to enhance capital market efficiency." We also agree that auditor independence is critical to achieving that goal.

Discussion

The Board proposes to define auditor independence as "freedom from those pressures and factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make audit decisions". However, the Board does not propose that independence or lack of independence in fact be determined. Rather, the Board proposes a "threats/safeguards" approach, which would require an assessment of "independence risk" by "independence decision makers". Under ED 00-2, "independence risk" is "the risk that threats to auditor independence, to the extent that they are not mitigated by safeguards, compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions".

We recognize that ED 00-2 is a proposal to establish a conceptual framework for auditor independence and we do not disagree with the Board's approach. Nevertheless, we believe that any standards developed within the proposed framework must be clear and workable in practice. We address some of our concerns in this regard below.

One aspect of the Board's approach that troubles us is that it would establish an objective standard- "whether well informed investors and other users of financial statements would reasonably consider the activities, relationships, or other circumstances in question as precluding independence." However, in practice, this standard may be applied subjectively by auditors, in the first instance, and then by "independence decision makers", including audit committee members. We are concerned that this could result in greater exposure to audit committee members when a tribunal applies an objective standard to an essentially subjective decision. If the audit committee is an independence decision maker, relied upon by investors and other users of financial statements to make independence decisions, there must be clear and workable criteria that they can apply and may rely on to protect them from liability for reasonable judgments made in good faith. Accordingly, we urge that any implementing standards provide audit committee members with objective criteria to look to in applying this standard.

We also believe that any implementing standards should draw a better line between inappropriate advocacy by independent auditors and their appropriate support of a client's position on accounting matters.

Further, we believe that the threat to independence from an auditor's desire to preserve the audit engagement to earn audit fees, which the Board recognizes, should be addressed in any implementing standards.

****

We thank the Board for the opportunity to submit our comments on ED 00-2. Members of our Committee would be available if the Board wishes to discuss our conclusions and suggestions.

Respectfully submitted,

/s/ Richard H. Rowe

____

Richard H. Rowe
Chair, Committee on law and Accounting

Drafting Group:

Richard H. Rowe
Dan L. Goldwasser

cc: Dan L. Goldwasser

bcc: Gwen Quillen

Date

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Général

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12

Brussels, 16 February 2001

Independence Standards Board
6th Floor
1211 Avenue of the Americas
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10036-8775
USA

Dear Madam, dear Sir,

Re: Exposure Draft ED 00-2: Statement of Independence Concepts – A Conceptual Framework for Auditor Independence

The Federation des Experts Comptables Europeens (FEE) wrote to you on 6 June 2000 relating to the Discussion Memorandum you issued on the above subject and we are pleased to have the opportunity to submit our comments on the Exposure Draft.

We very much welcome the Board's work advocating the use of a conceptual framework in the determination of guidance on auditor independence. As we explained in more detail in our letter of seven months ago, the use of a conceptual approach underpins FEE's own Common Core of Principles, set out in 1998. The International Federation of Accountants and the European Commission, in the current drafts of their forthcoming papers on independence, have since adopted a similar approach. In an increasingly global economy, international harmonisation is an important goal and the consideration of the conceptual framework in the context of the U.S. auditor independence code will greatly assist in this process.

We set out below some general observations on key aspects of the paper, together with some specific comments following up some of our responses to the questions posed in the Discussion Memorandum.

General observations

Firstly, we wonder whether the four basic guidelines needed to implement the conceptual framework are best described as 'principles'. In our view, the principles are the underlying requirements that auditors perform their work with objectivity and professional integrity. The conceptual framework of assessment of threats and safeguards is a means to achieving those principles.

The section of the Exposure Draft on the consideration of costs and benefits raises an important question and your paper considers the nature of some of the costs and benefits likely to result from auditor independence. We entirely agree with the conclusion that costs and benefits should be considered: independence cannot be absolute and it is reasonable to consider costs and benefits when determining the level of independence that is acceptable. In this connection, the concept of proportionality should be observed. This concept when applied to law or regulation requires that the effect of the law or regulation on the market place should be "proportionate" to the objective of protecting the public interest. However, the analysis of costs and benefits should not be overcomplicated.

Another issue that we believe could usefully be developed further is who is best placed to apply the framework. We believe there are merits in considering the benefits of placing the responsibility for making the decision on whether to undertake the engagement on the auditor alone. This is considered further below.

In the context of international harmonisation, we suggest that the definitions and the terminology should be revisited and adapted so that there is as much consistency as possible with the definitions used by IFAC in its ED on Independence and the EU in its proposed recommendation on statutory auditors' independence. The latter paper can be found at:
http://europa.eu.int/comm/internal_market/en/company/audit/news/indintro.htm

Comments on the resolution of certain issues raised in the Discussion Memorandum (DM 00-1)

Introduction – Scope and content

FEE is concerned that the conceptual framework is referred to, in paragraph 2 and several other contexts, as a tool for resolving independence issues "in the absence of ISB standards or other rules", or words to that effect. A reader could get the impression that all imaginable independence problems should ideally be covered by detailed rules, and that the conceptual framework is intended for use only in situations where such rules are not (yet) in place. For similar reasons FEE is also concerned over the definition of 'independence decision maker'. The definition includes individual auditors in assessing their own independence and in making decisions 'when faced with situations for which there is neither authoritative guidance nor firm policy'. As FEE noted in its response to the Discussion Memorandum, "the use of casuistic checklists may foster a mechanical attitude towards compliance with independence requirements. Auditors and supervisory bodies may get the false impression that if all the detailed prohibitions have been observed, independence issues need no more attention." In fact, this weakness of detailed rules is indirectly admitted in paragraph 6 of the ED.

In FEE's opinion the conceptual framework should serve *the individual auditor* as the main tool for resolving all independence issues. In the framework approach adopted internationally, the ability to cater for the infinite variety of individual circumstances that arise in practice is considered to be best served by placing the onus on the auditor actively to consider independence issues for each engagement. It goes without saying that the auditor must comply with any existing prohibitions, whether or not he finds them appropriate in the individual case. Such rules, however, should never be regarded as exhaustive. Even in a situation that is covered by detailed rules the auditor has to use an analytical approach in accordance with the framework model to identify any threats to independence that are not anticipated by the rules. In such circumstances, it must of course be incumbent on the auditor to be able to demonstrate that a responsible conclusion has been reached, assisting with the quality insurance that is necessary to retain public confidence. *The regulator* should complement the conceptual framework with detailed rules only to give guidance on the application of the general principles to specific situations, such as prohibitions where no other safeguard would be acceptable.

Goal of auditor independence

The Introduction to FEE's own Common Core of Principles notes that the statutory audit was introduced into the legal framework in Europe to protect the interests of shareholders and of other stakeholders in enterprises and, more generally, the public at large. We support the adoption of an outward-looking goal: independence is not an end in itself, but a means to an end.

Defining auditor independence

We agree that it is appropriate to consider independence of appearance as well as independence of mind. The draft European Union document[1], adopting a definition similar to that in the Common Core of Principles, considers that independence should address:

- "Independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand, but no others; and
- Independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that a reasonable and informed third party would question the Statutory Auditor's ability to act objectively."

[1] Consultative Paper on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles

We are concerned, that your definition will be taken to imply an unrealistic degree of absoluteness to independence: a fear that you express yourselves in Appendix C.

Basic Principles of Auditor Independence – Analysing Threats and safeguards

In the section concerning the determination of the acceptability of the level of the independence risk, it is mentioned in paragraph 26 that ‘independence decision makers should identify the individual or groups affected by threats to auditor independence and the significance of those threats’. To that end, FEE in its commenting letter on DM-001, categorised three groups of individuals in the audit firm whose ability to influence the outcome of the audit varies substantially. We consider that it would be helpful to introduce a categorisation of this sort into your document.

Basic Principles of Auditor Independence – Considering Stakeholders’ Perceptions

In FEE’s response to the Discussion Memorandum, it was observed that whilst the importance of stakeholder perceptions is acknowledged, the paper did not deal enough with what their perceptions are. We welcome the further analysis and definitions of who these stakeholders might be in the ED, but regret that no additional comments are made on those perceptions.

Again, we suggest that ISB considers the new and radically different paradigms of stakeholder engagement in the emerging fields of social, environmental and sustainability reporting.

We would be pleased to be of any assistance to you in respect of this project and in particular, any issues raised by this letter.

Yours sincerely,

H. Ring

Dr Harald Ring
Chairman
FEE Ethics Working Party

AICPA

PCPS

(12)

February 28, 2001

Susan McGrath, CPA
Director
Independence Standards Board
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Independence Standards Board (ISB) Exposure Draft (ED 00-02) Statement of Independence Concepts - A Conceptual Framework for Auditor Independence

Dear Ms. McGrath:

One of the objectives that the Council of the American Institute of Certified Public Accountants 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. These comments, however, do not necessarily express the positions of the AICPA.

TIC has reviewed the above referenced exposure draft ("ED") and is providing the following comments for your consideration.

Issue 1: DEFINITION OF AUDITOR INDEPENDENCE
The proposed conceptual framework defines auditor independence as "freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions."

TIC agrees with the definition of auditor independence as stated in the ED and is pleased with the approach taken to address the "appearance of independence" issue.

Issue 2: GOAL OF AUDITOR INDEPENDENCE
The proposed conceptual framework states that the goal of auditor independence is "to support user reliance on the financial reporting process and to enhance capital market efficiency."

TIC believes the goal of auditor independence is appropriate as stated.

Issue 3: CONCEPTS AND BASIC PRINCIPLES OF AUDITOR INDEPENDENCE
Are the concepts and basic principles appropriate and sufficiently operational? If not, what changes would you suggest, and why?

TIC believes that more specific guidance should be provided regarding the definition of self-review threats in paragraph 12b. TIC believes that, without further clarification, the scope of

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the definition may be misinterpreted. Paragraph 12b currently defines self-review threats as "threats that arise from auditors reviewing their own work or the work done by others in their firm." TIC identified two possible interpretations of the definition:

1. an auditor's review of the working papers prepared by staff or contract employees for an audit engagement (a quality control issue)
2. an auditor's review of the work of others in his/her own firm that have performed nonaudit services for a client (an independence issue).

TIC understands the ISB's intention was to limit the definition of self-review threats to the independence context only. To avoid additional confusion, TIC recommends, at a minimum, that clarifying language be substituted for the word "work" and that examples be given to illustrate the scope of the definition.

Other Issues: APPLICABILITY OF CONCEPTUAL FRAMEWORK

TIC noted that the scope paragraph from the conceptual framework DM 00-1, paragraph 2, seems to have been omitted entirely from the ED. TIC believes that the Statement of Independence Concepts should include a scope paragraph to state the applicability of the conceptual framework. TIC understands that the ISB's mandate is to set standards for auditors who are required to meet SEC independence requirements. However, since TIC believes that there should be no conceptual differences between audits of public and private firms, TIC recommends the inclusion of a scope paragraph that encourages all firms to adopt the *Statement of Independence Concepts – A Conceptual Framework for Auditor Independence.*

TIC appreciates 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,

Candace Wright

Candace Wright, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees

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Consultation Response

STATEMENT OF INDEPENDENCE CONCEPTS A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE

Exposure Draft ED 00-2 issued by the Independence Standards Board

Comments from the Association of Chartered Certified Accountants

February 2001

ACCA is the largest global professional accountancy body, with 250,000 members and students in 160 countries. ACCA's headquarters are in London and it has 28 staffed offices around the world. The ACCA syllabus has been recognised by the United Nations as providing the basis for a global accountancy qualification. ACCA's mission is to provide quality professional opportunities to people of ability and application, to be a leader in the development of the global accountancy profession, to promote the highest ethical and governance standards and to work in the public interest.

Further information on ACCA is available on ACCA's website, www.accaglobal.com.

Executive Summary

The Association of Chartered Certified Accountants (ACCA) is pleased to have the opportunity to comment on Exposure Draft ED 00-2 *Statement Of Independence Concepts A Conceptual Framework For Auditor Independence* (the proposed Statement) issued by the Independence Standards Board (ISB).

ACCA welcomes the proposed Statement as it embodies a framework approach to independence. This consideration of threats and safeguards is inherently superior to a rules based approach and is supported by the International Federation of Accountants (IFAC), the European Union, ACCA and many other professional bodies.

In our view, the most important step which can be taken to serve the public interest and protect and promote investors' confidence in securities markets is the adoption of an appropriate approach to auditor independence which is consistent worldwide. In order to achieve this, we consider that it is imperative that ISB repositions the proposed Statement and its extant Standards to align with the relevant aspects of the IFAC Code of Ethics for Professional Accountants (the IFAC Code of Ethics).

1 General Comments

Status of the Independence Standards Board

1.1 With the exception of the proposed Statement, ISB has deferred development of its pronouncements. We understand that this action has been taken as a result of the separate decision of the Securities and Exchange Commission (SEC) to modernise its auditor independence requirements (Rule 2-01). We assume, therefore, that ISB and its stakeholders will reconsider its mission in the light of these circumstances. In this regard, we would like to highlight the following structural matters.

1.2 Historically, the American Institute of Certified Public Accountants (AICPA) has acted as both professional body and standard setter. To an extent, for public companies, the SEC has acted as both a regulator and a standard setter. We suggest that ISB has not been able fully to establish itself as an independent standard setter because:

- ISB is concerned with independence rather than the whole range of professional ethics

- ISB is concerned only with auditors of public companies

  and

- ISB is not independent of the profession (there is no majority of lay members on its Board).

Consistent worldwide approach to independence

1.3 The IFAC Ethics Committee is currently developing revised material for the independence aspects of the IFAC Code of Ethics. We strongly suggest that the proposed Statement should be aligned with that material since, when it is finalised, it will have worldwide authoritative status.

1.4 The principal advantages of aligning the proposed Statement to the finalised IFAC Code of Ethics are that:

- a consistent worldwide approach to auditor independence will best serve the public interest and protect and promote investors' confidence in securities markets

- benchmarking of US requirements to best international standards will protect and promote US investor confidence

- there is greater likelihood of auditor compliance with US independence requirements when these are familiar because they are equivalent to requirements in other jurisdictions (for example, where an overseas subsidiary of a US corporation has local auditors)

  and

- compliance with US independence requirements may be enforced through accountancy bodies which promulgate the IFAC Code of Ethics and which have the power to discipline members in all jurisdictions.

Effect on the proposed Statement of the mission of the Independence Standards Board

1.5 The foreword to the proposed Statement notes that:

The mission of the Independence Standards Board (ISB or Board) 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. One of the Board's most fundamental projects since its establishment has been the development of a conceptual framework for auditor independence to help the Board issue principles-based independence standards for auditors of public companies.

1.6 The mission and the proposed Statement may be contrasted with the pronouncements (and proposed pronouncements) of other bodies dealing with professional ethics. Because of its importance, we restrict our comparative analysis to differences between the proposed Statement and the IFAC Code of Ethics.

1.7 In two respects, the proposed Statement may be seen to have a narrower focus than the IFAC Exposure Draft 'Independence Proposed Changes to the Code of Ethics for Professional Accountants' (the proposed IFAC Ethics Code):

- the proposed Statement focuses on audits, whereas the proposed IFAC Ethics Code deals with assurance engagements which are wider in their application (as defined in International Standard on Auditing 100 'Assurance Engagements')

  and

- the proposed Statement focuses on the audit of public entities, whereas the proposed IFAC Ethics Code is applicable to public and non-public entities alike.

1.8 In our comments at paragraph 1.2 above, we drew attention to the effect that this narrow focus could have on the ability of ISB fully to establish itself as an independent standard setter.

1.9 In one significant regard, however, the proposed Statement is much less clearly focused than the proposed IFAC Ethics Code. The objective of the proposed IFAC Ethics Code is to assist reporting accountants in decision making with regard to independence. The proposed Statement explains, however, that its principal purposes are:

a. *to help the Independence Standards Board (ISB or Board) meet its responsibilities to set sound and consistent standards by providing direction and structure for resolving independence issues*

b. *to assist other independence decision makers in resolving questions about independence in the absence of ISB standards and other independence rules*

c. *to help investors, other users of financial information, and other interested parties understand the nature, significance, and limitations of auditor independence*

and

d. *to focus debate and serve as a boundary for discussions about auditor independence issues, thereby helping interested parties contribute to the development and application of, and better understand the rationale and process underlying, ISB standards.*

1.10 The term 'independence decision makers' is defined in the Glossary as follows:

'Individuals, groups, and entities that make judgments about auditor independence issues. Independence decision makers include:

- *the ISB and other independence standard setters*
- *auditing firms in adopting independence policies and procedures in the absence of existing rules or standards*
- *individual auditors in assessing their own independence and in making decisions when faced with situations for which there is neither authoritative guidance nor firm policy*
- *the management, audit committees, and boards of directors of auditees in meeting their responsibilities to retain auditors who are independent*
- *regulators in meeting their responsibilities to ensure the independence of auditors.'*

1.11 This wide focus has devalued the document by making it less directly relevant to auditors. For example, the discussion of assessing the level of independence risk and determining its acceptability (paragraphs 22 to 26) should be of the utmost practical importance to auditors. However, the discussion is highly theoretical and hedged with modifying words. The table at paragraph 23, which is not used in the succeeding argument, describes a level of independence risk as 'no independence risk' and then suggests only that 'compromised objectivity is *virtually* impossible' (emphasis added).

1.12 By contrast, the IFAC Code of Ethics deals with practical decision points in an assessment: threats are either 'clearly insignificant' or safeguards must be considered, safeguards must be put in place to reduce significant threats to an 'acceptable level', but some threats are so significant that no safeguard is appropriate except refusal of the engagement.

1.13 We see no easy solution to the conflict between the desire of ISB to produce a conceptual framework for auditor independence to inform a wide spectrum of independence decision makers and the needs of firms and auditors when faced with situations for which there are no existing rules, standards or guidance. We believe that it places too great a demand on the proposed Statement fully to fulfil these principal purposes. We recommend, therefore, that the proposed Statement is addressed only to independence decision makers other than auditors. The practical needs of firms and auditors would be best met by ISB adopting and promulgating the IFAC Code of Ethics. To do this, it is necessary to align the terminology and concepts in the proposed Statement with those in the IFAC Code of Ethics.

Independence standards

1.14 In our comments above, we have argued that the proposed Statement should be aligned with the IFAC Code of Ethics first, to promote global consistency and, secondly, as a necessary consequence of its use to meet the practical needs of auditors. The IFAC Code of Ethics is intended to serve as the only mandatory pronouncement for independence: there are no separate 'standards'. This is in contrast to the ISB regime, where the Conceptual Framework does not itself establish rules.

1.15 We recognise that in the US environment greater emphasis is placed on rules and standards than is now the case in many other developed economies. Accordingly, we hesitate to suggest that ISB withdraws its extant Standards. It may be possible to continue to issue pronouncements as Standards which are, to all intents and purposes, the same as the analysis of specific situations in the IFAC Code of Ethics.

2 Comments on Specific Questions

Our comments on the specific questions set out in the preface to the proposed Statement are given below:

Definition of auditor independence
The proposed conceptual framework defines auditor independence as 'freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions.' The definition and the basis for the Board's conclusions are discussed in paragraphs 3–7 and 37–46. The other components of the conceptual framework are intended to help independence decision makers apply the definition to a wide variety of auditor independence issues. Is the definition appropriate? If not, what changes would you suggest, and why?

2.1 We suggest that the definition is made the same as that in the IFAC Code of Ethics when finalised. The proposed IFAC Code of Ethics draws attention to the danger of using the word 'independence' on its own as that may lead to an unrealistic expectation that there is some state of absolute independence.

Goal of auditor independence
The proposed conceptual framework states that the goal of auditor independence is "to support user reliance on the financial reporting process and to enhance capital market efficiency." The goal and the basis for the Board's conclusions are discussed in paragraphs 8–9 and 47–48. Is the goal appropriate? If not, what changes would you suggest, and why?

2.2 A conceptual framework for financial reporting necessarily addresses the purpose of financial statements. It is only by establishing the purpose of such reports that a suitable frame of reference can be created to allow accounting standards consistent with it to determine an appropriate form and content for reporting. The purpose of independence is, however, bound up with the purpose of auditing which is in turn bound up with the purpose of financial reporting. The proposed Statement suggests that the goal of independence is 'to support user reliance on the financial reporting process and to enhance capital market efficiency.' This goal could equally apply to auditing itself and, arguably, to the issue of financial statements.

Concepts and basic principles of auditor independence
The proposed conceptual framework contains basic principles related to four concepts of auditor independence: threats, safeguards, independence risk, and significance of threats/effectiveness of safeguards. The concepts, basic principles, and the basis for the Board's conclusions are discussed in paragraphs 10–32 and 49–60. The concepts and basic principles contained in the proposed framework are intended to serve as guidelines for independence decision makers to analyze and resolve independence issues. Are the concepts and basic principles appropriate and sufficiently operational? If not, what changes would you suggest, and why?

2.3 We consider the four concepts in the proposed Statement to be valid. However, while there is an obvious need for the concepts of threat and safeguard, we consider independence risk and the significance of threats/effectiveness of safeguards to be derived concepts and to be of little practical worth over and above their natural descriptive language. Threats and safeguards are important classes of objects and are worthy of enumeration. The other two concepts are not necessary. A semantic argument could be advanced that 'independence risk' is equivalent to 'independence threat' and so presenting the two as separate invites confusion. The IFAC Code of Ethics deals only with 'risks to independence' and 'safeguards'.

Paragraphs 49–53 describe the elements of a risk model for auditor independence in which independence risk is a function of the significance of threats to auditor independence and the effectiveness of safeguards to auditor independence. What are your views on the appropriateness of the independence risk model? Is there research that the Board should be made aware of that would be helpful in expanding the model or otherwise making it more useful for independence decision makers? If so, please describe that research.

2.4 We support ISB's view (expressed in paragraph 52) that it is appropriate to think in terms of independence risk rather than in terms of the existence or non-existence of independence. However, we are concerned by the statement at paragraph 49 that 'An auditor is independent when independence risk is at an acceptably low level, as determined by a particular independence decision maker'. This raises the prospect of decision makers disagreeing as to whether an auditor is independent only because they have differing viewpoints.

2.5 The proposed IFAC Code of Ethics focuses on the judgement of a reporting accountant and utilises terminology to draw attention to certain levels of independence risk:

- Risks are clearly insignificant

- The effect of risks and safeguards together fall below a level which would make acceptance or continuation of an engagement appropriate (ie. The risk to independence is at an acceptable level)

  and

- There are insufficient safeguards to reduce risks below the level which would allow acceptance or continuation of an engagement such that refusal is necessary (refusal is seen as a safeguard).

2.6 We have not carried out or commissioned research which would be helpful in expanding the model or otherwise making it more useful for independence decision makers.

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(14)

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February 14, 2001

Reference: ED 00-2

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

Gentlemen:

Thank you for the opportunity to comment on Exposure Draft 00-2, "A Conceptual Framework for Auditor Independence. We believe the framework offers a useful beginning structure for understanding independence risk. However, many of the concepts in the framework are ill defined. More importantly, there is little linkage between threats and safeguards, and no attempt to understand exactly how they affect auditors' independence. We believe The Independence Standards Board (ISB) should develop a broader model that will demonstrate how these factors interrelate and how they affect auditors.

The ISB's list of threats and safeguards related to independence risk is illustrated in Figure One. The Exposure Draft does not explain in any detail how the factors listed affect auditors to increase or decrease independence risk. As the Conceptual Framework is to be used:

a. to help the Independence Standards Board (ISB or Board) meet its responsibilities to set sound and consistent standards by providing direction and structure for resolving independence issues;
b. to assist other *independence decision makers*[1] in resolving questions about independence in the absence of ISB standards and other independence rules;
c. to help investors, other *users* of financial information, and other interested parties understand the nature, significance, and limitations of auditor independence; and
d. to focus debate and serve as a boundary for discussions about auditor independence issues, thereby helping interested parties contribute to

[1] Words and phrases defined in the Glossary are set in *italic type* the first time they are used in the Statement.

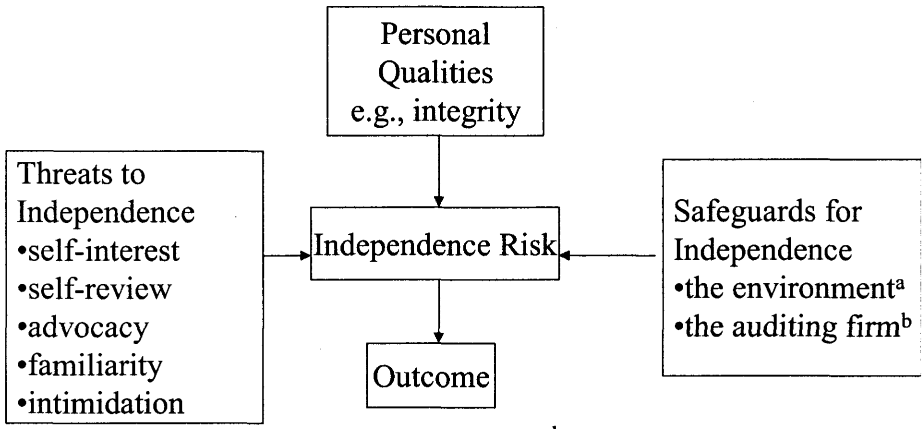
> the development and application of, and better understand the rationale and process underlying, ISB standards. (ISB 2000, paragraph 1),

we believe that providing a clearer understanding of the attributes underlying the threats and safeguards and causally linking them to independent risk is critical to the success of the Conceptual Framework. The Conceptual Framework continues:

> The significance of a specific threat depends on many factors, including the nature of the activity, relationship, or other circumstance creating the threat; the force with which pressure is exerted or felt; the importance of the matter that is the subject of the activity, relationship, or other circumstance; the position and level of the of responsibility of the persons involved; and the strength of the integrity of the persons involved. Independence decision makers should evaluate these and other factors when assessing the threats to auditor independence posed by various activities, relationships, and other circumstances. (ISB 2000, paragraph 19)

The Exposure Draft makes a similar statement for safeguards. If financial statement users and corporate board members are to properly evaluate auditors' independence, they must have an understanding of how various threats and safeguards affect that risk. This understanding also includes an appreciation of the role of moderating elements such as training, professional identity, and personal ethics. Individual auditors also need this understanding in assessing their own independence and in making audit decisions when, for example, there is no authoritative guidance.

Figure One
Conceptual Framework Independence Model



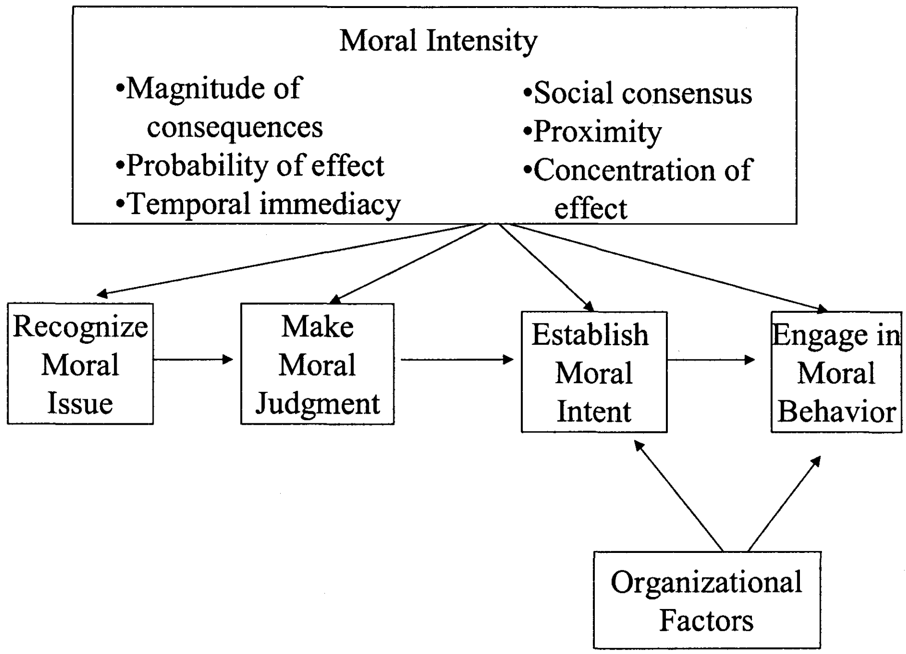
[a]Environment:
- reputations
- peer review
- corporate governance e.g., audit committees
- standards, rules and disciplinary actions
- legal liability

[b]Accounting firm:
- tone at the top
- professional environment and culture
- quality assurance programs
- other policies and practices
- personnel policies

Researchers have approached independence from a number of disciplines, including Economics (e.g. DeAngelo 1981, Simunic 1984, Antle 1984), Psychology (e.g. Bazerman, et al 1997), and Ethics (e.g. Sweeney and Roberts 1997). However, there has been little attempt to provide a comprehensive model linking the findings and implications from these disciplines. In order for users and decision makers to understand and evaluate independence risk, they must understand the underlying causes of the threats and safeguards proposed by the conceptual framework. Some studies have integrated theories from more than one discipline, such as economics and psychology (e.g. King 2001), organizational behavior and economics (e.g. Farmer et. al 1987), and ethics and economics (e.g. Koford and Penno 1992). However, no one, to our knowledge, has attempted to develop a comprehensive theoretical model from which to understand linkages between threats and safeguards in evaluating independence risk. The ISB's Conceptual Framework provides a starting point for undertaking this endeavor.

A useful framework to begin integration and model development comes from Jones (1991). As illustrated in Figure Two, Jones starts with four stages of moral decision making developed by Rest (1986). Jones adds moral intensity, which consists of magnitude of consequences, probability of effect, temporal immediacy, social consensus, proximity, and concentration of effect. Jones also includes organizational effects such as group dynamics, organizational authority, and socialization processes.

Figure Two
Jones (1991) Ethical Decision Making Model



Many of the concepts and factors from the Exposure Draft's Conceptual Framework can be mapped into this framework with little difficulty. For example, self-interest, self-review, advocacy, and familiarity are elements of moral intensity. Intimidation may be an organizational factor or an element of moral intensity. Environmental factors such as reputation, peer review, corporate governance, standards and legal liability are organizational factors, as are firm related factors.

The elements in the Exposure Draft's Conceptual Framework are provided on a piecemeal basis. The Jones model illustrates how the factors can begin to be linked together. A more thorough review of literature, obtaining descriptive data, and empirical testing of hypotheses is necessary for a complete model containing all-important factors. For example, Bazerman, et al. (1997) show that economic self-interest can subconsciously bias auditors toward their clients. However, King's (2001) results suggest that conscious factors like group identification can mitigate self-interest threats. Until we understand such linkages between conscious and subconscious threats and safeguards in a decision-making framework, it will be difficult for independence decision makers to make proper assessments of independence risk.

Threats can be categorized according to client type, the nature of the activity and its importance, the position and level of responsibility of persons involved. Another important part of the model will be the role of auditors' personal qualities and individual characteristics as sources of bias in independence risk assessment. Finally, the model should consider how independence decision makers weigh and combine critical factors in their independence risk assessments and how personal qualities, such as professional identification and integrity, modify these relationships and help to determine independence risk.

In sum, we believe the Board should develop a causal model that (1) identifies the primary factors that influence the significance of threats to independence and the effectiveness of mitigating safeguards, and (2) describes how these threats and safeguards combine and interact to determine inherent risk. This model should provide a useful template to help independence decision makers make independence risk assessments, gain insight into their own independence risk assessments and into the independence risk assessments of others. Based on existing research, we believe the Board should also accumulate evidence on the importance of personal qualities and characteristics in independence risk. The suggested model will also provide a framework for identifying and understanding differences in inherent risk assessments between different types of independence decision makers.

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Sincerely,

E. Michael Bamber, Ph. D.

Robert J. Ramsay, Ph. D., CPA

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15

February 28, 2001

To: Independence Standards Board

From: David Dufendach

Re: Statement of Independence Concepts
Exposure Draft ED 00-2

This memorandum will address the specific issues listed on pp. iii and iv of the Exposure Draft.

1. Definition of Auditor Independence

No comments – definition appears appropriate.

2. Goal of Auditor Independence

This is absolutely the right focus. This goal is also very consistent with Statement of Financial Accounting Concepts #1, which focuses on the needs of third-party investors as the primary goal of financial reporting.

3 & 4. Concepts and Basic Principles of Auditor Independence

Paragraph 23 presents a continuum of independence risk ("IR"), including the terms "no IR," "remote IR," and "some IR." Paragraph 25 then states that only a "very low level" of IR would be acceptable. To make these concepts operational, should the definitions be more consistent? For example, should the document state that "only a remote level of IR" would be acceptable? Or, should paragraph 23 be expanded/modified to incorporate a definition of "very low level" consistent with the guidance of paragraph 25?

Regarding the discussion of benefits and costs, I generally agree with the rationale concerning "second-order effects" that appears in paragraph 29. However, I am also familiar with anecdotal evidence (from the business media) that suggests that the experience and knowledge gained from the provision of non-audit activities is often not communicated to auditors in ways that facilitate audit quality. For these second-order effects to truly represent a "cost," our profession must do a better job of realizing and demonstrating the benefits that inhere in the provision of non-audit services. Is this topic an appropriate one to address in this ED? If not ultimately addressed, the issue of whether or not non-audit services should be provided by audit firms will likely surface again and again.

5. Other Issues

In general, this ED provides little specific guidance regarding non-audit services. Should the topic be addressed more explicitly?

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Commentary
Exposure Draft
Statement of Independence Concepts
A Conceptual Framework for Auditor Independence

This commentary is in response to the exposure draft (above referenced) and the supporting article in the Journal of Accountancy (February 2001). It follows the order of the "Questions for Respondents" in the exposure draft which are not necessarily in order of importance to this author.

1.) Definition of Auditor Independence

The 'publications' stress the auditors and audit teams and the pressures or factors that compromise … "an ability to make unbiased decisions." Further, we now have "independence decision makers," presumably practice units (firms or parts of firms) which will have the final responsibility for determining violations of or threats to independence.

What has happened to the "appearance of independence." In my forty-five years of practice, this was the beacon—the guiding light of independence concepts—now disappeared without even a good-bye. It used to be a given, that CPAs would not accept engagements or assignments where they could not function with objectivity, integrity, and independence. Rather, as a profession, we imposed the additional burden on ourselves of appearance—how would the business community and the public see the matter. We were unbending in the matter of appearance, even though our members incurred economic cost to respect this concept. Has economics now become the beacon?

2.) Goal of Auditor Independence

The publications suggest that the goal of auditor independence is to "support user reliance on the financial reporting process and to enhance capital market efficiency."

This is a very narrow definition. What about the image of the profession to the public? What about the respect afforded to CPA's in the 1001 services they provide clients outside of the attest function and financial statements.

Even applying the 'narrow' definition to our goal raises serious questions. Does the use of "independence decision makers" support reliance and enhance efficiency? Can the fox be trusted to design the chicken coop? … and even if we believe it can be trusted, how does it look? Worse, how does it look if a chicken(s) is (are) missing?

3. & 4.) Concepts and Basic Principles of Auditor Independence

Everyone who has some years in public practices is familiar with "independence risk." It is as natural to the public accountant's work as transpositions. Further, every firm has imposed safeguards—and these safeguards stem from and revolve around Rule 101 of the

Code of Professional Conduct. Now it appears we are discarding Rule 101 and suggesting that independence decision makers can assess an "acceptable level" of independence risk and modify it by steps taken as they see fit.

At the least, it seems the profession should mandate that such decisions put the burden on the independence decision makers to support an avoidance of Rule 101 (or its ISB successor) just as we require an auditor who makes a decision in conflict with published standards to support his variation or be found in violation of Rule 202.

Also, we are saying a basic principle of independence is a cost benefit rule. Thus, between an acceptable level of independence risk and the evaluation of cost vs. benefit of independence, we have achieved the concept of "just a <u>little bit</u> pregnant" as a measure for independence compliance.

Finally, these matters are summarized in a conceptual framework. Conspicuous by its absence is the indication that the ISB will provide a skeleton, a framework, and some consistency to the independence concept between and among the practice units. Thus, each individual or organization is free to assess, evaluate, and modify (rationalize) independence risks for the practice unit in free form. (Yes, Virginia, the public accounting profession really cares about independence.)

<u>5.) Other Issues</u>

The timing of this change so soon after the news was full of 'Big 5' violations of independence rules should be considered. Instead of disciplining the firms and their member violators, we give a perception of changing the rules so the acts in questions are no longer violations. This is too much too fast.

The relaxation of ownership rules for large firms with 'publicly traded' clients is asking for trouble. Imagine a client that has a terrific year with a corresponding stock value increase. Now the news is that a number of (non-engagement team) firm members purchased stock during the year. Could that be insider information? Can you stop a firm's jungle drums/grapevine? How will the press or SEC handle this and what happens to the rest of the profession?

The relaxation or elimination of family relationship rule(s) has great appeal. My heart goes out to the husband and wife example in the Journal of Accountancy article. However, I suspect that the frequency of occurrence of this example is next to nil. Imagine what will happen if there is a client bankruptcy or alleged financial impropriety. It is a given that H&W are innocent, but does that deter the plaintiff's attorney or press?

6.) Conclusion

Rule 101 has been in effect for some fifty years. It has helped to polish the professions reputation amongst the business and financial communities and helped to earn one of the "most respected professions" from the public at large.

Suddenly, we have the papers full of 'Big 5' violations and a new ISB which must feel pressured to "do something". Can it be right to cancel Rule 101 (which is admittedly burdensome) and transfer the ethics administration to the firms/practice units by creation of the concept of "independence decision makers" as the arbiters for independence questions? I don't think so. At the least, such a change should come in small steps or increments. Let us see how the change works by assigning one of the Sections of 101 to the firms and monitoring the results. Then, if satisfied, we can incrementally add to the firms responsibilities. If it doesn't, we can go back to what brung us.

Paul Goldberg

Paul Goldberg
Member Ethics Committee
Illinois CPA Society

Memorandum

THE CHURCH OF
JESUS CHRIST
OF LATTER-DAY SAINTS

Date: February 28, 2001
To: Art Siegel
From: Dennis Spackman
Subject: Response to ED 00-2

Thank you for the opportunity to respond to the *Exposure Draft, ED 00-2, Statement of Independence Concepts; A Conceptual Framework for Auditor Independence.*

I would like to express my appreciation for the excellent support you and your staff provided the development of this exposure draft, and to professors Jaenicke, Glazer and Clarkson for their exceptional support as well.

I also appreciate the extended period for comments. It has given me time to focus on both the content and relationships of the various elements of the framework.

Please find attached, my response to the questions asked in the ED and other observations I made during my reading of it. I hope you find them helpful.

Best regards always,

Dennis

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Statement of Independence Concepts:
A Conceptual Framework for Auditor Independence
Response to ED 00-2

Dennis Paul Spackman, CPA **February 28, 2001**

My comments concerning the Exposure Draft, *A conceptual Framework for Auditor Independence* follow:

Question on Definition of Auditor Independence: *Is the definition appropriate? If not, what changes would you suggest, and why?*

After careful consideration I find the definition to be effective. The discussion around the definition is very good. It places the definition in a relevant context that makes it operational.

There is however, one factor missing from the discussion and that is the importance of the role of management, boards and directors and audit committees. I believe the ED could give more attention to the responsibilities of management, boards of directors and audit committees for the development of sound financial information and maintenance of auditor/audit firm independence. The conceptual framework would benefit for instance, from the inclusion of some of the relevant thinking and beneficial efforts of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees and, the ISB's efforts on these same matters.

I also suggest the following change be made in paragraph #7, item "b": " . . . factors - defined in this Statement as safeguards, restrictions and prohibitions to auditor independence;" I make this suggestion because I believe the ED gives to much focus to the word "safeguards". I suggest a broader perspective be adopted such as "Safeguards, Restrictions and Prohibitions." This broader perspective recognizes the fact that standard setters have and will continue to set restrictions and prohibitions for particular activities, relationships and circumstances, not just "safeguards." Tucking restrictions and prohibitions under the broad umbrella of "safeguards" may be conceptually correct but it may also be a strategic error.

Question on Goal of Auditor Independence: *Is the goal appropriate? If not, what changes would you suggest, and why?*

I like the simplicity and clarity of the definition but it may have a weakness. The definition doesn't explain how or why auditor independence and the users' perceptions of the auditor's independence establish user reliance. Missing also are the concepts of credibility and confidence. This problem could be overcome if the goal statement was broadened to tie more effectively to the two key elements of the goal of independence, enhancing capital market efficiency and, user reliance and confidence on the financial reporting process. I believe the goal would be strengthened with this modification. The narrative discussion following the goal covers these matters. Couldn't these concepts be incorporated into the wording of the goal itself?

Question on Concepts and Basic Principles of Auditor Independence*: Are the concepts and basic principles appropriate and sufficiently operational? If not, what changes would you suggest, and why?*

I am troubled with the Concepts and Principles paragraphs of the ED. After some consideration I've concluded the ED probably doesn't have solid principles statements, principles that are statements of basic truths or standards. Instead, it presents a set of four concepts that are pretty solid and would probably better serve as principles and, four principles whose nature and application is instead more advisory.

After some consideration, I believe there are perhaps only three basic principles:

<u>Principle #1: Threats to auditor independence, independence risk:</u> (Paragraphs #18, and #10 through #12)

An auditor's ability to make unbiased decisions can be compromised if threats to the auditor's independence are not mitigated.

Threats to auditor independence that may compromise, or may reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions include:

- Self interest threats
- Self-review threats
- Advocacy threats
- Familiarity (or trust) threats
- Intimidation threats

(I suggest the four guiding principles of the SEC's revised independence requirements: 1) has a mutual or conflicting interest with the audit client, 2) audits his or her own firm's work, 3) functions as management or an employee of the audit client, and 4) acts as an advocate for the audit client, be incorporated into and made part of this principle.)

<u>Principle #2: Significance of threats to auditor independence:</u> (Paragraph #19)

The significance of a threat to auditor independence is the extent to which the threat increases independence risk. Significance depends on many factors including the nature of the activity, relationship, or other circumstance creating the threat including:

- Force of pressure exerted
- Importance of the matter relative to – activity, relationship or circumstance
- Position and level of responsibility of person involved
- Strength and integrity of person involved

<u>Principle #3: Safeguards, Restrictions and Prohibitions:</u> (Paragraph #13)

Safeguards, restrictions and prohibitions may be used to mitigate or eliminate threats to auditor independence.

<u>Concepts/Guidance – Safeguards, Restrictions and Prohibitions</u>: (Paragraphs #14a through #17 and #20)

The paragraphs of the ED cited discusses various means of mediating risks to auditor independence. They give important guidance, but I don't believe they operate at the same level, as do principles.

I suggest the subject matter of these paragraphs be presented in the following order:

Reference order and subject stem:
#15 Another way of describing safeguards is by their nature:
#16 A third way in which safeguards can be described . . . .
#20 The effectiveness of a safeguard to auditor independence is . . . .
#14/a Safeguards exist in the environment . . .

#14b Safeguards that exist within auditing firms . . . .
#17 Safeguards may work either singly or in combination . . . .

The material discussed in the above referenced paragraphs is important and does warrant separate treatment. However, as noted previously, I believe the EDs focus on the word "safeguards" is a mistake. A broader context should be adopted. One that gives recognition to the fact that standard setters have and will continue to set restrictions and prohibitions for particular activities, relationships and circumstances.

I would also like to see more attention given to the responsibilities of management, boards of directors and audit committees for developing sound financial information and the independence of the auditor/audit firm than is currently given in paragraph 14a.

Relevant information contained in paragraphs #22 - #32 should be incorporated into this section of the ED.

What are your views on the appropriateness of the independence risk model? Is there research that the Board should be made aware of that would be helpful in expanding the model or otherwise making it more useful for independent decision makers? If so, please describe that research.

I believe the risk model is sound and the profession's experience with it has substantiated its viability.

Question on Other Issues: *Are there other issues in connection with the proposed conceptual framework that the Board should consider? If so, what are those issues, and how would you advise the Board to resolve them?*

I do not have any other issues.

I hope you find these comments helpful. Should you have any questions or want to discuss them with me, please feel free to call.

Best regards always,

Dennis

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February 28, 2001

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

Dear Art:

I have read the Exposure Draft of ED 00-2 entitled *Statement of Independence Concepts A Conceptual Framework for Auditor Independence*. I believe that the ISB (Board) has developed a reasonably complete list of threats to auditor independence, and I support the safeguards approach to addressing identified threats.

I am responding as an individual, and my comments do not necessarily represent the views of the Auditing Standards Committee of the American Accounting Association's Auditing Section.

I hope all is well with you.

Best regards,

Joseph V. Carcello
Stokely Scholar and Associate Professor

COMMENTS ON "STATEMENT OF INDEPENDENCE CONCEPTS A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE" (EXPOSURE DRAFT NO. ED 00-2)

Comments of Joseph V. Carcello, Ph.D., CPA, CMA, CIA
Stokely Scholar and Associate Professor
University of Tennessee

I believe that the ISB (Board) has developed a reasonably complete list of threats to auditor independence, and I support the safeguards approach to addressing identified threats.

Major Concerns

Paragraph .12. ED 00-2 identifies five threats to auditor independence – self-interest threats, self-review threats, advocacy threats, familiarity (or trust) threats, and intimidation threats. I believe that some of these threats are exacerbated by pressures imposed by the firm. For example, the auditor may face: (1) penalties for losing a client, (2) demands to bring in new business, (3) cost of technical consultations being charged to the job thus hurting realization rates, etc. I suggest that the Board explicitly recognize these firm pressures, and recognize the pernicious effects that such firm pressures can have when they interact with the five threats to auditor independence identified in the document. This issue is particularly problematic since ED 00-2 identifies the firm as a primary party responsible for implementing safeguards to address threats to auditor independence. The Board should not lose sight of the fact that, in some cases, the firm and/or its representatives can be a non-trivial part of the problem.

Paragraph .12, e. In discussing intimidation threats, I encourage the Board to consider adding a statement that an auditor is not independent if the client fails to comply with the new audit committee rule whereby the auditor is to view the board of directors and the audit committee as the client. If client management cannot terminate the auditor without the audit committee's consent, management's ability to intimidate the auditor has been reduced (assuming a properly functioning audit committee). Explicitly stating that the auditor is not independent if the client fails to act in accordance with this new audit committee rule may give these new rules additional "teeth."

Paragraph .13. ED 00-2 states that safeguards include prohibitions, restrictions, *disclosures* (my emphasis), policies, procedures, etc. I encourage the Board to consider working with the SEC to require the auditor to report on Form 8-K any direct or implied threats from management.

Paragraph .17, a. In discussing the mitigation of self-interest threats, ED 00-2 suggests restrictions on the percentage of total firm fees earned from one auditee. I support this suggestion. However, audit decisions are made at the local office level, and by engagement personnel (partners). An additional safeguard would be to limit fees derived from any one client at the level of the local office and at the level of the individual partner.

Paragraph .24. ED 00-2 states that, "Independence decision makers should determine whether the level of independence risk is at an acceptable position on the independence risk continuum." I disagree. A quasi-regulatory agency (i.e., the ISB) charged with protecting the public interest should make this decision. "High independence risk" should never be acceptable, and "remote independence risk" should be required for those engagements representing high risk to the public (e.g., large company size, widely dispersed ownership, weak governance characteristics, rapid company growth, high PE ratios, volatile industry, financial distress, etc.).

I have another concern with paragraph .24. I am unsure as to whether certain independence decision makers (e.g., the ISB, audit committees, boards of directors, regulators) will have enough information to assess the substance, and not just the form, of safeguards that exist within auditing firms.

Paragraph .25. In this paragraph, ED 00-2 states that "... independence decision makers should consider only a very low level of independence risk to be acceptable." The continuum of independence risk presented on p. 9 does not contain a "very low level" of independence risk. Is a "very low level" between "no independence risk" and "remote independence risk" or between "remote independence risk" and "some independence risk." In addition, it seems that paragraphs .24 and .25 are not entirely consistent. Are independence decision makers to decide on the acceptable level of independence risk or is it to be specified by the ISB?

Paragraph .27. ED 00-2 states that, "Independence decision makers should ensure that the benefits resulting from reducing independence risk by imposing additional safeguards exceed the costs of those safeguards." The benefits from reducing independence risk accrue to both current and potential investors and creditors and to society as a whole. The costs are borne by the client and the audit firm. I do not believe that the costs and benefits should be weighted equally (i.e., the benefits should be weighted more heavily).

Paragraph .27, c. ED 00-2 discusses a benefit to senior management of reduced independence risk as being more reliable financial information. I encourage the Board to recall that senior management is typically involved when an entity experiences severe financial reporting problems.

<u>Minor Concerns</u>

Paragraph 4. ED 00-2 states, "... an auditor must be free only from those factors that are so significant that they rise to a level where they compromise ...". You might consider explicitly stating that factors can achieve the necessary level of significance such that independence might be compromised either alone (one very large threat to independence) or in combination (a series of smaller threats to independence that, when considered together, represent a large threat).

Paragraph .22. A key concept throughout all of ED 00-2 is that of "independence decision makers." Although this term is defined in the glossary (p. 13), I think its definition should appear early in the text because the entire Exposure Draft is dependent on the acceptance of this concept.

Paragraph .54. ED 00-2 states that "… in some cases, the costs of attempting to get closer to the "no independence risk" endpoint on the continuum may exceed the benefits of reducing independence risk. I encourage the Board to provide examples of such cases in the document.

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26 February 2001

Mr. Arthur Siegel, Executive Director
Independence Standard Board
1211 Avenue of Americas
New York, NY 10036-8775

Dear Mr. Siegel

On the attached sheet I have some comments re the November 2000 ED: Statement of Independence Concepts.

To present "concepts" in a lucid manner is not a simple task. At the same time, as I think about "independence" as a requirement for a public accountant, a clearer, more readily understandable explanation should be possible than is presented in this Exposure Draft.

I send my best wishes to you and your colleagues as you conclude your conceptual framework project.

Sincerely

Mary Ellen

Mary Ellen Oliverio
Department of Accounting

Attached: Some comments

EXPOSURE DRAFT

Statement of Independence Concepts
A Conceptual Framework for Auditor Independence November 2000

COMMENTS:

(I must begin by noting a bias: Possibly, nothing captured my attention when I studied auditing more than the notion that an auditor was independent. When I began teaching auditing, the textbooks I read discussed independence as "the foundation" of the auditor's qualifications. I continue to believe that the significance of an auditor's contribution is related to an unrelenting respect for independence and persistent adherence to objectivity which is the operational outcome of that respect.)

Implied conceptualization is troublesome. The Statement seems to be implying that independence is "only one source. . . of quality audits." (page 2) Further on there is a discussion of "considering benefits and costs" in relation to independence risk. It appears that decision makers can determine the risk they wish to accept. (pages 9-10) How does "low level of independence risk" become reconciled with "consider benefits and costs." It appears that the concept of independence is just one of many factors and there is opportunity to substitute other factors that are perceived to be sufficient for quality audits.

Auditor independence is freedom from those pressures. . . .(page 2) It is not clear how "independence is freedom. . . " Is not independence related to being able to separate one's decision making from pressures. "Freedom" is a somewhat unrealistic state. . . *the client is paying the auditor and is interested in presenting the company in the most favorable position. . . and that client may threaten the auditor that "we will find another auditor who better understands us. . "* . . . Paragraph 4 is a very fuzzy, ambiguous series of sentences.

Threats to auditor independence. (page 4, 6) I wonder why there is not a more realistic identification of firm policies (including the valued position of the rainmaker), such as the basis for retention, and promotion that could impact auditor independence. There is, for example, a listing of "maintaining the tone at the top.. .but should there be something more concrete than "stresses the expectation. . . " *(I teach auditing at the graduate level; many of our students accept positions with the Big-5 firms. One of the most disappointing experiences some former students explain to me is illustrated by this comment: "Yes, we get memos that we must adhere to policies-- every audit is to be high quality; however, that memo is for the record; it is not the reality. . . . ")*

Why not detail costs as benefits are enumerated? (page 10) Paragraph 29, it seems to me, should enumerate the costs.. . this is another fuzzy paragraph.

Where on the continuum of auditor independence risk must an audit firm be before the auditors can issue an opinion that is not a disclaimer? The current guidance (AU504.08-.09), as you know, requires a disclaimer if auditors are not independent. Given the ED, it would appear that auditors would make no claim about being independent because they may have determined that the really important factors do not include independence. Will the Board provide the alternative ways that auditors will report how they assessed the level of independence that was sufficient for their purposes?

. . . . .

Has the Board considered deregulating independence? Why not let companies determine if they want an audit by an outside auditor. A publicly-owned company could be free to present its financial statements with a report from its own CFO which clearly establishes the fact that no outside auditor was engaged.

Mary Ellen Oliverio
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February 27, 2001

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Attn: ED 00-2

Re Statement of Independence Concepts,
A Conceptual Framework for Auditor Independence,
Exposure Draft 00-2

Dear Board Members:

Although we support the threats-and-safeguards structure of the Exposure Draft (ED), we believe that flaws would render the statement harmful to independence decision-making, and we oppose its adoption in the present form. The defects begin with the definition of auditor independence and permeate the document. The ED represents an untenable balance between the old, insupportable appearances approach to independence and an approach based on the risk of compromised objectivity. The appearances approach is in the definition of independence, implied by the goal of auditor independence, and in the fourth principle (paragraph 30). For these reasons, lack of coordination among the ideas, and misleading and ill-chosen language, the ED falls well short of the intellectually rigorous conceptual framework we need. In our comments below, we recommend improvements that would make the document useful for its intended purposes.

The Definition's Two Criteria

The ED's definition of auditor independence should be more explicitly linked to the concept of independence risk. It is flawed by absolutism, contains internal tensions, and is inconsistent with some of the other concepts. This greatly affects the usefulness of the ED, since the definition affects the meaning of other concepts and principles that use the word "independence," and if the ED is adopted in its current form, the flaws would have a widespread effect on communications about independence. Here is the ED's definition:

> Auditor independence is freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions. (paragraph 4)

The relationship between the two characteristics connected by the "or" is not apparent or explained, though the characteristics function as criteria indicating whether a party is or is not independent. Why should a person who cannot reasonably be expected to have compromised ability to make unbiased audit decisions (the second criterion) not be considered independent under the first criterion, which is implied by having both criteria? Can a person who does not satisfy the second criterion be considered independent under the first? The "or" functions as "and," but no rationale for a definition with two different criteria is given. If two criteria are not necessary, there should be only one. Independence concepts should be simple and spare whenever possible.

The First Criterion Is Absolute

The first criterion, "freedom from those pressures and other factors that compromise...," is absolute. No person could be free from all the factors that compromise an auditor's ability to make unbiased audit decisions. The criterion includes immaterially compromised "ability to make unbiased audit decisions" and immaterial audit decisions. Audit decisions vary from those that influence the opinion to those that do not.

The criterion is absolute in another way. No one can determine prior to or during an audit whether the practitioner is free from all influences that compromise the ability to make unbiased audit decisions. There is no way to arrive at the conclusion that the criterion has been met.

Paragraph 41 of the Basis for Conclusions argues that the definition is not absolute. However, paragraph 41's argument is unconvincing. Whether or not an influence rises to the level of compromising audit decisions is irrelevant to whether it functions as an absolute criterion. *All* influences that rise to such a level are defined as impairing independence. The criterion is severe enough never to be satisfied. Paragraph 40 points out that under the definition "auditors can be affected by pressures and other factors that do not bias audit decisions," but such events are not of interest. Whether or not influences on auditors' decisions on recreation or family matters are influenced by some factor does not make the population of interest, that is, the population of influences on audit decisions, any less absolutely complete.

Paragraph 41 says that the definition "describes a state that an auditor can attain, namely, the ability to make unbiased audit decisions." However, the sentence focuses on the wrong state. The issue that the definition raises is whether the auditor is free of all influences that bias audit decisions, not whether the auditor can make unbiased audit decisions. In any case, no one can determine *either* state in advance of an audit with a sufficiency to satisfy the absolute nature of the definition.

In contrast, independence decision makers can determine whether the risk of impaired objectivity is unacceptable. As paragraph 6 of the ED says, "To be independent, an auditor must be able...to overcome pressures and other factors that would prevent unbiased audit decisions." Overcoming pressures and other factors is not being free of them. They are always present in some manner and in some degree. The audit fee is frequently cited to illustrate this point.

The Definition's The Second Criterion

Eliminating the definition's absolute element would leave: "Freedom from those pressures and other factors that can reasonably be expected to compromise an auditor's ability to make unbiased audit decisions." However, apart from its insupportable interpretation as a criterion for appearance of independence,[1] the definition using the reasonable-expectation criterion would not be desirable for this reason: It would be insufficiently linked to the idea of independence risk. (The relationship between the first criterion in the ED's definition and independence risk is treated below under a separate heading.)

The ED's first two principles reflect an independence-risk approach. The definition of independence should be linked to the independence-risk approach and the defined concept of independence risk. In addition and more importantly, the public interest is best served by a realistic definition of independence, and the only realistic definition of independence is based on an acceptable level of independence risk. Rulemakers' decisions about independence have always been about independence risk and always will be. No standard setter or regulator has attempted to ban every potential influence on auditor objectivity, including the audit fee, and no party has, to our knowledge, argued that it is necessary. Despite rhetoric about appearance of independence, even language about appearances in rules and requirements, no standard setter or regulator has attempted to ban practices because of appearances.

The test is not whether the rulemakers say they are using such a criterion, but how they go about making the rules. They have not, to our knowledge, sought defensible evidence of appearances, evaluated what that evidence meant, applied the findings, and regularly updated the rules for new findings on appearances or confirmed that the rules in place reflected current findings on appearances. Appearances change, and the stringency of rules would have to be altered as such changes occurred. Evidence that this has never been done lies in the plain fact that appearance of independence has never been used to consider relaxing independence requirements, much less actually relaxing them, even though evidence has been available that auditors' independence and work are well thought of by constituents. The ISB's Earnscliffe research is an example.

The idea of appearance of independence should not be available for arbitrary use in justifying prohibitions that cannot be justified as necessary to reduce independence risk to an acceptable level. Standard setters should not be encouraged to pretend they are applying the appearances criterion when they are merely paying it lip service. No conceptual framework with an appearances criterion can be considered forthright and thorough if it fails to acknowledge that the criterion has been used only by name in the past and has never been honored by the hard, and impracticable, work of ongoing research and maintenance. If fully pursued, an appearances criterion would probably never meet a cost-benefit test.

[1] See paragraph 2 of the Summary and paragraphs 42-45 of the Basis for Conclusions.

The notion that the "reasonable expectation" is the expectation of "well-informed investors and other users of financial information" (paragraph 4) is an appearance-of-independence concept. Note that it goes beyond the well-informed to include those not-well-informed ("and other users of financial information"). We have explained before why such a criterion is arbitrary, conceptually unsound, and inconsistent with evidence that investors and other stakeholders take no interest in independence rulemaking, do not know independence rules, and are unaware of the specifics of independence situations. Our arguments are reproduced in the appendix to this letter.

In another inconsistency, the ED's own statements show how ill-advised is the appearances approach to "reasonable expectation." Paragraph 38 says,

> [T]he Board recognizes that investors, users, and other interested parties ordinarily cannot obtain information about pressures and other factors that may affect a specific auditor's ability in a specific audit engagement to make unbiased audit decisions. They rely on independence decision makers to identify and analyze various activities, relationships, and other circumstances that are sources of pressures and other factors that can reasonably be expected to lead to biased audit decisions, and to adopt appropriate safeguards, if necessary, to reduce independence risk to an acceptably low level.

This statement suggests it is wrong and unworkable to treat "reasonable expectation" as the expectation of "well-informed investors and other users of financial information."

The Definition: Incompatibility with Independence Risk

The absolute criterion of independence ("freedom from those pressures and other factors that compromise…an auditor's ability to make unbiased audit decisions") is inconsistent with the concept of independence risk. Independence risk is the risk remaining, after balancing threats and safeguards, that the auditor's ability to make unbiased audit decisions will be compromised. The absolute criterion means there is no such risk (total freedom from compromising factors) or the auditor is not independent. In other words, under the absolute criterion, and therefore the definition, for practical purposes, independence risk is never operational. However, as paragraph 25 says, "Given certain factors in the environment in which audits take place…independence risk cannot be completely eliminated and, therefore, independence decision makers always accept some risk that auditors' objectivity will be compromised." The statement is inconsistent with the definition's absolute criterion of independence.

The Definition: Objectivity and Independence

The absolute first criterion in the ED's definition may derive from the desire to assert that independence is more than just following rules (as is argued in ED paragraph 6) and to preclude anyone from holding to such an assumption. If so, the exercise is tilting windmills. No one is going to be prevented from believing that following the rules yields a claim to independence. Even rulemakers must believe that following the rules they set yields a claim to independence. Otherwise they should turn in their credentials as protectors of users of financial statements. Are the ISB and its staff to hold in public that the standards they issue are not sufficient to ensure auditor independence?

More importantly, those who are trying to come to grips with the conditions that make for independence should not be confused into thinking that objectivity is identical to independence. The absolute criterion for independence effectively creates such an equivalency. It makes independence dependent on freedom from "pressures and other factors that compromise...an auditor's ability to make unbiased audit decisions." The auditor so absolutely free from undermining factors is automatically, by definition, 100 percent objective. There would be no need for a definition of "independence" if all it meant in the end was objectivity in making audit decisions. Objectivity is a common, widely understood term. The pretense that a synonym, "independence," is a different quality is confusing.

Evidence that the ISB staff and project leaders realized they had built into the definition an equivalency between independence and objectivity is in a recent article they published in the *Journal of Accountancy*. It states: "The proposed definition compels the auditor to make a personal assessment of his or her objectivity—to determine if pressures and other factors compromise the ability to make unbiased audit decisions."[2] As already noted, paragraph 41 of the ED says that the definition "describes a state that an auditor can attain, namely, the ability to make unbiased [i.e., objective] audit decisions."

The Definition: Threats and Safeguards

The definition of independence is not coordinated with the concepts of threats and safeguards. This flaw also supports our argument that a more explicit link is needed between the definition of independence and the concept of independence risk.

Safeguards "mitigate or eliminate threats to auditor independence," which means, according to the definition of threats, safeguards mitigate or eliminate "sources of potential bias that *may* compromise...an auditor's ability to make unbiased audit decisions." Thus by definition safeguards have no effect on pressures and other factors that in fact compromise an auditor's ability to make unbiased audit decisions. They therefore have no effect on the absolute criterion in the ED's definition ("freedom from those pressures and other factors that compromise...an auditor's ability to make unbiased audit decisions"). Such pressures by definition create bias. It is arguable that review procedures can mitigate compromised objectivity. A concurring partner's review can right a biased audit decision. Unfortunately, that does not solve the problem. Safeguards are defined as mitigating threats, not "pressures and other factors that compromise...an auditor's ability to make unbiased audit decisions." That is, safeguards, again, are defined as mitigating "sources of potential bias." Thus review procedures function as safeguards only to the degree that they prevent biased audit decisions, not to the degree that they rectify such decisions. In these ways, the definition of independence does not coordinate with the definitions of threats and safeguards.

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[2] Susan McGrath, Arthur Siegel, Thomas W. Dunfee, Alan S. Glazer, and Henry R. Jaenicke, "A Framework for Auditor Independence," *Journal of Accountancy*, January 2001, p. 40.

Our Recommended Definition

Here is the way the definition, with some editorial pruning, might look explicitly linked to independence risk:

> Auditor independence is freedom from any factors that create an unacceptable risk of biased audit decisions.

This definition could be made more explicit. It does not say that it is limited to material matters. However, the notions of material influences on objectivity and material or significant audit decisions are lodged in the qualifier "unacceptable." We recommend a version of this definition.

The fat should be trimmed from any conceptual-framework definition, and the ED's version has fat. "Any factors" is equivalent to "pressures and other factors," though we would prefer a less abstract term (e.g., "conditions" or "influences"). One of the aims of a conceptual framework is to make discourse on independence more efficient and fruitful. That cause is not served by using "pressures and other factors" every time a single word would convey the same message.

The independence-risk approach to defining independence would in a different way serve the purpose evoked in paragraph 6 of the ED, which as we have seen, attempts to preclude those who follow the independence rules from claiming to be "independent," as the ED defines it. Under the independence-risk approach, no one would have an unchallengeable claim that following the rules means *being objective*, because independence would not be equivalent to objectivity. Moreover, no one can know the level of independence risk in any circumstance. It must be estimated by all independence decision makers. That would not prevent people and rulemakers from legitimately claiming the rules indeed produce independence, but everyone who followed these matters would know that an acceptable level of independence risk is a level targeted by the standard setters making the claim, not something absolute, universal, and incapable of being adjusted. And everyone would know that independence was not the same as objectivity. A conceptual framework that does public service should not conclude its passage defining independence with the words: "Compliance with the rules is a necessary, but not a sufficient, condition for independence." It makes the ED's talk of more credible financial statements through independence empty and ironic. Compliance with the rules should be a sufficient condition for independence, but not a sufficient condition for being objective.

The text elaborating the ED's definition illustrates that a definition based on an "unacceptable risk of biased audit decisions" is superior to one based on the criterion "can reasonably be expected to compromise an auditor's ability to make unbiased audit decisions." Sentence three of paragraph 5 says that rules prohibiting activities and relationships apply to all auditors because "it is reasonable to expect audit decisions to be biased in those circumstances." However, this statement follows another recognizing that some auditors' objectivity would not be impaired by the activities and relationships, and it is obvious that auditors differ in their ability to withstand influences that could affect objectivity. Thus it is not reasonable to expect that audit decisions would "be biased in those circumstances." In fact, it is reasonable to believe that because auditors' levels of imperviousness to threats to objectivity can never be known, rules prohibiting activities and relationships mean the risk of impaired objectivity was considered unacceptable.[3]

Redundant Definition of Independence Risk

Here is the way the definition of independence risk from paragraph 18 would look with the term "auditor independence" replaced by its definition from paragraph 4. The replacement is in square brackets:

> Independence risk is the risk that threats to [freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions], to the extent that they are not mitigated by safeguards, compromise, or can reasonably be expected to compromise an auditor's ability to make unbiased audit decisions"

Redundancy is immediately apparent. All that would be necessary to convey the intended meaning is "Independence risk is the risk that threats to auditor independence are not mitigated by safeguards."

Goal of Auditor Independence

Through the ambiguous word "support," the goal allows that the credibility of the financial reporting process is an end of auditor independence separate from the goal of reliable financial reporting. This interpretation would contribute to the appearances approach to independence and is inconsistent with what auditors do and the public interest in what auditors do. Auditors undertake no activities designed to influence the credibility of the financial reporting process. Audit procedures are designed to obtain sufficient evidence to arrive at a correct opinion on the financial statements. Auditing standards are restricted to delineating what is required to arrive at correct opinions, and audit reports are carefully worded to avoid any other implications. They avoid all other implications because the evidence gathered in compliance with the standards pertains to the reliability of the financial statements, not to the desirability of owning the auditee's stock. A clean audit report follows an evidence-gathering process that could have resulted in an adverse opinion.

"Capital market efficiency," cited in the goal, refers primarily to the market's efficient impounding of information, a pricing mechanism.[4] It refers to both audited and unaudited information. It should not be a goal of auditor independence to have information impounded in prices regardless of whether it is reliable or not.

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[3] Sentence two of the same paragraph allows that rules apply generally because of the threat of bias (potential source of bias), which is consistent with the risk approach and inconsistent with the third sentence that is the subject of the paragraph above.

[4] As Burton G. Malkiel points out, "Markets can be efficient even if they make errors in the valuation of individual stocks and exhibit greater volatility than can apparently be explained by fundamentals such as earnings and dividends." Burton G. Malkiel, "Are Markets Efficient? Yes, Even if they Make Errors," *The Wall Street Journal*, December 28, 2000, p. A10. Barron's *Dictionary of Business Terms* defines efficient market this way: "theory that market prices reflect the knowledge and expectations of all investors." (Barron's Educational Series, Inc.: New York, 1987).

Everyone knows about the risks of a "bubble economy" and "irrational exuberance." Confidence in financial reports can be engendered by fraudulent activities. It would be improper for auditors to work for confidence in financial statements or the capital markets by any means other than helping to ensure the reliability of financial reports. Indeed, the threats to independence listed in paragraph 13 of the ED include "advocacy," which is contrasted with unbiased work on the financial statements. Advocacy, by inference, would include working to enhance public credibility for the financial statements apart from the work to evaluate their reliability.

The effect of high quality auditing, and therefore more reliable information, on the capital markets is better decisions by investors and creditors, the kind of decisions more likely to lead to economic growth and stability than decisions based on less reliable information. If the ED's goal is retained, which we do not recommend, "capital market efficiency" should be replaced by "capital market effectiveness."

We recommend the goal of auditor independence be based on what high quality auditing does for the economy, that is, on increasing the reliability of financial statements. Here is the way such a goal would look:

> The goal of auditor independence is to make it more likely that audits improve the reliability of financial statements.

Independence Concepts—The Threat Categories

The threat categories are insufficiently distinctive to be useful. Paragraph 12 admits that they are not mutually exclusive or exhaustive, but the admission does not make the categories useful. Quite the contrary, the admission indicates the categories cannot be relied on to discuss threats in a consistent way. What one party identifies as a threat of a particular category, another, by the ED's own admission, can rightly ascribe to a different category. Apart from that, there is no need to have a set of threat categories in the conceptual framework.

In any case, these threat categories are particularly clumsy. The first of them, "self-interest," is generic and includes the remaining four. The description of the self-interest threat is unequivocally expansive and inclusive: "Self-interests include auditors' emotional, financial, or other personal interests" (paragraph 12, item a, sentence 1). No threats are excluded from such a category. The "self-review threat," for example, arises because the auditor has emotional and often financial interests in the work performed. The "intimidation threat" works only if the auditor has a self-interest that can be threatened, such as the audit fee in the case of threatened firing. The advocacy threat includes the auditor promoting an auditee's securities, a role that creates a self-interest in sales of the securities or arises from a desire to retain the audit fee. The familiarity threat is a personal interest (a "particularly close or long-standing personal or professional relationship with the auditee").

The accompanying text is evidence of the sloppy thinking that the overlapping categories prompt and their singular inappropriateness for a conceptual framework. Self-interest threats do not necessarily "arise from auditors acting in their own interest" (paragraph 12, item a, sentence 1). Auditors' self-interests include maintaining their reputation, avoiding liability, and retaining the respect of their peers. Acting in pursuit of these self-interests does not threaten auditors' objectivity or independence. The implication that self-interest threats necessarily "arise from auditors acting in their own interest" is contradicted by the third sentence in item a: "Auditors may favor, consciously or subconsciously, those self-interests over their interest in performing a quality audit." This sentence admits that auditors have a self-interest in audit quality, and such a self-interest is entirely in keeping with objective audit judgments.

The examples of safeguards include self-interests ("the value auditing firms and individual auditors place on their reputations," "the legal liability faced by auditors and other participants").[5] It makes no sense to have a threat category so broad that it includes safeguards.

The sentence defining the advocacy threat contains a false opposition: "promoting or advocating for or against an auditee's position or opinion rather than serving as unbiased attestors of the auditees' financial statements" (paragraph 12, item c, sentence 1). The unbiased audit report with a clean opinion on the reliability of the financial statements promotes the client's position that they are reliable. An auditor who takes the same position as the client in discussions with the SEC can be totally objective.

Item d, discussing the familiarity threat, is circular. It says, "Such a threat is present if auditors are not sufficiently skeptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee." This sentence has the threat arising if the auditor has impaired objectivity (insufficient skepticism), which means that if the auditor is not independent, the threat is present. Apart from the circularity, the "threat" ignores that in effective audits, the auditor typically has good working relationships with the clients and relies on them for some information and audit evidence.

The analysis immediately above demonstrates that threat categories a. through e. are not useful. The set is fundamentally and consistently flawed.

Independence Concepts—Safeguards

There is no stated advantage to describing safeguards in three ways as is done in paragraphs 14-16. All the reader is told is that safeguards "can be described" in this way or that way. Discourse on independence is not served by a conceptual framework that offers three options for talking about a single thing unless some unique purpose is served by each of the three.

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[5] Paragraph 14, items a.1 and a.7.

The three are now incoherent. All but one of the items in paragraph 14 are preventive, and the exception needs to be revised to be unambiguously preventive. Yet paragraph 15 treats preventive safeguards as one of four categories. The other three categories in paragraph 15 are also preventive. No procedure or condition can qualify as a safeguard unless it mitigates or eliminates threats (potential sources of bias). That means safeguards prevent the potential source of bias from having the undesirable effect on objective auditing. In that sense, they are preventive. They may have other characteristics as well, but the characteristics that make them safeguards are preventive. For this reason, item 14.a.7 should be revised. It is only the prospect of disciplinary actions that function as safeguards. Disciplinary actions are safeguards only to the extent that they deter other auditors from biased auditing and violations of independence rules.

The first sentence of paragraph 16 is untrue. All safeguards do not "restrict activities or relationships," as demonstrated by the list in paragraph 14.

A partial remedy to the discord in this passage would be to delete paragraph 15, characterize all the examples in paragraph 14 as preventive, and state that paragraph 16 refers only to a subset of what is in paragraph 14 (for example: "Safeguards that restrict activities or relationships can be divided into four types").

Paragraph 17 shows the interaction of safeguards with the useless threat categories analyzed above. The paragraph should be deleted and its first two sentences relocated in paragraph 14. Since the threat categories are by admission not mutually exclusive, their correlations with safeguards are not mutually exclusive.

The Interested-Parties'-Views Principle (paragraphs 30-32)

Paragraph 30 sets out the ED's fourth principle of independence. It directs independence decision makers to consider the views of parties with an interest in financial reporting and to resolve independence issues "based on the decision makers' judgment about how best to meet the goal of auditor independence." We believe the principle's final words should be "based on the decision makers' judgment about how best *to arrive at an acceptable level of independence risk.*"

It is inconsistent to direct independence decision makers to determine an acceptable level of independence risk (the first two principles) and to consider costs and benefits (the third principle) and then to tell the same decision makers to resolve issues by a wholly different method, namely, by resorting somehow to the goal of independence, which, though vague, can be interpreted as based on stakeholders' attitudes. The interpretation is encouraged by the last sentence of paragraph 32 ("In order to achieve the goal of auditor independence..., all independence decision makers...should be sensitive to the likely views of investors, other users, and other interested parties, and the impact their decisions may have on those views"). The fourth principle should be consistent with the prior three. It can be made consistent by the change we recommend.

Paragraph 59 of the Basis for Conclusions, explaining this principle, says independence decision makers should ask "whether well-informed investors and other users would reasonably consider the activities, relationships, or other circumstances in question as precluding independence." As already pointed out, "and other users" incorporates the views of not-well-informed stakeholders. More importantly, it does not serve the public interest to try to go in this way beyond the wisdom and effectiveness of arguments gathered from interested parties and the Board's own reasoning and findings. Speculation about attitudes of fictional parties, even fictional "well-informed" parties, does not serve the public interest. It opens the road to fuzzy thinking and arbitrary decisions. It tells those interested parties who do submit reasoned views that they are unimportant, because the Board is going to consider instead the hypothetical views of "well-informed investors and other users." Participation by interested parties in ISB standard setting would decline from its already low level when it is realized that the Board's approach as indicated by paragraph 59 supersedes evaluating the risk of compromised objectivity based on available argument and evidence about threats and safeguards.

Paragraph 56 of the Basis for Conclusions says that the Board considered three approaches to this principle and that it rejected "develop[ing] standards that reflect the likely views of reasonable, fully informed investors or some other group or groups of interested parties." The sentence at issue from paragraph 59 brings to bear the approach paragraph 56 says the Board rejected.

We recognize that a Board or other independence decision makers would be free to say the goal of independence is best achieved by focusing exclusively on the risk model in the first three principles. That would be a better outcome than attempting to resolve issues according to the appearances-approach that can be read into the idea of achieving the goal or according to the hypothetical investor approach from paragraph 59. But it would not be an ineluctable outcome, and it would not be a consistent outcome. It would depend on politics and personalities. The process would demonstrate that the conceptual framework in this ED is attended by too many internal tensions and confusions to do the job it is supposed to do, create a principles-based approach to independence decisions. The tensions and confusions would be greatly reduced by the change we recommend to this principle.

Principles of Auditor Independence—The Risk Continuum

The independence-risk continuum in paragraph 23 uses language that is internally inconsistent. The five-point range of likelihoods ascends with these descriptors: virtually impossible, very unlikely, possible, probable, and virtually certain. Here are the first- and second-entry dictionary definitions of "possible" and "probable":

> possible – 1. Capable of happening, existing, or being true without contradicting proven facts, laws or circumstances. 2. Capable of occurring or being done without offense to character, nature, or custom.
>
> probable – 1. Likely to happen or be true. 2. Likely but uncertain; plausible.[6]

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[6] Both definitions are taken from *The American Heritage Dictionary of the English Language*, Third Edition (Houghton Mifflin Company: Boston and New York, 1996).

Clearly, all that is probable is possible. It is equally clear that the scale makes no sense at all with the word "possible" at its center. The points on both sides of what is possible are also possible; that is, "very unlikely" and "probable" are both possible. In fact, everything on the scale is possible except, perhaps, "virtually impossible."

In short, because of the descriptors, the continuum in its current form is nonsense and should not be in the conceptual framework.

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If you have any questions about our comments and recommendations, please contact John M. Guinan at 212-909-5449 or jguinan@kpmg.com.

KPMG LLP

Appendix

Why the Appearance-of-Independence Approach (Perceptions-of-Investors Approach) Is Conceptually Unsound and Inconsistent with the Real World of Independence Decision Making

Excerpts from KPMG's Response to Discussion Memorandum 00-1, May 26, 2000

[On the goal of independence]
A conceptual framework with such a goal—that is, one that separated achieving credibility from its origin in achieving reliability—would embrace and implicitly endorse auditors who commit fraud, auditors who violate generally accepted auditing standards (GAAS), incompetent auditors, and baseless confidence in financial statements and in capital markets that can lead to instability and misallocated capital. These points are given briefly but more specifically below:

- The auditor who knowingly works for credibility apart from reliability commits fraud and does so in the same way that a preparer of fraudulent financial statements commits fraud—by intentionally misleading users of financial statements.

- The auditor who unknowingly works for credibility apart from reliability is incompetent or the same as an incompetent. Providing a clean opinion on materially misstated financial statements delivers credibility without reliability.

- The auditor who works for credibility apart from reliability violates generally accepted auditing standards (GAAS), because GAAS demands sufficient evidence and is designed to ensure correct opinions. The auditor's work and deliverable are devoted exclusively to reliability.

- Confidence in financial statements is not always good for the capital markets or the economy. It is not good for them when the confidence is unwarranted and can lead to destabilized markets and ineffectively allocated capital.

These four points compel this conclusion: A conceptual framework for independence that incorporates the idea that credibility of financial statements is a goal separate from their reliability, a goal that can and should be pursued on its own by auditors, would bring within the realm of accepted behavior actions contrary to the public interest. Indeed, it would implicitly treat that behavior as professionally desirable and in the interests of audit independence and audit quality. No public-spirited party should want such thoughts in the ISB's conceptual framework.

Audit quality leads to reliable financial statements, which, other things being equal, would add to their credibility. How otherwise should an auditor work for credibility? Assuming the work for credibility apart from reliability excluded the nefarious options cited above, what seems to remain is public relations and sales efforts of the sort that lead accountants to be criticized for behaving commercially instead of professionally. There is certainly nothing professional in touting credibility apart from reliability. The effect would therefore be self-defeating, reducing the credibility of auditors and audited financial statements.

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[On the appearances approach to independence]
Paragraph 74 concedes that stakeholders do not know the members of the audit team of the company they own or are considering for investment. This makes goals based on the individual auditor's appearance inoperative and inappropriate. For this reason, paragraph 74 states: "[I]t can be argued that users' and other stakeholders' perceptions of, and their confidence in, the improved financial statement reliability added by an independent auditor may depend on their beliefs about the independence of auditors generally and about the effectiveness of the totality of the self-regulatory and public regulatory processes, including those concerning auditor independence, that help ensure audit quality."

This seems to be a version of the idea of profession-independence from R. K. Mautz and Hussein A. Sharaf, more recently cited and explicated in an article by Douglas R. Carmichael in *The CPA Journal.*[7] As Carmichael words it, "Profession-independence is the apparent independence of auditors, as a professional group, to the public." The idea reappears in paragraph 168 (Section VII of the DM), and Mautz and Sharaf are quoted in a footnote.

The profession-independence argument does not support the inclusion of credibility (or appearance) goals, definitions, concepts, or principles in a conceptual framework for auditor independence. The auditor on the job who is following independence rules is unwitnessed. Such unwitnessed activity and compliance cannot affect profession-independence (or appearance of independence). Auditors' collective performance is the primary influence on profession-independence, because audit failures get in the press, public figures talk about them, and steps are taken to prevent them, which also can attract attention. A consistently high level of audit failures would depress public estimates of audit quality and from that base, everything connected to it. Note, however, that it is audit quality that is perceived, not audit independence. If audit quality is the primary determinant of profession-independence, independence goals, definitions, concepts, principles, and standards would contribute to profession-independence best by contributing to audit quality—in other words by focusing on the auditor's job under GAAS, to boost the reliability of financial reporting. There would be no argument for a separate self-sufficient goal of credibility apart from the goal of the reliability of financial statements.

Institutions and authorities, primarily standard setters and enforcement bodies, also can contribute to profession-independence by the respect they generate. Thus, apart from au-

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[7] Douglas R. Carmichael, "In Search of Concepts of Auditor Independence," *The CPA Journal*, May 1999, pp. 39-43.

dit quality and its consequences, so-called profession-independence is based primarily on stakeholders' perceptions of regulators. Perceptions of regulators and the regulatory environment are not perceptions of auditors, whether individually or as a group. At most there are derived impressions of auditors, audit quality, and audit independence.

This process should not be confused with stakeholders' perceptions of specific rules and rulemaking processes. Stakeholders, as a group, do not know about the rules that institutions and authorities make and have made. We know this, for instance, from the Earnscliffe research, but it can also be inferred from the complexity and arcane nature of independence rules and from the extremely low level of stakeholder participation in the ISB's standard-setting operation. Because we have good reason to believe that there is no widespread following of independence standard setting by stakeholders, basing standards on how the ISB might appear could not have any significant influence on profession-independence.

Moreover, even if most stakeholders did follow standard setting closely, basing standards for audit independence on the image of the standard setters, not on what they do for audit quality and the reliability of financial statements, would diminish profession-independence, not raise it. Consider the consequence of public perceptions that the standard setters were basing rules not on audit quality, but on how they, the standard setters, were perceived. Rational stakeholders would evaluate independence standard setters (or standards, if they did evaluate them) for their effect on the fact of independence, that is, for their effect on the auditor's work for reliability of financial statements. If they learned that standard setters were not setting standards to boost audit quality through the fact of independence, confidence in standard setting would plummet, as well it should. The idea that the standard setters had ceased to be independent judges of what was best for audit quality or audit independence, and instead were devoted primarily to how they appear, would be dispiriting to all stakeholders. Putting such ideas in a conceptual framework would ensure the dive in confidence. In short, arguments that independence standards should be based on the image of standard setters risks depressing stakeholders' confidence in the standard-setting process and in profession-independence.

The ISB has been constitutionally devised to build confidence in its work. It has an open standard-setting process that could generate additional profession-independence, other things being equal. Thus, new steps have been taken fairly recently to build profession-independence. We should let them work.

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Stakeholders' perceptions (the separate credibility goal, the appearance of independence approach to independence, the idea of profession-independence) should not be in a goal or in a definition of independence or in any concepts mentioned in Section V. Appearances, apart from the fact of independence, cannot affect audit quality or audit objectivity or change the risk of fraud or the risk of financial injury to the investing public. They do not affect in any way the reliability of financial statements. As we have seen, because stakeholders do not perceive the conditions that affect auditors' objectivity on the job or the auditors' compliance with the rules and do not know the independence rules, the assumptions governing them, or how they are changing, profession-independence is based primarily on audit quality and stakeholders' attitudes toward institutions and authorities. Setting standards based on contributing to audit quality is consistent with contributing to profession-independence, because it improves audit quality. The notion that standard setters are basing standards on how they, the standard setters, might appear could damage stakeholder trust in the system and profession-independence. Apart from that, it would be of limited effect, given the low level of stakeholder awareness of what standard setters are doing. The best way for institutions and authorities to win stakeholders' approval and confidence, therefore, is to base rules on what reduces risks to auditors' objectivity to an acceptable level, to thereby promote reliable financial statements, and to do this through confidence-inducing due process.

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[On an interested-parties-views principle]
To adopt the principle that standards should directly reflect stakeholders' perceptions (proposed principle 9A) would be pretense and sham. Standard setting is incompatible with an abstract, pure democratic model, where the standards are made by the views of the constituents. Kenneth Arrow, the Nobel laureate, showed that ideal outcomes could not be a direct aggregation of constituent preferences.[8] It would be inefficient, even if it were feasible, to collect stakeholders' perceptions in order to create standards from them in a manner that reflects them all, or reflects even investors' perceptions alone. Perceptions differ and change over time, and research instruments must avoid shaping opinion when obtaining it. Participation in the standard-setting process to date suggests that responses to discussion documents can never be a source of representative comment. There would be no reason to have a highly qualified Board if its sole function was to serve as a conduit for some measure of stakeholder opinion. The Board's obligation to set standards with due-process input and its own thinking and deliberative processes reflects a sensible division of labor. There is no reason to assume that busy investors want to study independence issues and drafts in order to have their views reflected directly in the Board's standards. They want to be able to trust the Board, and the Board will violate that trust if it publicly endorses giving away its responsibility to set standards to a requirement to find some measure called stakeholders' perceptions.

The Board would lose any right to constituents' cooperation if it asked for their views and then put them in the trash in favor of the views of a hypothetical set of investors (proposed principle 9B). All constituents who read the conceptual framework would know the Board was going to trash their views, that the Board was just going through the motions of meaningful due process. Constituents in such circumstances need not read the conceptual framework to learn about the Board's insult to their intelligence and misuse of their time. All they would have to do is read the basis for the Board's conclusions in its standard-setting documents. The Board would there confess that regardless of whatever wisdom and analytical truths constituents offered, the Board made decisions based on the

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[8] Kenneth J. Arrow, "Social Choice and Justice," *Collected Papers of Kenneth J. Arrow*, vol. 1, (Cambridge, MA: The Belknap Press of the Harvard University Press).

hypothetical fully informed investor. The Board has received relatively little input so far. The well would soon run dry.

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American Accounting Association's Financial Accounting Standards Committee Comments on the ISB's Exposure Draft ED 00-2: A Conceptual Framework for Auditor Independence

Stephen G. Ryan, Chair; Robert H. Herz; Teresa E. Iannaconi; Laureen A. Maines; Krishna Palepu; Katherine Schipper; Catherine M. Schrand; Douglas J. Skinner; Linda Vincent

The Financial Accounting Standards Committee of the American Accounting Association (hereinafter the Committee) is charged with responding to requests for input on issues related to financial reporting. The Committee is pleased to respond to the ISB's invitation to comment on the *Exposure Draft ED 00-2: A Conceptual Framework for Auditor Independence* (hereinafter the Exposure Draft). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response to the Exposure Draft is presented in three sections. The first section presents the Committee's views as to characteristics of a conceptually sound framework for auditor independence, noting which of these characteristics are and are not contained in the Exposure Draft. The second section summarizes empirical academic literature on auditor independence that is relevant to the conceptual framework. The third section contains responses to the specific questions posed in the Exposure Draft. These responses are based on the views laid out in the first section and empirical academic research discussed in the second section.

Conceptual basis for a framework for auditor independence

The Committee believes the following characteristics should underlie a conceptual framework for auditor independence. These characteristics are classified according to (1) characteristics of persons associated with or affected by auditor independence, (2) characteristics related to consequences of auditor independence, and (3) characteristics related to the evaluation of auditor independence.

Characteristics of persons associated with or affected by auditor independence

1. The framework should recognize that independence resides in persons. An independence framework should distinguish the auditor from his/her firm and should acknowledge that the individual auditor faces incentives and penalties that may differ from those facing the audit firm as a whole.

2. The framework should recognize that the entity whose financial reports are the subject of the audit is not a natural person (i.e., the client) with a unique state of mind. Rather, the committee believes the framework should adopt a contracting view, in which a corporation is composed of multiple groups of economic agents, each with

potentially different interests. The auditor has relations and interactions with several of the contracting parties who comprise the entity whose financial reports are being audited. For example, an auditor might interact with members of management and the audit committee of the board of directors. Since the latter have an oversight function with respect to the former, the interests of the two (management and audit committee) cannot be assumed to be identical.

3. The framework should recognize that the benefits of auditor independence depend on the perceptions of individuals who rely on auditors' decisions. These perceptions include both those related to various factors that create and mitigate bias in auditors' decisions and those related to the importance of independence to the overall quality of auditors' decisions. The framework should consider primarily the views of "reasonable" financial statement users who have full information and process this information appropriately.

Characteristics related to consequences of auditor independence

4. The framework should recognize that the relevant consequence of auditor independence is its effect on auditors' decisions.

5. The framework should acknowledge that auditor independence has both benefits and costs. Such an approach would recognize that auditor independence is not an objective in and of itself, but is desirable if it improves the quality of auditors' decisions and the decisions of individuals who rely upon auditors' decisions. This approach also would recognize that there are costs to achieving auditor independence, which should be weighed against the benefits associated with independence.

6. The framework should recognize that the quality of auditors' decisions is influenced by both their independence and competence (expertise). Specifically, in the assessment of the benefits and costs of auditor independence, the framework should consider potential positive or negative effects on expertise of attempts to achieve independence.

Characteristics related to the evaluation of auditor independence

7. The framework should evaluate auditor independence in terms of observable factors that are likely to influence whether an auditor's decisions are unbiased, rather than in terms of unobservable factors, such as an auditor's state of mind. Observable factors include both factors that create bias in auditors' decisions and factors that mitigate this bias.

8. The framework should evaluate an auditor's independence in terms of a continuum (i.e., the degree of independence), rather than as a dichotomous variable (i.e., an auditor is either independent or not independent).

The Committee believes that the Exposure Draft largely integrates characteristics 1, 4, 5, and 8 into its framework for auditor independence. In the Committee's opinion, the Exposure Draft's framework integrates characteristics 3 and 7 in a limited fashion and does not integrate characteristics 2 and 6. We discuss issues related to the partial inclusion of characteristics 3 and 7 in our response to question 1 of the Exposure Draft. Additionally, we comment on the exclusion of characteristics 2 and 6 in our response to question 5 of the Exposure Draft.

Review and discussion of empirical research

The academic research provides evidence relevant to both the Committee's views on characteristics of a conceptually sound framework and the Exposure Draft's proposed auditor independence framework. The discussion of this research is organized into four sections: (1) factors that compromise auditor independence and lead to bias in auditors' decisions, (2) factors that ameliorate impairments of auditor independence and bias in their decisions, (3) benefits and costs of auditor independence, and (4) users' perceptions of auditor independence. Given the distinctive nature of auditors' knowledge, auditing tasks, and the audit environment, we present conclusions about auditors' judgments and decisions only from research which examines auditors doing tasks that are taken from, modeled on or adapted from their work environment, as opposed to conclusions from the general judgment and decision-making literature.[1]

1. Factors that compromise auditor independence

Research indicates that auditors' judgments and decisions are influenced by observable task and environmental factors. These factors include an auditor's involvement in prior audits of a client and incentives to retain audit or acquire non-audit engagements.

Tan (1995) shows that auditors' judgments are influenced by their involvement in prior audits of a client. Specifically, in his study, auditors who were involved in the prior-year audit paid more attention to current-year audit information that was consistent with judgments made for the prior-year audit than did auditors who were not involved in the prior-year audit. This suggests that auditors do not evaluate their own judgments in the same manner as they evaluate the judgments of other auditors.

Farmer et al. (1987) show that an auditor is more likely to agree with managers' financial-reporting preferences when the risk of losing an engagement is high versus low. Trompeter (1994) finds that auditors who are compensated based on local-office

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[1] For a discussion, see J. Smith and T. Kida, "Heuristics and Biases: Expertise and Task Realism in Auditing," *Psychological Bulletin* 109:3, 1991, pp. 472-489. This paper contrasts research on biases in auditors' judgments with similar research in psychology on biases in the judgments of other individuals. Smith and Kida conclude that auditors generally exhibit less bias or different types of bias than that found in general psychology research.

profitability are more likely to agree with clients' preferences as GAAP becomes more subjective. Overall, this research suggests that auditors' judgments are influenced by incentives to retain audit clients over time.

Other studies examine across-services incentives for obtaining or retaining non-audit (e.g., consulting) engagements for audit clients. For example, Emby and Davidson (1998) show that auditors' judgments are influenced by client managers' preferences for financial reporting when auditors provide non-audit services for the client. The effect of this factor is less when engagements involve specialized, as opposed to general, non-audit services. This result suggests that auditors are less susceptible to manager pressures when they possess greater economic power in their consulting arrangements with these clients.

2. Incentives and institutions that ameliorate impairments of auditor independence

Research documents several factors that mitigate the effects of factors that compromise auditor independence. These mitigating factors include environmental forces, such as litigation and reputation loss. These factors also encompass institutional arrangements within audit firms, including auditor rotation, the review process, peer review and compensation arrangements. Finally, some of the contracting parties at the entity whose financial reports are being audited, such as audit committees, also provide counterbalancing forces.

Several environmental forces mitigate the effects of incentives faced by auditors to compromise or impair their independence, including the possibility of reputation loss and the threat of litigation or other similar sanctions.[2] Individual auditors who face significant penalties if they are caught having performed a defective audit have strong incentives to avoid defective audits.[3] Research indicates that the risk of litigation reduces the influence of manager preferences on auditors' decisions and deters unethical behavior on the part of auditors (Farmer et al. 1987; Trompeter 1994; Shafer et al. 1999). Wilson and Grimlund (1990) also document that audit firms whose reputations have been impaired due to a SEC disciplinary action suffer losses in terms of market share and client retention. These results indicate that environmental forces provide incentives for auditors to enhance their independence by developing and implementing organizational structures and processes related to independence.

Research has examined whether institutional arrangements within audit firms and the audit profession provide mitigating forces against threats to auditor independence. Tan (1995) finds that both auditor rotation and the hierarchical auditing review process reduce

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[2] Other environmental forces include strong self-regulatory mechanisms such as the Public Oversight Board, the Auditing Standards Board, and the Independence Standards Board.

[3] The argument that the Private Securities Litigation Reform Act (PSLRA) of 1995 reduced the penalties for bad audits depends on whether the pre-PSLRA environment was one of merit-based litigation or one of random losses imposed by a legal system where merit did not determine outcomes. Random "enforcement" of rules would not be expected to induce compliance since the penalties are decided on bases other than breaking or adhering to the rules.

auditors' overemphasis on information that is consistent with their prior judgments. Similarly, Shafer et al. (1999) show that peer review deters unethical behavior on the part of auditors. Certain types of auditor compensation arrangements also appear to mitigate the effect of incentives for client retention. Trompeter (1994) finds that auditors do not use the flexibility in GAAP to justify clients' preferences when firm-wide, as opposed to local-office, profitability is emphasized in auditor compensation arrangements (large-pool compensation). Carcello et al. (2000) indicate that the type of compensation plan (small- versus large-pool) interacts with client size in determining the likelihood that an auditor issues a going concern opinion. These results suggest that audit firms' compensation plans play a role in whether auditors compromise their professional judgment in light of pressure from corporate managers.

Certain corporate governance arrangements, such as the audit committee of the board of directors, also appear to mitigate forces that compromise auditor independence. McMullen (1996) documents that the presence of an audit committee is associated with lower auditor turnover involving an accounting disagreement. This finding suggests that the presence of an audit committee enhances auditors' ability to withstand pressure from client management.

Another governance arrangement that supports auditor independence is direct or indirect monitoring of the amount of non-auditing services provided by auditors. Parkash and Venable (1993) find that the amount of recurring non-audit services purchased by audit clients varies with proxies for the level of agency costs between client managers and shareholders. Specifically, they find smaller purchases of non-audit services from auditors when share ownership is dispersed and management owns a relatively lower percentage of stock. Firth (1997) documents a positive relation between the purchase of non-audit services from the auditor and ownership concentration (measured as director shareholdings and the percentage shareholding of the largest owner), implying that lower ownership concentrations--a proxy for agency costs--are associated with larger purchases of non-audit services from auditors. These results suggest that either corporate managers or audit committees (or both) are sensitive to issues related to auditor independence when purchasing non-audit services from their auditors.

3. Benefits and Costs to Auditor Independence

Research has documented several benefits of higher quality audits, including reduced risk perceptions on the part of capital market participants and reduced earnings management on the part of corporate managers. The research uses general proxies for audit quality, which do not distinguish between the effects of auditor independence and auditor competence.

Recent survey evidence documents one potential cost to auditors' independence. Specifically, this evidence suggests that placing restrictions on auditors' provision of non-audit services to audit clients may reduce auditor competence. The survey documents a decline in students majoring in accounting and attributes this decline in part to *students' perceptions that auditing provides a less-rewarding and challenging career than other careers such as consulting.*

Several studies document benefits associated with higher audit quality, with audit quality typically defined in terms of CPA firm size or audit fees. Beatty (1989) documents that the degree of underpricing in initial public offerings is lower when higher-priced (i.e., higher quality) auditors are associated with a company's financial statements. Relatedly, Menon and Williams (1991) find that investment-banking fees charged for initial public offerings are lower for firms that employ national (Big Eight) auditing firms. Results of both of these studies suggest that market participants attribute less risk to firms audited by large CPA firms. Becker et al. (1998) find that clients of Big Six auditing firms exhibit smaller amounts of income-increasing earnings management than companies audited by non-Big Six auditing firms. Although these studies document benefits of audits provided by higher quality CPA firms, the proxies used for auditor quality are imprecise and do not distinguish whether the higher quality of large CPA firms is due to greater independence or greater competence.

A recent study published by the American Accounting Association suggests that a potential cost of increasing auditor independence via restriction of certain activities is a reduction in the competence of persons choosing the auditing profession.[4] This study shows that the accounting profession currently faces problems acquiring high quality professional employees. Specifically, the study indicates that the number of accounting graduates (per year) has decreased approximately 25% from 1995-96 to 1998-99. Additionally, 80% of educators and 46% of practitioners believe that accounting students are currently less qualified than in the past. Educators and practitioners attribute this decline primarily to two factors: (1) the relatively lower starting salaries in accounting compared to other business disciplines such as information systems and finance and (2) students' perceptions that accounting is less challenging and rewarding than other fields of study. Approximately 90% of the practitioners and accounting educators surveyed in the study strongly agree that consulting work in CPA firms is viewed as challenging and rewarding; however, only about 60% of these two groups strongly agree that audit services in a CPA firm are challenging and rewarding. Thus, improving auditor independence by imposing restrictions on auditors' provision of consulting services may further reduce the quality of students who choose employment at CPA firms.

4. *Users' perceptions of auditor independence*

In general, financial statements users express greater concerns about auditor independence than do auditors. Research suggests that these differences are related in part to experience and knowledge differences between users and auditors. Research has focused on effects of one specific factor that may compromise independence, the provision of non-audit services to audit clients, on users' perceptions of auditor independence. Results of this research generally suggest that financial statement users

[4] See W. S. Albrecht and R. J. Sack, *Accounting Education: Charting the Course Through a Perilous Future*, Sarasota, FL: American Accounting Association, 2000.

believe relatively small amounts of consulting services have little effect on auditor independence and increase auditor competence. Separation of the audit staff from the staff performing consulting services also increases the perceived independence of auditors.

Several studies show that financial statement users express greater concern than do auditors that factors such as competition, the provision of non-audit services, and incentives to retain clients negatively affect auditor independence (Shockley 1981; Reckers and Stagliano 1981; Firth 1980).[5] This result may be due in part to users' lower levels of knowledge about the auditing profession and the audit environment. For example, Reckers and Stagliano (1981) find that a larger percentage of MBA students express concerns about auditor independence than do financial analysts. Analysis in Shockley (1981) indicates that partners in Big Eight CPA firms have more complex mental models for evaluating auditor independence than the mental models of commercial loan officers and financial analysts. Thus, some financial statement users' concerns about auditor independence may reflect a lack of understanding of the checks and balances in the audit environment, regardless of whether the issue is over-time or cross-sectional threats to independence.[6]

Results of research on users' perceptions of the effect of non-audit services on auditor independence suggest that various factors mitigate users' concerns about compromised auditor independence. For example, several studies show that users perceive little impairment in auditor independence when the amount of non-auditing services provided to clients is small (Lowe and Pany 1995; 1996). Studies indicate that users perceive that small amounts of non-audit service enhance, rather than reduce, audit quality (McKinley et al. 1985; Pany and Reckers 1988). Additionally, the use of separate staffs for providing audit and non-audit services reduces users' concerns about auditor independence (Lowe and Pany 1995). Overall, these results are consistent with the idea that users believe that there are positive synergies between auditing and consulting. Users perceive the benefits of these positive synergies to exceed negative effects on independence as long as the consulting fees are not material to an individual office, and audit and non-audit services are provided by different individuals within the firm.

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[5] Much of the research on financial statement users' perceptions of the effect of non-audit services on auditor independence was conducted during the 1980s, a time period in which the level of non-audit services provided was less than that provided in the 1990s. The results of these older studies should be evaluated in light of this limitation.

[6] These results for financial statement users are consistent with research on the psychology of attitude formation. Psychology research finds that peoples' beliefs about groups to which they do not belong (e.g., college students' beliefs about senior citizens) are less complex than their beliefs about groups to which they do belong (e.g., college students beliefs' about other college students). These simpler belief structures lead to more extreme beliefs for out-groups than in-groups (Eagly and Chaiken 1993, 120; Linville 1982).

Responses to questions posed in the Exposure Draft

Q1 *The proposed conceptual framework defines auditor independence as "freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditors' ability to make unbiased audit decisions."*

Is this definition appropriate? If not, what changes would you suggest, and why?

We believe that the definition should be modified to state "freedom from the *effects* of those pressures and other factors that can compromise..." The definition as stated implies the *absence* of factors that significantly compromise an auditor's ability to make unbiased decisions. This approach is inconsistent with subsequent portions of the Exposure Draft's conceptual framework, specifically the independence risk model in which threats to auditor independence can be mitigated by safeguards. The Committee's modification to the definition of auditor independence incorporates the idea underlying the independence risk model, i.e., that safeguards can mitigate the effects of independence threats on auditors' ability to make unbiased decisions.

We agree with the definition's focus on auditors' decision making and on observable factors that can influence auditors' decisions, as indicated in points 4 and 7 in our discussion of the conceptual basis for a framework for auditor independence. However, as noted above, the Exposure Draft's definition does not reflect the idea that safeguards can mitigate threats. Since both threats and safeguards are observable factors (at least to certain groups), the Committee believes that the definition of auditor independence should reflect the effects of both threats and safeguards, consistent with point 7 of our discussion of the conceptual basis for a framework for auditor independence.

We also agree with the inclusion of the clause "or can reasonably be expected to compromise" in the definition of auditor independence. This clause reflects the Committee's view (point 3 of our discussion of the conceptual basis for a framework for auditor independence) that the benefits of auditor independence depend on the perceptions of individuals who rely on auditors' decisions. For the benefits of independence to accrue, it is not sufficient that auditors are unaffected by factors that may compromise unbiased decisions; reasonable users who rely on auditor judgments must also perceive that such factors do not compromise auditors' decisions. Additionally, the inclusion of the word "reasonably" in the definition is consistent with research indicating that financial statement users' views about auditor independence depend on their knowledge about auditors and the audit environment. Financial statement users can have unreasonable beliefs about auditor independence for two reasons: either they are not fully informed or they fail to process information rationally. The Committee suggests the possibility that the group most likely to avoid both conditions is corporate audit committees, because of their expertise and access to information.

While we agree with the inclusion of the words "reasonably expected" in this clause, we disagree with the Exposure Draft's approach for assessing "reasonable expectations." As indicated in paragraph 56 of the Exposure Draft, the ISB plans to incorporate users' views by soliciting comments from users, while formulating standards based on the ISB's evaluation of these views and the ISB's judgment about how to best meet the goal of auditor independence. While this approach may be appropriate for the ISB, it limits the applicability of the conceptual framework for other groups who are not in a position to solicit users' views. The Committee proposes that the Exposure Draft take the second approach stated in paragraph 56, that of incorporating the viewpoint of fully informed financial statement users, such as audit committee members. The approach stated in the Exposure Draft (i.e., having the ISB solicit users' views) can be viewed as the *method* by which the ISB implements this second approach. Other independence decision makers, such corporate audit committees, may choose other methods, such as using their professional judgment as a surrogate for reasonable views of financial statement users.

Q2 *The proposed conceptual framework states that the goal of auditor independence is "to support user reliance on the financial reporting process and to enhance capital market efficiency."*

Is this goal appropriate? If not, what changes would you suggest, and why?

In general, we believe that this goal is appropriate. This goal is consistent with both the Committee's view (stated in point 5 of our discussion of the conceptual basis for a framework for auditor independence) and research indicating that auditor quality (competence and independence) influences capital markets participants' assessments of the risk of investments. We believe, however, that the goal should emphasize more strongly that auditor independence is important for *all* users of financial statements (including, for example, creditors, employees, suppliers). While the focus on investors in the capital markets is consistent with the mission of the ISB as stated in paragraph 42 of the Exposure Draft, an emphasis on multiple users of financial statements will broaden the applicability of the conceptual framework.

Q3 *The proposed conceptual framework contains basic principles related to four concepts of auditor independence: threats, safeguards, independence risk, and significance of threats/effectiveness of safeguards. The concepts and basic principles contained in the proposed framework are intended to serve as guidelines for independence decision makers to analyze and resolve independence issues.*

Are the concepts and basic principles appropriate and sufficiently operational? If not, what changes would you suggest, and why?

We agree with the concepts of threats to auditor independence and safeguards against those threats. These concepts are consistent with both the Committee's view (expressed in point 7 of our discussion of the conceptual basis for a framework for auditor independence) and empirical accounting research. Specifically, research documents that at least two of the threats listed in the Exposure Draft (self-interest threats and self-review threats) can influence auditors' judgments. Research also supports the efficacy of various factors that mitigate these threats, including factors in both categories listed in paragraph 14 of the Exposure Draft. We also agree that independence threats and safeguards combine to determine independence risk, as noted in the definition of independence risk. We comment on the Exposure Draft's independence risk model in Q4 below.

Q4 *Paragraphs 49-53 describe the elements of a risk model for auditor independence in which independence risk is a function of the significance of threats to auditor independence and the effectiveness of safeguards to auditor independence.*

What are your views on the appropriateness of the independence risk model? Is there research that the Board should be made aware of that would be helpful in expanding the model or otherwise making it more useful for independence decision makers? If so, please describe that research.

As noted in the response to Q3, we agree with the concepts underlying the independence risk model, i.e., that independence threats and safeguards combine to determine independence risk. We believe that the independence risk model would be more useful for independence decision makers if it were stated with greater specification, using an approach similar to that for audit risk. In the audit risk model, audit risk is typically viewed as a multiplicative function of inherent risk, control risk, and detection risk (SAS No. 47). Similarly, the independence risk model can be viewed as a multiplicative function of two risks: the risk that threats to independence exist and the risk that safeguards do not eliminate these risks.

This approach would separate the assessment of the probability that unmitigated threats to independence exist from the assessment of the implications of such unmitigated threats. In the Exposure Draft, the assessment of the probability of an unmitigated threat (i.e., independence risk) is confounded with the assessment of the magnitude of the impact of the unmitigated threat. For example, paragraph 19 defines the significance of a threat to auditor independence as "the extent to which the threat increases independence risk." While this definition appears to relate to assessing the probability that the threat will affect independence, examples in paragraph 19 of factors that affect the significance of a threat include items that influence the *magnitude* of the consequence of the threat, not the *probability* of the threat. For example, "the importance of the matter that is the subject of the activity" relates more to assessing the magnitude of the effect of a threat than to assessing the probability that a threat exists.

Accordingly, we recommend that the independence risk model separate the assessment of the probability that unmitigated threats to independence affect an auditor's ability to make unbiased decisions from the assessment of the magnitude of effects of these unmitigated threats. The first assessment would emulate the audit risk model, defining independence risk as a multiplicative function of the risk that threats to independence exist and the risk that existing safeguards do not eliminate these threats. The magnitude of consequences associated with threats that are not fully mitigated would then be assessed separately. The expected impact of independence risk would then be estimated by multiplying the independence risk probability by the estimated magnitude of consequences.

Such an approach allows for a cost/benefit evaluation of safeguards that mitigate independence threats. For example, if no safeguards currently exist, the cost of a threat to independence is the probability of the threat multiplied by the magnitude of the consequences of the threat. This cost can also be viewed as the benefit that would accrue if a safeguard totally eliminates the threat. This benefit could be compared against the cost of implementing the safeguard.

We realize that it may be infeasible to specify values for parameters of the model in specific situations; i.e., it may be difficult to estimate the probability that a particular safeguard will mitigate a threat to auditor independence or to assess the magnitude of consequences of such a threat. However, we believe that the structure of this model will enhance individuals' ability to evaluate auditor independence by specifying the different constructs that relate to effects of deviations from auditor independence.

We agree with the focus in paragraph 30 of the Exposure Draft related to considering the views of users of financial reports and other individuals who rely on auditor decisions. As indicated previously (point 3 of our discussion of the conceptual basis for a framework for auditor independence and our response to Q1), the views of reasonable financial statement users are important to assessing the likelihood that threats to independence exist and the probability that safeguards fail to eliminate this threat. Additionally, consequences to individuals who rely on auditors' judgments will be a significant part of the assessment of consequences of independence risk.

Q5 *Are there other issues in connection with the proposed conceptual framework that the Board should consider? If so, what are those issues, and how would you advise the Board to resolve them?*

As indicated in the first section of this comment letter, the Committee believes the Exposure Draft's conceptual framework does not incorporate two important elements. First, we believe the Exposure Draft should explicitly include the view that the entity whose financial reports are the subject of the audit is not a natural person with one state of mind, but rather is composed of multiple groups of contracting parties (point 2 of our discussion of the conceptual basis for a framework for auditor independence). Separating an audit client into its various groups (e.g., management, audit committee) should aid in the identification of threats to auditor independence that are created by auditors' interactions with these various groups. Similarly, this approach should aid in evaluating the effectiveness of safeguards to threats to auditor independence. For example, auditors' interactions with management are likely to result in threats to auditor independence, while auditors' interactions with the company's audit committee are likely to mitigate some of these threats.

Second, the Committee believes that the framework should incorporate more explicitly the idea that audit quality is a function of both auditor independence and auditor competence, and that achieving high levels of auditor independence can have negative effects on audit firms' ability to obtain high levels of competence in its human capital. While the Exposure Draft refers to such "second-order" effects in paragraph 29, the Committee believes these effects are not given sufficient prominence. In the Committee's opinion, these "second-order" effects are at least as important as the "first-order" costs of developing and implementing safeguards because the second-order effects can result in the failure to achieve the overall goal of auditor independence, i.e., higher quality audits. We believe that auditor independence cannot be evaluated separately from auditor competence given the interactions between the two. Accordingly, we recommend that the interactive effects of auditor independence and auditor competence be explicitly addressed in the conceptual framework.

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06 March 2001

Arthur Siegel, Executive Director
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RE: ED 00-2, *A Conceptual Framework for Auditors Independence*

Dear Mr. Siegel:

The Association for Investment Management and Research (AIMR)[1] is pleased to comment on the Independence Standards Board's Exposure Draft, *A Conceptual Framework for Auditors Independence* (ED). The Audit Subcommittee of the AIMR U.S. Advocacy Committee (AIMR Committee)[2] offers its comments below.

General Comments

The AIMR Committee commends the Board on it efforts to establish a conceptual framework for auditors' independence. As mentioned in our previous comment letter[3], such a framework is essential in the development of principles-based set of standards for auditor independence and must provide for the following:

1) direction and structure for the Board for promulgating sound and consistent standards of independence, as well as resolving independence issues and questions;
2) guidance to those making decisions regarding auditor independence in absence of ISB standards and other independence rules;
3) assurance to stakeholders that auditors' independence is being maintained; and
4) boundaries for debate and discussions of issues related to auditor independence between stakeholders and the Board in developing, or enhancing, auditor independence standards.

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[1] The Association for Investment Management and Research is a global, nonprofit organization of over 48,000 investment professionals from over 90 countries. Through its headquarters in the U.S. and more than 100 Member Societies and Member Chapters throughout the world AIMR provides global leadership in investment education, professional standards, and advocacy programs.
[2] The U.S. Advocacy Committee is a standing committee of AIMR charged with responding to new regulatory, legislative, and other developments in the United States affecting the efficiencies of U.S. financial markets.
[3] Comment letter addressed to Arthur Siegel, Executive Director at ISB, regarding Discussion Memorandum 00-1, *A Conceptual Framework for Auditors Independence*, dated June 1, 2000.

We believe that external auditors, who are independent and objective, play a critical role in maintaining the credibility of the financial information disseminated and used by market participants in making informed investment decisions. Consequently, independent auditors are integral to the overall stability and strength of these markets. Moreover, credible and reliable information is essential for the efficient operation of financial capital markets, insuring that capital will be allocated to those investments that create the greatest returns commensurate with the risks and uncertainties of the investments. The ability to discern these risks and uncertainties has become critical (as well as difficult) for users of financial statements because more measurements and valuations are based on management's subjectivity and discretion. Thus, an objective opinion of an independent auditor is paramount, especially in regards to the reliability of these valuations and adequacy of the related disclosures.

Comments of Specific Issues

Definition of Auditor Independence

We believe that the following proposed definition should be modified to be more explicit about the perception of independence –

> *Auditor independence is freedom from those pressures and other factors that compromise,* ***or can reasonably be expected to compromise****, an auditor's ability to make unbiased audit decisions.*

The wording of the definition should be more consistent with the concept of independence noted in the U.S. Securities and Exchange Commission's recent revision of auditor independent requirements. The revised rule state that *an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment.* We believe that this consistency will make the ISB's definition of auditor independence congruent with the SEC's concept of independence noted above.

Goal of Auditor Independence

We agree strongly with the proposed goal of auditor independence, which emphasizes the *user's reliance on the financial reporting process and to enhance capital market efficiency.* However, we recommend that "users" identified in paragraph 8 of the proposed framework be expanded to include the independent members of an enterprise's board of directors, in particular, members of the audit committee. Those board members are responsible for both the governance of the enterprise and the financial statements presented to the public. Thus, they also must rely on the auditor's opinions, as well as the representations made by management, in making decisions about corporate governance, including whether to engage or terminate relationships with the audit firm.

Auditor Independence Concepts

We believe that the following concepts are necessary components of an effective framework for auditor independence: (1) threats to auditor independence; (2) safeguards to auditor independence; (3) independence risk; and (4) significance of threats and effectiveness of safeguards.

- ***Threats to Auditor Independence*** – We recommend that the "perception" of whether independence is impaired be incorporated into the definition of threats to auditor independence. Additionally, we believe that the illustrative examples of threats to auditor independence provide good guidance for assessing whether auditor independence is impaired by the following threats: (1) self-interest; (2) self-review; (3) advocacy; (4) familiarity (or trust); and (5) intimidation. Therefore, this guidance should remain a part of the conceptual framework.

- ***Safeguards to Auditor Independence*** – We agree with the proposed definition of safeguards. In addition to the seven safeguards noted under paragraph 14(a), we recommend that disclosure of current (as well as pending) relationships between the audit firm and its audit client should be included as a safeguard. Such a disclosure was considered necessary information by 84% of 970 respondents (who are analysts and portfolio managers) surveyed by AIMR in August 2000.

- ***Independence Risk*** - We agree with the proposed definition of independence risk. The independence risk is expressed as a point on a continuum that ranges from *no independence risk* to *maximum independence risk.* However, we suggest that the conceptual framework include some guidance as to what level of risk is appropriate once all threats to independence and safeguards utilized to mitigate these threats have been analyzed and assessed. In other words, define the acceptable level of risk or provide some guidance in determining the acceptable level of risk.

- ***Significance of Threats and Effectiveness of Safeguards*** – We agree with the proposed definitions for the significance of threats and effectiveness of safeguards. A thorough assessment of independence risk must include an analysis of the types of threats and safeguards affecting independence. This analysis should consider the degree of severity or significance of the actual or potential threats to auditor independence offset by those safeguards that effectively mitigate or eliminate the effect of the identified threats.

Principles of Auditor Independence

We believe that underlying principles are essential in developing an effective code of standards for professional conduct. Three of the four principles identified in the ED are appropriate – (1) assessing the level of independence risk, (2) determining the acceptability of the level of independence risk, and (3) considering the views of investors and other interested parties when auditor independence issues are addressed. We believe that the latter principle is essential to assess properly the integrity (as well as perceived integrity) of the financial statements and other information disseminated to the public, who use this information to make investment decisions.

However, we have concerns about the principle relating to the benefits and costs associated with imposing safeguards to reduce independence risk. In particular, the example discussed in paragraph 29 to explain costs that would likely exceed benefits, or compromise the quality of the audit. The example provided indicates that audit quality would be impaired if certain safeguards such as restrictions or prohibitions were imposed, relating to investment in audit clients or employment relationships between family members of the auditor and its audit client. Audit quality under these circumstances would be diminished because the audit firm would have more difficulty in attracting employees.

We believe that the above example is flawed because it is not specific about the investments or employment relationships. Certain investments and employment relationships should be prohibited or restricted due to their nature and the level of risk they pose to auditor independence, regardless of the cost. In a recent AIMR survey on auditor independence, 875 respondents (analysts and portfolio managers) answered the following question: *Should an audit firm, its partners or audit professional staff be permitted to have financial ownership or financial interest in the firm's audit client?*

- ***85%*** of the respondents answered that audit firms should have ***no*** ownership or financial interest in the audit client.
- ***86%*** of the respondents answered that partners of the audit firm, who are involved in the audit engagement, should have ***no*** ownership or financial interest in the audit client.
- ***76%*** of the respondents answered that professional staff of the audit firm, who are involved in the audit engagement, should have ***no*** ownership or financial interest in the audit client.

Concluding Remarks

The AIMR Committee commends the Board on its efforts to promulgate effective auditor independence standards. We appreciate the opportunity to provide comments on this Exposure Draft regarding a conceptual framework for auditor independence. Should you have any questions or need elaboration with regards to the Committee's comments, please do not hesitate to contact Georgene Palacky at 804.951.5334 or gbp@aimr.org.

Sincerely,

DeWitt Bowman/gbp

DeWitt Bowman, CFA
Chair, Audit Subcommittee
AIMR Advocacy Advisory Committee

Georgene B. Palacky

Georgene B. Palacky, CPA
Associate, Advocacy
AIMR Advocacy Program

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ARTHUR ANDERSEN

Arthur Andersen LLP
225 North Michigan Avenue
Chicago IL 60601-7600
Tel 312 782 0225
Fax 312 507 2548

March 7, 2001

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

Re: ED 00-2

Gentlemen:

We appreciate the opportunity to respond to your request for comments on Exposure Draft 00-2 (ED 00-2), *A Conceptual Framework for Auditor Independence*. The following are our responses to key questions raised in the ED.

Definition of Auditor Independence
Auditor independence is defined as "freedom from those pressures and other factors that compromise, or could be reasonably expected to compromise, the auditor's ability to make unbiased audit decisions." This definition implies an absolute standard of "freedom" that could never be met. Recognizing this, the ED in the sentence immediately following the definition contradicts the definition by noting that there is no intention to imply the auditor must be free of all pressures. The discussion continues by noting that it is only those factors that are "so significant" that they could reasonably be expected to impair the auditor's objectivity.

We would suggest the definition be modified to acknowledge, as the ED does in the discussion, that auditor independence does not require freedom from all influences. The definition should stress that independence is an absence of influences that create an unacceptable risk of bias.

Goal of Auditor Independence
We agree that the goal of auditor independence is to support user reliance on the financial reporting process. Although it is not unreasonable to claim that this goal would in turn contribute to market efficiency, the profession's duties relate more immediately to reliable financial reporting.

Concepts and Basic Principles of Auditor Independence
These sections of the ED provide a useful discussion of the concept of and basic principles relating to independence. Paragraph 19 discusses the significance of threats to auditor independence, noting that a specific threat depends on many factors. Although there is a reference to "the importance" of the matter, we believe the notion of "materiality" of the matter

should be included. In some cases, the relationship or matter may give rise to one of the threats identified in paragraph 12, yet because the relationship or matter is immaterial, an unacceptable risk to independence does not exist. The concept of materiality should be recognized as a threshold issue when considering the threats to independence.

Other Issues

In paragraph 1.d., the word 'boundary' implies that future discussions of independence will be limited by the Framework's content. We do not believe this is the intent, or will be the effect, of the final Framework.

In conclusion, we support the Board in its efforts, and believe that the structure and content of the Framework will be very useful. If you should you have any questions on our comments, please feel free to call Charles A. Horstmann at (312) 507-3071 or Jean L. Rothbarth at (312) 507-2827.

Sincerely,

Arthur Andersen LLP

AICPA

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February 28, 2001

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

Attn: ED 00-2

Gentlemen:

The AICPA's Professional Ethics Executive Committee (PEEC) is pleased to submit this comment letter to the Independence Standards Board with regard to ED 00-2, *Statement of Independence Concepts – A Conceptual Framework for Auditor Independence.*

With regard to the specific questions outlined in the Exposure Draft, we have the following comments:

1. The proposed conceptual framework defines auditor independence as "freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions." As noted in our response to DM 00-1, we believe that the definition of auditor independence should be risk-based and include a materiality or unacceptable risk threshold. We also believe that the phrase "*freedom from pressures and other factors*" included in the definition is too absolute and could seldom be achieved. We recommend that the Board consider using the phrase "*absence of influences*" which we believe better reflects the concept of independence.

   Accordingly, we recommend an independence definition as follows:

   > *Auditor independence is an absence of influences that create an unacceptable risk of bias with respect to an auditor's ability to make audit decisions.*

2. The proposed conceptual framework states that the goal of auditor independence is "to support user reliance on the financial reporting process and to enhance capital market efficiency."

   We believe that the enhanced reliability of audited financial information is the primary value of the audit and that such reliability enhances the efficiency of the capital markets. The enhancement of capital market efficiency is an indirect result of enhancing the reliability of audited financial information.

   We recommend that the Board revise the goal to refer to capital market *effectiveness* instead of *efficiency* since effectiveness is a broader term and captures the concept of efficiency.

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ISO 9001 Certified

3. The proposed conceptual framework contains basic principles related to four concepts of auditor independence: threats, safeguards, independence risk, and significance of threats/effectiveness of safeguards. We believe that these concepts are appropriate and generally agree with the basic principles except as specifically stated below.

The second basic principle (par. 24) states that "*Independence decision makers should determine whether the level of independence risk is at an acceptable position on the independence risk continuum.*" Paragraph 26 further states that:

> *Some threats to auditor independence may affect only certain individuals or groups within an auditing firm, and the significance of some threats may be different for different individuals or groups. To ensure that independence risk is at an acceptably low level, independence decision makers should identify the individuals or groups affected by threats to auditor independence and the significance of those threats. Different types of safeguards may be appropriate for different individuals and groups depending on their roles in the audit.*

We agree that independence decision makers should consider which individuals within the firm are specifically affected by one or more threats to independence and the types of safeguards that may be appropriate to mitigate or eliminate such threats. However, we strongly recommend that the Board include a separate basic principle that specifically incorporates an engagement-focused approach to independence. The Board has already introduced this concept in ISB Standard No. 2 and embraced it in its project on Financial Interests and Family Relationships. The SEC has also embraced this approach in its recent rulemaking and the PEEC is in the process of modernizing the AICPA's independence rules along those same lines. We agree that the threats to independence are strongest for those individuals who serve on the audit engagement team and to some extent, to those individuals who are otherwise in a position to influence the audit. Many other individuals pose little or no threat to independence and can be subject to recusal or consultation within the firm and accordingly, need not be subject to independence restrictions. Independence decision makers would benefit if the framework supported this approach through the inclusion of a separate basic principle.

Another component that we strongly believe should be included in a conceptual framework is the concept of materiality. The framework should explicitly recognize the importance of materiality as a threshold consideration in determining whether an auditor could resist a potential threat to his or her independence. The present implicit approach to addressing this through a combination of threats and safeguards is too subtle and we believe would be ineffective in conveying this important concept. Accordingly, we recommend that the Board include a basic principle such as the following:

Immaterial activities or relationships between individuals in an audit firm (as well as the firm itself) and an audit client should be presumed not to impair independence, absent evidence to the contrary.

4. We support the elements of the risk model for auditor independence as described in paragraphs 49-53 of the proposed conceptual framework and believe that the proposed risk model is appropriate. We are not aware of other relevant research to bring to your attention.

5. We are not aware of any other issues in connection with the proposed conceptual framework that the Board should consider.

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 Exposure Draft.

Sincerely,

James L. Curry

James L. Curry
Chair
PEEC

cc: Susan Coffey, Vice President
Self Regulation and SECPS

Lisa Snyder, Director
Professional Ethics Division

(24)

February 28, 2001

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

Attn: ED 00-2

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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 Exposure Draft.

Sincerely,

James L. Curry
Chair
PEEC

cc: Susan Coffey, Vice President
Self Regulation and SECPS

Lisa Snyder, Director
Professional Ethics Division

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March 16, 2001

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

RE: Exposure Draft, *Statement of Independence Concepts: A Conceptual Framework for Auditor Independence*

Attn: ED 00-2

Dear Mr. Siegel:

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents 29,500 CPAs whose audit firms will be affected by the eventual outcomes of the independence standards setting process addressed in the conceptual framework. We are pleased to submit the attached comments regarding Independence Standards Board conceptual framework exposure draft. With this letter I am transmitting the comments of the Auditing Standards and Procedures Committee; the comments of the Professional Ethics Committee will be sent to you separately. We appreciate the opportunity to express our beliefs concerning this important exposure draft.

Please contact William Stocker, chair of the Auditing Standards and Procedures Committee at (212) 503 - 8875, or Robert H. Colson, NYSSCPA Staff, at (212) 719-8350 if you require further information.

Very truly yours,

P. Gerard Sokolski

P. Gerard Sokolski, CPA
President

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on Independence Standards Board Exposure Draft

Statement of Independence Concepts: A Conceptual Framework for Auditor Independence

ED 00-2

March 16, 2001

<u>Principal Drafter</u>

William Stocker, CPA, Chair
Auditing Standards and Procedures Committee

NYSSCPA
2000-2001 Accounting and Auditing General Committee

Brian A. Caswell (Chair)
Thomas O. Linder
William M. Stocker, III
Paul J. Wendell
Susan M. Barossi
Robert M. Sattler
Paul D. Warner
John F. Georger, Jr.
Robert E. Sohr
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Julian E. Jacoby
Jerry Marting Klein
Helen R. Liang
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Lawrence E. Nalitt
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Bruce H. Nearon
R. Michael Peress
John J. Piccinnini
Thomas Sorrentino
Jonathan Brett Taylor
William H. Walters
Paul D. Warner
Barry Wexler
Margaret A. Wood

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Robert H. Colson

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on Independence Standards Board Exposure Draft

Statement of Independence Concepts: A Conceptual Framework for Auditor Independence

ED 00-2

Comments of the Auditing Standards and Procedures Committee

The Auditing Standards and Procedures Committee agreed to express it concerns about three issues related to the effects on auditors of adopting the Exposure Draft as a conceptual framework. The Committee understands that not all aspects of these issues are completely controlled by ISB, but believe that ISB should address them in their final statement.

Extension of Conceptual Framework to Broader Independence Issues

It became apparent to the committee during the course of its discussion that its members had implicitly assumed that the application of the conceptual framework would go beyond the auditors of SEC registrants, in spite of ISB's officially restricted scope. At the conceptual framework level, it will be difficult to sustain distinctions between concepts that apply differently to SEC registrants and non-registrants. Moreover, conceptual distinctions of this nature would be difficult to explain to the public.

Appropriate Treatment of Independence Safeguards

The committee discussed briefly the three elements of the conceptual framework related to definitions, goals, and threats. However, its discussion on safeguards revealed several concerns:

- The committee agreed that, regardless of ISB's possible desires to restrict the use of the conceptual framework to its own deliberations, it would be inevitable that audit firms would also use it for guidance and for formulating their independence compliance programs. In this context, many members expressed a concern that placing "safeguards" at the same level as "threats" in the conceptual framework would lead firms to pay less attention to threats to independence because of the (possibly over confident or mistaken) reliance on the existence of an adequate safeguard for every threat.
- Several members suggested that safeguards would be more appropriately handled as an element of the cost/benefit analysis later in the conceptual framework.
- Others indicated their belief that safeguards should not be specifically addressed in the conceptual framework.

Appearance of Independence

The committee concluded that the conceptual framework was helpful in their discussions related to independence in fact. However, they concluded that the conceptual framework does not adequately provide guidance with respect to the appearance of independence. They believe that appearance of independence should be more explicitly defined and discussed in the conceptual framework, especially in light of the SEC's recent rulemaking, which focuses almost exclusively on appearance of independence.

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March 16, 2001 26

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

RE: Exposure Draft, *Statement of Independence Concepts: A Conceptual Framework for Auditor Independence*

Attn: ED 00-2

Dear Mr. Siegel:

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents 29,500 CPAs whose audit firms will be affected by the eventual outcomes of the independence standards setting process addressed in the conceptual framework. We are pleased to submit the attached comments regarding Independence Standards Board conceptual framework exposure draft. With this letter I am transmitting the comments of the Professional Ethics Committee; the comments of the Auditing Standards and Procedures Committee will be sent to you separately. We appreciate the opportunity to express our beliefs concerning this important exposure draft.

Please contact Allen Fetterman, chair of the Professional Ethics Committee at (212) 867 - 4000, or Robert H. Colson, NYSSCPA Staff, at (212) 719-8350 if you require further information.

Very truly yours,

P. Gerard Sokolski

P. Gerard Sokolski, CPA
President

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on
Independence Standards Board
Exposure Draft

Statement of Independence Concepts: A Conceptual Framework for Auditor Independence

ED 00-2

March 16, 2001

<u>Principal Drafter</u>

Allen Fetterman, CPA,
Professional Ethics Committee

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
Comments on Independence Standards Board Exposure Draft

Statement of Independence Concepts: A Conceptual Framework for Auditor Independence

ED 00-2

Comments of the Professional Ethics Committee

The Professional Ethics Committee of the New York State Society of Certified Public Accountants has reviewed the Exposure Draft (ED 00-2) of Statement of Independence Concepts: A Conceptual Framework for Auditor Independence. The Committee thinks that the concepts enumerated in the Exposure Draft represent a good step in the evolution of independence standards applicable to the audits of public companies.

In response to the Questions for Respondents, the Committee has the following thoughts:

1. The definition of auditor independence is appropriate.

2. The goal of auditor independence should be to "support user reliance on the financial reporting process." Enhancing capital market efficiency is a benefit of that goal (among other benefits) and not part of that goal.

3. The concepts and basic principles are appropriate and sufficiently operational.

4. The independence risk model is appropriate and comprehensive.

Specifically, in paragraph 28, the last two words, "reputational capital", are too esoteric and subject to misinterpretation. We suggest substituting "reputation".

NYSSCPA
2000-2001 Accounting and Auditing General Committee

Brian A. Caswell (Chair)
Thomas O. Linder
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Anthony Angelo Carro
Rona L. Cherno
John A. Cherpock
Melvin A. Crystal
Jeffrey D. Green
Richard D. Isserman
Suzanne M. Jensen
A. Rief Kanan
Robert Kawa
Charles P. LaCagnina
Stuart G. Lang
E. Peter Logrieco
Sameul S. Perelson
R. Michael Peress
Joseph Schachter
Burton L. Shepard
Paul Sippel
Charles Weissman

NYSSCPA Staff

Robert H. Colson

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March 27, 2001

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

Dear Mr. Siegel:

We have reviewed the Independence Standards Board's (ISB) Exposure Draft (ED) 00-2, *Statement of Independence Concepts - A Conceptual Framework for Auditor Independence.* We support the framework as proposed and do not have any substantive comments on it at this time.

As you know, Jim Schiro and Ken Dakdduk participated in the project task force that assisted in the development of the ED. We look forward to their continued participation in the effort to finalize a new conceptual framework for auditor independence.

If you have any questions, please contact Kenton J. Sicchitano (212-707-6230) or Kenneth E. Dakdduk (201-521-3048).

PricewaterhouseCoopers LLP