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Introduction to the Independence Standards Board, Presentations to American law Institute of the American Bar Association

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Independence Standards Board

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AMERICAN LAW INSTITUTE
of the
AMERICAN BAR ASSOCIATION

AN INTRODUCTION TO THE
INDEPENDENCE STANDARDS BOARD

Susan McGrath

Director, ISB

January 29, 1999

I am delighted to join you here in New Orleans today. Unfortunately, Art Siegel, the Executive Director of the Independence Standards Board, was unable to make it here today, and asked me to take his place and provide you with an update on ISB activities.

Before I begin, however, I need to remind you that my remarks today reflect solely my personal views, and not necessarily those of the Board, individual Board members, or other members of the Staff.

The Board came into being because both the SEC and the accounting profession have long wanted a clear conceptual framework for independence rules applying to auditors of public companies.

Why is a conceptual framework needed? Since the federal securities laws were enacted in the 1930's, the independence rules have evolved in a piecemeal fashion, with no clear underlying set of principles. There are now more than 200 pages of published rules, interpretations and "no-action" letters of the SEC and its staff. These are in addition to 50 pages of rules, interpretations and ethics rulings of the AICPA, with which all US auditors must comply.

The absence of clearly articulated principles means that the rules are often hard to apply to new situations by analogy. And in today's dynamic world, there are many new kinds of situations.

In addition, the present rules generally assume that "one size fits all" – but what is appropriate for a 10-person accounting firm in one small city is not necessarily appropriate for a firm of 20,000 people spread across the country. Finally, the multitude of detailed independence rules would eventually make it difficult to harmonize U.S. independence requirements with those of other nations, and in a global economy with increasing amounts of cross-border investing, this is become a higher priority.

However - and importantly - despite its shortcomings, the current system has worked. Investors are comfortable in relying on published financial statements in large part because they have confidence in the integrity and objectivity – and in the *independence* – of the auditor. Therefore, before we discard what we have, we must have confidence in its replacement – we need a framework that *better* protects the public interest.

The Board's formal Operating Policies clearly define its objectives and mission. The Board is "to establish independence standards applicable to audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets." A simple and straightforward charge, but a very complex assignment.

The Board is comprised of eight members - four from the public and four from the accounting profession. William Allen, the Chairman, was for twelve years the Chancellor of the Court of Chancery in Delaware - that is, the head of what is generally

recognized as the most important business court in the country. The other public members are:

John Bogle, the founder and now senior chairman of Vanguard, the second largest mutual fund group in the country;

Robert Denham, now a partner in a law firm in Los Angeles, and who for many years served as the chairman of Salomon Brothers; and

Manuel Johnson, the head of a financial consulting firm, who earlier in his career was a vice chairman of the Fed.

The members from the profession are CEOs Steven Butler of KPMG, Philip Laskawy of Ernst & Young, James Schiro of PricewaterhouseCoopers and Barry Melancon of the AICPA.

As you can see, it is an important and impressive group, and they take their charge very seriously.

The Chief Accountant of the SEC also attends our Board meetings and has observer status, meaning he sits at the table and actively participates – which is very helpful.

The Board is an independent body. While the AICPA’s SEC Practice Section funds it, the Board sets its own budget and operates autonomously.

In that respect, and in the openness of its processes, it is very similar to the FASB. The ISB, for example, also is required to issue exposure drafts of any planned pronouncements, and will issue invitations to comment and hold public hearings when warranted.

In addition, the Board’s deliberative processes are conducted “in the sunshine,” and you are welcome to attend its meetings or to listen by telephone. The next meeting, by the way, is April 8 in New York.

The ISB Staff

The ISB professional staff currently consists of Art Siegel, as Executive Director, myself and another Director, along with an administrative assistant. Art previously served as Vice-Chairman – Auditing at Price Waterhouse. We are actively trying to increase our staff right now, as our workload has increased significantly.

The staff’s role generally is two-fold. First, we support the Board in the development of standards and in all of its other missions. And second, we receive and respond to inquiries from practitioners and others – and we have had about eighty in the last eight months.

The staff maintains a public file of all appropriate documents, including minutes of meetings. However, the best source of ISB information is our website, at www.cpaindependence.org.

The IIC

The Independence Issues Committee is comprised of eight members from the profession. They were selected because they were the senior people in their firms responsible for independence matters, and therefore were most likely to be aware of current independence issues. Their names and affiliations are also shown on our website. The IIC's principal role is to deal with emerging independence issues in the same way FASB's Emerging Issues Task Force does on emerging accounting issues. That is, see if a consensus can be reached and published for the guidance of auditors and others. They are also charged with assisting the Board in understanding issues the Board is addressing.

Art Siegel serves as the Committee's non-voting Chairman, and, just as at EITF, the SEC chief accountant or his designee serves as an observer. The Committee also operates in public, and its next meeting is February 2, in New York.

Although the IIC will use issue summaries and publish minutes and consensuses, just as the EITF does, there is a key difference. Unlike the EITF, an IIC consensus will not become "substantial authoritative support" in the eyes of SEC staff, unless and until it is ratified by the ISB.

ACTIVITY TO DATE

Now let me talk briefly about what the Board itself has been doing and intends to do.

Discussions with Audit Committees

At the Board's meeting on January 8th, it approved its first pronouncement on independence discussions with audit committees, which will require firms auditing public companies to:

- describe each year, in a written report, all relationships with an audit client that could impact independence;
- confirm in that written report that the firm is independent; and
- discuss the contents of the report with the client's audit committee.

The Board's intent in enacting this rule was to deepen the understanding by audit committees of independence issues, in recognition of the fact that companies have an obligation to engage independent accountants, and should not rely exclusively on representations from the auditor. While audit committees are not expected to have

detailed knowledge of the independence rules, they can bring business judgment to this question just as they do to other issues coming before them as directors.

On the Road to a Conceptual Framework

The most important project on the Board's agenda is the development of the conceptual framework. The Board has engaged Professor Henry Jaenicke of Drexel University as project director, and Professor Alan Glazer of Franklin & Marshall is assisting him. In addition, we have formed a broad-based project task force. This advisory task force held its first meeting on October 29th, and a second meeting is scheduled for February 5. The task force has a representative from the Bar Association – Tom Baker – as well as representatives from the user and academic communities, the practicing profession, international independence standard setters, along with corporate directors and executives.

The Board's objective is first to develop a neutral discussion memorandum which will be exposed for public comment. With that input, the Board will then deliberate on the contents of a conceptual framework with the goal of issuing an exposure draft, again for public comment. At each stage of this process the Board will consider whether public hearings also should be held. After obtaining that input, the Board would then again deliberate and conclude on the contents of the conceptual framework for independence.

Let me share with you some early thinking on the possible contents of a conceptual framework:

- The investor's need for reliable and credible financial statements;
- The objectives of audits and of auditor independence;
- The relationship of independence to objectivity and integrity. This would include a definition of independence; and
- If there is a "reasonable investor" test, how that theoretical person might be defined.

Also, the Conceptual Framework should address the factors to consider in setting independence standards. For example:

- Should costs and benefits be considered, if they can be measured?
- Can threats to independence be mitigated by firm-specific safeguards, or compensating controls, and if so, when?
- When should the *appearance* of impaired independence be a factor, and how should that be determined?
- Is materiality a consideration in reaching – or applying – independence standards, and if so, how should it be measured?
- What does "mutuality of interests" mean and when might it properly be considered a threat to independence?

Additional Issues to Consider

Additional issues that may need to be considered are:

- What is the role of firm codes of conduct and cultures?

- What role, if any, in maintaining independence is properly assigned to corporate officers and directors, including the audit committee?
- And finally, what role should be played by the profession's overseers. This would include the SEC, the Public Oversight Board, the state boards of accountancy, and the AICPA.

As you can see, the conceptual framework is the most basic and important issue facing the Board. It also is complex and multi-faceted, and we should not expect any final conclusions for probably two years or so. When it is completed, it will not, of itself, "answer" independence questions, but it should define the parameters within which one would logically find conceptually consistent answers.

Employment with Audit Clients

The Board has chosen to proceed with two other projects concurrently with the development of the conceptual framework. Let's first review the issues related to the project on Partners and Staff joining audit clients.

The concerns expressed when professionals leave firms to join audit clients generally are threefold:

- First, that members of the audit team, who may have been friendly with, or respectful of a former partner or professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional. As a result, they might accept a client's proposed accounting without exercising appropriate objectivity and skepticism.
- Second, in situations where partners or other audit team members resign to accept positions with audit clients, questions may be raised regarding whether the individuals exercised an appropriate level of skepticism during the audit process prior to their departure.
- And finally, that the departing partner or professional may be familiar enough with the firm's audit approach and testing strategy so as to be able to circumvent its design.

Generally, proposed solutions to this contentious issue center either around the:

- Establishment of safeguards or mitigating controls by the audit firm, or
- Establishment of a mandated cooling-off period – specifying some period of time during which the audit firm's independence would be impaired if a professional were hired in an "audit sensitive" role – thus forcing the client to engage a new auditor.

There is not a lot of empirical data in this area, in part because it is so difficult to attribute causation to the existence of an "alumnus" of the audit firm at the client when there are allegations of financial fraud. But it is a high profile issue because it is so easy for the press to identify the alumni on the company's payroll, and there is the inevitable analogy to the "revolving door" which has such a bad name in Washington. Of course, in the vast majority of cases, this is a one-way door. People rarely go back to their audit firm. But

the issue has gotten more attention lately because we have seen more senior people, including partners, leaving their firms to go to work at clients. So it is an issue that cries out for resolution.

The Board also created a broad-based project task force on this topic, which met in October and helped to prepare a discussion memorandum examining all viewpoints on the issues. The Board approved the issuance of the DM for public comment (it will be out shortly), with the ultimate goal of developing an ISB independence standard.

Family Relationships

Let me briefly discuss the family relationships issue.

- Currently, there are family relationships between audit firm professionals and client personnel that are deemed to impair the auditor's independence.

But there are new stresses on the operation of the existing rules. For example:

- The notion of close family has evolved.
- Many audit firms and clients have become large, multinational organizations, while some of the rules were written when firms were small and collegial, and company operations were more centralized. Does it make sense to say that a consulting partner's spouse who works on the West coast cannot participate in an employee stock plan because the firm audits the company out of its New York office?
- In this age of instant communications, do the previously applied "geographic separation" rules continue to be appropriate?
- Finally, the success of women in business has increased the number of employment-related family relationship questions.

Questions to be answered include:

- Should considerations be different for those participating on an engagement vs. firm personnel not on an engagement? For that matter, who is considered to be "on an engagement?"
- What are "close family" relationships? Should the rules be rigid or flexible, and where should the lines be drawn?
- Do different rules for partners, managers and all other employees make sense?
- Is geographic distance a mitigating control today, or is using the chain of command better?
- Are there materiality considerations that need to be considered?
- Can "firewalls" within the auditing firm be effective?
- What is best practice? What rules are in existence in other countries, or in other professions or government agencies?

At the direction of the Board, the Staff is preparing an Invitation to Comment on several of the issues, as well as a new, alternative approach to determining when and where family relationships would impair the auditor's independence.

IIC Activities

Let's switch now to the Independence Issues Committee. The IIC has two issues under consideration beyond activities supporting the Board projects just described.

- The first of these is on "alternative practice structures." As you may have seen in the press, American Express and several other corporations have become "consolidators" of the non-attest operations of small to middle-sized accounting firms. Often the attest services remain in a separate firm owned by the CPAs, but the attest firms lease staff, facilities, etc. from the corporate entity. The IIC is attempting to develop a consensus on the restrictions that should apply in these situations to auditors of public companies. The issue summary on this matter is available on our website, and we hope that the Committee reaches a consensus at its February 2nd meeting.
- Another matter being studied by the IIC relates to the level and nature of assistance an auditor can provide an audit client in implementing FAS 133, "Accounting for Derivative Instruments and Hedging Activities." Again, we are hopeful that a consensus will be reached at the Committee's February 2nd meeting.

Conclusion

In conclusion, we at the ISB know we have a major challenge ahead of us. However, this also is a unique opportunity.

I believe I can speak for the Board in encouraging all who have an interest in the subject of auditor independence to fully participate in our processes. Only in that way can we be confident that we are best serving the public interest. And it is clear to me that an emphasis on the public good has been, and continues to be, in the best long-term interests of the profession.

Thank you very much for your attention.