2000

Comment Letters on Evolving Forms of Firm Structure and Organization (DM 99-2)

Independence Standards Board

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IFAC INTERNATIONAL FEDERATION OF ACCOUNTANTS

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5 January 2000

To: Members of the Independence Standards Board

Re: DM 99-2

The Ethics Committee of the International Federation of Accountants (IFAC) is pleased to have this opportunity to respond to the Board's invitation to comment on the Discussion Memorandum on Evolving Forms of Firm Structure and Organization.

It is most timely that different, non-traditional forms of ownership/partnership be considered. IFAC has recently issued a position paper relating to the ownership and control of firms and the legal form of practice. It is clear that these new forms may raise issues concerning auditor independence and important that any regulations address the substance of firm ownership as well as the legal form.

IFAC believes that restrictions on the ownership and control of firms are justified only to the extent that they are necessary in the public interest to protect the independence, objectivity and integrity of the licensed professional providing the regulated service concerned and should be no more restrictive for foreign owned and/or controlled firms than for host country firms. The maintenance of sufficient professionalism in the ownership and management of the firm is the key. There is no good reason to distinguish the accountancy profession from almost all other commercial activities which have unrestricted rights to select and operate under any of a variety of legal operating structures permitted generally.

Responses to Certain Specific Questions Raised

Q1. We do not believe that the traditional focus of accounting firms on professional standards and independence would be compromised by the types of relationships discussed provided that adequate safeguards are in place to address any potential risks of impairment.

Q2. Not inappropriate provided that the standards of independence can be maintained. Public ownership is no more of a risk than any other legal form and with a suitably wide ownership, maybe even less of a risk.

Q3. We believe this would pose a risk to independence if their clients, directors owned stock in the audit firm unless the interest was clearly insignificant to both the client and the firm.

Q4. Yes, making sure rules are obeyed in substance as well as in form.

Q5. Yes, if a relationship puts an auditor's independence at risk then similar relationships with those that could influence the auditor also puts the auditor's independence at risk.

Q6. No, if the auditor is subject to a restriction as an individual then the restriction would also apply where he owns the firm which employs him.

Q7. We believe materiality is a concept which can be more clearly applied to financial statement issues. We propose a higher test, namely that of a relationship being clearly insignificant to the auditor.

Q8. If officers and directors have direct influence on the auditor, then they pose a risk to the auditor's independence. Officers and directors should observe requirements imposed on "members". IFAC feels that the term "officers" should be defined by each individual country.

Q9. The same factors should be applied when determining the relationship between the auditor and the auditor's client.

Q10. There is no difference in our response, but the relationships themselves might pose requirements for additional safeguards.

Q11. If the nature of the relationship is such as to require a restriction, the fact that the relationship is temporary would not seem to be a factor.

Q12. The same considerations would apply to controlling all significant shareholders as would apply to an employer or his officers.

Q13. Precise safeguards would depend on the circumstances.

Q15. & Q16.
We believe that any rules should look through the legal formalities and consider the underlying circumstances in each case.

Q17. We would need to extend restrictions to significant non-auditor owners, even though the auditor remains in control. A significant non-controlling shareholder could still be in a position to influence the share price of an audit business.

Q18. Yes

Q19. & Q20.
We believe no such relationships should be allowed unless they are clearly insignificant to the auditor.

Q21. - Q25.

We believe they have an influence and that they do pose a threat to the auditor's independence whether held by an audit client or by its officers unless they are clearly insignificant. It may be possible to adopt safeguards the nature of which will depend on circumstances.

Q26. Yes, we do believe they can be very useful. Some key safeguards which we have identified include:

Safeguards created by the profession as a whole, including the following.

- Educational and experience requirements for entry into the profession.
- Continuing education requirements.
- External review of a reporting accountant's quality control system.

Safeguards existing within the entity that is the subject of the assurance engagement, including the following.

- The appointment of the reporting accountant by persons other than the entity's management.
- The employment by the entity of staff of sufficient caliber and in sufficient numbers to ensure that the reporting accountant is not required to perform managerial functions for the entity.
- The assurance client's internal procedures for objective choice in commissioning non-assurance engagements. It is particularly useful if documentation of the results of these procedures can be supplied, where applicable, to the audit committee and/or supervisory board and/or all persons and organs responsible for proposing the appointment of the reporting accountant.
- The entity's own corporate governance structure.

The reporting accountant's own systems and procedures for reducing risks to independence, which include one or more of the following, as well as other methods not listed here.

- The reporting accountant's policies and procedures intended to promote quality control of assurance engagements.
- Arrangements to ensure that staff are empowered to communicate to senior levels within the practice any issue of independence and objectivity that concerns them. The arrangements include ensuring that staff are aware of the arrangements.
- The involvement of an additional professional accountant in public practice who did not take part in the conduct of the assurance engagement to carry out

reviews or otherwise advise.

- Consulting a third party such as a committee of independent directors, a professional regulatory body or another reporting accountant.
- Arrangements to reduce the risk of conflict by compartmentalizing responsibilities and knowledge in specific cases.
- Rotation of senior personnel.
- Publicly visible steps, including public disclosure, to explain how the risk of conflict has been recognized and mitigated in specific situations.
- Refusal to perform the assurance engagement where no other appropriate course of action can resolve the perceived problem.

We trust these comments will be useful to the ISB and appreciate the opportunity to provide them on behalf of the Ethics Committee.

Very truly yours

Marilyn A. Pendergast
Chair, IFAC Ethics Committee

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POB

PUBLIC OVERSIGHT BOARD

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January 12, 2000

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

Attn: DM 99-2

Gentlemen:

This response is limited to what we consider to be the threshold question—that part of general question no. 2 that asks: "Is it appropriate for a multi-disciplinary professional service firm (such as a "Big 5" accounting firm) to have public ownership in either the firm itself or in its parent...?"

Our response is: public ownership in a firm performing audits ("an audit firm") or in its parent or in an entity that effectively has control of the audit firm is not appropriate. It is true that many other types of service firms that traditionally had operated as general partnerships or, if in corporate form, been owned by the service providers, have since converted to public ownership. However, we believe the special public responsibilities of audit firms distinguish audit firms from those other types of service firms. The often quoted opinion of the Supreme Court (United States v. Arthur Young & Co.) identifies those special public responsibilities:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires fidelity to the public trust.

Public ownership in an audit firm or in its parent or in an entity that effectively has control of the audit firm would add another form of allegiance and accountability to those identified by the Supreme Court—a form of allegiance that in our opinion will be viewed as detracting from, if not conflicting with, the auditor's "public responsibility."

If the Independence Standards Board concludes that public ownership in an audit firm or in its parent is not appropriate, then careful assessment of the *substance* of the various alternative practice structures is needed. The Discussion Memorandum in paragraph 9 (and elsewhere) characterizes most of the transactions creating the alternative structures as, "the sale of the non-audit practice to a third party...and retention by the former partners of the audit practice...." One question to consider in assessing those transactions is whether those former partners have the full rights of traditional ownership, for example, the unilateral right to sell to or merge the audit practice with an unaffiliated audit firm and retain any consideration paid by that other firm.

Very truly yours,

Charles A. Bowsher

Charles A. Bowsher
Chair

CAB/mb

cc: David A. Costello, President and Chief Executive Officer
National Association of State Boards of Accountancy

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MORGAN STANLEY DEAN WITTER & CO.

ROBERT G. SCOTT
Executive Vice President
& Chief Financial Officer

January 10, 2000

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

Re: Evolving Forms of Firm Structure and Organization (DM 99-2)

Dear Mr. Allen:

Morgan Stanley Dean Witter (MSDW) is pleased to respond with general comments concerning the Discussion Memorandum, "Evolving Forms of Firm Structure and Organization." While many of the issues raised by the DM are best addressed by the auditing firms themselves, as a securities firm, MSDW would like to address certain issues related to the implications of public market ownership of affiliates of auditing firms, such as when a consulting division is taken public.

We agree that the independence of auditing firms is an essential element of the efficient operation of financial markets and the investment community should be able to rely on the integrity of the independent auditor's work without question. This suggests that auditor independence should always be subject to a high standard. However, we also believe that that high standard can be maintained without the application of restrictive and formulaic rules of independence that could severely limit the ability of auditing firms or their affiliates to raise capital by either denying access to public capital markets or severely limiting permissible security holders.

The Board should recognize that access to capital will be important as auditing firms and their affiliates face evolving client needs, a changing business environment and the need to compensate high-quality professionals who have attractive employment opportunities outside of the auditing profession. Perhaps most important in the long-term might be the inability of firms to maintain the quality of their professional staffs in a highly competitive environment. This could degrade the quality of the auditor's work as surely as independence standards that are too loose by impairing the ability of the auditor to retain professionals who can respond to technological and business dynamics.

We believe that independence should be assessed in light of the ability to influence the work of the auditor. While we do not believe that there is necessarily a specific bright line applicable in all cases to determine when influence is present, the Board's deliberations should consider and be guided by generally recognized practical parameters for assessing independence, such as the ones outlined below.

- Multi-disciplinary professional services firms should not be precluded from retaining a non-controlling interest in an affiliate whose shares are publicly held ("a public affiliate").
- A client firm should not be precluded from holding an investment in a public affiliate where the investment is not material, perhaps setting a limit of not more than 5% of the public affiliate's voting securities. Examples include investments made in the ordinary course of portfolio management activities by an Investment Company client of the auditing firm and investments held in a client's pension fund.
- Senior-level employees of client firms should not be precluded from making investments in public affiliates that individually or in the aggregate for all such employees of the client firm are not material. Again, we suggest 5% as a reasonable test for materiality.

We see no reason why any of these situations should compromise (or automatically be presumed to compromise) auditor independence.

We would be pleased to discuss our views with the Board.

Very truly yours,

Robert G. Scott

Robert G. Scott
Executive Vice President & Chief Financial Officer

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RS&A

RHODE, SCRIPTER & ASSOCIATES LLP
CERTIFIED PUBLIC ACCOUNTANTS

Larry L. Scripter, CPA, Partner
Rodell J. Rudolph, CPA, Partner
Rick Waidler, CPA, Partner
Rick Bedell, CPA, Partner

January 10, 2000

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

Re: DM 99-2

Dear Members of the Board:

We would like to present our comments to questions 24 and 25 of the discussion memorandum on Evolving Forms of Firm Structure and Organization. Investments by audit clients, client officers and client directors in diversified mutual funds that may invest in audit firm or corporate employer securities should be subject to the same analysis as that applicable to direct stock ownership by such individuals. Immaterial client, client officer, or client director holdings of the audit firm's or auditor's employer's equity securities do not threaten the auditor's independence, and neither would immaterial interests indirectly held through diversified mutual fund investments.

Even if new rules were adopted to prohibit investment in employer equity securities, immaterial, isolated or inadvertent violations of the rule that do not result in an impairment of the audit result would be mitigated adequately by second partner review, disclosure to the audit committee, and disclosure to the public.

Thank you for the opportunity to comment on the discussion memorandum. We would be happy to discuss our comments with the Board or its representatives if you have any questions.

Sincerely,

Rhode, Scripter & Associates LLP

Rodell J. Rudolph, Partner

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Texas State Board of Public Accountancy

333 Guadalupe, Tower III Suite 900, Austin, Texas 78701-3900

William Treacy, Executive Director

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January 20, 2000

Independence Standards Board
Sixth Floor
1211 Avenue of the Americas
New York, New York 10036-8775
Attention DM 99-2

Dear Sirs:

This letter presents the comments of the Texas State Board of Public Accountancy (the Texas Board) to the Discussion Memorandum of the Independence Standards Board (ISB) titled "Evolving forms of Firm Structure and Organization" ISB DM 99-2. The Texas Board thanks the ISB for the opportunity to comment and for extending the deadline for comments to permit the Texas Board to approve its comments at its January 20, 2000 meeting.

As background, the Texas Board is created by statute to administer the Public Accountancy Act, Chap. 901, TEX. OCCUP. CODE (Vernon's 1999)(The Act) and associated rules. 22 T.A.C. §501 *et seq.* The public policy of the State of Texas is that public accountancy is a learned profession requiring specialized education and experience and that "the term…'auditor'…[has] an implication of competence in the profession of public accountancy on which the public relies in personal business and public activities and enterprises." Act §901.005. The Texas Board administers a complex group of qualification, licensing, disciplinary and quality review programs to insure that persons "…engaged in the practice of public accountancy maintain high standards of professional competence, integrity and learning." Id. The Texas Board believes that this strong regulatory structure is good for the profession precisely because its purpose is to protect the public. Certainly the profession has flourished in Texas: there are 54,701 Certified Public Accountants in Texas and 10,175 registered practice units.

The Texas Board agrees that independence is essential to the function of an audit in our market system. The independence of an auditor contributes not only to public confidence in the audit, but also to the reliability of an audit. Independence ensures the objectivity of the auditor in exercising the judgment necessary to the audit process. Independence, therefore, affects both the reliability of an audit report and public confidence in the reliability of reports. The Texas Board requires independence in fact and in appearance whenever a Texas CPA issues a report on financial statements. 22 T.A.C. 501.11.

The Texas Board agrees with the description in the Executive Summary in the Discussion Memorandum that the rules governing independence were developed for a business model of the profession of a small partnership in which all partners managed firm operations and participated in firm profits. The market has now generated a number of different business models and many CPAs believe that they can successfully serve the public through these arrangements.

In November 1998 the Texas Board issued an opinion in which it outlined the parameters within which Texas law dictates an alternative CPA business structure must operate. Consistent with the Board's mission to enforce the Public Accountancy Act, the Board has not approved or disapproved any specific model, but simply states what it believes to be lawful in Texas. The Texas Board therefore will not comment on the 'appropriateness' of specific kinds of issues arising in connection with these alternative practice structures, like public ownership of a Big Five firm, because 'appropriateness' is a very different standard from legality.

As the Texas Board opinion explains, it is lawful in Texas for CPAs to develop close business relationships with unregistered business entities, including publicly held companies, so long as certain criteria are met. Texas law does not permit non CPAs to own a CPA firm, although approximately 22 states do permit some form of non-CPA ownership. Texas law requires that if any attest work is to be performed in the new business entity, a CPA firm wholly owned by CPAs must survive in fact and in appearance as part of the new business entity. This CPA firm and only this CPA firm may perform attest or compilation services, or issue reports on financial statements or any element thereof.

However, the Texas Board's opinion recognizes that even if the CPA Firm survives as a separate entity, the entire business structure must be considered in applying the Board's Rules of Professional Conduct, including its independence rules. Therefore, the Board opinion states that CPAs cannot use the business structure to avoid the strictures of the Code of Professional Conduct, because under the Board's rules, a CPA cannot accomplish through others what he cannot do himself. A CPA must comply with the Code of Professional Conduct in his or her dealings with clients whether or not those dealings occur in the regulated CPA firm or the unregulated entity.

The Texas Board believes that its conclusions are consistent with those of the National Association of State Boards of Accountancy (NASBA) Taskforce on the Regulation of Alternative Practice Structures. The NASBA Taskforce concluded, among other things, that professional standards for relationships between CPAs and their clients should apply universally, without regard to the types of related entities that directly or indirectly provide attest services. The NASBA Taskforce concluded that the entire business structure of the alternative practice unit must be regulated as a single entity, whether or not it is a licensed CPA Firm.

The Texas Board looks forward to the Independent Standards Board's analysis of the issues in this complex area. Thank you for the opportunity to comment on these questions.

Very truly yours;

K. Michael Conaway
Presiding Officer
Texas State Board of Public Accountancy

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THE CAPITAL GROUP COMPANIES, INC.

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THOMAS M. ROWLAND
Senior Vice President
Fund Business Management Group

January 18, 2000

Mr. William T. Allen, Chairman
Independence Standards Board
1211 Avenue of the Americas
New York, NY 10036-8775

Dear Mr. Allen:

Capital Research and Management Company appreciates the opportunity to comment on the Independence Standards Board's (ISB) Discussion Memorandum (DM) *Evolving Forms of Firm Structure and Organization*. We commend the Board for its efforts in addressing this subject.

Overview

We believe that the Board's efforts to examine auditor independence issues arising from new structures and relationships is timely and important. The traditional focus on professional standards has not addressed the many changes that have occurred in the business services and alliances of independent accounting firms. Expanded consulting services provided by independent accounting firms and their alliances with other service providers have increased opportunities for potential independence conflicts. Changes in firm structures as outlined in the DM add another dimension to auditor independence matters. To date, a firm's investment restriction policies, quality control measures, disclosure of non-audit services provided to audit clients and regulatory reporting, have been the principal methods of safeguarding against independence conflicts. Clearly, it is not certain that the historical measures to ensure auditor's independence, and the perception thereof, will be effective or practical to address the contemplated audit firm structures.

Questions for which Comments are Requested

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

Q 1.Do you believe that the traditional focus of accounting firms on professional standards and independence may be compromised by the types of relationships described above? Why or why not? Does your answer depend on the type of relationship?

Yes. Changes in the organizational structure of accounting firms as described in the DM, whereby related parties (corporate employer, Non-Auditor owner or investee) conduct business with audit clients, increases the potential for independence conflicts. New structures and relationships may result in financial incentives to firms, or the firm's personnel, which could impair their independence. Current safeguards provided by the firm's quality control measures may not be effective in overcoming real or perceived lack of independence. As firms have grown, principally through merger and additional service offerings, it has been difficult for them to monitor their independence restrictions. A recent event involving a failure of a "Big Five" accounting firm to comply with its independence standards illustrates that it is difficult for large firms to monitor compliance with its policies. We understand a subsequent compliance audit conducted by this firm revealed a number of additional violations of their policies. Strict adherence to investment restrictions also raises the potential for conflict among members of the firm. It may be extremely difficult to persuade a firm member performing consulting services to non-attest clients that he/she must comply with firm investment restrictions. Attracting and retaining personnel becomes an issue when these situations arise. Additional related party relationships as described in the DM would increase the difficulty in maintaining compliance with independence policies and procedures. Expanding related party relationships beyond the traditional firms' structure will add significant complexities in establishing independence standards and policies. It may also prove to be extremely difficult, or possibly impractical, to "enforce" and monitor activities of related parties with audit clients.

Q 2. Is it appropriate for a multi-disciplinary professional service firm (such as a "Big 5" accounting firm) to have public ownership in either the firm itself or in its parent, subsidiary, or investee?

Public ownership of a professional service firm providing attest services or its parent does not seem appropriate. Public ownership implies owners other than those providing client services, possibly including audit clients. Audit client ownership of an audit firm would result in a relationship similar to that of an internal auditor, although once removed. Clearly, internal audit departments do not fulfill the same function as independent accountants. The partnership structure of large public accounting firms results in a personal financial liability of partners for the quality of services rendered. This plays an important role and incentive in maintaining high standards of service and independence. Corporate ownership of the firm or its parent would lessen this incentive. Subsidiaries of the public parent of an audit firm could also provide services to audit clients. This arrangement may result in direct or indirect financial incentives to the audit firm and its members and influence the real or perceived independence of the auditors. It may not be possible or practical to preclude business relationships between the audit firm's related entities and audit clients. It may also be difficult to establish guidelines for related entities conducting business with audit clients that would be effective in precluding independence conflicts of interest. Public ownership of subsidiaries or an investee of audit firms results in many of the same challenges.

Q 3.Do you believe that the independence of a firm would be impaired if an audit client or one of its officers or directors owned stock in the audit firm or one of the audit firm's subsidiaries? Would your answer be different if the investment were not material to the investor, or the client-shareholder owned less than say 5% or 10% of the shares of the public entity?

Independence would be impaired if an audit client or one of its officers owned stock in the audit firm. Issues similar to those described above would influence the actual and perceived independence. The further removed an audit client is from direct ownership in the audit firm, for example ownership of a subsidiary or investee, may reduce, but not eliminate potential independence conflicts. Certainly, a relatively low percentage ownership may reduce the potential for independence conflicts; however, it may not eliminate the perceived lack of independence.

Q 4.When an audit partner is also an employee of a corporation, do you believe that the restrictions applied to the auditor and his or her firm on activities and relationships with audit clients should be applied to the corporation?

Ideally, it would be desirable for a corporate owner of an accounting firm to comply with guidelines similar to that of the audit firm, but it does not seem practical for all situations. Guidelines addressing the percentage ownership of audit partners in a corporate parent, coupled with the corporations other business relationships need to be considered. Additional disclosure requirements for business relationships of corporate parents with audit clients should be formulated.

We appreciate the opportunity to express our views and would be pleased to discuss them with you. If you have any questions, please contact me at 714-671-7188.

Sincerely,

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Accounting Firms Associated, inc.

CPA Mutual

Douglas H. Thompson, Jr., CPA

February 16, 2000

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

Re: Independence Standards Board Firm Structures Staff Recommendations

Dear Susan:

My compliments to you and all involved for an excellent job on your initial draft of the referenced recommendations.

I wanted to confirm, in writing, my comments and differences with respect to staff recommendations on pages 3 and 4 of your draft. Specifically:

- "Sister firms are audit firms related by virtue of: ... membership in associations.
- "Standards should require firms to observe independence restrictions with respect to sister firm Audit Clients when Audit Firms are related by: ... common name – firms practicing under an umbrella organization's name, or the name of an association ('ABC Firm, a Member of XYZ Association').
- "This proposal imposes new restrictions on many firms that are members of associations (we don't believe that firms that are members of associations currently maintain independence with respect to one another's audit clients). Under the proposal, while firms in associations advertising under a common name must now maintain independence with respect to sister firm audit clients, members in these firms, are unrestricted except they can't control or exercise significant influence over a sister firm audit client."

Please be advised that I think it is critical that staff and the Independence Standards Board understand that individual, autonomous firms that are members of associations of CPA firms are independent of each other both by perception and in fact.

For example, the 70 large, independent, full-service CPA firms and consulting firms that are members of CPAmerica International:

- Practice under their own names and not in the name of CPAmerica International or any other firm name.

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- Perform little, if any, "joint" engagements and make few referrals to each other. (All joint engagements are reported annually to the PCPS and SECPS with our application to administer peer reviews.)

- The firms of CPAmerica International have no direct or indirect financial interest in each other.

Further, CPAmerica International is not licensed to practice public accounting in any state and does not practice public accounting in any state. We are in process of changing our name from Accounting Firms Associated, inc. to CPAmerica International. The enclosed copy of our new letterhead containing our logo prominently states under our name ... "World's largest <u>network</u> of <u>independent</u> CPA and consulting firms" (underlining for emphasis).

I believe the staff is overreaching when it includes independent firms that happen to be affiliated by virtue of their common membership in the same association are "sister firms." And, I disagree with staff conclusion on page 4 stating, in part,

> "We don't believe that firms that are members of associations currently maintain independence with respect to one another's audit clients."

That is not a true, correct statement.

I urge you to reconsider your position. To assist you, I will be pleased to provide any additional information regarding CPAmerica International's structure, operation and relationships. I am confident that, once you have carefully and completely considered all facts, you and the Independence Standards Board will conclude that independent, local CPA and consulting firms practicing under their own firm name, that have no direct financial interest in each other are, both in appearance and in fact, independent even though they may belong to the same full-service association of CPA firms.

Sincerely,

Douglas H. Thompson, Jr.

DHT:b
Enclosure

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Tax & Business Services

February 16, 2000

American Express
Tax and Business Services Inc.
American Express Tower
World Financial Center
200 Vesey Street
New York, NY 10285

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

Re: Alternative Practice Structures (DM99-2)

Gentlemen:

American Express, as an interested party, sought to participate in and contribute to the dialogue about the application of independence precepts to Alternative Firm Structures. We, and others like us, have attended meetings and were appointed to a Project Task Force for Alternative Firm Structures established by the Board to assist in the formulation of principles and rules to address auditor independence concerns brought about by new relationships born of new firm structures.

In many respects, the Board's staff has undertaken to write rules before and without considering the underlying issues and the interests of the public and the profession. Doing so, we believe, undercuts and will effectively circumscribe the Board's mandate to analyze the conceptual framework in which independence issues arise. As we noted in our comments on DM 99-2, "[T]hreats [to independence] cannot be addressed piecemeal or within the context of rules for alternative practice structures. Once the conceptual framework task force has completed its work and a new paradigm for auditor independence is established, the independence threats ... can be addressed."

In response to DM 99-2, we and many others commented on a series of specific questions about firm structures. At the February 4th meeting of the Task Force, it was noted that the staff's summary of the public comments on DM 99-2, distributed to Task Force members in late January, was biased and that the staff analysis and recommendations, only made available to us at the February 4th meeting, failed to address meaningfully the public comments. The Task Force participants were essentially told that their role was to answer the staff's questions and not to expect that the participants' recommendations would necessarily be presented to the Board.

Rather than examine the public policy implications of new independence rules on the accounting profession and investors, the staff chose to attempt to apply existing independence rules to alternative firm structures without analysis of the underlying rationale for such application or its impact on audit quality, investors or the accounting profession. The staff's analysis, as presented at the February 4th meeting, reflects a fundamental hostility to these new structures and an unwillingness to recognize the fundamental economic forces that created them.

These new structures evolved and will continue to evolve in response to changing market conditions, intense competition for audit clients and for able personnel, increased technology and operating costs, and the need for capital to meet these challenges. Faced with these pressures, firms sought to depart from their traditional narrow confines and to develop the ability to deliver a broad range of professional services. The pressures are exacerbated because most providers of audit services believe that audit engagements are less lucrative than consulting and other services sought by their clients, and because able young accountants skilled in audit techniques are easily lured to alternative career paths. Unfortunately, the traditional notions of independence that intersect with the realities of today's accounting profession were developed before these pressures emerged and have remained largely unexamined as the surrounding atmosphere changed. But independence is only one component of a regulatory scheme that demands high quality, unbiased, objective financial information.

The Board was created against this background "to establish standards applicable to auditors of public entities that serve the public interest by promoting investor confidence in securities markets." The Securities and Exchange Commission undertook to "consider principles, standards, interpretations and practices established or issued by the ISB as having substantial authoritative support for the resolution of auditor independence issues."

Moreover, at the time the Board was established, the Commission recognized the importance of the then-announced "mergers of several 'Big 6' accounting firms . . . and the accelerating trend toward consolidation of auditing firms generally... ." One visible manifestation of this "accelerating trend" is the emergence of new accounting firm structures. These new structures may be separate practices, roll-ups, associations of smaller accounting firms, the spin-off of consulting or other businesses by existing accounting firms, or other forms of organization. Although there may be a wide diversity in forms and structures, the new organizations have a common purpose in creating an environment conducive to attracting capital investment to the accounting profession so that it can meet the challenges of a competitive market place and continue to provide high quality audit services. Rather than protecting the integrity of the profession, slavish adherence to concepts and principles developed in another time and based on a different industry model jeopardizes the ability of the profession to continue to meet Congress' mandate that the Commission and investors look to independent public accountants to audit financial statements.

Taken as a whole, the staff's recommendations will create a new, complex and intrusive set of quasi-governmental regulations that do little to advance the interest of investors in obtaining competent, unbiased and objective financial information. They do not address the realities of today's economy and the state of the profession.

"Materiality" is Relevant to Evaluating All Aspects of Perceived Threats to Auditor Independence

Perhaps the principal flaw in the staff's analysis is its categorical rejection of materiality as a basis for determining when independence restrictions apply to entities associated with auditors.

Materiality and ability to influence audit judgments are familiar concepts in serious independence analysis. They provide a framework for analyzing and reconciling the tensions between economic interests and objective auditing. These concepts take into account the reality of business life, the firm's and its strategic partners' economic interest in preserving, not compromising, integrity, and the absence of financial incentives to influence audit judgments. Yet, regarding entity restrictions, the staff abandons materiality as a concept relevant to imposing entity restrictions in dual employment situations and suggests that the corporate employer and its subsidiaries should be "prohibited from having any relationship with an audit client that the audit firm cannot have directly." No rationale is reflected in the commentary.

The staff asserts: "[W]e believe the auditor is more likely to be influenced by relationships that other entities now affiliated to the audit firm have with audit clients." Why the staff "believes" this to be so is not explained. One can just as easily reach the opposite conclusion. Nonetheless, the recommendations that flow from the premise would, as a practical matter, chill or deter many investors and other strategic partners from entering into arrangements with audit firms because the price of entry would be to forego business relationships unrelated to the audit process. The staff makes no attempt to discuss the nature or significance of the relationships that might, in its view, affect audit objectivity.

At the February 4th meeting, the staff expressed the notion that the corporate employer might "retaliate" or the auditor/employee might fear retaliation for audit decisions that might be contrary to the corporate employers' presumed interests. Why that would be so when the corporate employers' interest was not material was unexplained. To suggest that auditors would be so easily cowed demeans the profession without demonstrable basis. The thought that someone in the American Express hierarchy could or would have any interest in compromising an audit performed by a separate practice firm that American Express neither owns nor controls and that probably accounts for a miniscule fraction of 1% of American Express corporate revenues is simply preposterous.

The staff's abandoning of materiality in the corporate employer context also stands in marked contrast to the Board's expanded use of the concept in ISB Standard No. 2, dealing with financial interests of audit personnel and their immediate families in mutual funds, the staff's own extensive use of materiality in dealing with audit client investment in audit firms, and AICPA Ethics Interpretation 101-14 dealing with alternative practice structures.

Moreover, the public responses to DM 99-2 reflect that users of audited financial reports (investors and investment advisors, for example) are prepared to accept evolving forms of firm structures that allow immaterial relationships between auditors and their affiliates (on the one hand) and audit clients (on the other). Many experienced observers also suggest that disclosure of certain relationships among these parties may well provide enough information to those who rely on audit reports to assess the objectivity of the report. Nevertheless, the staff presentation failed even to discuss alternative approaches to independence issues, relying instead on arbitrary prohibitions based on undefined and empirically non-demonstrable fears.

The Staff Recommendations Will Constrict the Ability of Audit Firms to Raise Capital and are Anti-Competitive

Accounting firms, and especially middle-market firms, are unquestionably under intense pressure to generate or attract capital. Many, we are told, have difficulty obtaining bank lines to meet operating expenses, let alone expansion and modernization needs. The demise of many middle-market firms, including several firms of national size and repute, and the consolidation of many other accounting firms support the observation that many firms seek consolidation as a means of reducing costs and expanding access to capital. For the accounting profession and the marketplace for accounting services to remain vibrant and meet its obligations to clients and the public, firms today must have access to capital for personnel, training, technology and operations. The new firm structures that have evolved in recent years are designed to assure that the profession has the capital necessary to survive in a competitive marketplace. Constraining audit firms to traditional structures lessens their attractiveness to investors and weakens them. Financially weak firms cannot be relied upon to provide quality – and independent -- services.

Moreover, weakened firms and partners faced with financial and career uncertainties too easily engender a dependent relationship between auditors and their clients. Such dependence threatens the exercise of independent judgment. Ultimately, financial dependence on audit clients for fees and job protection is a threat greater than the possibility that immaterial corporate relationships with separate practice audit clients could or would color audit judgments through fear of retaliatory action by separate practice corporate officials against individual auditors. Strong firms and secure auditors can better resist client pressures.

New qualified entrants to the profession that are well capitalized should be encouraged, not discouraged. As recent experience suggests, middle-market firms, especially, have difficulty in competing for public audit clients and providing the high level of professional competence to which they aspire (and that is demanded for public companies). Evolving practice structures offer such firms and their partners an opportunity to level the playing field by providing access to expanded opportunities and services, not to mention capital to meet firm needs.

Audit Quality is Threatened by the Staff's Recommendations

Recent SEC enforcement actions and strident SEC staff commentary suggests a decline in audit quality attributable, at least in part, to the use of young, inexperienced and inadequately trained and supervised staff accountants. There may be disagreement over whether the audit function is profitable, but there can be no disagreement that the accounting profession and the marketplace regard the attest function as less profitable than the consulting and other financial services that full service accounting firms provide. Quality audits require not only objectivity, but also highly qualified and experienced auditors to do the work. This means that audit service providers must compete for talented accountants with consulting firms and other employers. Moreover, the highly specialized and rigorous nature of audit work requires a significant investment in training, technology and infrastructure. Without the ability to attract outside investment and provide the opportunities that flow from it, audit firms will inevitably attract less qualified accountants, suffer staff turnover that endangers quality, struggle to provide adequate training, demand performance without providing the technology to accomplish it, and not have the wherewithal to provide a work environment conducive to producing quality results.

Many in the profession attest to, and newspapers chronicle, the enormous difficulty firms have in attracting and retaining talented young accountants. Promising accountants, before or after joining the firm, are seduced by the glamour of alternative careers, higher compensation, and the opportunity to participate in the growth of the enterprise. The experience of our associated separate practices is that recruiting and retention of qualified personnel has improved markedly. These firms are no longer regarded as "dead ends" by applicants and are able to offer young accountants security and an attractive career path. The limitations on firm structure inherent in the staff's recommendations simply make public accounting a less attractive career than other available opportunities. This is especially true at a time when jobs are plentiful and recruiting and retaining talented professionals is so difficult.

Conclusion

The restructuring of the accounting profession has occurred and will continue because of fundamental economic forces. It has occurred in an environment that is anything but unmindful of the public interest, investors' needs and the risks and exposure that failure brings. There is simply no evidence that the evolving firm structures have compromised audit quality or put investors at risk. The challenge is to adapt the regulatory construct (of which independence is part) to the needs of the public and the profession. It is not met by looking only backwards. We believe that before the narrow rule-writing exercise evidenced in the staff's recommendations is allowed to co-opt the broader conceptual process, the Board must consider Firm Structure issues in the context of the public's and investors' interest, the maintenance of a vibrant profession, and on policy grounds.

Sincerely yours,

Genevieve H Roche

Genevieve Harris Roche

cc: All Board Members
All Task Force Members

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McGLADREY&PULLEN, LLP
Certified Public Accountants

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February 21, 2000

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

Dear Mr. Siegel:

I offer the below comments regarding the ISB's initial thoughts on alternative practice structure independence policies, as presented at the Task Force meeting on February 4. My comments are directed towards the Dual Employment and the Audit Client Investment in Firm scenarios presented by the ISB Staff.

- While I understand that materiality is not part of this project, I believe the ISB should revise existing rules to indicate that materiality must be used to identify and assess violations.
- I suggest that the Staff consider further the corporate restrictions discussed at the top of page 2. I am concerned with the issue of restricting all services provided by the Corporate Employer in situations where (i) the Corporate Employer is a sizable, diversified business, (ii) the audit firm has significant firewalls between itself and the Corporate Employer, and (iii) where the audit partners derive significant portions of their current and future compensation from the audit firm. In this situation, I believe that it would be difficult and unlikely that the Corporate Employer would be able to exert significant influence on the audit firm in the performance of an audit engagement. I am also concerned that it will not be economically possible to identify all such services provided to an audit client by subsidiaries of the Corporate Employer, unless such services are so material to the audit client that they are obvious to management and the audit firm. Additionally, large companies frequently buy and sell businesses and change management personnel, so it will be difficult to identify and track all of these types of services provided by the Corporate Employer. If it is difficult to identify and track immaterial services, then I question whether this indicates that there has been any impact on the audit engagement. As a result, we believe that subsidiaries or divisions of the Corporate Employer that are outside the chain of command should be able to provide an audit client with restricted services that are offered in the normal course of their respective business, unless such services are clearly material.
- I suggest the staff clarify that the personal restrictions on page 2 do not apply to independent Board members.

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- I agree with the concepts presented in Audit Client Investment in Firm presented on pages 9 and 10. However, I suggest that the 3% of equity factor be modified to address situations where the registrant does not have significant or positive equity. Some businesses, such as the broadcast industry, consistently operate with deficit equity but have significant positive cash flows (due to large intangibles). I also suggest that these concepts by expanded to cover immaterial loans obtained in the ordinary course of business (i.e., credit card balances).

Thank you for considering my thoughts. I appreciate the efforts of the ISB on this important topic and concur with many of the recommendations set forth in the initial draft. In particular, I commend the Staff for focusing on the significant matters that would enable an audit client to have the ability to influence the audit engagement. The profession cannot spend time and resources tracking insignificant matters that have no ability to influence the auditor's decisions. To do so would add a cost to the users and the audit firms that provide no real benefit to the capital markets.

Sincerely,

William D. Travis

William D. Travis
Managing Partner

WDT:sgh

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AMERICAN EXPRESS

Tax & Business Services

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Facsimile

To: Task Force Members

From: Genevieve Harris Roche

Subject: Alternative Practice Structures

Pages: 5

Date: April 3, 2000

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cc: Art Siegel, Executive Director (212-596-6137)

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Comments:

In preparation for tomorrow's Task Force meeting, we prepared the attached recommendation on dual employment as an alternative to the ISB Staff's approach in the Outline for ED distributed at the last Task Force meeting.

Independence Standards Board
Firm Structures
American Express Recommendation re Dual Employment - Outline for ED

The ISB staff proposes to draft a standard that addresses firm structures in five broad categories:

A. **"Dual Employment"** - a structure in which the auditor is either a partner or employee of the Audit Firm as well as an employee or partner of another entity not providing audit services (called a *"Corporate Employer"*).

B. **"Sister Firms"** - a structure in which two or more Audit Firms are related by virtue of common employment of professionals, membership in the same practice association, or practice under an umbrella organization.

C. **"Firm Investment in Other Entities"** - a structure in which an Audit Firm has an investment in another entity (called an *"Investee"*).

D. **"Third Party Investment in the Firm"** - a structure in which another entity has an investment in an Audit Firm or in an Investee.

E. **"Client Investment in the Firm"** - a structure in which an Audit Firm client invests in the Audit Firm's Investee or Corporate Employer.

Dual Employment

American Express proposes a standard relating to Dual Employment substantially as follows[1]:

The proposed standard deals with how and when restrictions to protect Audit Firm independence should apply to individuals and entities other than certified public accountants or Audit Firms that are involved in dual employment structures. It also establishes safeguards to ensure that individuals and entities involved in dual employment situations do not engage in certain conduct. It is not intended to affect the rules that apply to audit firms and their CPA employees who perform audits.

Two types of restrictions are distinguished:

1. *"Entity Restrictions"* - an Audit Firm's independence would be impaired if a Corporate Employer, sister firm, investee or third-party investor ("specified entity") had material relationships with an Audit Client that an Audit Firm would not be permitted to have under current independence standards (*e.g.*, loans, bookkeeping services).

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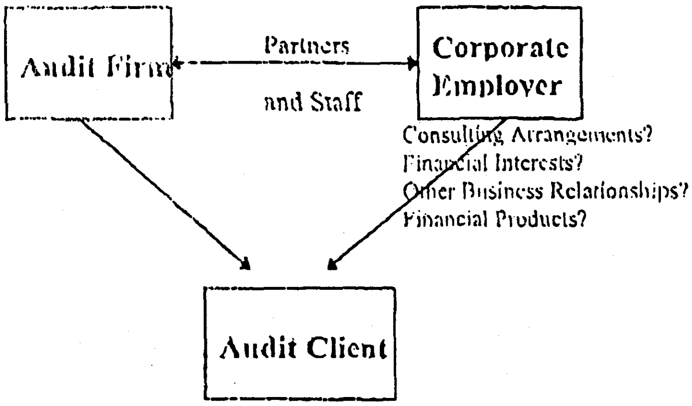
[1] The standard we propose does not conflict with the staff proposals for other structures contained in its "Firm Structures - Outline for ED" and is consistent with the concepts in those standards. We have attempted to follow the staff's drafting conventions and definitions. Although we will participate in the Task Force discussion of the other proposed standards, we do not expect to submit separate proposals.

2. *"Personal Restrictions"* - an Audit Firm's independence would be impaired if certain individuals had relationships with an Audit Client that a Member of an Audit Firm would not be permitted to have under current independence standards (*e.g.*, equity ownership).



Recommendation

Entity Restrictions. Where there are relationships between the Corporate Employer and the Audit Client that are material to either the Corporate Employer or the Audit Client, Entity Restrictions would apply to the Corporate Employer. This would assure that where such relationships exist the Corporate Employer would be prohibited from doing for Audit Clients anything that an Audit Firm would be prohibited from doing. For purposes of Entity Restrictions, the Corporate Employer includes the ultimate parent company or any unit, subsidiary or division that employs members of the Audit Firm and any intermediate entity.

Personal Restrictions. Personal restrictions would apply to direct supervisors of dually-employed personnel and, where there are relationships between the Corporate Employer and the Audit Client that are material to either the Corporate Employer or the Audit Client, Personal Restrictions would apply to:

(a) indirect supervisors of dually-employed personnel involved in an audit ("indirect supervisors" are supervisors one or more levels removed from the personnel conducting the audit who have the motive and opportunity to influence the outcome of the audit);

(b) persons in a managerial position who reside in an office in which dually-employed personnel are involved in providing significant audit services to the Audit Firm's Audit Client; and

(c) controlling shareholders who have the motive and opportunity to influence the outcome of the audit ("controlling shareholders" include a "control group" of shareholders to the extent there is a history or other reasonable basis for believing they would act in concert).

Personal Restrictions would apply also where a person in any of the above examples has a material interest in the Audit Client irrespective of the relationship between the Corporate Employer and the Audit Client.

Exceptions/Limitations. Neither Entity Restrictions nor Personal Restrictions would apply to Corporate Employers or their personnel if the Dual Employment results from:

(a) part-time professorships;

(b) service on a charity's board or other governing body; or

(c) part-time or temporary employment.

Safeguards. Certain relationships between a Corporate Employer and an Audit Client are of such significance that they should not be permitted regardless of materiality. Safeguards designed to prohibit such relationships will add to user confidence.

An Audit Firm's independence would be impaired whenever a Corporate Employer had any of the following relationships with an Audit Client, irrespective of materiality considerations:

1. Performing any service that derogates from acceptance of full responsibility by the Audit Client for its financial statements;

2. Assuming management authority over an Audit Client, including but not limited to, consummating transactions, having physical or legal custody of assets, or exercising authority over its assets;

3. Making commercial loans to an Audit Client, but excluding credit and charge card relationships that are not material to either the lender or the borrower and are maintained in the ordinary course of business and in accordance with their terms;

4. Performing any services requiring registration as a broker or dealer, except for the purchase and sale of securities in an account fully insured by SIPC and not involving investment discretion or the extension of credit;

5. Making investment or business risk decisions for an Audit Client or accepting discretionary authority over an Audit Client's investments; and

6. Preparing research reports on the investment merit of an Audit Client, but the Corporate Employer may provide statistical information from publicly available sources or disseminate research reports about the Audit Client published by third parties.

Commentary

This proposal is generally consistent with the current AICPA rule. It allows materiality to be considered when determining whether the Corporate Employer and indirect supervisors of Audit Firm partners can have certain relationships with Audit Clients. The proposal recognizes that material relationships are more likely to impair independence than relationships that are not material.

Using materiality as the touchstone in evaluating relationships that may compromise or appear to compromise auditor independence shifts the focus of independence analysis away from inconsequential details, e.g., financially insignificant relationships between Corporate Employer and Audit Client, and concentrates on economic substance. Independence is threatened only in those situations where there are the motive and opportunity to exert pressure on the auditor to compromise objective analysis of the financial condition of an audit client.

Evaluating the impact of dual employment on independence with respect to a particular client requires an analysis of the substance of the economic relationship between the Corporate Employer and the Audit Client, as well the relationship between the Corporate Employer and the dual employee. Where there is a material economic interest between the Corporate Employer and the Audit Client, independence would be impaired. In the absence of such interest, there is no reason for the Corporate Employer even to attempt to influence independent auditors who are also corporate employees.

Personal Restrictions, of course, apply to direct supervisors of dual employees who are engaged in providing audit services. In addition, the proposal recognizes that Personal Restrictions should extend to indirect supervisors of the dual employees and other personnel who have the motive and opportunity to influence significantly the outcome of the audit. Managerial personnel of the Corporate Employer who are not performing functions directly or indirectly related to dual employees have little or no ability to influence decisions by or related to those employees and should not be subject to Personal Restrictions.

Some relationships between a Corporate Employer and an Audit Client, however, are of such significance that they should be prohibited irrespective of materiality considerations. Safeguards should be established to provide an additional level of user confidence in those instances where the relationship between Corporate Employer and Audit Client suggests inherent independence risk.

The objective of the independence rules is to insure that users of financial statements have confidence in the integrity of the audit process. Reasonable investors will not consider audit independence to be impaired in the absence of a material interest by the auditor or by an entity theoretically capable of exercising significant influence over the auditor or audit firm. This reasoning is confirmed by the comments of users of financial statements that responded to DM 99-2. However, the question of how users of financial statements will evaluate these relationships need not be left to the opinions and beliefs of the drafters of these rules. Audit committees and users of financial statements should have the opportunity to assess whether these relationships affect auditor objectivity. To accomplish this objective, details about the Corporate Employer's relationship with an Audit Client should be disclosed to the audit committee of the Audit Client and publicly disclosed.