

ITC 98-1, Recommendation to the SECPS

ISB Invitation To Comment (ITC 98-1)

Proposed Recommendation to the Executive Committee of the SEC Practice Section of the American Institute of Certified Public Accountants

May 29, 1998

Comments should be received by July 23, 1998, and addressed to
Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: ITC 98-1

Comments may also be faxed to (212) 596-6137, or sent via e-mail to
isb@cpaindependence.org (the subject line should refer to ITC98-1).

Date May 29, 1998

To: Interested Parties

From: William T. Allen, Chairman

The Independence Standards Board (ISB or Board) was created jointly by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) to establish a conceptual framework to serve as the foundation for principles-based independence standards for auditors of public companies. The SEC, in Financial Reporting Release No. 50 (February 18, 1998), recognized the Board as the standard-setting body designated to provide leadership in improving current independence requirements. The mission of the ISB is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investor's confidence in the securities markets.

The operating policies of the ISB are designed to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue.

To further its goal of improving current independence requirements, the Board is considering making a recommendation to the Executive Committee of the AICPA's SEC Practice Section (SECPS) that it require member firms to confirm their independence annually to each public company client's audit committee or board of directors (every firm that audits SEC registrants and belongs to the AICPA must be a member firm of SECPS). In the confirmation, the auditor would also offer to meet with the committee or the board to further discuss independence. If SECPS adopts the recommendation as a membership requirement, compliance would be tested as part of its peer review program.

While the ISB welcomes comments and suggestions on any aspect of the proposed Recommendation, input is specifically being sought on the following questions:

- 1) Will the proposed Recommendation be helpful in fostering additional attention on independence issues by audit committees and their auditors?
- 2) Is there a more or equally effective mechanism for promoting audit committee evaluation of the independence of the entity's auditors?
- 3) Do the benefits of the proposed requirement outweigh its costs?
- 4) While the recommendation encourages independence discussion with the audit committee early in the audit process so that any concerns of the audit committee can be addressed before the audit is fully underway, the recommendation is drafted to allow flexibility in the timing of confirmation delivery. Would it be desirable to recommend that the independence confirmation be delivered at the time that the auditor is appointed for the upcoming audit?
- 5) A small number of auditors of U.S. public companies, as well as auditors of foreign companies registered with the SEC, are not members of SECPS. Therefore, if the Recommendation became a SECPS membership requirement, rather than a requirement under U.S. generally accepted auditing standards, it would not apply to all audits of companies subject to SEC reporting requirements. Should the Recommendation be submitted to the Auditing Standards Boards (ASB), as opposed to SECPS, so that the requirement would apply to all audits of public companies? (It should be noted that there are existing SECPS requirements that apply only to member firms, such as those mentioned in paragraph 9 of the attached proposal.) Or should the proposal be a dual recommendation to both the SECPS and the ASB, because the SECPS Executive Committee can implement it immediately, while the ASB's processes would require a significantly longer period of time?

Responses should be addressed to the Independence Standards Board, 6th Floor, 1211 Avenue of the Americas, New York, New York 10036-8775, Attn: ITC 98-1. Responses may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to ITC98-1). Comments must be received by July 23, 1998.

All responses will be available for public inspection and copying for one year at the offices of the Independence Standards Board and at the library of the AICPA at Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey.

Proposed Recommendation to the Executive Committee of the SEC Practice Section of the American Institute of Certified Public Accountants

Confirmation of Auditor Independence

Objective

1. The Independence Standards Board (ISB or Board) is considering a recommendation to the Executive Committee of the AICPA's SEC Practice Section (SECPS), to require member firms confirm their independence annually to each public company client's audit committee or board of directors, and to offer to meet with the committee or the board to further discuss independence. The Board believes that the proposal would serve its objectives by further focusing both the auditor and the audit committee on issues of auditor independence. In addition, the discussion of independence with the audit committee that may result from issuance of the confirmation should improve the directors' understanding of independence issues, thereby assisting them in exercising their corporate governance responsibilities.

Applicability

2. This proposed recommendation, if adopted by the SECPS, would be applicable as a membership requirement to all member firms when auditing the financial statements of Securities and Exchange Commission registrants.

Proposed Recommendation

3. An auditor of a Securities and Exchange Commission registrant shall issue to the entity's audit committee, or board of directors, at least annually, a written report confirming the auditor's independence under the applicable rules of the Securities and Exchange Commission, the Independence Standards Board, and the American Institute of Certified Public Accountants. In addition, the auditor should offer in that confirmation to meet with the audit committee or board to further discuss the firm's independence, including the firm's compensating controls employed when independence issues arise.

Recommended Confirmation Language

4. Such a confirmation might be worded as follows:

Audit Committee of the Board of Directors [or The Board of Directors] ABC Company

[Optional - Under membership requirements of the American Institute of Certified Public Accountants SEC Practice Section, the auditor of a company subject to the rules of the Securities and Exchange Commission is required to issue to the company's audit committee or board of directors a report confirming the auditor's independence under the applicable rules. Accordingly, and]

R(r)elating to our examination of the financial statements of the ABC Company as of December 31, 19x1 and for the year then ended; we are independent accountants with respect to the ABC Company, under the published requirements of the Securities and Exchange Commission, and the Independence Standards Board, and under Rule 101 of the American Institute of Certified Public Accountants' Code of Professional Conduct and its interpretations and rulings. We would be pleased to meet with you, at your convenience, to further discuss our independence, including the related controls employed by our firm.

Discussion

5. The Board believes that the above proposal would serve its objectives by further focusing both the auditor and the audit committee on issues involving auditor independence. It is expected that in some cases the auditor, knowing that explicit confirmation of independence will be required, will remain mindful of the need to devote substantive attention to independence issues. Similarly, the discussions of independence with the audit committee that may result from issuance of the report should improve the directors' understanding of independence issues. This should assist them in exercising their corporate governance responsibilities in this area.

6. The Board recognizes that all additional requirements imposed on auditors carry a cost, and that a requirement to issue another standard letter could be criticized as taking the auditor's time and attention away from the important task at hand - performing an effective and efficient audit. The Board also recognizes that maintaining independence is a requirement under generally accepted auditing standards (GAAS), and compliance with GAAS is confirmed in every audit report. The Board believes, however, that there are incremental benefits in an explicit requirement which outweigh the costs of providing an independence confirmation (such costs are believed to be nominal). In addition, the proposed requirement does not impose additional responsibilities on the auditor beyond confirming, in writing, compliance with existing standards.

7. The Board discussed the possibility of a recommendation that the audit committee conclude on the auditor's independence. However, auditor independence today is generally defined as compliance with specific and complex bodies of rules, and the Board concluded that it is not reasonable at this time to expect audit committee members to be sufficiently knowledgeable about those rules to make such a determination. In addition, the audit committee's conclusion on the auditor's independence would necessarily be based, in large part, solely on the representations of the auditor (for example, an audit committee would find it difficult, if not impossible, to confirm the auditor's representation that the audit firm and all of its members did not own any stock of the company). The Board believes that the proposed requirement will increase audit committee knowledge of independence issues by focusing attention on auditor independence and increasing meaningful dialogue between auditors and audit

committees.

8. The auditor is required to assess his or her independence prior to engagement acceptance, and to monitor his or her continued independence throughout the audit—independence is not a point-in-time requirement. The Board considered, as part of its recommendation, that the independence confirmation be delivered by the auditor at the beginning of the audit. It seems logical to initiate discussions about independence with the audit committee early in the audit process, so that any concerns of the audit committee can be addressed before the audit is fully underway. In addition, a confirmation of independence issued early in the audit process followed by the issuance of the auditor's report at the end of the audit process serves to reaffirm that the auditor was independent at both the beginning and end of the audit.

9. The Board, however, believes that the proposed reporting requirement could be easily incorporated into the other annual communications made by the auditor to the audit committee, which typically occur at the end of the audit (the "SAS 61 letter"). Other requirements that the SECPS has imposed on its members are typically included in the SAS 61 letter, such as the requirement to communicate total fees received from the client for management advisory services during the year under audit and a description of the types of such services rendered. In addition, engagement circumstances and audit committee schedules vary, and the Board believes that flexibility should be allowed in the timing of the independence confirmation. As such, the Board believes that the confirmation could be delivered at any time during the audit process that fits the facts and circumstances. Although not required to be delivered before the issuance of the auditor's report on the financial statements, the confirmation should be delivered on a timely basis. Depending on the circumstances, auditors (and audit committees) may want to initiate these discussions early in the audit process.

10. With regard to the report itself, the suggested wording is consistent with that for auditor "comfort letters" under Statement on Auditing Standards 72, "Letters for Underwriters and Certain Other Requesting Parties." Similar representations as to independence often are required when a principal auditor makes use of the work of another auditor.

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