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Independence

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## Auditor independence education materials: The importance of being independent

Video discussion questions: Section II – The public accounting profession

Developed in conjunction with the University of Illinois Center for Professional Responsibility in Business and Society.

Audit • Tax • Consulting • Financial Advisory •

## Section II – The public accounting profession

Section II focuses on professionalism, professions, and independence in appearance.

V2.1) Your uncle is employed as the controller of Company J, an audit client of your firm. You are asked to serve on the Company J audit team. You are pretty sure that the independence rules do not prohibit you from serving on the audit team because technically your uncle is not a “close relative.” You have a close relationship with your uncle and see him on a regular basis. Should you disclose this relationship to your firm?

V2.2) What do other professions, such as law or medicine, have in common with the accounting profession?

# Appendix A: Fundamentals of independence

## Definitions

1. **Accounting role:** A role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.
2. **Affiliate:** Affiliate of the audit client means:
  - An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client’s parents and subsidiaries;
  - An entity over which the audit client has significant influence, unless the entity is not material to the audit client;
  - An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and
  - Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.
3. **Attest client:** An entity whose financial statements (or other information) the accounting firm audits, reviews, or is attested to.

Attest engagements include:

- Financial statement audits
  - Financial statement reviews
  - Audits of internal control over financial reporting performed under Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit Of Internal Control Over Financial Reporting That Is Integrated with an Audit Of Financial Statements*
  - Engagements performed under the AICPA Statements on Auditing Standards (SASs) or Statements on Attestation Standards
4. **Audit and professional engagement period** includes both:
    - The period covered by any financial statements being audited or reviewed (the “audit period”); and
    - The period of the engagement to audit or review the audit client’s financial statements or to prepare a report filed with the Securities and Exchange Commission (SEC) (the “professional engagement period”):
      - » The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client’s financial statements) or begins audit, review, or attest procedures, whichever is earlier; and
      - » The professional engagement period ends when the audit client or the accountant notifies the SEC that the client is no longer that accountant’s audit client.
    - For audits of the financial statements of foreign private issuers, the “audit and professional engagement period” does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the SEC, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the SEC.
- Note: If an accounting firm audits a company over multiple years, the professional engagement period is an ongoing period i.e., does not end once the current-year audit is completed and recommence when next year’s audit begins.

5. **Close family members:** A person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

Note: Under AICPA guidance, a close family member is equivalent to a close relative.

7. **Contingent fee:** Except as stated in the next sentence, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. A fee is not a "contingent fee" if it is fixed by courts or other public authorities or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered.

8. **Covered persons:** The following partners, principals, shareholders, and employees of an accounting firm:

- The "audit engagement team;"
- The "chain of command;" i.e., persons who (1) supervise or have direct management responsibility for the audit and at all successively senior levels through the chief executive officer, (2) evaluate the performance or recommend the compensation of the audit partner, and (3) provide quality control or other oversight of the audit;
- Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided 10 or more hours of nonaudit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide 10 or more hours of nonaudit services to the audit client on a recurring basis; and
- Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

Note: "Covered member" (AICPA Code of Professional Conduct) is synonymous with the SEC term, "covered person."

9. **Direct financial interest:** A financial interest (ownership or guarantee of debt or equity securities, options, warrants, long or short security positions, and rights or other commitments to acquire such securities) which is owned directly by an individual, together with other persons, or through an intermediary if:

- A. The individual supervises or participates in the intermediary's investment decisions, or controls the intermediary, or
- B. The intermediary is not a diversified management investment company as defined by the SEC, and the financial interest is 20% or more of the total value of the intermediary.

10. **Federal Deposit Insurance Corporation (FDIC):** An independent agency of the federal government, created in 1933 that preserves and promotes public confidence in the U.S. financial system by insuring deposits in banks and thrift institutions for at least \$100,000.

11. **Financial reporting oversight role:** A role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

12. **Immediate family members:** A person's spouse, spousal equivalent, and dependents.

13. **Independence** (free of conflicts of interest that would cause the firm to be biased either for or against the attest client):

The AICPA has defined independence as:

*Independence of mind* — The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

*Independence in appearance* — The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

14. **Independence check:** An independence check is typically completed before a public accounting firm proposes to provide any services to a new potential client. Independence may be impaired if another member firm is already providing audit or nonaudit services to the potential client. If the nonaudit services being performed are considered prohibited by the independence rules, then the proposing audit engagement team would need to factor these services into the firm's ability to perform the audit.

To make the independence check process consistent, typically a standardized form is completed by the proposing engagement team and sent to the Independence Office for review. The Independence Office will check its databases and send communications to another member firm or affiliate to make sure no services are being provided to the potential client that would impair the firm's independence. Any information received from the international or U.S. office is then forwarded to the proposing engagement team to assess the independence implications.

Generally, professionals at the manager/senior manager levels will be involved in assessing independence compliance and making recommendations to the engagement partner. Entry level (e.g., staff/associate) or senior staff (i.e., below manager level) could be involved in a support role. For example, a staff person might assist an audit manager by gathering relevant information, performing research, and checking firm databases. Ultimately, the lead engagement partner is responsible for determining that all relevant independence requirements have been met since he or she has overall responsibility for the client relationship.

15. **Indirect financial interest:** This term includes a financial interest in an entity through an intermediary that does not meet the definition of a direct financial interest. For example, an individual may have a direct financial interest in A, which in turn has a direct financial interest in B. Provided the individual does not control A, and cannot supervise or participate in A's investment decisions, and A's financial interest in B is less than 20% of the value of A's total investments, the individual's financial interest in B is considered to be an indirect financial interest to the individual.

16. **Investment company complex:** An investment company complex includes:

- (A) An investment company and its investment advisor or sponsor;
- (B) Any entity controlled by or controlling an investment advisor or sponsor, or any entity under common control with an investment advisor or sponsor if the entity:
  - » Is an investment advisor or sponsor; or
  - » Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment advisor, or sponsor; and
- (C) Any investment company or entity that would be an investment company, but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) that has an investment advisor or sponsor included in this definition by either (A) or (B).

An investment advisor, for purposes of this definition, does not include a subadvisor whose role is primarily portfolio management and is subcontracted with or overseen by another investment advisor. Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

17. **Objectivity:** Objectivity is a state of mind, a quality that lends value to a public accounting firm's services. It is a distinguishing feature of the public accounting profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a public accounting firm's objectivity in rendering attestation services.

18. **Professional skepticism:** An attitude and state of mind that includes a questioning mind and a critical assessment of audit evidence.
19. **Proposal:** A promotional and informative packet that is put together by the proposal engagement team. The proposal is made up of multiple sections and normally includes (1) the accounting firm's background, including locations, revenues, and market share; (2) the client service team chosen to service the potential client, including the team's background and biographies; (3) the services the accounting firm is proposing to perform; (4) the approach the firm will take to provide quality service, (5) independence confirmation (if applicable); (6) the accounting firm's commitment and dedication to the potential client; and (7) references and other resources, including accounting software and technology that will be used to serve the client. The proposal is normally bound with a glossy cover and has pictures and graphic art throughout the document.
20. **Proxy statement:** Statement required of a U.S. publicly traded company when soliciting shareholder votes. The company files the proxy statement (schedule 14a) with the SEC. The statement is useful in assessing how management is paid and potential conflict-of-interest issues with auditors. The statement includes: (1) voting procedure and information, (2) background information about the company's nominated board of directors, (3) director compensation, (4) executive compensation, and (5) a breakdown of audit and nonaudit fees paid to the auditor.
21. **Registrant:** A company publicly traded on a U.S. stock exchange for which they are required to be registered with the U.S. Securities and Exchange Commission.
22. **Restricted entities:** Accounting firm and their professionals should be independent of all "restricted entities" of the firm in accordance with the relevant independence standards. Restricted entities include:
  - (1) All attest clients of a firm, and
  - (2) Certain attest clients' affiliates.
23. **Securities Investor Protection Corporation (SIPC):** A federally mandated nonprofit corporation in the United States that protects securities investors from harm if a broker/dealer defaults. Investors are not insured for any potential loss while invested in the market. SIPC was created by the 1970 Securities Investor Protection Act, but it is not a government agency; rather, it is a membership corporation funded by its members. SIPC serves two primary roles in the event that a broker-dealer fails. First, SIPC acts to organize the distribution of customer cash and securities to investors. Second, to the extent a customer's cash and/or securities are unavailable, SIPC provides insurance coverage up to \$500,000 of the customer's net equity balance, including up to \$100,000 in cash.

## Regulatory bodies that govern independence

The accounting profession has generally described ‘independence’ in various professional standards and regulations as a lack of certain interests and relationships that are presumed to impact auditor **objectivity**. The primary independence standard-setters are:<sup>1</sup>

- The Securities and Exchange Commission (SEC)
- The Public Company Accounting Oversight Board (PCAOB)
- American Institute of Certified Public Accountants (AICPA)

### *The U.S. Securities and Exchange Commission (SEC)*

The SEC is a U.S. federal agency whose mission is to protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation. It is the primary overseer and regulator of the U.S. securities markets. Among its many responsibilities, the SEC interprets federal securities laws and oversees the conduct of professionals who audit public companies.

Federal securities laws require public companies to disclose certain financial and other information to the public in periodic filings with the SEC. For example, a company’s annual report (e.g., Form 10-K) should include an audit report (i.e., opinion letter(s)) signed by an *independent auditor*, which addresses the company’s financial statements and internal control over financial reporting. Such information (in part) helps to maintain confidence in the financial and capital markets

#### Qualifications of accountants

[Rule 2-01, Qualifications of Accountants](#), interprets [Regulation S-X of the Securities Exchange Act of 1934](#). Under Rule 2-01, the SEC will not recognize an accountant as independent of a company (i.e., the audit client) if the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the engagement. The SEC rules provide several examples of relationships and interests that are considered to impair a firm’s independence. However, the rule does not purport to describe all of the circumstances that raise independence concerns. Therefore, Rule 2-01 also provides a general standard, which requires the accountant to consider whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that he or she is independent. This is referred to in the profession as the “appearance” of independence and requires the accountant to apply professional judgment in considering the perceptions of reasonable and informed third parties.

The SEC revised rule 2-01 in 2000 and again in 2003. The amendments are explained in [Release No. 33-7919, Revision of the Commission’s Auditor Independence Requirements](#) and [Release No. 33-8183A – Strengthening the Commission’s Requirements Regarding Auditor Independence](#), respectively.

### *The Public Company Accounting Oversight Board (PCAOB)*

The Public Company Accounting Oversight Board (PCAOB) is a private, nonprofit corporation created by the [Sarbanes-Oxley Act of 2002](#) to oversee the auditors of public companies. The PCAOB was created to protect investors and the public interest by promoting informative, fair, and independent audit reports.

The PCAOB adopted the following rules as [interim independence standards](#):

- Rule 101 (Independence) of the AICPA *Code of Professional Conduct* and its interpretations and rulings

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<sup>1</sup> Other entities, such as state accountancy boards, federal and state regulators (e.g., Department of Labor), and regulators in other countries may impose additional independence requirements, depending on the type and location of the company.

- The independence standards and interpretations of the Independence Standards Board (ISB)<sup>2</sup>

The interim standards do not supersede the SEC's auditor independence rules. To the extent a provision of the SEC's rules is more (or less) strict than the interim standards, an accounting firm should comply with the more restrictive aspects of the rules.

The Board has also adopted several [independence and ethics standards](#) of its own.

### *American Institute of Certified Public Accountants (AICPA)*

The AICPA is a nonprofit, membership organization of approximately 340,000 professional accountants, mainly Certified Public Accountants (CPAs). For over 100 years, the AICPA has developed independence and other ethics rules for the accounting profession. The rules are published in the [AICPA Code](#). The Professional Ethics Executive Committee is the senior technical committee of the AICPA authorized to interpret and enforce the AICPA Code.

AICPA Professional Standards require professionals to be independent when they perform attest services, such as financial statement audits. For example, AICPA Statement on Auditing Standards (SAS) No. 1,<sup>3</sup> states in part that:

“In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.”

The standard goes on to say that:

“It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances, which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners.

The profession has established, through the AICPA Code precepts to guard against the presumption of loss of independence. “Presumption” is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests. Insofar as these precepts have been incorporated in the profession's code, they have the force of professional law for the independent auditor.”

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<sup>2</sup> The ISB was created in 1997 through an agreement between the SEC and the AICPA to initiate research, develop standards, and engage in a public analysis and debate of auditor independence issues. The ISB discontinued its operations on July 31, 2001. Much of the ISB's work was incorporated into the SEC's auditor independence rules adopted in November 2000. (Source: SEC News Release 2001-72)

<sup>3</sup> AU§220 of the AICPA Professional Standards, vol. I.

## Appendix B: Additional resources

Reference in independence education tool kit	Title	Source/URL (if available)
<b>Video:</b>		
Act I, "Independence 101"	<p><i>"Top 10 Audit Deficiencies"</i></p> <p>Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson</p>	<p>Journal of Accountancy, April 2001</p> <p><a href="http://www.aicpa.org/pubs/jofa/apr2001/beasley.htm">http://www.aicpa.org/pubs/jofa/apr2001/beasley.htm</a></p>
Act II, "The Public Accounting Profession"	<p><i>"The Public Accounting Profession"</i></p>	<p><a href="http://www.deloitte.com/dtt/cda/doc/content/accounting_profession4.pdf">http://www.deloitte.com/dtt/cda/doc/content/accounting_profession4.pdf</a></p>
Act III, "Independence at Work"	<p><i>"AICPA Plain English Guide to Independence"</i></p>	<p><a href="http://www.aicpa.org/download/ethics/plainenglish.doc">http://www.aicpa.org/download/ethics/plainenglish.doc</a></p>
<b>Case Study:</b>		
Case Study 1	<p>PCAOB Standing Advisory Group</p> <p><i>"Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters."</i></p>	<p><a href="http://www.pcaobus.com/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Indemnification.pdf">http://www.pcaobus.com/Standards/Standing_Advisory_Group/Meetings/2006/02-09/Indemnification.pdf</a></p>
	<p><i>"PCAOB Rules on Independence and Personal Tax Services Current Guidance for Public Company Auditors"</i></p> <p>Catherine Allen</p>	<p>The CPA Journal, Feb. 2007</p> <p><a href="http://www.nysscpa.org/cpajournal/2007/207/essentials/p28.htm">http://www.nysscpa.org/cpajournal/2007/207/essentials/p28.htm</a></p>
	<p><i>"AICPA Plain English Guide to Independence"</i></p> <ul style="list-style-type: none"> <li>➤ <i>Nonattest Services</i></li> <li>➤ <i>Fee Issues</i></li> </ul>	<p><a href="http://www.aicpa.org/download/ethics/plainenglish.doc">http://www.aicpa.org/download/ethics/plainenglish.doc</a></p>
Case Studies 1 and 2	<p>Sarbanes-Oxley Act of 2002</p> <p>Title II, <i>Auditor Independence</i></p> <p>Title III, <i>Corporate Responsibility</i></p>	<p><a href="http://www.pcaobus.com/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf">http://www.pcaobus.com/About the PCAOB/Sarbanes Oxley Act of 2002.pdf</a></p>
	<p><i>"Ethics Rules Get Tighter: New PCAOB independence rules focus on tax services and contingent fees"</i></p>	<p>Journal of Accountancy, Dec. 2006</p> <p><a href="http://www.aicpa.org/pubs/jofa/dec2006/allen.htm">http://www.aicpa.org/pubs/jofa/dec2006/allen.htm</a></p>

Reference in independence education tool kit	Title	Source/URL (if available)
<b>Case Study:</b>		
Case Study 2	Office of the Chief Accountant – Securities and Exchange Commission (SEC)  <i>“Audit Committees and Auditor Independence”</i>  <i>“How Audit Committees Can Assess Auditor Independence”</i>  Catherine Allen  <i>“An Update for Audit Committees: New Rules on Auditor Provided Tax Services”</i>  Catherine Allen	<a href="http://www.sec.gov/info/accountants/audit042707.htm">http://www.sec.gov/info/accountants/audit042707.htm</a>           Directors Monthly, Dec. 2006  <a href="http://www.auditconduct.com/articles/Allen%20DM%20ec06_final.pdf">http://www.auditconduct.com/articles/Allen%20DM%20ec06_final.pdf</a>           Directors Monthly, May 2007  <a href="http://www.auditconduct.com/articles/Allen-DM-May07-final.pdf">http://www.auditconduct.com/articles/Allen-DM-May07-final.pdf</a>
Case Studies 3 and 4	<i>“AICPA Plain English Guide to Independence”</i> <ul style="list-style-type: none"> <li>➤ <i>Introduction</i></li> <li>➤ <i>Applying the Rules — Covered Members and Other Firm Professionals</i></li> <li>➤ <i>Applying the Rules – Family Members</i></li> <li>➤ <i>Financial Relationships</i></li> <li>➤ <i>Business Relationships</i></li> </ul>	<a href="http://www.aicpa.org/download/ethics/plainenglish.doc">http://www.aicpa.org/download/ethics/plainenglish.doc</a>
Case Study 5	PCAOB Disciplinary Proceedings Involving Independence	<a href="http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2005/11-22_Kenny_Lee_and_Kwang_Ho_Lee.pdf">http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2005/11-22_Kenny_Lee_and_Kwang_Ho_Lee.pdf</a>  <a href="http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2007/11-14_Birkert.pdf">http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2007/11-14_Birkert.pdf</a>  <a href="http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2007/12-14_Kantor.pdf">http://www.pcaobus.com/Enforcement/Disciplinary_Proceedings/2007/12-14_Kantor.pdf</a>
General Independence/Corporate Governance	Sarbanes-Oxley Act of 2002  <i>Report on the Survey of Audit Committee Members Conducted by: The Center for Audit Quality</i>	<a href="http://www.pcaobus.com/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf">http://www.pcaobus.com/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf</a>  <a href="http://thecaq.org/newsroom/pdfs/auditsurvey.pdf">http://thecaq.org/newsroom/pdfs/auditsurvey.pdf</a>

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