

TITLE

**Assessing Your Audit Firm's Independence:
Guidance for Audit Committee Members**

CITE

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Sidebar: The Independence Standards Board sets standards governing the independence of auditors from their public-company audit clients. The Securities and Exchange Commission and the American Institute of Certified Public Accountants agreed to form the Board in 1997, but it operates independently of each. For more information about the Independence Standards Board and auditor independence issues, visit their website at www.cpaindependence.org.

Required communications between the company's audit committee and its external auditor have been strengthened as a result of the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, subsequently adopted by the major stock exchanges and Nasdaq, and requirements adopted by the Independence Standards Board, the Auditing Standards Board of the American Institute of Certified Public Accountants, and the Securities and Exchange Commission. With respect to auditor independence, there are now requirements for:

- auditors to report and discuss with the audit committee matters bearing on auditor independence;
- companies to disclose annually in their proxy statements fees paid to their audit firms for audit, information technology, and other services, and whether their audit committees have considered the compatibility of any non-audit services with auditor independence; and
- audit committees to specify in their charters, which must be filed with the SEC, that the outside auditor is ultimately accountable to the board of directors and its audit committee, who have ultimate authority over the selection, evaluation, and replacement of the outside auditor.

The first requirement – for the auditor to report and discuss with the audit committee matters bearing on the auditor's independence – is mandated by ISB Standard No. 1, Independence Discussions with Audit Committees. ISB No. 1 requires auditors to disclose, in writing, all relationships between the firm and the audit client that in the auditor's professional judgment may reasonably be thought to bear on independence. The audit firm must also confirm its independence in writing and discuss independence with the audit committee. The purpose of the standard is to engage audit committees and the external auditors in substantive discussions regarding independence, as a way to emphasize its importance to the auditors, the audit committee, and the company's management. The standard also recognizes that the federal securities acts require registrants to engage independent public accountants, so the company has a responsibility to make such a determination.

This article seeks to assist audit committee members in assessing the relationships disclosed by the auditor under ISB No. 1 and how those relationships might bear on the auditor's independence.

Auditor Independence Requirements

Auditor independence rules have traditionally proscribed certain activities and relationships between the audit firm (including its partners, employees, and affiliates) and the audit client (including its officers, directors, and affiliates). Those prohibitions were designed to preserve both the auditor's objectivity and the appearance of objectivity. Close family relationships, financial interests, business relationships, and bookkeeping are examples of activities and relationships with the client that have historically been proscribed under the SEC's auditor independence rules. Audit firms, however, have been permitted to provide a wide variety of other services to their audit clients, including tax planning and compliance, systems design and installation, and due diligence services.

The growing size and importance of the consulting practices in the large audit firms have renewed the focus on services provided to audit clients and their possible effect on independence. The SEC recently revamped its auditor independence rules, modernizing those covering financial interests and family relationships, and clarifying its list of prohibited non-audit services. The agency originally considered severe curtailments in permitted services, but ultimately decided to rely instead on a new requirement for registrants to disclose fees paid to the audit firm for non-audit services. The SEC also endorsed ISB No. 1 by requiring the audit committee to state, in its report included in the company's proxy, whether the independence confirmation was received and discussed with the audit firm.

So if the audit committee is to discuss the auditor's confirmation letter, what should the committee and the auditor talk about?

Clearly the auditor should not be reporting situations proscribed by the rules and asking for dispensation. The audit committee doesn't have that authority and the auditor should know that. Therefore, the letter should describe permitted activities and relationships that the auditor believes would be of interest to the audit committee because they may bear on independence. For example, the letter might include a description of permitted non-audit services provided or proposed to be provided around the world (perhaps only those with fees above an agreed-upon materiality level), or permitted family relationships between audit firm professionals and company officials. The information in the confirmation letter and the discussion with the auditor will enable the committee to exercise informed business judgment about whether permitted services and relationships are nevertheless inappropriate in the company's particular circumstances.

With respect to non-audit services, some audit committees are requiring that management obtain "pre-approval" from the audit committee or its chair before hiring the audit firm for non-audit projects with projected fees in excess of some threshold – a company policy

consistent with recommendations of the Public Oversight Board's Panel on Audit Effectiveness (O'Malley Panel) and the Blue Ribbon Committee.

Some audit committees are also asking the auditor about the audit firm's systems to capture information about activities and relationships with its audit clients, particularly when both the firm and the company have operations and personnel around the world. Audit committees also might inquire about the criteria used by the auditor to determine when activities and relationships are inconsequential and should be omitted from the confirmation letter.

The Importance of the Right Tone at the Top

Many behaviorists believe that establishing the right tone at the top is the most important factor in influencing behavior in an organization. If everyone knows what is valued and what is acceptable, the impact on actions can be profound – particularly if senior management “walks the talk.” Audit committees can play an important role in this area by making sure that everyone knows that the company values quality financial reporting and that management is expected to cooperate fully with the outside auditors.

But the audit committee also can help to ensure that the right tone at the top exists at its audit firm by asking the auditor some probing questions, such as:

- Does your firm value its audit practice, and how is that demonstrated?
- What criteria are used within your firm to evaluate, compensate, and promote professionals? How do those criteria support independence and quality auditing?
- How does your firm evaluate independence risk before offering a new service to audit clients?
- Does the firm ever impose independence restrictions on itself or on its professionals that go beyond minimum professional and regulatory requirements?
- Has the firm ever declined to provide a permitted consulting service to an audit client, and if so, under what circumstances?

Senior management of the audit firm will find out quickly that audit committees are asking such questions and are interested in the answers. As a result, those firms without a culture that emphasizes independence will adopt one, and those that already have one will appreciate the encouragement such questions will generate.

The ISB's Conceptual Framework and How it Can Help

The ISB is developing a conceptual framework to assist the Board in setting consistent, principles-based standards for auditor independence and to aid others involved in making independence decisions, including audit committee members.

An exposure draft issued last year defines independence as freedom from threats that are sufficient to compromise, or can reasonably be expected to be sufficient to compromise, an auditor's objectivity – that is, the ability to make unbiased audit decisions. The definition calls for both an introspective evaluation of independence by the auditor (independence of mind) and an assessment of how activities and relationships with the audit client would appear to well-informed investors and other users of financial information (independence in appearance).

The framework also describes the goal of independence as supporting user reliance on the financial reporting process and facilitating optimal capital allocation. That is, the goal looks beyond the immediate benefit of auditor independence – unbiased audit decisions – to broader targets. The goal reminds those assessing independence that standards and decisions which may reduce independence risk slightly, but carry unintended consequences that harm the quality of financial reporting or optimal capital allocation, do not serve the public interest.

The conceptual framework proposes the following model for analyzing independence issues:

- Identify threats to auditor independence and their significance;
- Evaluate the effectiveness of potential safeguards, including prohibitions and restrictions on activities and relationships with audit clients; and
- Ensure an acceptably low level of independence risk – the risk that the auditor's independence will be or will appear to be compromised.

Threats to auditor independence – sources of potential biases – include the following:

- Self-interest threat – an auditor acting in his or her own emotional, financial, or other personal self-interest.
- Self-review threat – an auditor auditing his or her own work or the work of a firm colleague.
- Advocacy threat – an auditor acting as an advocate for or against a client or its position rather than as an unbiased attestor of its financial statements.

- Familiarity (or trust) threat – an auditor being improperly influenced by a close relationship with a client.
- Intimidation threat – an auditor being, or believing that he or she is being, overtly or covertly coerced by a client or by another interested party.

Although some of the threats involve conscious acts by an auditor in his or her self-interest, others may be subconscious.

Once threats are identified and their significance evaluated, the model requires an evaluation of the effectiveness of existing and potential safeguards. Safeguards include restrictions on an auditor's relationships with an audit client, such as prohibitions on owning the stock of an audit client, or on assigning firm professionals to an audit when they have family members employed in key positions at the client. Safeguards also include audit firm policies and procedures to protect auditor independence, such as periodically assigning a new engagement partner, review by a second partner, consultation with designated professionals in the firm, or disclosure to the audit committee.

When assessing the acceptability of the level of independence risk, the framework directs those analyzing independence issues to consider the costs and benefits of alternative safeguards, and to examine potential unintended consequences of restrictions or prohibitions. Finally, the framework directs those analyzing independence issues to consider the likely views of investors, other users of financial information, and other interested parties, recognizing that an auditor's independence does not serve the auditor or his or her client well if investors and other users do not believe that the auditor is independent.

The model for analyzing independence issues proposed by the framework is a disciplined approach to evaluating human motivations, competing incentives, and the sometimes conflicting roles of auditors and audit client management. The approach helps to ensure that effective restrictions or other safeguards protect the independence of the auditor, while supporting the larger goals of user reliance on audited financial statements and the optimal allocation of capital.

Using the Conceptual Framework to Assess the Independence Implications of Disclosed Relationships

The following example illustrates how an audit committee might use the ISB's conceptual framework to evaluate relationships between the audit firm and the company. In our example, the audit committee is informed that management plans to award a two-year consulting contract to the external audit firm to assist in developing and installing a system to allow the company's customers to view and pay their accounts on line. The external auditors won the contract through competitive bidding, and the contract fees will be twice as large as the audit fee in each year. Following the framework's approach, the audit committee first identifies the following potential threats to auditor independence:

- The auditors may, in the course of the audit, examine financial results produced by a system that firm consultants helped to design and install and, therefore, the auditors may lack the requisite skepticism (self-review and familiarity threats). Furthermore, they may be reluctant to expose flaws in a system that firm professionals helped design and install (self-interest).
- The auditors may acquiesce to questionable accounting and reporting matters in an effort to retain a lucrative consulting assignment or to win future contracts (self-interest).

The audit committee then considers the effectiveness of potential safeguards, asking questions such as:

- Will competent members of management closely oversee the system development and make all important design decisions?
- Will the system be thoroughly tested by management and the company's internal auditors before being put into service and periodically thereafter?
- Is the consulting fee, even though significantly larger than the audit fee, material to the audit firm or the practice office?
- Can the audit partner confirm that obtaining or retaining the consulting engagement does not directly or materially impact her compensation?
- Can both management and the auditor confirm that there was no explicit or implicit quid pro quo in awarding the contract (i.e., to ensure a "friendly" audit)?
- Would investors, if informed of the facts, reasonably conclude that the auditor could be objective in these circumstances?

The audit committee can now determine the level of independence risk by evaluating the significance of the threats and the effectiveness of the safeguards that the company and the firm will employ. In assessing the acceptability of independence risk, the audit committee should consider potential benefits of awarding the contract to the firm, which may outweigh an increase in independence risk. In analyzing potential benefits, audit committee members might ask:

- Does the audit firm have any unique qualifications, such as extensive experience in installing systems of this type at other companies, or in-depth knowledge of the company's business resulting from the audit and prior consulting assignments?
- Will the audit firm be better equipped to develop and implement tools to audit the new systems effectively because the firm is doing the consulting work?

- Is the audit firm the most cost-effective provider, based on an evaluation of competitive bids?

After going through this kind of analysis the audit committee members can make an informed decision as to whether, in their view, awarding the contract to the audit firm compromises auditor independence. Different audit committees and companies have, and will, make different decisions in these circumstances. ISB No. 1 was not meant to discourage companies from hiring their audit firms to do consulting work, but to heighten awareness of the independence implications of non-audit services and other relationships between the firm and its audit client, so that appropriate safeguards can be installed to better protect independence. The important thing, in our opinion, is that independence issues are aired and addressed, an analysis of the threats and safeguards is conducted thoroughly, and informed business judgment is applied.

Conclusion

We believe that the ISB's conceptual framework can assist audit committee members in fulfilling their responsibilities to assess the independence of the external auditor.

Although those responsibilities have increased, we hope that audit committee members welcome and embrace their expanded role. The audit committee plays a critical role in ensuring a company's commitment to quality financial reporting, in discouraging attempts to intimidate the auditor, and in emphasizing the auditor's responsibilities to the board, its audit committee members, and the investors that they represent.

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