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Independence

Auditor independence education materials: The importance of being independent

Case Study 3: Assembling the audit team

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

Audit. Tax. Consulting. Financial Advisory.

Instructions and Table of Contents

Instructions

In this case study, you are Jeff Smith, an audit manager for the public accounting firm, Meridien, LLP. You have been assigned to manage the audit of the public company, Bond Financial Services, Inc. You have met with several potential audit team members. Your task is to determine which potential team members are independent of Bond and eligible to join the audit team.

Below is a table of contents for Case Study 3. Please read the Briefing Documents, Case Facts and Background, and Appendix A prior to answering any questions.

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Independence literature relating to this case study:

1. Securities and Exchange Commission's (SEC) Independence Rules
   - » Rule 2-01 of Regulation S-X, Article 2 — *Qualifications of Accountants*, Reg. §210.2-01 (https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml)
   - » Final Rule: Revision of the Commission's Auditor Independence Requirements (http://www.sec.gov/rules/final/33-7919.htm)
   - » Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence (http://www.sec.gov/rules/final/33-8183.htm)
2. American Institute of Certified Public Accountants (AICPA) *Code of Professional Conduct*
   - » Section 1.200 — Independence Rule; Section 1.210 — Conceptual Framework for Independence; Section 1.240 — Financial Relationships (http://www.aicpa.org/research/standards/codeofconduct/pages/default.aspx)
   - » AICPA Plain English Guide to Independence (http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf)

Briefing Documents

The company/client

Name: Bond Financial Services, Inc. ("Bond")

Location of headquarters: Boston, Massachusetts.

Type of business: Bond is a financial services firm which provides capital market services, brokerage, investment banking and advisory services, wealth management, asset management, insurance, and other related financial services.

Ownership structure: Publicly owned corporation (since 1998); registered with the Securities and Exchange Commission (SEC); issuer of securities.

Number of employees (worldwide): 4,275

Bond employees: Charles Adams, Chief Financial Officer

Dennis Moscati, Chief Operations Officer

Bruce Weaver, Internal Audit Director

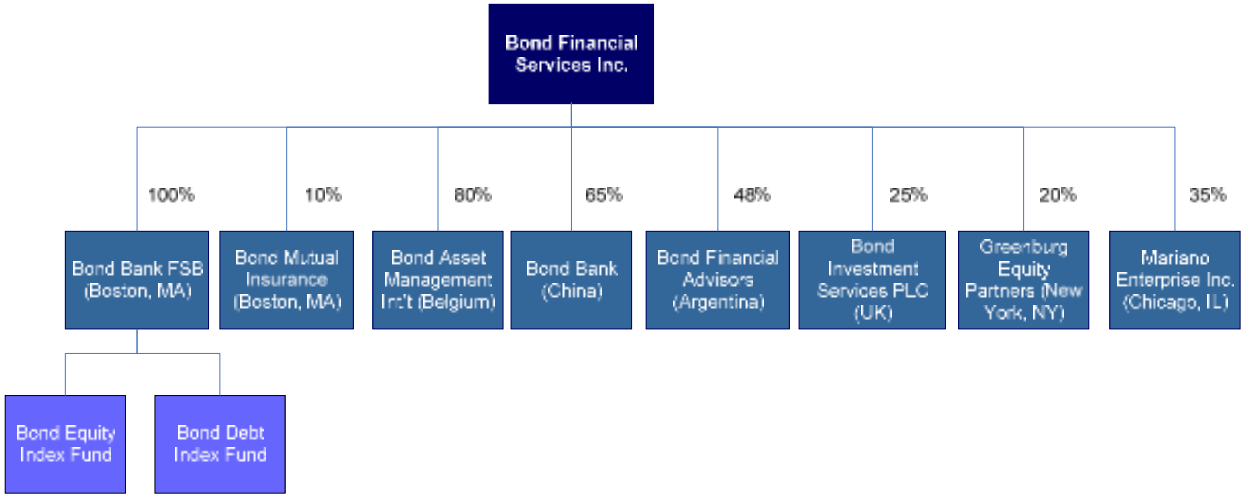
Bond Audit Committee members: Salvatore Marconi, Chair

Mary Armstrong, Member

Laverne Santiago, Member

Other: Net revenues for the fiscal year ended December 31, 20X3 were $2.6 billion, which represent an increase of 3% over the prior year. Compared to its peers, Bond has a very strong balance sheet and most financial analysts expect solid growth into 20X4. All of the Bond companies are financially sound; the debt securities of Bond and its **affiliates** are A rated or above.

Entities associated with bond:



The public accounting firm

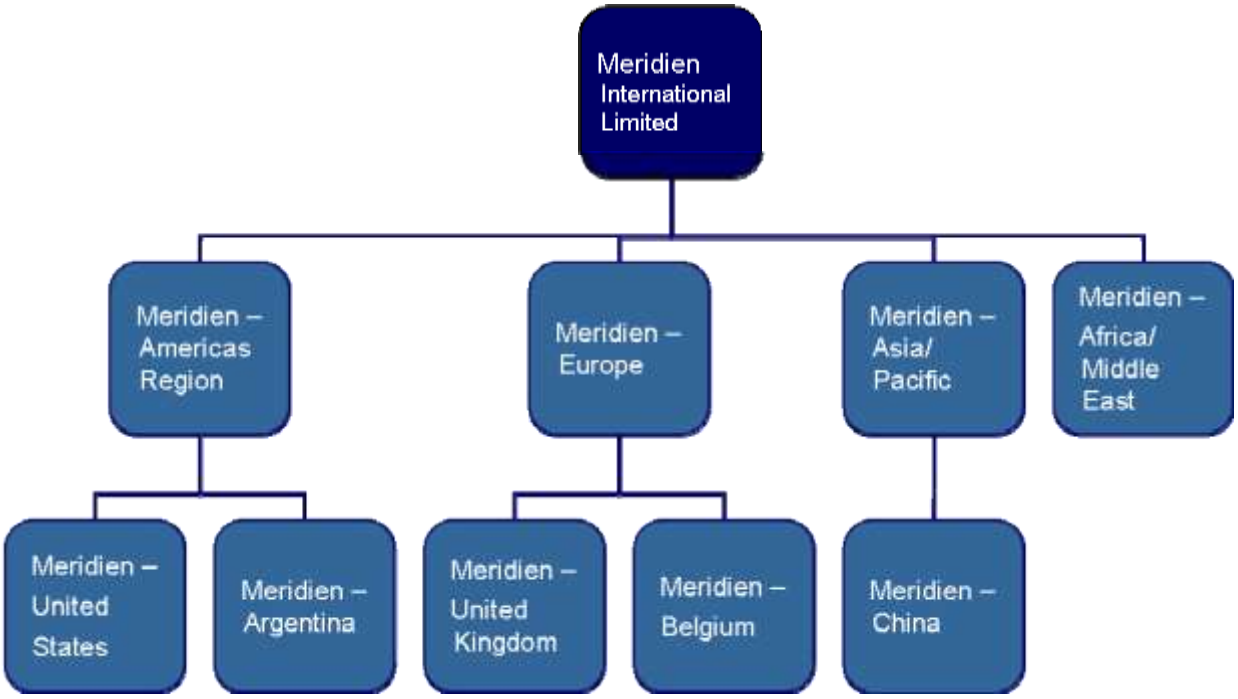
Name: Meridien, LLP (Meridien) is a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

Location of headquarters: New York, New York.

Meridien professionals: Barbara Cortez, Audit Partner
Tanisha Williams, Audit Senior
Manager Jeff Smith, Audit Manager
Frank Shepard, Tax Partner
John LaPelle, Tax Associate
Rod Mitchell, Independence Office Consultant

Independence Policy: Link to Meridien Independence Policy

Ownership structure: Meridien is a Delaware limited liability partnership that belongs to a network of member firms of Meridien International Limited, each of which is a separate and independent legal entity. The member firms of Meridien International Limited is made up of member firms located in over 50 countries. Meridien International Limited does not provide any professional services to clients; rather, it helps coordinate the activities of the member firms. The member firms provide professional services (such as audit, tax, and consulting services) to clients. Unless stated otherwise, "Meridien" or "the Firm" means the Meridien member firm located in the United States. The Meridien member firms involved in the Case Studies appear in the bottom row of the organizational chart below.



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Case Facts and Background

After reviewing four **proposals** from audit firms, Bond's audit committee appointed Meridien to perform the 20X4 audit. Barbara Cortez, the Meridien audit partner for Bond, contacted Tanisha Williams, the senior manager, who helped with the Bond **proposal**, and asked her to assemble an engagement team to be ready to start working on the client by August 1, 20X4.

Tanisha Williams then appointed Jeff Smith as the new manager on Bond and asked him to be the point person for verifying the independence of additional team members. As Bond's banking, brokerage, and other financial services are popular in the Boston area, Tanisha and Jeff understood some Meridien employees may have associations with Bond that may impair their ability to serve on the Bond audit team. This could make selecting an engagement team a little more challenging. Tanisha gives Jeff the names of the eight people she would like to have work on the Bond engagement.

"These are the top eight employees in the office that have financial services experience and would be a great addition to the team…so I'd like you to find out if they are independent of Bond," she tells Jeff. "If they are independent and would like to join the team, we would need their written confirmation by the end of the week."

Jeff meets with each person on the list to find out if they have any financial interests or relationships with Bond that may impair their independence. He listens carefully during the meetings and takes detailed notes. See Jeff's notes below:

Link to 3.1 Jeff's Notes

After performing some follow-up steps, Jeff meets with Tanisha to report his findings.

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Suggested Questions

Simple – Rules based (SR)

SR3.1) For each candidate below, explain if he or she would be independent under independence rules. Explain the basis of your conclusion.

1. Michael Rose
2. Lidija Tomas
3. Dinari Botha
4. Peter Valvo
5. David Wallace

SR3.2) Can any of the professionals, listed in question 1 above who are not considered independent of Bond take action to become independent? If so, what actions should be taken?

Complex – Rules based (CR)

CR3.1) For each candidate below, explain if he or she would be independent under independence rules. Explain the basis of your conclusion?

1. Adam Whittcamp
2. Catlyn Frederick
3. Jeannette Smith

CR3.2) Can any of the candidates above take action to become independent, in order to provide audit services to Bond? If yes, what actions could be taken?

Conceptual (C)

C3.1) Jeff informs Tanisha that Lidija Tomas (who has experience in auditing banks) has not been able to resolve her independence issues; however, another senior who does not have industry experience is available. Tanisha asks Jeff to give Lidija some options to help her resolve her issues so she can serve on the team. Assume Tanisha explains to Jeff that she is under a lot of pressure to staff the team with those who have financial services industry experience. (Also see Question No. 2 in this section.) How would you suggest Jeff handle this request?

C3.2) Continuing with Question No. 1 in this section: From a public interest perspective, does it make sense to allow Lidija Tomas to work on this engagement even if she does not resolve her independence issues? In other words, should investors be willing to tolerate some loss of independence in exchange for specific industry experience? Provide an argument both for and against this trade-off.

C3.3) Do you believe the independence rules are sufficient to ensure that the public accounting firm and its professionals exercise the appropriate level of skepticism and objectivity while performing an audit?

C3.4) Imagine that as a Bond investor with a significant amount of your retirement funds invested in Bond securities, you are concerned about the independence of Meridien. Describe how changing your perspective from Meridien's audit manager to a Bond investor may have influenced your opinion about the independence of the Meridien audit engagement team.

C3.5) After reviewing Jeff's notes (see 3.1) did you initially believe any of the candidates had independence issues? Were you surprised by the application of the independence rules i.e., did you expect a different result? If so, explain.

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Bond Financial – Potential Team Members

Michael Rose – Associate

- Credit card issued by Bond
- Card has $7K balance on it /he is working on paying it off / stopped charging purchases on card
- Also has Bond checking, savings and overdraft accounts with bank (checking + savings = approx. $4K / overdraft balance = $0)

  Follow-up: Is credit card permissible? Insured deposits ok – conditions?

Lidija Tomas – Sr. Associate

- 2 student loans with Bond
- Says total amount ($43K) is material to net worth
- 8 years remaining on both loans

  Follow-up: Can student loans be grandfathered?

Dinari Botha – Sr. Associate

- Auto insurance policy through Bond affiliate (since June 20X1)
- Standard coverage / never filed a claim

  Follow-up: Is it OK if insurance policy already exists?

Peter Valvo – Sr. Associate

- Bond brokerage account holds cash (cash held in the account is approximately $150,000)
- Has auto loan with Bond with only 8 months left to pay / balance is not material to his net

  worth Follow-up: Brokerage accounts???

David Wallace - Associate

- Grandparents created trust account for him 22 years ago (he is sole beneficiary)
- Current value of account is $ 87K
- Half of the trust's holdings are in Bond stock and a Bond mutual fund – they are material to his net worth
- Grandparents are trustees of the trust, David has no control over the investment decisions made

  Follow-up: holding in Bond funds through trust????

Adam Whittcamp – Associate

- Girlfriend is former Bond employee
- Girlfriend has investments in Bond 401(k) plan, which holds Bond stock and unrestricted investment options
- Couple has lived together 3 months
- They keep separate finances, insurance policies, and living arrangement is temporary (no marriage plans)

Follow-up: spousal equivalent – **call independence office on this one!**

Catlyn Frederick - Manager

- Husband (Tim) is Bond employee (broker) since last year
- Participates in Bond stock compensation plan, which he holds unvested stock options

  Follow-up: employment an issue? / if no, can he divest of Bond stock options so Catlyn can serve on team?

Jeannette Smith – Associate

- Father has small investment in Bond preferred stock via Individual Retirement Account (IRA) – not material to him and his spouse
- Jeannette lives at home / parents do not charge her rent / helping her with expenses (e.g., credit cards, student loan payments, train fare, food, clothes, etc.)
- Plans to move out in near future
- Parents do not claim her as a dependent on their tax return

  Follow-up: are investments in IRA ok? Is she considered to be a dependent?

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Meridien Independence Policy

The following are excerpts from Meridien's Independence Policy:

Importance of independence

It is fundamental to the professional practice of Meridien, LLP (Meridien) that all personnel adhere to the highest standards of independence, integrity, and objectivity and be free from conflicts of interest. These standards guide Meridien and its professionals as they consider their interests in and relationships with entities to help avoid situations that could erode the public trust in the services Meridien provides. Disregard of these standards or inadvertent failure to comply with them, puts the Meridien and our clients at considerable risk and exposes Meridien to serious consequences, including:

- Damaged reputation in the marketplace
- Rejection of our report(s) by the Securities and Exchange Commission (SEC)
- Threatened or actual litigation against Meridien by clients and other parties
- Sanctions against Meridien by the SEC, the Public Company Accounting Oversight Board (PCAOB), the American Institute of Certified Public Accountants (AICPA) and state licensing boards
- Loss of investor and public confidence in Meridien's reports
- Sanctions by regulatory bodies against Meridien professionals
- Sanctions by Meridien against its professionals
- Loss of clients

Affiliates

An affiliate of an audit client is:

a. A company that controls[1] the audit client, e.g., a parent company.

b. A company that the audit client controls, e.g., a subsidiary.

c. A company that is under common control with the audit client, i.e., company is controlled by the same parent as the audit client.

d. A company that has significant influence[2] over the audit client (i.e., the company uses the equity method to account for its investment in the audit client and the investment in the audit client is considered material[3] to the entity).

e. The audit client has significant influence over a company (i.e., the audit client uses the equity method to account for its investment in the company and the investment in the company is considered material to the audit client).

[1] Control generally is attained via a majority interest (over 50%) of the outstanding equity of a company. However, there are situations where a company (Company A) does not have over 50% of the outstanding equity of an entity, yet still has control over the entity. This can be due to Company A having a significant ownership of the entity's stock (between 20% and 50%) and a significant presence on the entity's Board of Directors (i.e., of the 10 voting Board Members, 8 of the members are associated with Company A.)

[2] Significant influence is generally deemed to exist when ownership interest is between 20% and 50%.

[3] Material is defined as the parent company's aggregate carrying amount of investment in a subsidiary that exceeds 5 percent of the parent's consolidated total assets or the parent's equity in the subsidiary's income from continuing operations before income taxes exceeds 5 percent of the parent's consolidated income from continuing operations before income taxes.

f. Companies that are in an "investment company complex" with the audit client, i.e., if Meridien audits a mutual fund's sponsor (an SEC registrant), an investment company complex (ICC) exists. When an ICC exists, other funds, advisors and similar entities that are in the ICC are considered affiliates.

Retired partners

Consistent with SEC independence Rule 2-01(c)(2)(iii), a former partner who seeks to accept an accounting role or a financial reporting oversight role with an restricted entity may accept the role if the former partner:

1. Does not influence Meridien's operations or financial policies,
2. Has no capital balance in Meridien, and
3. Has no financial arrangement with Meridien other than one providing for regular payment of a fixed dollar amount.

All amounts owed to the former partner should be fully funded and not dependent on Meridien's current revenues, profits, or earnings.

Further, given the operation of the SEC's requirement for a "cooling-off period" in different circumstances, a former partner should not accept a financial reporting oversight role with an restricted entity without the approval of the Independence Office if the former partner provided, or was in a position to influence, attest services for the restricted entity during the one-year period preceding the expected date of his or her initial employment by the restricted entity.

Broker-dealer accounts

Accounts at a restricted entity broker-dealer in which cash or securities are left on deposit or the broker- dealer extends credit or has discretionary authority to execute transactions, including margin, cash management, active asset, and other similar accounts, are prohibited for covered persons. Any such accounts owned by a professional should, upon he or she becoming a covered person, be closed at his or her expense.

Trusts or estates — beneficiary

If a covered person is the beneficiary of a trust that has a financial interest in a restricted entity, the independence of a member firm ordinarily would be impaired if (1) the indirect financial interest in the restricted entity is material to the covered person, or (2) the trust was created by the covered person who is named as beneficiary, or (3) the beneficiary had direct or indirect control over the investment decisions or assets of the trust. Generally, this also applies to a beneficial interest in an estate that has a financial interest in a restricted entity. Any financial interest in a restricted entity distributed to a covered person beneficiary from such a trust or estate should be divested upon receipt.

Spousal equivalent

A spousal equivalent:

- Resides continuously in the same residence as the professional
- Shares a committed and mutually dependent relationship with the professional that is similar to that of a married couple, but the cohabitant and professional have either chosen not to marry or cannot legally marry.

Remote relatives

The appearance of independence is normally not impaired as a result of the financial interests and business relationships of a remote relative. However, if other factors indicate a particular closeness with

the remote relative (e.g., having financial ties or jointly participating in a business enterprise), an impairment of independence could result. Similarly, if there is a possibility of a substantial inheritance from the remote relative, independence could be impaired. In these cases, the relationship with the remote relative more clearly resembles that of a Close Family Member and, for independence purposes, should be treated as such. An example would be an uncle of a Partner who is a majority owner of a restricted entity; the uncle has no other living Close Family Members and the Partner is aware that the uncle's will provides that the Partner will be the chief beneficiary of his estate.

In limited circumstances, financial interests and position of the remote relative are so significant that the appearance of independence is impaired (e.g., in the case of a remote relative who is a majority shareholder and president of a restricted entity). Any unusual circumstances should be discussed with the Independence Office.

Disciplinary process

The Chief Independence Officer is primarily responsible for administering the process to address violations of independence policies of Meridien. Generally, this process is designed to be remedial rather than disciplinary. However, if after considering all relevant facts and circumstances, it is concluded that a violation of the independence policies is serious or repetitive, the response will be to impose an appropriate disciplinary action, which could be severe or punitive, including termination of employment or removal from the partnership.

All professional personnel and administrative and clerical personnel are subject to possible disciplinary action for violation of the independence policies of Meridien. It is the duty of each individual to comply with these policies, including, without limitation, the policies regarding investments, loans, insurance products, and other financial interests, and to fully cooperate with any compliance audit and verification activities conducted by the Independence Office.

Any proposed disciplinary actions will be determined by the Chief Independence Officer in consultation with national, regional, or office leadership, including the Board of Directors of Meridien, as appropriate. In determining the appropriate level of consultation, the Chief Independence Officer will consider, among other matters, (1) the level of individual with the independence violation, (2) the severity of the independence violation, (3) the severity of the proposed disciplinary action, and (4) whether the violation of the policies affects the relationship of Meridien with a restricted entity. Individuals will be given an opportunity to provide information regarding any alleged independence violation prior to disciplinary action being taken against the individual. Notwithstanding the foregoing, if the individual does not cooperate with any request for information, Meridien may prescribe whatever disciplinary action it believes is warranted.

The need for and severity of any disciplinary action will be based on the facts and circumstances surrounding each violation of the policies and procedures of Meridien. Some of the items that may be considered include:

- The manner and timeliness in which the individual resolved the independence matter. An individual's failure to promptly resolve an independence matter or lack of cooperation in responding to requests for information or in resolving the matter will generally involve a more serious sanction.
- Whether the professional knew or should have known of the circumstances causing the violation of the policies and procedures of Meridien.
- Whether the professional was a part of the audit engagement team, in the chain of command, or provided 10 or more hours of nonaudit services to a restricted entity. An independence violation by an individual providing any professional services to an audit client will generally involve a more serious sanction.
- The number, frequency, and materiality of the independence violations. A large number or high frequency of violations during a short period of time or violations that are material to the professional or the restricted entity will generally involve a more serious sanction.

- The impact of the independence violation on Meridien from a regulatory, legal, or public relations perspective. A violation that affects Meridien from a regulatory, legal, or public relations perspective will generally involve a more serious sanction.
- The impact of the independence violation on the restricted entity and its relationship with Meridien. A violation that has a detrimental effect on the restricted entity, its filings with a regulatory agency, or the client's relationship with Meridien will generally involve a more serious sanction.

Disciplinary actions could include one or more of the following actions, as deemed necessary:

- A written reprimand to be included in the individual's personnel file. The existence of such a reprimand should be taken into consideration by the individual's immediate supervisor when annual performance ratings and compensation determinations are made.
- Communication to Leadership.
- Requiring the individual to complete continuing professional education in the area of independence.
- Mandatory cap on an individual's annual performance rating.
- Reduction of annual compensation.
- Restricting the individual from providing services to a restricted entity, a class of clients, or from all restricted entities, or changing the individual's job responsibilities.
- Termination of employment or removal from the Partnership.

Individuals will have the right to appeal disciplinary actions to the Managing Partner of Meridien. A description of the appeal process will be communicated to the individual at the time the individual is notified of the disciplinary action.

When disciplinary action has been taken against an individual, a memorandum describing the nature of the violation and the sanctions imposed will be included in the individual's personnel file.

Attest vs. Nonaudit services

There are some distinct differences between attest and nonaudit services. Attest services generally provide some form of assurance about the information which is being reported. The public often has a keen interest in the outcome of such services. Thus to provide attest services accounting firms must follow various independence requirements. For example, an audit opinion that is filed in a public company’s annual report (Form 10-K) is posted to the SEC’s web site and may be used by an unknown number of interested parties.

In a nonaudit service engagement, the accounting firm and the company’s management determine the nature and scope of the work. The services may result in findings, conclusions, and recommendations but generally would not provide assurance about the information being reported. Typically, nonaudit work is performed for the sole use and benefit of the client, and distribution of the results of the work is often restricted to specified client parties.

Nonaudit services

Meridien also may provide services *other than* attest services (“nonaudit” services) to their clients. If Meriden ***only*** provides nonaudit services (i.e., tax or consulting services) to a client, the independence rules do not apply. However, if the firm performs both audit and nonaudit services to the same client, the firm will be subject to the independence rules, which prohibit certain nonaudit services.

Examples of nonaudit services include:

- Tax compliance services (e.g., tax return preparation) and consultations on tax matters
- Business advisory services, including consultations involving technology or risk management
- Litigation support

- IT system design and implementation.

Note: If an accounting firm provides both attest and nonaudit work to the same client, the firm must comply with the independence rules to ensure that the scope of the nonaudit work will not affect the firm's independence.

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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 PCAOB Auditing Standard No. 2201, *An Audit Of Internal Control Over Financial Reporting That Is Integrated with an Audit Of Financial Statements*
   - Engagements performed under the AICPA clarified Statements on Auditing Standards (AU-Cs) or Statements on Standards for Attestation Engagements (ATs)
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 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 CEO, (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:

   – The individual supervises or participates in the intermediary's investment decisions, or controls the intermediary, or
   – 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 a member to perform 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 who has knowledge of all relevant information, including the safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the attest engagement team is 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 adviser or sponsor;
    - (B) Any entity controlled by or controlling an investment adviser or sponsor, or any entity under common control with an investment adviser or sponsor if the entity:
        - Is an investment adviser or sponsor; or
        - Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, 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 adviser or sponsor included in this definition by either (A) or (B).

      An investment adviser, for purposes of this definition, does not include a subadviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser. 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. 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: [4]

- 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 (now codified as §1.200.001 – Independence Rule) of the AICPA *Code of Professional Conduct* and its interpretations and rulings

[4] 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) [5]

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 400,000 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 of Professional Conduct* ("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 clarified Statement on Auditing Standards (AU-C) No. 200, states in part that:

> "In the case of an audit, it is in the public interest and, therefore, required by this section, that the auditor be independent of the entity subject to the audit."

Further, the AICPA's pre-clarity Statement on Auditing Standards (AU) No. 220, stated in part that:

> "The auditor must maintain independence in mental attitude in all matters relating to the audit."

The former standard went 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's Code of Professional Conduct, 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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[5] 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)

Appendix B: Additional Resources

Reference in independence education tool kit	Title	Source/URL (if available)
Video:		
Act I, "Independence 101"	"*Top 10 Audit Deficiencies*" Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson	Journal of Accountancy, April 2001 http://www.journalofaccountancy.com/issues/2001/apr/top10auditdeficiencies.html
Act II, "The Public Accounting Profession"	"*The Public Accounting Profession*"	
Act III, "Independence at Work"	*"AICPA Plain English Guide to Independence"*	http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf
Case Study:		
Case Study 1	PCAOB Standing Advisory Group "*Emerging Issue – The Effects on Independence of Indemnification, Limitation of Liability, and Other Litigation-Related Clauses in Audit Engagement Letters.*"	https://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf
	"PCAOB Rules on Independence and Personal Tax Services *Current Guidance for Public Company Auditors"* Catherine Allen	The CPA Journal, Feb. 2007
	"AICPA Plain English Guide to Independence" ➢ *Nonattest Services* ➢ *Fee Issues*	http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf
Case Studies 1 and 2	Sarbanes-Oxley Act of 2002 Title II, *Auditor Independence* Title III, *Corporate Responsibility*	http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf
	"Ethics Rules Get Tighter: New PCAOB independence rules focus on tax services and contingent fees" Catherine Allen	Journal of Accountancy, Dec. 2006 http://www.journalofaccountancy.com/issues/2006/dec/ethicsrulesgettighter.html

Reference in independence education tool kit	Title	Source/URL (if available)
Case Study:		
Case Study 2	Office of the Chief Accountant – Securities and Exchange Commission (SEC) *"Audit Committees and Auditor Independence"*	http://www.sec.gov/info/accountants/audit042707.htm
	"*How Audit Committees Can Assess Auditor Independence*" Catherine Allen	Directors Monthly, Dec. 2006
	"*An Update for Audit Committees: New Rules on Auditor Provided Tax Services*" Catherine Allen	Directors Monthly, May 2007
Case Studies 3 and 4	*"AICPA Plain English Guide to Independence"* ➢ *Introduction* ➢ *Applying the Rules – Covered Members and Other Firm Professionals* ➢ *Applying the Rules – Family Members* ➢ *Financial Relationships* ➢ *Business Relationships*	http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf
Case Study 5	PCAOB Disciplinary Proceedings Involving Independence	https://pcaobus.org/Enforcement/Decisions/Documents/11-22_Kenny_Lee_and_Kwang_Ho_Lee.pdf https://pcaobus.org/Enforcement/Decisions/Documents/11-14_Birkert.pdf https://pcaobus.org/Enforcement/Decisions/Documents/12-14_Kantor.pdf
General Independence/ Corporate Governance	Sarbanes-Oxley Act of 2002	http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf
	Report on the Survey of Audit Committee Members Conducted by: The Center for Audit Quality	http://thecenterforauditquality.org/newsroom/pdfs/auditsurvey.pdf

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