COMMENTARY

A Pathology of the Independence Standards Board's Conceptual Framework Project

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> ISB to cease operations after making major contributions to the resolution of difficult and longstanding auditor independence issues. (AICPA 2001b)

With that headline, the Independence Standards Board (ISB or Board) announced that it was closing its doors. Why did the Board dissolve before officially adopting its largely completed conceptual framework? What does the Board's demise mean for the future of independence rule making? This commentary is a pathology—which the dictionary defines as "the scientific study of the nature of disease, its causes, processes, development, and consequences"[1]—of the ISB's conceptual framework project, which ultimately affected the Board's ability to survive.

FORMATION AND OPERATION OF THE ISB

The Securities and Exchange Commission (SEC) is responsible for developing rules to ensure the independence of auditors of public entities. The SEC, the American Institute of Certified Public Accountants (AICPA), and the largest auditing firms agreed in June 1997 to form an independent, private body to establish independence standards applicable to the auditors of SEC registrants (SEC 1998, Sec. II). Funded by the accounting profession, that body—the ISB—consisted of four well-known and highly respected public members, one of whom was elected chair, and four members from the accounting profession—three CEOs from the Big 5 and the CEO of the AICPA. The SEC's Chief Accountant, or his/her designee, had observer status at Board meetings. An Executive Director and a small staff coordinated the Board's operations (which began in October 1997), helped inform the public about the ISB's activities, and ensured regular communications with the SEC, the AICPA, and regulators and standard setters outside the U.S.[2]

In addition to issuing three independence standards, the Board started a project to develop a framework to serve as a conceptual foundation for its future work. The ISB retained us as project directors and appointed a task force composed of auditors, audit committee members, academics, state board of accountancy representatives, analysts and other financial statement users, corporate executives, representatives from international standard setters, the AICPA chair,

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1 *American Heritage Dictionary* (1980).

2 Additional information about the Board's operations, including the names and affiliations of Board members and the independence standards and other documents it issued, is available at http://www.cpaindependence.org.

and the SEC observer. The Board also retained a business ethicist to assist in the project, and a group of three Board members monitored the framework project.

To stimulate public debate about conceptual issues, in February 2000 the Board issued Discussion Memorandum (DM) 00-1, *A Conceptual Framework for Auditor Independence* (ISB 2000a). After considering the comments received during the exposure period from individuals and groups in the academic, auditing, standard-setting, and investor communities, the Board directed the staff and consultants, assisted by the project task force, to develop an Exposure Draft (ED) of a proposed Statement of Independence Concepts. That ED was issued in November 2000 (ISB 2000b). Based on additional public comments and further assistance from project task force members, the Board's oversight task force, and others, the staff and consultants revised the ED and prepared a final draft of a conceptual framework for the Board's review.[3]

CONTROVERSIAL ISSUES IN THE FRAMEOWORK PROJECT

The most significant debates among the parties involved in the framework's development concerned the role of *independence in appearance* and the appropriateness of a *threats and safeguards approach*. The nature of those debates provides important insights into the future of auditor independence regulation.

Independence in Appearance

The appearance of independence has long been part of auditors' ethical standards.[4] Nevertheless, how to incorporate investors' and other financial statement users' perceptions into a conceptual framework for independence was extremely controversial.[5]

There was little disagreement among the project's participants that improving financial statement credibility and enhancing user confidence are important outcomes of an audit and an auditor who appears to be independent contributes to those outcomes.

> The audit function adds to the *credibility* of information because the user can…be more confident in using the information for its intended purposes than he would be if the audit function had not been performed. This confidence allows the full potential value of the accounting information to be realized—for that value is realized through the *use* of the information, not its preparation and dissemination. (American Accounting Association 1973, 13) (emphasis in the original)

The importance of the appearance of independence to the public interest was emphasized by the U.S. Supreme Court:

> Public faith in the reliability of a corporation's [audited] financial statements depends upon the public perception of the outside auditor as an independent professional. *(United States v. Arthur Young* 1983, 819-820, and note 15)

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3 That final draft of the framework and the related glossary are included as an appendix to this commentary. The complete framework including "Background Information" and "Basis for Conclusions," published by the ISB as a Staff Report, is available at: http://www.cpaindependence.org/upload/doc_db.php3?doc_id=Staff+Report%2C+A+Conceptual+Framework+for.

4 The present version can be found in AICPA (2001a, ET sec. 101.02). A history of the appearance issue is contained in Previts (1985, 69-88).

5 This issue is discussed at length in the DM (ISB 2000a, paras. 68-78).

The SEC staff interprets its regulatory responsibilities in that light:

> the goal of the requirement of auditor independence is to foster investor confidence in the securities markets. That sense of investor trust and confidence will endure only so long as auditors not only are in fact independent, but also are perceived to be independent. (Sutton 1997, staff analysis p. 14)

Some Objections

Despite these widely held views, some members of the project task force, especially those from the largest auditing firms, were concerned about overemphasizing perceptions in a conceptual framework. They stressed that improved financial statement reliability is the major outcome of an audit. Although enhanced credibility and user confidence are important, they result from improved reliability and should, therefore, not be given equal weight in, or be separate components of, a conceptual framework. Those participants were concerned about the difficulty of identifying those who judge enhanced credibility and confidence and the resulting ability of the ISB to assess whether those outcomes will likely occur if a proposed independence standard is adopted:

> the sole purpose of independence is to improve the reliability of financial statements…[C]redibility, as a separate goal, concept or principle *to be pursued on its own* (that is, divorced from the reliability of financial statements), would have extremely undesirable consequences for the conceptual framework. (KPMG 2000, 1) (emphasis in the original)

> Appearances, apart from the fact of independence, cannot affect audit quality or audit objectivity or change the risk of fraud or the risk of financial injury to the investing public. They do not affect in any way the reliability of financial statements. (KPMG 2000, 21)

The participants who took this view also might have had a pragmatic reason for their position. Including the appearance of independence as a central component of the framework would allow the Board, as it allows the SEC, to justify rules not to the firms' liking. For example, the Board might issue standards that prevent auditing firms from entering into alliances with audit clients and otherwise expanding the range of services they offer to those clients even though the Board had no "proof" that those alliances or services actually compromised auditors' objectivity. An AICPA "White Paper" submitted to the ISB stated that:

> the bulk of [existing SEC and AICPA independence] requirements focus on situations that are perceived by the [SEC] Staff to impair the *appearance* of independence. But these perceptions embody assumptions that are highly subjective, lack any empirical foundation (although research by academics and practitioners suggests that investors and other stakeholders perceive non-audit services to have, at most, minimal effects on auditor independence) and result in arbitrary and unduly restrictive regulation. (AICPA 1997, 11) (emphasis in the original)

Supporting Arguments

Other participants argued that it was critical to include explicitly the appearance of independence in the ISB's framework. In their view, both enhanced financial statement reliability and credibility are critical outcomes of audits that result when auditors are not only independent, but also are perceived by the public as being independent. As SEC Chairman Arthur Levitt noted:

> some say that appearance simply doesn't matter; that auditors should be free to perform almost any service unless it can be proven that a business or financial relationship directly undermines the audit. But that view misses one of the most important aspects of an auditor's responsibilities. It is not the bright line of right and wrong that the lack of auditor independence often implicates as much as it is that gray area where the answers aren't so clear; where the temptation to "see it the way your client does" is subtle, yet real.
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> Independence is, in many respects, a condition of the mind of the auditor, its reflection of the trust and confidence of the public. To suggest that we should wait to experience erosion before we act to preserve this confidence is to ignore the wisdom of Benjamin Franklin, "Glass, china, and reputation are easily cracked, and never mended well." (Levitt 2000, 3-4)

It was clear to us that many project participants, especially the SEC observer, viewed this as a make-or-break issue—the ISB's conceptual framework would be fatally flawed if it failed to include independence in appearance as a central element. It was equally clear that other participants were opposed to any type of conceptual framework suggesting that a direct outcome of independence was to help ensure the credibility of financial statements and to improve user confidence in those statements.

Because there did not appear to be any way to resolve this fundamental difference of opinion, the ISB staff and consultants asked task force members for guidance. Although a vocal minority disagreed, most task force members strongly supported the inclusion of independence in appearance as a central element of the ISB's framework. The Board members agreed and, as a result, the Staff Report incorporates both independence of mind and independence in appearance in the framework's definition and goal of auditor independence. The framework also includes as a basic principle the need for the ISB to consider the views of investors and other financial statement users when resolving auditor independence issues.

Threats and Safeguards Approach

The other controversial aspect of the project concerned the *process for analyzing independence issues*. From early on in its deliberations, the Board supported a *threats and safeguards approach* based on analyzing threats to auditor independence that may be sources of bias for auditors or may lead financial statements users to conclude reasonably that auditors face an unacceptably high risk of such bias. The approach also requires the ISB and other independence decision makers to evaluate both the effectiveness of safeguards—controls and proscriptions that exist or could be put in place to reduce the potential effects of those threats—and the costs and benefits of alternative safeguards.

Like the FASB's conceptual framework, the ISB's framework contains an integrated set of concepts and basic principles designed to provide direction and structure for the Board's future standards and to assist other independence decision makers in resolving issues in the absence of specific standards or rules. The framework was to provide a vocabulary for the Board to use to describe the basis for its conclusions—the specific threats that it saw in a particular activity or relationship, the significance of those threats, and the reasons why specific safeguards were or were not necessary.

A threats and safeguards approach also contributes to the international harmonization of independence requirements. Representatives of two international groups—the International Federation of Accountants (IFAC) and the Fédération des Experts Comptables Européens (FEE)—actively participated in all phases of the Board's conceptual framework project. The approach used in the ISB's framework is consistent with the approaches used by those groups and by independence standard setters globally.[6]

Some project participants, especially the SEC's Chief Accountant, expressed concern that a threats and safeguards approach allows auditing firms and individual auditors too much freedom to make decisions about independence matters. That flexibility could be used to justify whatever a firm or individual wanted to do, even if it is contrary to existing independence rules. The SEC also feared that the ISB would have broader leeway to respond to audit firms' desires to relax the existing rules, perhaps by using a cost-benefit analysis.

Despite the widespread support among Board members, staff, project participants, and international groups for the threats and safeguards approach, the SEC, who retained legal responsibility for regulating auditor independence, explicitly rejected it. The new SEC independence rules adopted in November 2000, prior to the completion of the ISB's conceptual framework project, state that:

> a "safeguards" approach, which is dependent on a firm's self-analysis and self-reviews, will not provide a definitive standard. In our view, independence is better assured by consistent and uniform rules, rather than by rules that rely on the auditor's assessment of the extent of its own self-interest. Furthermore, it has been our experience that the existence of safeguards or quality controls alone does not ensure compliance with even the most basic independence regulations. (SEC 2000, Sec. IV.D.2 [footnote omitted])

The new SEC rules do not use the word "safeguards." Instead, the SEC rules proscribe specific financial, employment, and business relationships and nonaudit services. Those proscriptions apply with "limited exceptions" when certain conditions are satisfied, such as rule violations due to events wholly beyond the auditor's control, or when relationships meet specified criteria (like auditors' credit card balances of less than $10,000 held by audit clients). By rejecting the ISB's threats and safeguards approach, and thus its future approach to standard setting, the SEC put the future of the conceptual framework project, and the ISB itself, in jeopardy.

SEC'S FAILURE TO SUPPORT THE ISB'S CONCEPTUAL FRAMEWORK

Why didn't the SEC support the ISB's framework? We believe that both of the above controversies played a role.

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[6] See, for example, IFAC (2001), FEE (2001), Commission of the European Communities (2002), Institute of Chartered Accountants in Australia (2002), Institute of Chartered Accountants in England and Wales (2001).

Inadequate Attention to "Independence in Appearance"

The ED attempted to achieve a compromise on the appearance issue by offering a definition and concepts of auditor independence without the phrase "independence in appearance" but containing other wording and commentary that implied independence in appearance. For example, the ED discussion of the definition of auditor independence states:

> The level at which the auditor's ability to make unbiased audit decisions is, or can reasonably be expected to be, compromised represents a threshold that distinguishes between when the auditor is independent and when the auditor is not. Reasonable expectations refer to rationally based beliefs of well-informed investors and other users of financial information. (ISB 2000, para. 4)

This attempted compromise, however, was not acceptable to either the largest firms or the SEC. For example, one of those firms' comment letters concluded that:

> [t]he ED represents an untenable balance between the old, insupportable appearances approach to independence and an approach based on the risk of compromised objectivity. (KPMG 2001, 1)

The Chief Accountant, in a speech made shortly after the ED's release, summarized the SEC's views:

> A conceptual framework that fails to adequately address the concepts in those four principles [i.e., as stated in the SEC's proposed rules] as well as the appearance concept based on a reasonable investor knowledgeable of all the relevant facts falls short of the mark. While the staff continues to follow the work of the ISB on a conceptual framework, we think its current exposure draft has not hit the bulls-eye. (Turner 2000, 7)

The final version of the ISB's framework probably would have included the term "independence in appearance" in the definition of auditor's independence. Before that version could be finalized, however, the SEC issued its new rules, and the events leading to the ISB's dissolution, described below, began to unfold.

Concerns over "Threats and Safeguards" Approach

The threats and safeguards controversy also undermined the SEC's support for the ISB's framework. Although that approach gained acceptance worldwide, it was not explicitly used by independence rule makers in the U.S., other than the ISB. Nevertheless, it was enthusiastically supported by Board members and the conceptual framework task force. But as noted above, the SEC did not use the approach in its new rules and, after the ISB issued its conceptual framework ED, the Commission explicitly rejected it as a basis for regulating auditor independence in the U.S.

One possible reason for the SEC's rejection is that the SEC simply may have misunderstood the ISB's threats and safeguards approach, or at least how the Board intended to apply it in future standard setting. For example, in a speech to the International Organization of Securities Commissions (IOSCO), the SEC's Chief Accountant noted that:

> [t]he threats and safeguards approach does not provide the type of definitive guidance or transparency that enhances investor confidence in a firm's ability to make unbiased and objective audit decisions. Under the "threats" and "safeguards" approach investors will not know when a threat exists, whether any safeguards are in place or what the firm thinks is an acceptable level of risk. A "threats" and "safeguards" approach also provides the auditor with the ability to reduce the level of independence risk to an acceptable level based on his or her own determination. Investors are asked to blindly believe that the auditor will do the right thing. The "threats" and "safeguards" approach has been referred to in some circles as the "fox guarding the henhouse" approach because the accounting firm becomes the sole and final arbiter of whether the accounting firm's independence has been impaired. (Turner 2001, 6)

The Board's approach—discussed at length at Board and project task force meetings attended by the Chief Accountant and members of his staff, described at length in the DM and ED, and used by many independence rule makers all over the world—identifies a system quite different than that described by the Chief Accountant. The ISB's Executive Director explained those differences as follows:

> [The Chief Accountant] implies that a conceptual approach that employs threats and safeguards replaces mandated prohibitions and restrictions. That is clearly not the case. As described in detail in our conceptual framework, the purpose of analyzing threats and potential safeguards is so that standard-setters, regulators, and other independence decision-makers can determine what prohibitions, controls or restrictions to impose to mitigate threats. This process must have been used by the SEC—implicitly if not explicitly—in arriving at the conclusions expressed in its November 2000 release on auditor independence….
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> In other words, the threats and safeguards approach, properly applied, does not lead to a situation where individual auditors or audit firms are deciding what type of activity or relationship should be permitted or prohibited. Rather, it represents a principles-based approach for standard setters to use in analyzing independence threats so that appropriate safeguards, including prohibitions, can be mandated. (Siegel 2001, 2)

Another possible explanation for the SEC's rejection of the ISB's framework is that the Commission did not favor a principles-based approach for resolving independence issues. That position may have been taken because the Chief Accountant and others at the SEC did not believe that independence decision makers other than the SEC would arrive at "right" decisions—that is, those in the public interest—using broad principles. In other words, the SEC's rejection of the ISB's conceptual framework may have resulted not from a misunderstanding of the threats and safeguards approach, but from a lack of trust in auditing firms', individual auditors', and possibly even the ISB's ability to apply it to the SEC's satisfaction.

That lack of trust was obvious in the strained relationship between the Commission and the largest auditing firms that existed during the framework's development. Many cases of alleged financial fraud surfaced during this period, including Cendant, Microstrategy, and Waste Management. The SEC also was investigating several major cases accusing the largest auditing firms of failing to comply with existing SEC independence rules. In this environment, the SEC may have lost confidence in the profession's ability, and the ISB's ability to force the profession, to develop an effective process that ensures the independence of auditors, especially in the increasingly more complex area of nonaudit services. The resulting lack of confidence probably led the Commission to favor its existing compliance-based system—one in which the SEC staff interprets existing rules on a case-by-case basis—over an untried conceptual approach being developed by the new, and relatively untested, ISB.

THE INDEPENDENCE STANDARDS BOARD DISSOLVES

The Board's decision to dissolve was precipitated not only by the SEC's failure to support the ISB's conceptual framework, but also by the Commission's decision in November 2000 to issue revised auditor independence rules. The reasons for the SEC's decision to preempt the ISB and issue rules in two major areas—financial, employment, and business relationships (where the SEC rules are based largely on the ISB's preliminary conclusions), and nonaudit services—are known only to the key players in that decision, but likely include the following:

- As discussed above, the SEC's Chief Accountant was disdainful of the threats and safeguards approach to resolving independence issues. The Commission may have expected any ISB resolution of the nonaudit services issue to reflect the Board's analysis of threats and safeguards and result in an outcome not to the Commission's liking.
- The SEC was responding to the belief of the ISB's public members that the SEC—not the ISB—should address at least the information technology and internal audit portions of the nonaudit services issue because, as the ISB chairman stated during the public hearings on the SEC's proposed rule, that issue "is not well suited for a Board of our character. It's really a public policy choice that the government needs to make, I think. And that's, I think, the view of us all."
- At the time, the ISB's membership consisted of four members representing the public and four representing the public accounting profession. The Panel on Audit Effectiveness recommended in August 2000 that the ISB reconstitute its membership to include only three members representing the profession (Public Oversight Board 2000, para. 6.35). The Board supported that recommendation, but the Board dissolved before it could be adopted. The SEC may have believed that an evenly split ISB—or even one with only a bare majority of public members—could not reach agreement on the nonaudit services issue, particularly at a time when some, but not all, of the five largest auditing firms had divested, or were in the process of divesting, their consulting practices.
- The ISB standard-setting process was believed to be too slow to permit major revisions in the independent rules on a timely enough basis, either to meet the needs of investors or to be completed before the SEC Chairman and Chief Accountant left the Commission, or both.

Although the ISB could have continued to operate after the SEC revised its independence rules, the profession, the SEC, and the Board itself did not support that. Some believed that, at best, the Board's subsequent role would be limited to "repairs and maintenance," and would not be able to attract the same high-quality and high-profile individuals who comprised the existing Board. As part of its compromise with the accounting profession over the nonaudit services to be permitted under the new rules, the SEC apparently agreed to defer further consideration of other topics that the ISB had, or was about to place, on its agenda, such as the effects on independence of alternative practice structures. With major substantive issues removed from the table, the ISB's role would be reduced even further.

The largest auditing firms also may have recognized their need for time to create the quality controls necessary to implement (1) changes in the SEC's independence rules and (2) additional membership requirements relating to independence adopted by the AICPA's SEC Practice Section. In addition to not wanting more rules likely to be imposed by a standard-setting body, the largest firms also may have believed that the principal remaining independence issues were not particularly relevant to their practices. In effect, neither the firms nor the SEC had any further need for the ISB and its annual $2,000,000 cost to the profession. Whatever the reasons, the SEC, the AICPA, and the largest auditing firms all approved the ISB's decision to dissolve.

On July 9, 2001, before finalizing its conceptual framework, the Board passed a resolution of dissolution effective July 31, 2001 and directed the staff to make the framework's final draft available to the public. Issued on July 30, 2001 as a Staff Report, that document is "the conceptual framework that its authors [the ISB's consultants and staff] would have recommended the Board adopt as a Statement of Independence Concepts."

HAS THE SEC DEVELOPED A CONCEPTUAL FRAMEWORK? IS ONE STILL NEEDED?

Some believe that the SEC's November 2000 revision of its independence rules contains a conceptual framework. We disagree—the rules do not contain an articulated and logically connected approach for evaluating auditor independence issues. For example, they do not explicitly define independence or state its goal. Instead, Rule 2-01(b) contains a "general standard":

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission. (SEC 2000, sec. 210.2-01(b))

We have no quarrel with this statement; it closely parallels the ISB's conceptual framework's definition of independence. But it is not a formal definition. The SEC's "general standard" is an operational benchmark against which the Commission and its staff can measure auditors' and public companies' compliance with the statutory requirements for independence under the federal securities acts. We have no doubt that such a benchmark is useful for regulatory purposes. Nevertheless, we believe it is too vague to form the foundation of a conceptual approach to auditor independence.

SEC's Independence "Principles" Are Not a Conceptual Framework

The remaining "conceptual" portion of the SEC's approach is included in the "Preliminary Note" to the new rules. That Note describes four "factors" the Commission will consider for guidance in applying its general standard:

> whether a relationship or the provision of a service (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client. (SEC 2000, sec IV.A [footnotes omitted])

The Commission's "Discussion of Final Rules" refers to these four factors as "principles" and indicates that they "provide an appropriate framework for analyzing auditor independence issues." The Discussion further states that "the four principles constitute a body of principles to which accountants and audit committees can look for guidance when an independence issue is raised that is not explicitly addressed by the final rule." In fact, the Chief Accountant of the SEC stated subsequently that the Commission "did adopt a conceptual approach based on four principles outlined in the preamble of the rule" (Turner 2001, 5).

Despite the SEC's claims, we believe the four factors contained in the SEC rules constitute neither independence concepts nor a "conceptual approach" for analyzing independence issues. Rather, they are, at best, descriptions of four possible threats to auditor independence.[7] As ISB Chairman William Allen noted in his testimony concerning the SEC proposal, "The framework of the [SEC's] proposed rule is a first step at a conceptual framework, but it is just a first step….[T]hese generalities need much more conceptual refinement before they can be useful guides to standard-setting independence determinations" (Allen 2000, Sec. 4E). A conceptual approach to resolving independence issues must include more specific guidance in applying the Commission's general standard than that provided by the four factors. In turn, that guidance must specify a process to analyze the potential impairment to independence that the presence of one or more factors creates. A conceptual approach also must include the desirability, after considering social (not simply auditor or client) costs and benefits and the broader goals of auditor independence described in the Staff Report, of permitting a specific relationship or nonaudit service. It must, however, impose limitations, restrictions, prohibitions, or other controls that mitigate the relationship's or service's adverse consequences.

Unresolved Independence Issues

Of course, we do not need a conceptual framework if all of the major independence issues are resolved. Unfortunately, we do not believe that is the case. Many major issues concerning auditor independence remain unresolved, as does the question of the body that should address them. Among those issues are:

- dependence on an audit client
- the effect on independence of alternative practice structures
- implementation of the engagement team approach in the SEC's and the AICPA's new independence rules

[7] Some also argue that the factors are vaguely worded. For example, does a common desire to generate reliable financial information violate the first factor by creating an unacceptable mutual interest between the auditor and the client?

- guidelines for distinguishing permissible services in which an auditing firm assists client management from services that should be impermissible because the firm actually performs the function
- the harmonization of various sets of independence rules, both domestically—AICPA, SEC, General Accounting Office, Department of Labor, and the various state accountancy boards—and globally
- the decision to employ a public, private, or mixed regulatory model for developing auditor independence rules for auditors of public companies.

The AICPA's Professional Ethics Executive Committee (PEEC) is the private-sector body with the authority to address several of these issues. PEEC recognized, however, that an authoritative conceptual framework is critical for resolving these and other auditor independence issues and is currently developing its own conceptual framework to guide its future work. Responsibility for setting independence standards for auditors of public companies now falls to the newly created Public Company Accounting Oversight Board. It remains to be seen whether that body will find it helpful to develop its own conceptual framework for auditor independence.

CONCLUSION

In our opinion, the best conceptual framework for resolving independence issues is based on a threats and safeguards approach that expressly incorporates the appearance of independence. That approach was used in the ISB's Staff Report, included as an appendix to this commentary, and by other national and international bodies. A clearly articulated and well-reasoned framework would serve as a foundation for future independence standard setting, regardless of the organization that has the responsibility to do so. It also could help educate audit committees, managements, investors, and creditors about the nature and importance of auditor independence and may help restore confidence in the accounting profession and the objectivity of auditors.

APPENDIX

<u>Staff Report</u>

A Conceptual Framework for Auditor Independence

July 2001

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This conceptual framework reflects the conclusions of the authors. The Board approved and issued an Exposure Draft of a Statement of Independence Concepts, but before having an opportunity to review the comments received and to issue a final document, events led to the dissolution of the Board. Had the Board met to consider this document, it might have made substantive changes before adopting it as a Statement of Independence Concepts. The Board did, however, authorize the issuance of this document as a staff report. The document is the conceptual framework that the authors would have recommended the Board adopt as a Statement of Independence Concepts.

A Conceptual Framework for Auditor Independence

INTRODUCTION—SCOPE AND CONTENT

1. The principal purposes of this conceptual framework for *auditor independence*[1] are:

    a. to help the Independence Standards Board (ISB or Board) meet its responsibilities to set sound and consistent standards by providing direction and structure for resolving independence issues;
    b. to assist other *independence decision makers* in resolving questions about independence;

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[1] Words and phrases defined in the Glossary are set in *italic type* the first time they are used in the conceptual framework.

c. to help investors, other *users* of financial information, and other interested parties understand the nature, significance, and limitations of auditor independence; and

d. to focus debate and provide a common language for discussions about auditor independence issues, thereby helping interested parties contribute to the development and application of, and better understand the rationale and process underlying, ISB standards.

2. This conceptual framework does not establish rules for auditor independence. Rather, it specifies various components—a definition, a goal, concepts, and basic principles—that together form a conceptual framework. This framework serves as a foundation for the Board to develop principles-based standards to clarify and improve authoritative guidance and current practice. The framework also should assist other independence decision makers in analyzing and reaching conclusions about what is acceptable in the absence of applicable authoritative guidance. The Board expects, over time, to identify and reconsider any existing authoritative guidance that conflicts with this framework. Until any required changes are made, the framework should not be used to justify departures from existing guidance. Appendices to this framework describe the major steps in developing the conceptual framework and the basis for the conclusions expressed in it.

DEFINING AUDITOR INDEPENDENCE

3. *Quality audits* improve the *reliability* and enhance the *credibility* of the financial reporting process, thereby contributing to its usefulness and to the optimal allocation of capital, which serves the public interest. Quality audits are audits performed in accordance with generally accepted auditing standards (GAAS). These standards provide guidance in making significant decisions regarding planning the audit, gathering evidence, and communicating and reporting audit findings. The exercise of sound judgment is an important feature of GAAS, and independence helps ensure that an auditor has the requisite *objectivity* when making significant audit decisions.

4. The quality of an audit depends on many factors, including the personal attributes that individual auditors bring to an engagement, the policies and procedures of the auditing firms in which they work, and the attitudes and actions of the management of those firms, sometimes referred to as the "tone at the top." In addition, various self-regulatory and public regulatory bodies help ensure audit quality. The independence of auditors and the controls that help ensure their independence are only one source, albeit an important source, of quality audits.

5. **Auditor independence is both (a) independence of mind—freedom from the effects of *threats to auditor independence* that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.**[2]

[2] The components of the conceptual framework are set in **boldface type**.

6. The definition of auditor independence recognizes that auditor independence has two dimensions—independence of mind and independence in appearance. Independence of mind is a personal attribute of an auditor that cannot be directly assessed by investors and other users. The definition, therefore, also includes independence in appearance, which is the absence of those activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor's objectivity is compromised.

7. The definition clarifies that an auditor need not be free from all threats that may impair[3] an auditor's objectivity. *Safeguards to auditor independence* may mitigate the effects of threats by eliminating the threats themselves—by prohibiting the activities, relationships, or other circumstances from which threats arise—or by lessening the severity of their effects by other means. Independence requires an auditor to be free only from the residual effects of those threats, after the application of safeguards, that are at a level sufficient to compromise, or that well-informed investors or other users reasonably would conclude is sufficient to compromise, an auditor's objectivity. That level represents a threshold that distinguishes between when an auditor is independent and when an auditor is not.

8. Threats that may compromise an auditor's objectivity arise both from a wide variety of activities, relationships, and other circumstances as well as from various personal qualities and characteristics of auditors that may be sources of bias. Regulatory and standard-setting bodies issue authoritative guidance that limits or proscribes certain activities, relationships, and other circumstances because they believe that those activities, relationships, and other circumstances represent potential sources of bias for auditors generally, even though some individual auditors may be impervious to the effects of the threats that arise in those circumstances. Authoritative guidance applies to all auditors because regulatory and standard-setting bodies believe that it is reasonable to expect that an auditor's objectivity will be compromised in those circumstances. Authoritative guidance is designed to help ensure independence of both mind and appearance. Accordingly, noncompliance with authoritative guidance might not preclude a particular auditor from being objective, but it would preclude the auditor from being independent.

9. The definition, however, means that auditor independence is more than just compliance with authoritative guidance—not every threat that may be a source of bias or that would lead well-informed investors and other users reasonably to conclude that there is an unacceptable high risk that an auditor lacks objectivity can be identified and covered by a rule. To be independent, an auditor must be able, and a reasonable well-informed investor or other user would expect the auditor to be able, to overcome the effects of threats that would compromise objectivity. Accordingly, even if existing authoritative guidance permits, or does not limit or forbid, a particular activity, relationship, or other circumstance—for example, auditing a company in which the chief financial officer is the

[3] As used in this conceptual framework, an auditor's objectivity is "impaired" if it is negatively affected to any degree; objectivity is "compromised" if the impairment rises to the level of precluding unbiased audit decisions.

auditor's close friend—an auditor is not independent if his or her objectivity is compromised, or if well-informed investors and other users reasonably would conclude that there is an unacceptably high risk that the auditor's objectivity is compromised as a result of that activity, relationship, or other circumstance. In other words, compliance with authoritative guidance is a necessary, but may not be a sufficient, condition for independence.

10. Assessing the independence of auditors requires independence decision makers to consider:
    a. threats that might result in the inability to be objective and the significance of those threats;
    b. safeguards that might reduce the impact of those threats and the effectiveness of those safeguards; and
    c. the likelihood that an auditor's objectivity would be compromised by the effects of unmitigated threats, or reasonably would appear compromised to well-informed investors and other users—defined in this framework as *independence risk.*

    These concepts are discussed in paragraphs 14-24. Resolving auditor independence issues also requires independence decision makers to consider how best to meet the goal of auditor independence.

GOAL OF AUDITOR INDEPENDENCE

11. **The goal of auditor independence is to support reliance on the financial reporting process by investors and other users and to facilitate the optimal allocation of capital.**

12. The focus of the goal is on independence as one aspect of quality audits—audits that improve the reliability and enhance the credibility of the financial reporting process. Reliable and credible financial information, in turn, helps ensure that investors and other users have confidence in that information. Those outcomes are in the public interest because they help investors, creditors, and other users make more informed resource-allocation decisions.

13. Independence decision makers should make decisions that help ensure that auditors are, and that well-informed investors and other users would reasonably believe that auditors are, independent. If auditors are sufficiently free from bias but investors and other users do not believe that they are, audits may not enhance the credibility of financial information and, as a result, investors or other users may place less reliance on audited financial information. Independence decision makers, however, should not make decisions that might enhance the credibility of financial information but which have unintended consequences that decrease its reliability. Credible financial information that lacks underlying reliability is undesirable and, in the long term, self-defeating. Therefore, the goal contemplates well-placed user reliance and confidence.

AUDITOR INDEPENDENCE CONCEPTS

14. This section describes three concepts related to auditor independence:
    a. threats to auditor independence;
    b. safeguards to auditor independence; and
    c. independence risk.

    These concepts, together with the basic principles of auditor independence described later in this framework, are intended to help independence decision makers analyze auditor independence issues.

Threats to Auditor Independence

15. **Threats to auditor independence are pressures and other factors that impair an auditor's objectivity.**

16. Threats may arise from various types of activities, relationships, and other circumstances. Identifying the types of threats posed by specific activities, relationships, or other circumstances helps independence decision makers understand the nature of those threats and their potential impact on auditor independence.

17. The following list provides examples of the types of threats that can lead to biased audit decisions. Although the list is not mutually exclusive or exhaustive, it illustrates the wide variety of threat types that independence decision makers need to consider when analyzing auditor independence issues.
    a. Self-interest threats—threats that arise from auditors acting in their own interest. Self-interests include auditors' emotional, financial, or other personal interests. Auditors may favor, consciously or subconsciously, those self-interests over their interest in performing a quality audit. For example, auditors' relationships with *auditees* create a financial self-interest because auditees pay the auditors' fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor's spouse and an auditee.
    b. Self-review threats—threats that arise from auditors reviewing their own work or the work done by others in their firm. It may be more difficult to evaluate without bias one's own work, or that of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat may arise when auditors review judgments and decisions they, or others in their firm, have made.
    c. Advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee or its position or opinion rather than serving as unbiased attestors of the auditees' financial information. Such a threat may be present, for example, if auditors or others in the auditing firm serve as promoters for an auditee's securities.
    d. Familiarity (or trust) threats—threats that arise from auditors being influenced by a close relationship with an auditee. Such a threat is present when auditors are not sufficiently skeptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee.

For example, a familiarity threat may arise when an auditor has a particularly close or long-standing personal or professional relationship with an auditee.

e. Intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. Such a threat may arise, for example, if an auditing firm is threatened with replacement over a disagreement about an auditee's application of an accounting principle, or if an auditor believes that an auditee's expression of client dissatisfaction would damage his or her career within the firm.

18. The significance of a threat may have both probability and magnitude dimensions, and threats can be significant individually or in combination. The significance of a threat depends on many factors, including the nature of the activity, relationship, or other circumstance creating the threat; the force with which pressure is exerted or felt; the importance of the matter that is the subject of the activity, relationship, or other circumstance; the position and level of responsibility of the persons involved; and the strength of the integrity of the persons involved. Independence decision makers should evaluate these and other factors when assessing threats to auditor independence posed by various activities, relationships, and other circumstances.

Safeguards to Auditor Independence

19. **Safeguards to auditor independence are controls that mitigate the effects of threats.**

20. Safeguards take a variety of forms, including:

a. authoritative guidance that prohibits or restricts certain activities, relationships, or other circumstances or that requires disclosure of such activities, relationships, or other circumstances;

b. auditing firm policies, procedures, and practices;

c. institutional arrangements, such as the threat of disciplinary action and legal liability;

d. environmental conditions, such as the value that auditing firms and individual auditors place on their reputations; and

e. aspects of corporate governance and auditing firm culture, such as effective communications between audit committees and auditors, and appropriate "tone at the top" of auditees and auditing firms.

Because effective safeguards help ensure that auditors are objective in the presence of threats to auditor independence, independence decision makers should consider existing safeguards as well as new safeguards that could be put in place to mitigate those threats.

21. Different safeguards may mitigate different types of threats, and one safeguard may mitigate several types of threats simultaneously. For example:

a. self-interest threats may be mitigated by, among other safeguards, prohibitions against certain financial interests and family relationships between auditors and auditees, restrictions on the percentage of total fees earned from one auditee, and auditing firm disclosures to the audit committee of all services provided to the auditee;

b. self-review threats may be mitigated by, among other safeguards, prohibitions against auditors acting in the capacity of auditee management;
c. advocacy threats may be mitigated by, among other safeguards, prohibitions against and limitations on auditors providing certain services for auditees that involve advocacy roles;
d. familiarity threats may be mitigated by, among other safeguards, mandatory periodic replacement of engagement partners and restrictions on certain employment relationships between auditors' family members and auditees; and
e. intimidation threats may be mitigated by, among other safeguards, concurring partner reviews, internal consultation requirements, and an appropriate "tone at the top" in both auditing firms and auditees.

22. Safeguards may be effective either individually or in combination. The effectiveness of a safeguard depends on many factors, including whether it is suitably designed to meet its objectives, how it is applied, the consistency with which it is applied, by whom it is applied, and to whom it is applied. Independence decision makers should evaluate these and other factors when assessing safeguards that exist or can be put in place in response to specific activities, relationships, and other circumstances that post threats to auditor independence.

Independence Risk

23. **Independence risk is the likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users.**

24. Independence risk increases in the presence of threats to auditor independence and is reduced by safeguards. Independence decision makers should evaluate the significance of threats posed by activities, relationships, and other circumstances and the effectiveness of safeguards to determine whether additional safeguards are necessary to reduce independence risk. Paragraphs 25-38 describe basic principles that independence decisions makers should use to consider and assess the level of independence risk.

25. This section discusses three basic principles of auditor independence:
a. considering the level of independence risk and assessing its acceptability;
b. considering benefits and costs; and
c. considering the views of investors and other interested parties.
The basic principles serve as guidelines for independence decision makers in analyzing auditor independence issues in a wide variety of circumstances.

Considering the Level of Independence Risk and Assessing Its Acceptability

26. **Independence decision makers should (a) consider the level of independence risk by analyzing threats and their significance and safeguards and their effectiveness, (b) assess whether that level is acceptably low, and (c) apply appropriate safeguards if it is not.**

27. This basic principle describes a process by which independence decision makers should analyze threats and safeguards to consider the level of independence risk that results from various activities, relationships, or other circumstances. Although it cannot be measured precisely, the level of independence risk for any specific activity, relationship, or other circumstance can be described as a position on a continuum that ranges from "no independence risk," where compromised objectivity is virtually impossible, to "maximum independence risk," where compromised objectivity is virtually certain. When considering the level of independence risk, independence decision makers should consider the views of well-informed investors and other users of financial information.

28. This basic principle also describes the need for independence decision makers to assess the acceptability of the level of independence risk that arises from specific activities, relationships, and other circumstances. That evaluation requires them to judge whether existing safeguards adequately mitigate threats to auditor independence posed by those activities, relationships, or other circumstances. If they do not, independence decision makers should decide which additional or alternative safeguards (including prohibition) would reduce independence risk to an acceptably low level. When assessing the acceptability of independence risk, independence decision makers also should consider the aggregate risk arising from different threats because their effects may be cumulative. The acceptability of a level of independence risk arising from different activities, relationships, and other circumstances will vary based on an analysis of costs and benefits and the views of well-informed investors and other users of financial information.

29. Given certain factors in the environment in which audits take place—for example, that the auditor is paid by the auditee—independence risk cannot be completely mitigated and, therefore, independence decision makers always accept some risk that auditors' objectivity may be compromised. Nevertheless, independence decision makers should consider only a very low level of independence risk to be acceptable. Only such a small likelihood of compromised objectivity is consistent with both the definition and the goal of auditor independence.

30. Some threats to auditor independence may affect only certain individuals or groups within an auditing firm, and the significance of some threats may be different for different individuals or groups. In determining whether independence risk is at an acceptably low level, independence decision makers should identify the individuals or groups affected by threats to auditor independence and the significance of those threats. Different types of safeguards may be appropriate for different individuals and groups depending on their ability to influence the outcome of the audit.

Considering Benefits and Costs

31. **Independence decision makers should conclude that the benefits of reduced independence risk from applying safeguards exceed their costs.**

32. Although the benefits f reduced independence risk and costs of safeguards are often difficult to identify and quantify, independence decision makers should consider them when assessing the acceptability of the level of independence risk. Because the independence of auditors is important not only in its own right but also in helping ensure that broad public interest objectives are met, independence decision makers should consider costs and benefits to society at large, not just those they may incur or enjoy themselves. Similarly, independence decision makers should consider indirect effects and potential unintended consequences that go beyond the direct impact of specific safeguards. It is not appropriate, however, to ignore a mandated safeguard based on a belief that its costs exceed its benefits.

33. The benefits of applying safeguards result from reduced independence risk. Such reductions help to ensure auditor independence, providing positive direct and indirect benefits that accrue to various parties. Examples of those benefits include:
    a. for investors and other users of financial information, auditor independence helps ensure quality audits and the reliability of the financial reporting process, which also may lead to increased confidence in that reliability. These benefits, in turn, help improve investors' and other users' resource-allocation decisions, an outcome that is in the public interest.
    b. for auditees, auditor independence helps reduce their cost of capital by reducing the premium that investors and creditors demand as compensation for assuming the risk that they will make incorrect decisions because the financial information used in making those decisions contains material misstatements or omissions.
    c. for auditees' boards of directors, audit committees, and senior management, auditor independence helps ensure the reliability of financial information prepared by lower-level management.
    d. for auditees and auditors, auditor independence may help reduce litigation and related costs resulting from alleged and actual situations involving unreliable financial information.
    e. for individual auditors, auditing firms, and the auditing profession as a whole, independence facilitates the discharge of their responsibility to conduct GAAS audits and may help enhance their reputations and self-esteem.

34. Various parties bear a variety of costs related to safeguards to auditor independence. Direct costs include developing, maintaining, and enforcing safeguards, including the costs of auditing firms' independence-related quality controls and costs related to the systems of public regulation and self-regulation of auditor independence. Indirect costs and unintended consequences of safeguards include possible reductions in audit quality or other negative outcomes that may result from safeguards that prohibit or restrict auditors' activities and relationships. For example, restrictions on auditing firm personnel's investments and on employment of their family members by auditees may

reduce the attractiveness of auditing firms as employers and thereby lead to reduced audit quality. The direct and indirect costs of safeguards may be affected by many variables, including the number of individuals in a firm that will be affected by a safeguard.

Considering Interested Parties' Views in Addressing Auditor Independence Issues

35. **Independence decision makers should consider the views of investors, other users, and others with an interest in the integrity of financial reporting when considering the level of independence risk, when assessing its acceptability, and when considering the costs and benefits of applying safeguards.**

36. Because of its responsibility for issuing independence standards for all auditors of public entities, the ISB's process of considering interested parties' views is more extensive than the process used by other independence decision makers. The ISB's due process provides opportunities for extensive participation in its standard-setting by various parties, including investors and other users, auditors, educators, regulators, and auditee management. By being informed about the views of various types of individuals and groups, the ISB learns about threats to independence and the potential effects of various safeguards on the reliability of financial information, audit quality, and the broader goal of optimal capital allocation. The ISB also gains insight about the views of well-informed investors and other users of financial information concerning independence risk and its acceptability in specific circumstances.

37. Supporting user reliance on the financial reporting process is an important component of the goal of independence, and the framework's basic principle to consider the level of independence risk and assess its acceptability directs independence decision makers to consider the beliefs of well-informed investors and other users at this point in their decision-making process. Considering the views of well-informed investors and other users does not, however, abrogate the ISB's responsibility to exercise its own judgment in setting independence standards that are consistent with both the definition and the goal of auditor independence and the framework's principle of assessing the acceptability of independence risk in light of costs and benefits. Effective communication of ISB decisions, and of the reasoning that underlies them, also may help ensure that investors and other users of financial information have confidence in the ISB's standard setting process and conclusions.

38. In the absence of specific authoritative guidance, independence decision makers other than the ISB should consider how well-informed investors and other users might view their decisions about the level of independence risk, its acceptability, and the costs and benefits of applying safeguards. Independence decision makers other than the ISB, however, may not have, and would not be expected to have, the benefit of extensive due process in resolving auditor independence issues.

APPENDIX A—GLOSSARY

39. This appendix contains definitions of certain terms or phrases used in this conceptual framework.

Auditees

Entities whose financial information is being audited.

Auditor independence

Both (a) independence of mind—freedom from the effects of threats to auditor independence that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.

Credibility

The quality of information that makes it believable.

Independence decision makers

Individuals, groups, and entities that make judgments about auditor independence issues. Independence decision makers include:

- the ISB and other independence standard setters
- auditing firms in adopting independence policies and procedures in the absence of existing authoritative guidance
- individual auditors in assessing their own independence and in making decisions when faced with situations for which there is neither authoritative guidance nor firm policy
- the management, audit committees, and boards of directors of auditees in meeting their responsibilities to retain auditors who are independent
- regulators in meeting their responsibilities to ensure the independence of auditors.

Independence Risk

The likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users.

Objectivity

The ability to make unbiased audit decisions.

Quality audit

An audit performed in accordance with generally accepted auditing standards.

Reliability

"The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent."[4]

Safeguards to Auditor Independence (Safeguards)

Controls that mitigate the effects of threats.

Threats to Auditor Independence (Threats)

Pressures and other factors that impair an auditor's objectivity.

Users

Investors, creditors, audit committee members, analysts, and others who use audited financial information in making investment, credit, and similar decisions.

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[4] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (Stamford, CT: FASB, 1980), "Glossary of Terms."

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