

# 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.

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## 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.

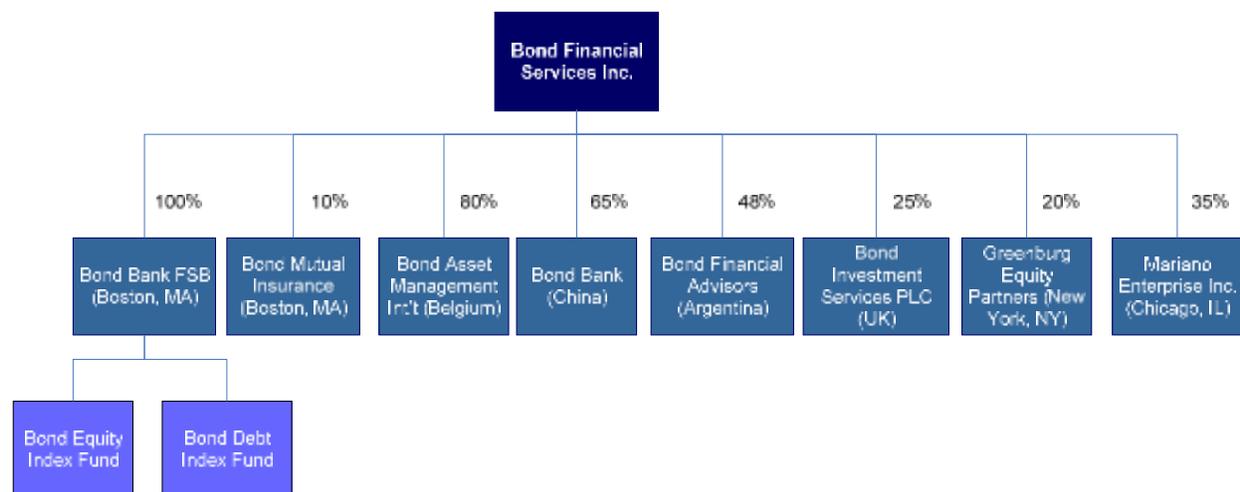
**Number of employees (worldwide):** 4,275

**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

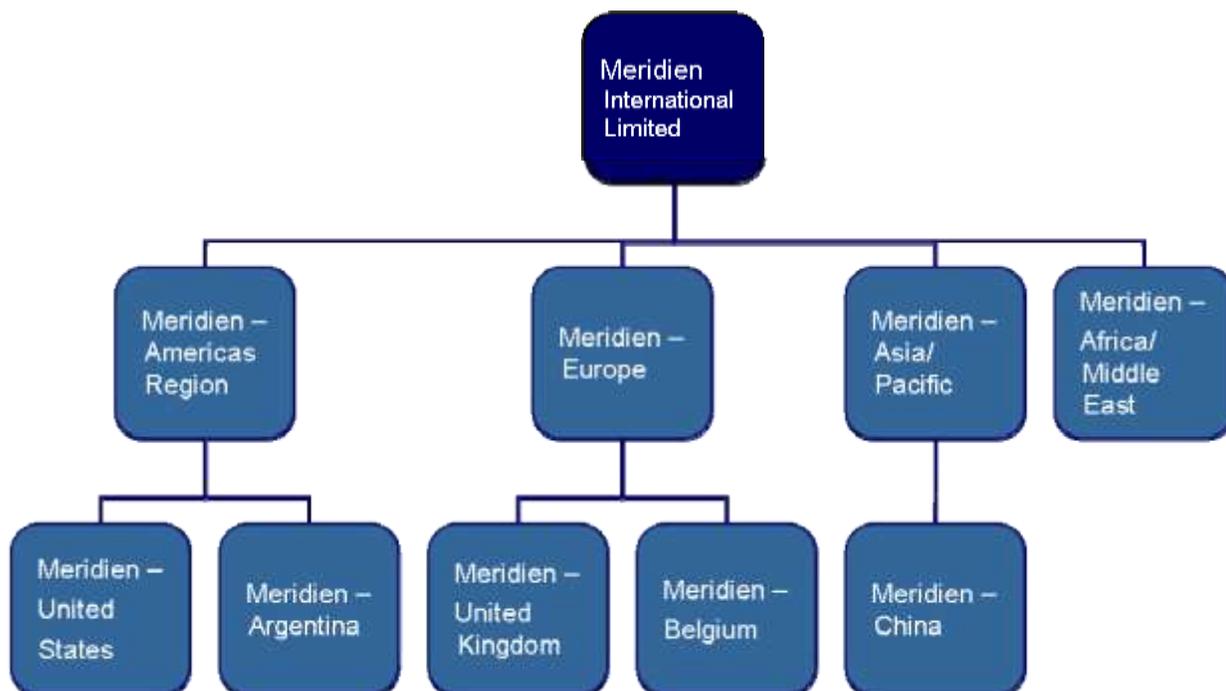
**Name:** Meridien, LLP (Meridien) is a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

**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

### **Suggested solution(s):**

For applicable SEC and AICPA guidance referenced in the solutions, see teaching notes below.

- Michael Rose – Michael is independent based on Rule 2-01(c)(1)(ii)(B) and (E) as his credit card balance is less than \$10,000 and as his savings and checking accounts are under the **Federal Deposit Insurance Company's (FDIC's)** insured limit (\$100,000). Michael can serve on the Bond engagement team.
- Lidija Tomas – Lidija is not independent as under Rule 2-01(c)(1)(ii)(A) she has a prohibited student loan with Bond, which would impair independence if she served on the audit team. Only certain types of loans are permissible (see guidance below) by the borrower under the SEC rules and student loans are not among them. Lidija cannot serve on the Bond engagement team.
- Dinari Botha – Dinari is independent based on Rule 2-01(c)(1)(ii)(F) as she is allowed to retain a Bond insurance policy that was obtained before she became a **covered person**. In addition, according to the Case Studies Background, there is no indication that Bond Mutual is in danger of becoming insolvent. In fact, the information indicates that the Bond companies are financially sound. Dinari can serve on the Bond engagement team.
- Peter Valvo – Peter is independent under SEC Rule 2-01(c)(1)(ii)(A) and (C) as his brokerage account balance is below the **Securities Investor Protection Corporation's (SIPC's)** limit (\$250,000) and his auto loan is fully collateralized. However, as brokerage accounts are not permitted at Restricted Entities for **covered persons** under Meridien Independence Policy, he would not be considered independent if he provided services to Bond (see [Meridien Independence Policy](#)). Peter cannot serve on the Bond engagement team.
- David Wallace – David Wallace is not independent under independence rules as he has a material investment in Bond mutual funds through a trust that was established for him by his grandparents. Under AICPA 0.400.22, the trust's investments are considered **indirect financial interests** to David as he has no control over the investment decisions made by the trust, and under SEC Rule 2-01(c)(1)(i)(D) a covered person is not permitted to have a **material indirect financial interest** in an audit client. Also note that David's financial interest in Bond is prohibited under Meridien's independence policy (see [Meridien Independence Policy](#)) as the investments in Bond funds are considered material to him. David cannot serve on the Bond engagement team.

## Teaching notes —

As it relates to Peter Valvo's independence situation, you may wish to differentiate between independence rules (i.e., professional standards imposed by regulators, such as the SEC on auditors and others employed in the auditing profession) versus firm independence policies (i.e., "rules" imposed by a particular accounting firm on the firm's partners and employees).

Firm independence policies are generally based on the profession's standards and may even be the same as those standards; however, sometimes, the firms' policies are stricter than the profession's rules. Public accounting firms may choose to have stricter policies and create a higher threshold of independence compliance for their partners and employees; therefore, if a violation occurs it would only be against the firm's policy and not SEC regulations.

In addition, if the public accounting firm created a higher standard that all managers or staff should be independent of the audit clients in their practice office, that would allow any managers or staff to work on all audit clients in the office, creating more resource flexibility within the practice office. Hence, a situation like the case study above would not be as much of an issue, as all managers and staff would be required to be independent of all audit clients in their practice office.

In Peter's specific case above, Meridien's independence policy is more restrictive for brokerage accounts and does not permit a **covered person** to have a brokerage account with an audit client. Under SEC policy, brokerage accounts are permitted if they are under the SIPIC limit. Thus, it is possible to be in compliance with the profession's independence standards, but be in violation of a firm's independence policy.

Relevant excerpts from SEC Regulation S-X Rule 2-01(c)(1) appear below:

"(i) Investments in audit clients. An accountant is not independent when:

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term material indirect investment does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), that invests in an audit client.

(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) Loans/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

- (1) Automobile loans and leases collateralized by the automobile;
- (2) Loans fully collateralized by the cash surrender value of an insurance policy;
- (3) Loans fully collateralized by cash deposits at the same financial institution; and
- (4) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(B) Savings and checking accounts. Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting

firm account may have an uninsured balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

(C) Broker-dealer accounts. Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:

(1) Any such account includes any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act of 1970 (SIPA) (15 U.S.C. 78aaa et seq.));

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (15 U.S.C. 78fff-3); or

(3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.

(E) Credit cards. Any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to \$10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

(F) Insurance products. Any individual policy issued by an insurer that is an audit client unless:

(1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and

(2) The likelihood of the insurer becoming insolvent is remote."

Relevant excerpts from AICPA *Code of Professional Conduct*, Section 0.400.22 appear below:

"Indirect financial interest: A financial interest beneficially owned through an investment vehicle, an estate, a trust, or an other intermediary when the beneficiary neither controls the intermediary nor has the authority to supervise or participate in the intermediary's investment decisions."

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?

**Suggested solution(s):** The professionals who are not independent could take the following actions to become independent:

- Lidija Tomas could pay off her student loans or move them to a nonrestricted entity.
- Peter Valvo could transfer the cash balance to another nonrestricted broker-dealer.
- David Wallace could ask his grandparents to sell the trust's shares in the Bond mutual funds.

### Teaching notes —

See applicable SEC and AICPA guidance referenced in the Teaching Notes to Question 1. All independence issues **should** be fully resolved prior to providing any services to Bond. Typically any expense associated with resolving the independence issues are at the expense of the individuals.

## 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

### Suggested solution(s):

For applicable SEC and AICPA guidance referenced in the solutions, see teaching notes below.

- Adam Whittcamp's independence depends on whether or not his girlfriend is considered a spousal equivalent. Even though the SEC defines "spousal equivalent" (see definition below and Meridien Policy), the term is still subjective and students may have differing opinions on this matter. (As a side note: This is an opportunity to underscore that professional judgment is paramount to independence in part because situations sometimes arise that just are not fully covered by extant rules or specific firm policies.) If students conclude that Adam's girlfriend is a spousal equivalent, then he would not be considered independent under Rule 2-01(c)(1)(iii)(A), as Adam's spousal equivalent has a **direct financial interest** in the audit client (i.e., Bond stock through the 401(k) plan and the 401(k) itself, as the 401(k) plan is sponsored by Bond). If the students conclude Adam's girlfriend is not a spousal equivalent, then her financial holdings would not impair Meridien's independence. However, some of these students may still feel that by staffing Adam on the Bond audit engagement it creates an independence appearance problem, even though it does not technically violate the rules, and, therefore, would not allow Adam to serve on the Bond engagement team. For this case study, Jeff concludes that Meridien is independent, as Adam's girlfriend is not a "spousal equivalent" under the rules because they have only been living together for 3 months and the couple keeps their finances and insurance policies separate, and they have no marriage plans. Adam can serve on the Bond engagement team.
- Catlyn Frederick would not be considered independent under Rule 2-01(c)(1)(iii)(C) if she is part of the audit engagement team as her husband (Tim) participates in the employee stock compensation plan, which would not meet the exception outlined in the rule. The compensation plan would be permitted, as long as the stock options are unvested, and Catlyn does not provide audit services to Bond or would not be considered in the chain of command. As for Tim's employment with Bond, if he is considered in a **financial reporting oversight role**, Catlyn would not be able to become a **covered person** with respect to Bond. However, as he is a broker, his position would not be considered a **financial reporting oversight role**; therefore, it would not be considered an independence concern. Catlyn cannot serve on Bond due to her husband's employee stock compensation.
- Jeannette Smith's independence is determined based on whether or not she is considered a dependent of her parents. If the students conclude that Jeannette is a dependent of her parents, her father's investment in Bond, even though immaterial to his net worth, would not be permitted under SEC Rule 2-01(c)(1)(i)(A) as he would be considered "immediate family." Under SEC rules, an **immediate family member** (spouse, spousal equivalent, dependent) is treated as if the **covered person** owned the stock. So, as long as Jeannette is her father's dependent, his investment would be treated as if it were hers. If the student's conclude that Jeannette is not a dependent of her parents, her father's investment in Bond would be permitted under SEC Rule 2-01(c)(1)(i)(B) as her father does not own more than 5% of the Bond's equity securities and does not control Bond. For this case study, Jeff concludes that Jeannette is a dependent of her parents as she lives with them and they pay for her credit cards, clothes, food, etc. and do not charge her rent. Jeannette cannot serve on the Bond engagement team.

Note: When determining dependent status of an individual, one may consider if an individual is claimed as a dependent on the parent's tax return. If claimed as a dependent on a parent's return, an individual

would likely be deemed dependent for auditor independence purposes. However, just because an individual is not claimed on a parent's return does not necessarily mean the individual would not be dependent for auditor independence purposes. Rather, the tax return evidence is a starting point and other factors should be considered, as seen in the case study above.

## Teaching notes –

An excerpt from the [SEC's Final Rule: Revision of the Commission's Auditor Independence Requirements](http://www.sec.gov/rules/final/33-7919.htm) (<http://www.sec.gov/rules/final/33-7919.htm>) appears below:

### "Close Family Members"

We are adopting, as proposed, Rule 2-01(f)(9) that defines "close family members." Close family members is defined to mean a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling. These terms should be understood in terms of contemporary family relationships. Accordingly, "spouse" means a husband or wife, whether by marriage or under common law; "spousal equivalent" means a cohabitant occupying a relationship generally equivalent to that of a spouse; "parent" means any biological, adoptive, or step-parent; "dependent" means any person who received more than half of his or her support for the most recent calendar year from the relevant covered person; "child" means any person recognized by law as a child or step-child; and "sibling" means any person who has the same mother or father.

"Close family members" includes the persons separately defined as "immediate family members" (spouse, spousal equivalent, and dependent), and adds certain family members who may, as a general matter, be thought to have less regular, but not necessarily less close, contact with the covered person in question (parent, nondependent child, and sibling). We distinguish the two groups, in part, because the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence. Commenters, in general, raised few issues with the proposed definition of "close family members" and, therefore, we are adopting this definition as proposed.

Relevant excerpts from SEC Regulation S-X Rule 2-01 appear below:

"(c)(1)(i) Investments in audit clients. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (17 CFR 240.13d-101 or 240.13d-102) with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client.

(c)(1)(iii) Exceptions: Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:

(C) Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer's employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.

(c)(2) Employment relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(f)(9) Close family members means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(f)(13) Immediate family members means a person's spouse, spousal equivalent, and dependents."

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?

**Suggested solution(s):** The candidates could take the following actions to become independent before they join the audit team:

- For Catlyn Frederick to be considered independent of Bond, her husband would need to dispose or voluntarily forfeit of any vested or unvested stock options and discontinue his participation in the stock compensation plan.
- For Jeannette Smith to be considered independent of Bond she has two choices: (1) she can move out and no longer be a dependent of her parents, and, therefore, her parents' immaterial investment in Bond would not impair her independence, or (2) her parents can continue to support her financially and her father sells his investment in Bond securities.

## 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?

**Suggested solution(s):** (1) Seek to understand the difficulty Lidija is experiencing with respect to her independence matters, (2) Explain to Lidija that her service on the Bond audit would be valuable to her career development, (3) Explain that the client has specifically requested professionals with industry experience, and (4) Offer suggestions to help her come up with a plan to resolve her independence issues.

### Teaching notes —

If Lidija would be agreeable to resolving her independence issues, any actions she would take (e.g., paying off loans or moving them to an unrestricted entity, which may charge a higher rate of interest), would likely be at her own expense. Independence is a personal and professional obligation; firms generally do not pay these expenses on behalf of professionals.

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.

**Suggested solution(s):** Given the choice, some investors may choose to have the more experienced/less independent personnel on the audit while others may not.

Argument for the trade-off: Industry experience allows an auditor to be more aware of potential issues that may be encountered during the audit. Since Lidija would be performing a staff level role (i.e., her work will be reviewed by more senior members of the team), her independence may not be as critical an issue as it would be if she were a manager or a partner. In addition, Lidija may in fact be independent of Bond despite her student loans, as she may be able to maintain an objective state-of-mind while providing audit services. Independence is a state-of-mind rather than just following independence rules. Therefore, regardless if the auditor has a relationship with the client or not, his or her state-of-mind should be free from bias and objective at all times during the audit.

Argument against the trade-off: Independence is critical to performing a quality audit engagement and if a member of the engagement team is not independent it may taint the reliability of the audit report. A professional with no experience will gain industry experience over time, however, a professional with independence issues may never be viewed as independent unless the interest is disposed of and all other standards are met.

### Teaching notes —

This question raises the important issue of audit quality and the extent to which users of financial statements might be willing to sacrifice independence for enhanced skill sets. Sometimes the most qualified auditor cannot serve on an audit because of an interest or relationship with the client (e.g., spouse is a financial executive with the client). Clients may expect and even demand particular expertise, however, the engagement team's independence should be maintained.

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?

**Suggested solution(s):** Responses to this question will likely vary. Some students may believe that the current independence rules are sufficient to ensure an appropriate level of skepticism and **objectivity** as they limit all financial and employment relationships with the audit client. Other students may conclude that the independence rules are not sufficient and should be more restrictive. If this is the case ask the students to expand on areas of the independence rules that they would enhance. Still other students may conclude that the independence rules are too restrictive as some of the rules might not be necessary to ensure skepticism and **objectivity**. If this is the case ask the students to expand on the areas of the independence rules that they would change or delete.

### Teaching notes —

This question encourages the student to think in terms of independence in appearance.

Note: Section I of the Video also addresses the public's reliance on the auditor's professional skepticism and the suggested solutions cover audit research germane to this issue.

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.

**Suggested solution(s):** As a Meridien manager with responsibility for staffing and ensuring independence compliance on the engagement, one may approach independence in terms of whether or not the professional standards (e.g., rules or regulations) have been met. Whereas, a Bond investor, with a lot of money at risk, may view independence more holistically, as it is more personal to the investor.

### Teaching notes —

Another way to pose this question to your students might be:

**Compare and contrast how a Bond investor and a Meridien audit engagement team manager might view differently 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.

**Suggested solution(s):** A range of answers may be expected. Some students may be surprised to learn that certain types of financial interests and relationships with a **restricted entity** are permitted, whereas others may feel that the rules were too restrictive and that more exceptions and allowances should have been permitted.

### Teaching notes —

You may pose another question to the students regarding their willingness to work in the public accounting profession with these current independence rules regarding financial and employment relationships.

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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<sup>1</sup> 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<sup>2</sup> 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<sup>3</sup> 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).

<sup>1</sup> 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.)

<sup>2</sup> Significant influence is generally deemed to exist when ownership interest is between 20% and 50%.

<sup>3</sup> 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 Meridien **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: <sup>4</sup>

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

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

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

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

#### **Qualifications of accountants**

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

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

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

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

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

- Rule 101 – Independence (now codified as §1.200.001 – Independence Rule) of the AICPA *Code of Professional Conduct* and its interpretations and rulings

<sup>4</sup> Other entities, such as state accountancy boards, federal and state regulators (e.g., Department of Labor), and regulators in other countries may impose additional independence requirements, depending on the type and location of the company.

- The independence standards and interpretations of the Independence Standards Board (ISB)<sup>5</sup>

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

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

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

The AICPA is a nonprofit, membership organization of approximately 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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<sup>5</sup> The ISB was created in 1997 through an agreement between the SEC and the AICPA to initiate research, develop standards, and engage in a public analysis and debate of auditor independence issues. The ISB discontinued its operations on July 31, 2001. Much of the ISB’s work was incorporated into the SEC’s auditor independence rules adopted in November 2000. (Source: SEC News Release 2001-72)

## Appendix B: Additional Resources

Reference in independence education tool kit	Title	Source/URL (if available)
<b>Video:</b>		
Act I, "Independence 101"	" <i>Top 10 Audit Deficiencies</i> "  Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson	Journal of Accountancy, April 2001  <a href="http://www.journalofaccountancy.com/issues/2001/apr/top10auditdeficiencies.html">http://www.journalofaccountancy.com/issues/2001/apr/top10auditdeficiencies.html</a>
Act II, "The Public Accounting Profession"	" <i>The Public Accounting Profession</i> "	
Act III, "Independence at Work"	" <i>AICPA Plain English Guide to Independence</i> "	<a href="http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf">http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf</a>
<b>Case Study:</b>		
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."	<a href="https://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf">https://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf</a>
	"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	<a href="http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf">http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf</a>
Case Studies 1 and 2	Sarbanes-Oxley Act of 2002  Title II, <i>Auditor Independence</i>  Title III, <i>Corporate Responsibility</i>	<a href="http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf">http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf</a>
	"Ethics Rules Get Tighter: New PCAOB independence rules focus on tax services and contingent fees"  Catherine Allen	Journal of Accountancy, Dec. 2006  <a href="http://www.journalofaccountancy.com/issues/2006/dec/ethicsrulesgettighter.html">http://www.journalofaccountancy.com/issues/2006/dec/ethicsrulesgettighter.html</a>

Reference in independence education tool kit	Title	Source/URL (if available)
<b>Case Study:</b>		
Case Study 2	Office of the Chief Accountant – Securities and Exchange Commission (SEC)  <i>"Audit Committees and Auditor Independence"</i>	<a href="http://www.sec.gov/info/accountants/audit042707.htm">http://www.sec.gov/info/accountants/audit042707.htm</a>
	<i>"How Audit Committees Can Assess Auditor Independence"</i>  Catherine Allen	Directors Monthly, Dec. 2006
	<i>"An Update for Audit Committees: New Rules on Auditor Provided Tax Services"</i>  Catherine Allen	Directors Monthly, May 2007
Case Studies 3 and 4	<i>"AICPA Plain English Guide to Independence"</i> <ul style="list-style-type: none"> <li>➤ Introduction</li> <li>➤ Applying the Rules – Covered Members and Other Firm Professionals</li> <li>➤ Applying the Rules – Family Members</li> <li>➤ Financial Relationships</li> <li>➤ Business Relationships</li> </ul>	<a href="http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf">http://www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf</a>
Case Study 5	PCAOB Disciplinary Proceedings Involving Independence	<a href="https://pcaobus.org/Enforcement/Decisions/Documents/11-22_Kenny_Lee_and_Kwanq_Ho_Lee.pdf">https://pcaobus.org/Enforcement/Decisions/Documents/11-22_Kenny_Lee_and_Kwanq_Ho_Lee.pdf</a>  <a href="https://pcaobus.org/Enforcement/Decisions/Documents/11-14_Birkert.pdf">https://pcaobus.org/Enforcement/Decisions/Documents/11-14_Birkert.pdf</a>  <a href="https://pcaobus.org/Enforcement/Decisions/Documents/12-14_Kantor.pdf">https://pcaobus.org/Enforcement/Decisions/Documents/12-14_Kantor.pdf</a>
General Independence/ Corporate Governance	Sarbanes-Oxley Act of 2002  <i>Report on the Survey of Audit Committee Members Conducted by: The Center for Audit Quality</i>	<a href="http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf">http://www.pcaobus.org/About/History/Documents/PDFs/Sarbanes_Oxley_Act_of_2002.pdf</a>  <a href="http://thecenterforauditquality.org/newsroom/pdfs/auditsurvey.pdf">http://thecenterforauditquality.org/newsroom/pdfs/auditsurvey.pdf</a>

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