

NASBA

PROPOSED UNIFORM DEFINITION OF INDEPENDENCE

Submitted by:

Ethics and Strategic Professional Issues Committee

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Discussion Paper

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INTRODUCTION

The 2009-2010 charge of the NASBA's Ethics and Strategic Professional Issues Committee is:

Monitor and evaluate the issues of the AICPA's Professional Ethics Executive Committee (PEEC), to harmonize ethics standards of State Boards of Accountancy with other regulatory bodies, to promote the development and adoption of UAA ethics provisions uniformly among the states, and to share with state boards emerging ethics and other professional issues.

A properly developed concept of independence will enable auditors to carry out their responsibility to report accurate, unbiased financial information to shareholders. As the Committee began to survey the jurisdictions and various regulatory bodies, we identified several reasons for a uniform definition of independence:

- A uniform definition of independence is critical to the consistency, reliability and creditability of financial information examined by auditors and is in the public interest.
- The Advisory Committee of the Auditing Profession recommended that independence and ethics standards be harmonized to the extent possible by regulators.¹
- For State Boards of Accountancy to maintain their focus on public protection it is important for them to develop clear independence guidance.
- Because nearly all of the 55 jurisdictions have adopted mobility, it is imperative that independence standards be uniform for firms and licensees who practice across state boundaries.

LITERATURE SURVEYED AND COMMITTEE EXPERIENCE

The Committee reviewed and discussed the following articles and documents related to definitions of independence: Baker (2005), Ascher and Foer (2010), *AICPA Code of Professional Conduct* (2009), *IFAC Code of Ethics for Professional Accountants* (2009), *Government Accountability Office Audit Standards* (2007), *UAA Model Rules* (2009) and segments of 42 states' rules. References to these articles and documents are included in the Appendix. In reviewing the information, it is apparent the concept of independence varies with each international, national and state regulatory body.

In reviewing state rules, the Committee discovered certain states (23) broadly define independence from an exceptions approach, indicating a licensee or firm is not independent if certain conditions prevail, such as direct ownership or being a trustee of a trust. At the end of the

¹ *Final Report of the Advisory Committee of the Auditing Profession to the U.S. Department of the Treasury*, October 6, 2008, Recommendation 4(a), page VIII.

exceptions there is typically a statement to the effect, “The above examples are not intended to be all inclusive.” Some states merely reference the independence standards of the AICPA as of a certain date (15). Only four states of the 42 surveyed use their own unique definition of independence.

Baker’s article (2005) brings into focus the apparent change of the auditor’s role to “trusted advisor” from a truly independent auditor reflecting a “separation between registered auditors and client management.” This shift in focus is somewhat attributable to the emergence of the PCAOB. Baker quotes University of Alabama Professor Thomas A. Lee, who defines independence as, “an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influence and pressures of conflicting interests.”

Also, the Committee reviewed the independence definitions of the International Federation of Accountants (IFAC) and the American Institute of Certified Public Accountants (AICPA).

The IFAC definition of independence is (bold emphasis added for discussion below):

- a. Independence of mind – the state of mind that permits the **expression of a conclusion** without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- b. Independence in appearance – the avoidance of **facts and circumstances** that are so **significant that a reasonable and informed** third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm’s, or a member of the audit or assurance team’s, integrity, objectivity or professional skepticism has been compromised.

The AICPA definition of independence is (bold emphasis added for discussion below):

- a. *Independence of mind* – The state of mind that permits the **performance of an attest service** without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
- b. *Independence in appearance* - The avoidance of **circumstances** that would cause a reasonable and informed third party, having knowledge of all relevant information, **including safeguards applied**, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

COMPARISON OF IFAC AND AICPA INDEPENDENCE DEFINITIONS

The Committee focused on the IFAC and AICPA definitions as potential models for a uniform definition of independence. Both definitions contain two parts: independence of mind and independence in appearance. The Committee elected to follow the AICPA definition. In the first paragraph, the AICPA's definition includes the phrase "performance of an attest service" as compared to "an expression of a conclusion" in the IFAC definition. Because accountants express opinions based on the performance of attest services, which then leads to conclusions, the Committee believes the AICPA definition more accurately describes the work of a CPA.

In the second paragraph, there are several seemingly small differences which evoked substantial discussion. The Committee began with the AICPA definition and discussed the differences. The first set of verbiage focused on was the words "facts and" before "circumstances." The Committee believes there is a substantive difference between "circumstances" and the phrase "facts and circumstances." The Committee then discussed the IFAC language of "significant that a reasonable and informed..." The Committee believes the word "significant" connotes an indefinite measure of precision which could be subject to different interpretations. For that reason the word was not included in the proposed definition.

In April 2006, the AICPA PEEC adopted its *Conceptual Framework for Independent Standards*. The framework includes a threats and safeguards approach to resolving independence issues not otherwise addressed in the AICPA *Code of Professional Conduct*. The Committee had a vigorous discussion about the use of the threats and safeguards approach. One of the concerns expressed about the use of safeguards was that some CPAs might rationalize threats so there would be few, if any, situations in which a CPA would not be considered independent. Additionally, the UAA *Model Rules*, Rule 10-4, Section VII, *Principle: Independence*, does not include the threats and safeguards language. For these reasons, the Committee has not recommended the retention of the threats and safeguards concept in the proposed definition.

A final modification was made in the second paragraph. The AICPA definition refers to "member" and not "licensee." The Committee considered using "licensee" instead of "member." However, the Committee believes the use of "licensee" would inadvertently imply independence is only required of individual CPAs. Consequently, the proposed definition emphasizes that the CPA firm and all engagement team members, including non-certified staff and non-CPA partners, must be independent. In this context, "member" refers to the engagement team and not enrollment in the AICPA.

The Committee also notes that there are other authoritative standard-setting bodies that promulgate independence requirements, e.g., SEC, GAO and DOL. There currently is not a specific UAA requirement to comply with the independence requirements of these other bodies. Rather than attempt to embody their additional requirements in a UAA definition of independence, the Committee believes specific acknowledgement of compliance with such additional requirements be considered elsewhere in the UAA. The AICPA Code addresses such circumstances in Rule 202, Compliance with Standards, of its *Code of Professional Conduct*, which effectively says compliance with these other bodies is required.

RECOMMENDATIONS

The Committee believes the following recommendations should be seriously considered:

1. Forward the following proposed uniform definition of independence to NASBA's UAA Committee for consideration.
2. Continue to work with other regulatory and private sector, standard-setting bodies to promote uniform independence standards.
3. Consider a specific UAA independence requirement to comply with standards promulgated by various other authoritative bodies.

PROPOSED UNIFORM DEFINITION OF INDEPENDENCE

Independence is comprised of both of the following:

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

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

APPENDIX REFERENCES

Baker, Richard. *The Varying Concept of Auditor Independence*, The CPA Journal, August, 2005, <http://www.nysscpa.org/cpajournal/2005/805/infocus/pzz.htm>

Asher, Bernard and Foer, Albert A. *Financial Reform and the Big 4 Audit Firms*, The American Antitrust Institute, January 2010, bascher@antitrustinstitute.org

AICPA Code of Professional Conduct, 2009, ET§100.01

Code of Ethics for Professional Accountants, July 2009, International Federation of Accountants, (IFAC)

Uniform Accountancy Act, Model Rules, April 24, 2009

Government Audit Standards, 2007

Report to the Treasury Committee from the Institute of Chartered Accountants in England & Wales, March 28, 2002.