MEMO# 11375

November 2, 1999

ISB DISCUSSION MEMORANDUM ON AUDIT FIRM STRUCTURE

[11375] November 2, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 41-99 SEC RULES COMMITTEE No. 90-99 RE: ISB DISCUSSION MEMORANDUM ON AUDIT FIRM STRUCTURE ____ The Independence Standards Board recently issued the attached Discussion Memorandum (Memo or DM) on the changing nature of audit firm structure and the related threats to auditor independence. The DM is intended to be a neutral discussion document designed to foster public participation in the ISB's study of the structure and organization of businesses providing auditing services to public companies and the implications for auditor independence. The memo is the first step in a process that will lead to issuance of formal guidance to preserve auditor independence when auditors are involved in new firm structures. Also attached is letter from the ISB Chairman to "Senior Management of U.S. Institutional Investors" seeking buy-side participation in the standard setting process. Comments on the DM must be filed with the ISB by December 31, 1999. If you have any ideas or suggestions that you would like the Institute to consider including in a possible comment letter, please provide them to me by phone (202/326-5851) or e-mail (smith@ici.org) no later than December 3. Background Traditionally, audit firms have been organized as partnerships with individual partners bearing responsibility for the conduct and supervision of audit engagements. Existing independence rules apply to firm members (i.e., firm partners, managerial employees in an office participating in the engagement, and individuals providing professional services to the audit client). Recently, new firm structures and relationships with other entities have raised questions as to the appropriate application of the restrictions designed to protect auditor independence. For example, a public accounting firm may place its non-audit businesses in a subsidiary and sell a portion of the subsidiary in a public offering. Another evolving firm structure involves the sale of non-audit businesses to a corporate purchaser. In these transactions, the audit business often remains in a partnership owned and operated by the original partners, who become employees of the corporate purchaser. Another form of organization involves combining several audit firms under a holding company, which then sells shares in a public offering. The holding company may also have subsidiaries engaged in other business, such as insurance or securities. Potential Threats to Auditor Independence The DM describes a set of threats to auditor independence that result from relationships between auditors and other individuals and entities, who in turn have relationships with the auditor's audit clients. These other individuals and entities may include the auditor's corporate employer, or entities that own shares in the audit firm or its subsidiaries (together referred to as Related Parties). For example, the Memo indicates that a Related Party could attempt to influence the auditor to allow an audit firm client favorable accounting treatment or to influence an audit opinion because of: (i) a loan to or a personal or corporate investment in a firm audit

client; (ii) a personal or corporate business venture with a firm audit client; or (iii) a family relationship with someone at a firm audit client. Also, the auditor could be placed in a position of auditing the results or value of a product or service a Related Party sold to an audit firm client. These emerging forms of firm structure raise the question of when and to what extent should auditor independence rules be applied to Related Parties. Investment Company Issues A potential threat to auditor independence in these structures is that the auditor might end up auditing the value of an investment held by an audit client in his audit firm (or the firm's parent or subsidiary) or corporate employer (referred to as "Firm or Employer Securities"). The DM notes that substantial investment by an audit client in Firm or Employer Securities would enable the client to exert influence over the firm or employer and place the auditor in an untenable situation. The DM seeks comment on whether immaterial audit client investment in Firm or Employer Securities constitutes a threat to auditor independence. Should independence rules proscribe investments by audit clients in Firm or Employer Securities (i.e., a "zero tolerance" rule), or alternatively, should investments in immaterial amounts be permitted? The DM describes a related situation where the audit client is a public corporation and asks whether the corporation and its officers and directors should be permitted to invest in mutual funds that hold Firm or Employer Securities. Do these indirect holdings of Firm or Employer Securities by the audit client corporation, its officers and directors, constitute a threat to the auditor's independence? How would a zero tolerance rule apply to index funds where Firm or Employer Securities are part of the index the fund seeks to replicate? Gregory M. Smith Director - Operations/ Compliance & Fund Accounting Attachments

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