

DRAFT DISCUSSION PAPER

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PROPOSED UNIFORM DEFINITION OF INDEPENDENCE

Submitted by:

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The NASBA Ethics and Strategic Professional Issues Committee studied the issue of a uniform definition of independence as a charge from Billy Atkinson, Chair of NASBA. As the committee began to survey the jurisdictions and various regulatory bodies we identified several reasons for a uniform definition of independence:

- The US Treasury’s Advisory Committee on the Auditing Profession recommended that independence and ethics standards be harmonized to the extent possible by regulators.
- In order for the CPA profession to maintain its long standing self-regulating feature, it is necessary for Boards of Accountancy to be proactive in developing clear independence guidance. If not, the profession could become increasingly regulated by congressionally mandated laws such as the Sarbanes-Oxley Act of 2002 which established the Public Company Oversight Board (PCAOB).
- Since nearly all of the 55 jurisdictions of NASBA 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 & 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 Appendix A. 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 exceptions there would typically be 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 in the role of the auditor from “trusted advisor” to a truly independent auditor which reflects 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:

- (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:

- (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.

and
- (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

Through conference calls, our committee focused on the IFAC and AICPA definitions as potential models for a uniform definition of independence. Both definitions contained two parts: independence of mind and independence in appearance. The committee elected to follow the AICPA definition. In the first paragraph the AICPA has the phrase "performance of an attest service" as compared to "an expression of a conclusion" in the IFAC definition. Since accountants express opinions based on the performance of attest services which then leads to conclusions, the committee believed the AICPA definition more accurately describes the work of a CPA.

In the second paragraph, there were several seemingly small differences which evoked substantial discussion. The committee began with the AICPA definition and discussed the differences. The first small change was to include the words "facts and" before "circumstances." The committee believed there is a substantive difference between "circumstances" and the more concise 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.

The committee then had its most significant debate about the omission of the phrase "including the safeguards applied..." from the committee's proposed definition. One of the committee's concerns with the safeguards approach, was that some CPAs could rationalize away threats so there would be few, if any, situations in which a CPA would not be considered independent by applying the safeguards. Additionally, in the UAA Model Rules, Rule 10-4, Section VII, "Principle: Independence," does not include the threats and safeguards language. For these reasons the committee also did not include a reference to the threats and safeguards concept.

Another change in the second paragraph considered by the committee would have changed the word “member” to “licensee.” The committee concluded the use of “licensee” could potentially imply that independence would only apply to CPAs. Consequently, a change was made to emphasize all engagement team members, whether a younger non-certified staff person or a non-CPA partner must be independent.

The final paragraph of the proposed definition was modeled after reviewing the State of Texas board’s rule on independence. The Texas rule indicates the application of their rule is based on requirements of the standard as of the date the conduct is being evaluated. The final sentence was added in an attempt to have an effective date that did not require a rule change every year (we noted that some states reference dates as old as 1997 in their independence rules).

Recommendations

1. We recommend NASBA forward the following uniform definition of independence to the NASBA UAA Committee for consideration.
2. We recommend NASBA continue to work with other regulatory and private sector, standard-setting bodies to promote uniform independence standards.

Proposed Uniform Definition of Independence

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.

A licensee engaged in the practice of public accountancy shall conform in mind and appearance to the independence standards adopted by the Board, and/or, where applicable, the U.S. Securities and Exchange Commission (SEC), the Government Accountability Office (GAO), the Public Company Accounting Oversight Board (PCAOB), and other national or international regulatory or professional standard setting bodies. The application of any such standard to a firm or licensee’s conduct shall be based on the requirements of the standard as of the date of the conduct being evaluated.

Appendix References

Baker, Richard. 2005. "The Varying Concept of Auditor Independence", The CPA Journal, August, <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