Important Note: The Securities and Exchange Commission recently released a comprehensive revision to its auditor independence requirements (the Revision). The Revision contains provisions covering settlement of capital and retirement interests when former firm professionals join firm audit clients, which supercede the requirements described in paragraph 2.b.iv of this standard. Consequently, at the next ISB meeting, the ISB staff will recommend that the Board delete paragraph 2.b.iv of this standard. All other provisions of this standard remain in effect. The Revision can be found at the SEC's website at www.sec.gov.

Independence Standard No. 3

Employment with Audit Clients

July 2000

ISB

Independence
Standards
Board

Independence Standards Board Standard No. 3

Employment with Audit Clients

July 2000

SUMMARY

This standard describes safeguards that firms should implement when their professionals join firm audit clients. These safeguards are designed to assist in ensuring that:

- professionals who are broadly evaluating their career options will exercise an appropriate level of skepticism while performing audits prior to their departure from the firm;

- a former firm professional now employed by the client cannot circumvent the audit because of familiarity with its design, approach, or testing strategy; and

- the remaining members of the audit team maintain objectivity when evaluating the work and representations of a former firm professional now employed by the audit client.

The procedures should be adapted depending on several factors, including whether the professional served as a member of the audit team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.

The standard also specifies the circumstances under which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.

The standard's requirements are effective for employment with audit client situations arising after December 31, 2000.

Employment with Audit Clients

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Independence Standards Board Standard No. 3

Employment with Audit Clients

STANDARD

Underlying Principle

1. An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.

Safeguards

2. An established program of safeguards including the following procedures, when conscientiously administered, is deemed to constitute steps that effectively eliminate the risk of independence impairment:

a. Pre-change in employment safeguards:

i. Firm professionals are required promptly to report to the firm conversations between themselves and an audit client respecting possible employment.

ii. Firm professionals engaged in negotiations respecting possible employment with an audit client are immediately removed from the audit engagement.

iii. Upon removal of a professional from the audit engagement as provided above, the firm reviews the professional's work to assess whether he or she exercised appropriate skepticism while working on the audit engagement.

b. Post-change in employment safeguards:

i. If a professional accepts employment with the audit client, the on-going engagement team gives active consideration to the appropriateness or necessity of modifying the audit plan to adjust for risk of circumvention.

ii. When a former firm professional joins an audit client and will have significant interaction with the audit team, the firm takes appropriate steps to provide that the existing audit team members have the stature and objectivity to effectively deal with the former firm professional and his or her work.

iii. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the next following annual audit is separately reviewed by a firm professional uninvolved in the audit to determine whether the remaining engagement team maintained the appropriate skepticism when evaluating the representations and work of a former firm professional. The extent of this review should be tailored based on the position that the former professional has assumed at the audit client and other facts and circumstances that would heighten or mitigate threats to independence.

iv. The firm requires the prompt (1) liquidation of all capital balances of former firm partners who become employed by an audit client; (2) settlement[1] of all retirement balances[2] of former firm professionals who become so employed that are not both immaterial to the firm and fixed as to amount and timing of payment; and (3) settlement of retirement balances of any firm professional, regardless of the financial immateriality of such balances to the firm, when, within five years of disassociating from the firm the identity of such former firm professional as an officer or employee of the audit client is required to be disclosed in the audit client's proxy statement or annual report filed with the Securities and Exchange Commission (SEC) pursuant to its regulations.

Effective Date

3. The above requirements are effective for employment with audit client situations arising after December 31, 2000.

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[1] In the United States, the payment of retirement benefits to the individual would immediately subject such benefits to income taxes. In some cases, this tax liability can be deferred by transferring the remaining retirement benefits to an Individual Retirement Account or similar vehicle, in which case the amounts become taxable only when paid to the individual. In other cases, the amount can be transferred to a "Rabbi Trust" which also serves to defer such income taxes. A Rabbi Trust is an irrevocable trust whose assets are not accessible to the firm until all benefit obligations have been met; however, such assets are subject to the claims of creditors in the event of the firm’s bankruptcy or insolvency. To meet the requirements of this standard, such a trust can only be used if the amounts are fixed as to amount and timing of payment (i.e., the benefits do not fluctuate based on firm results, and the present value of benefits due to the departing professional can be calculated and placed in the trust), and the bankruptcy of the firm is considered remote.

[2] Retirement balances as used in this statement do not include a professional’s benefits under the firm’s defined contribution plan, such as a 401(k) plan, if the firm has no obligation to fund the individual’s benefits after he or she disassociates from the firm.

BACKGROUND

4. The Board began to study the independence implications of audit firm professionals going to work for the firm's audit clients shortly after its formation. After determining that guidance was needed in these situations, the Board began the process of developing a standard concurrent with its work on a conceptual framework for auditor independence.

5. A Discussion Memorandum (DM 99-1, *Employment with Audit Clients*) covering the issues was prepared with the assistance of a Board oversight task force, and a broad-based project task force consisting of representatives from the investor, preparer, academic, and regulator communities, in addition to members of the auditing profession. The DM was released in March 1999 for a 90-day comment period. Comment from investors was specifically sought; the DM was mailed to several investor organizations and to 370 institutional investors in an effort to encourage responses from that constituency. Twenty-eight comment letters were received. After considering these letters, and with further assistance from the project and Board oversight task forces, the Board developed a proposed standard for public comment.

6. An Exposure Draft (ED) of the proposed standard was released at the end of December 1999 with a comment period that ended on February 29, 2000. Copies of the ED were mailed to a variety of individuals and groups, including those representing investors, to encourage and solicit responses. Fourteen comment letters were received. After considering these comments, and with further assistance from the project and Board oversight task forces, the Board approved the issuance of this standard.

THREATS TO INDEPENDENCE

7. The concerns expressed when professionals leave firms to join audit clients are generally threefold:

   a. That partners or other audit team members who resign to accept positions with audit clients may not have exercised an appropriate level of skepticism during the audit process prior to their departure.

   b. That the departing partner or other professional may be familiar enough with the audit approach and testing strategy so as to be able to circumvent them once he or she begins employment with the client.

   c. That remaining members of the audit team, who may have been friendly with, or respectful of a former partner or other professional when he or she was with the firm, would be reluctant to challenge the decisions of the former partner or professional and, as a result, might accept the client's proposed accounting without exercising appropriate skepticism or maintaining objectivity.

8. The perceived threats to auditor independence when the former partner or professional has retirement benefits or a capital account with the audit firm are as follows:

   a. It may appear that ties between the audit firm and the partner or other professional have not been severed – that the firm has placed its "own man" (or woman) at the client, functioning as management, and is in effect auditing the results of its own work.

   b. If the retirement benefits of the former partner or other professional vary based on the firm's profits, then the former partner or other professional may be inclined to pay the firm higher fees to inflate his or her retirement benefits (or to increase the likelihood of receiving benefits in unfunded plans). As a result, the firm may be less rigorous in its scrutiny of the client's accounting policies because its fees are overly rich.

   c. If the former partner's or other professional's unfunded retirement benefits or other monies held by the firm are material to the firm and the firm is experiencing cash flow problems, the firm may be less rigorous in its audit of the client's financial statements in exchange for forbearance on the amounts owed to the former partner or other professional.

BASIS FOR CONCLUSIONS

9. The Board's desire is to protect the quality and integrity of audited financial statements for the ultimate benefit of investors and other users of those statements. To accomplish this goal, the Board weighed a variety of factors, some of which are described below, in determining an appropriate approach to address the threats to auditor independence posed by situations where firm professionals join audit clients.

Effectiveness of Safeguards

10. The Board believes that the safeguards described in this standard will effectively protect auditor independence in situations where firm professionals go to work for their audit clients. A requirement to review an individual's work after he or she enters into employment negotiations with an audit client and, when appropriate, review the engagement team's work on the subsequent audit, is expected to have a deterrent effect. First, the expectation is that professionals who are broadly evaluating their career options will be more careful to ensure that the work they perform, including the decisions they make during the audit, will withstand scrutiny when they know it will be subject to a special review if they enter into employment negotiations with the audit client. Second, the skepticism of the remaining audit team members when evaluating the statements of a former colleague or leader may be higher; knowing that their work will be reviewed, individuals will most likely be more sensitive to appearing to have acquiesced to a client's aggressive or incorrect accounting, and will be more likely to refrain from doing so.

11. Open discussion of the client's employment of audit firm professionals with the audit committee or board of directors, as required in certain circumstances by ISB Standard No. 1, *Independence Discussions with Audit Committees*, can also serve as an effective safeguard. Airing, "in the sunshine," the potential threats to independence posed by these situations, and the safeguards employed by the firm to protect auditor independence, is likely to sensitize those involved (both the former firm professional now with the client and the remaining audit team) to these issues, and make independence impairments less likely. In addition, while auditors are responsible for upholding their own professional standards, including those related to independence, the audit committee can "set the tone at the top," and emphasize the proper separation between management and the auditor.

12. In developing the standard, the Board allowed for flexibility in adapting the safeguards to the facts and circumstances of the employment situation. The Board believes, for example, that the concerns one would have when a partner joins a client would exist, but to a lesser extent, when professionals with lower levels of responsibility join clients. These concerns would also vary depending on the nature and level of responsibilities assumed by the professional in his or her new role at the client. In addition, the issues may vary for active versus retired partners and other professionals, those leaving the firm voluntarily

versus those terminated, and *engagement* professionals versus firm professionals having little or no direct prior professional relationship with the client. Therefore, the Board believes that an effective standard must establish principles that contemplate a variety of situations, especially as the structure of firms change, and more professionals are given new responsible, non-partner roles in firms.

13. The safeguards proposed in the ED contemplated a review of the former firm professional's work upon employment by the audit client. After further consideration, the Board determined that the trigger for this review should be instead the commencement of employment negotiations between the firm professional and the audit client. The Board believes that the concerns about the work of an audit team member contemplating employment with his or her audit client would exist regardless of whether the firm professional eventually accepted a position at the client. Audit team members in employment negotiations with an audit client should be returned to the engagement only if negotiations cease and employment is no longer sought.

14. When a former firm professional joins an audit client within one year of disassociating from the firm and the professional has significant interaction with the audit team, the standard requires an additional review of the next annual audit following the professional's acceptance of employment. This review is meant to determine whether the audit team had an appropriate level of skepticism when evaluating the work and representations of the former firm professional. Some asked whether such a review should always be performed prior to the firm's "sign-off" on the audit. The Board concluded that the primary benefit of the review is its deterrent effect. That is, members of the audit team, knowing that their work will be subject to an additional review, will be less likely to acquiesce to questionable client proposals. Further, mandating such a review prior to issuance of the audit report could result in deferring for a significant period of time release of the audited financial statements. Such a delay could impose a significant cost to users of financial statements and the Board did not consider the additional benefits, if any, of a pre-issuance review to justify such costs.

Peer Review

15. The ED proposed a requirement that firms have their compliance with the provisions of the standard evaluated in a peer review. The Board believes that peer review of firms' compliance with all auditing and quality control standards, including independence standards, is an important component of the profession's self-regulation. The Board ultimately concluded, however, that the scope or content of established peer review programs should be left to those that administer them, and that mandating participation in such a program should be left to other groups in the profession's regulatory system.

Settlement of Financial Interests

16. The Board considered the necessity of a "full-payout" requirement in situations where capital account and retirement obligations are immaterial to the firm, and fixed as to amount and timing of payment. The Board believes that a former partner of an audit firm who is employed by the firm's audit client should not remain an equity investee in the firm. Accordingly, the standard requires the firm to liquidate all capital accounts prior to the employment of the professional by the audit client, regardless of their materiality.

17. With respect to retirement obligations, the standard requires the firm to settle such obligations prior to employment by the client in all situations where a professional's benefits are not immaterial to the firm, and fixed as to amount and timing of payment. The Board concluded, however, that retirement obligations owed to a former professional that *are* both fixed and immaterial to the firm are not likely to impinge on the firm's independence. On the other hand, it recognized that unsettled amounts may present an "appearance" concern when a former firm professional joins an audit client in a visible position where his or her former employment at the client's audit firm is likely to be disclosed or known. Therefore, the standard mandates settlement of even immaterial retirement obligations when a former firm professional joins an audit client within five years of disassociating from the firm in a position where his or her name is required to be disclosed in the company's proxy statement or annual report to the SEC. However, because the character of retirement benefits is different from capital balances, the Board concluded that settlement of retirement obligations could be done through a "Rabbi Trust" or similar vehicle in certain circumstances.

18. In reaching its conclusions regarding retirement balances, the Board was concerned that a requirement to settle all obligations could create significant tax or other liabilities for the departing partner in either the United States or in a foreign country. In addition, such a requirement might jeopardize the tax status of certain qualified plans if all plan participants were not treated equally. Such a result could serve to either actively discourage the partner from accepting the employment position, require the client to engage a new audit firm, or drive firms to reduce benefits provided under its plans because of accelerated funding requirements. The Board did not believe such consequences were in the public interest except for benefits that were not both fixed and immaterial to the firm, and in the limited circumstances involving former partners identified in an SEC filing, as described in paragraph 2(b)(iv).

19. Some expressed concern that a former firm professional could join a large, multinational audit client several years after leaving the firm, perhaps at a foreign location. In these circumstances, it is possible that the firm would not be aware of the former professional's new position at the audit client, and may not have liquidated capital balances, or retirement benefits that are not both immaterial and fixed. The Board does not intend that an inadvertent and isolated failure to comply with these settlement provisions be deemed an impairment of independence. It does expect, however, that firms will impose conditions on former professionals who have remaining capital accounts or

other than immaterial and fixed retirement benefits with the firm. One of those conditions should be to advise the firm when they are contemplating a change in employment, to allow the firm to determine if the new employer is a client subject to this standard. These arrangements should eliminate the need to implement elaborate and burdensome partner and employee tracking systems to comply with the provisions of the standard – a concern of some of the respondents to the ED. However, any inadvertent failures to comply should be corrected as soon as identified.

20. In reaching these conclusions, the Board considered making several distinctions, suggested by respondents to the DM, in determining when standards should require a full-payout of retirement benefits. These respondents suggested that a settlement requirement distinguish between defined contribution plan benefits and defined benefit plan benefits, fully funded benefits versus unfunded amounts, fixed benefits versus those that vary based on profits, and other criteria. The Board concluded that benefits which are other than immaterial to the firm, or that vary based on, for example, firm profitability, should always be settled, regardless of the amount of time that has elapsed since the professional's departure from the firm. In addition, the Board concluded that the settlement requirement should not extend to defined contribution plan benefits such as those in a 401(k) plan if the firm has no ongoing obligation to fund the individual's benefits.

The Board's Consideration of a Mandated Cooling-Off Period

21. In studying these issues, the Board considered and rejected a mandated "cooling-off period" – a rule deeming an impairment of the firm's independence when certain firm professionals join an audit client. The Board concluded the costs of such a rule would exceed its benefits.

22. A cooling-off approach would mean either deeming independence to be impaired if *any* firm professional accepted an employment offer from an audit client, or specifying which types of persons would be included in such a rule and which would not. The former course seemed unnecessary, and the latter very complex or arbitrary, since the types of individuals who might represent threats would presumably depend upon their positions in the firm, their roles in the audit, and the positions they would be assuming at the audit client. Generalizing when that combination might constitute a threat to auditor independence and when it would not seemed to be a daunting task which should not be undertaken when an effective alternative is available.

23. The Board believes that with the appropriate safeguards in place, as called for by this standard, the threats to auditor independence are slight. In addition, the Board believes that the benefits to society and the profession of allowing firm professionals to accept employment with audit clients, without fear of jeopardizing their former firm's independence, outweigh the costs. In reaching this conclusion, the Board recognizes that a mandatory cooling-off period may promote the <u>appearance</u> of independence more completely, and might *eliminate* the risk that the audit team could be unduly influenced by a

former colleague, but it believes the differences in actual threats to independence under the two approaches are insignificant.

24. The Board recognizes that the attraction of future employment opportunities draws talented and ambitious recruits to the profession. Turnover at public accounting firms can be quite high, and many recruits do not intend to stay long enough to be promoted to partner. Furthermore, they join public accounting firms because of the broad experience they expect to gain at the firm, and the contacts they expect to make in industry. In addition, turnover within the partner ranks has increased in the last few years. If the future employment prospects of recruits and experienced auditors now working for audit firms were limited by a mandated cooling-off period, the Board is concerned that the caliber of professional attracted to public accounting might decline.

25. The Board agreed with several corporate officials and others responding to the DM who argued that companies benefit from the ability to hire staff at all levels from their audit team. An auditor who has worked for several years on an engagement is often thoroughly familiar with the client's systems, and knows most of the client's key people and their responsibilities. Beyond familiarity with the hiring company, the auditor brings broad experience "to the table" from working at a variety of companies, and sometimes in a variety of industries. In addition, partners and professionals in public accounting firms are generally recognized as experts in accounting, financial reporting, and internal control matters – skills needed by companies with financial reporting responsibilities to investors.

26. A mandated cooling-off period might force a client to choose between, for example, its audit partner and its audit firm, knowing that if the partner was hired, the audit firm would have to be replaced. The Board recognizes that replacement of an audit firm carries costs to firms, clients, and investors. There is a learning curve on a first-year audit; auditors spend significantly more time and resources on them (developing audit programs, familiarizing themselves with the system of internal controls, etc.), and client personnel spend more time answering the auditors' questions and producing documentation previously provided to the prior auditors. And because the Board believes that audits are strengthened by institutional continuity, rotation of auditors and the increased risk that the first-year audit poses carries a cost to investors.

27. The Board acknowledges the counter-argument that a fresh look by a new audit team may carry some benefits that cannot be achieved with the same audit team and approach year after year. The consideration of a requirement that companies change audit firms periodically, however, is beyond the scope of this project.

28. The Board also concluded that a restriction on hiring former audit partners or other professionals may be a heavier burden to smaller corporations in need of the accounting expertise provided by someone familiar with their business and industry, and to smaller firms. Smaller corporations may be at a

disadvantage in recruiting personnel when competing with larger companies with strong national or regional name recognition. Restricting these smaller companies from hiring directly from their audit firm (from among those who know the company well) may hurt them disproportionately.

29. Professionals from smaller accounting firms may face the same difficulties when competing in the job market with professionals from large, well-known firms. A rule that impairs the ability to go from an audit firm directly to a client, where management knows you and you have had a chance to demonstrate your abilities, may be more of a burden if you work for a smaller firm.

30. Finally, the Board concluded that a mandatory cooling-off period would be ineffective in preventing fraud or collusion between the auditor and client. If the firm professional and client management were intent on committing fraud, the professional might remain with the firm rather than risk turning the engagement over to another individual who may uncover the conspiracy. In addition, if management wanted to compensate a firm professional for his or her role in a fraud, a ban on hiring the professional for a certain period of time would not prevent the company from providing payments to the professional, after he or she resigns from the firm, via consulting contracts or other means.

Other Matters

31. The Board concluded that the threats to auditor independence described in this standard are in many respects different from those that arise when former firm professionals are elected as non-executive members of the Board of Directors. Existing rules cover these non-executive director situations and remain in effect.

32. This standard was adopted unanimously by the Board.