ISB

Independence
Standards
Board

Staff Report

A Conceptual Framework for Auditor Independence

July 2001

Henry R. Jaenicke
Drexel University
Alan S. Glazer
Franklin & Marshall College
Arthur Siegel
Independence Standards Board
Susan McGrath
Independence Standards Board
Richard H. Towers
Independence Standards Board
Thomas W. Dunfee
University of Pennsylvania

This conceptual framework reflects the conclusions of the authors. The Board approved and issued an Exposure Draft of a Statement of Independence Concepts, but before having an opportunity to review the comments received and to issue a final document, events led to the dissolution of the Board. Had the Board met to consider this document, it might have made substantive changes before adopting it as a Statement of Independence Concepts. The Board did, however, authorize the issuance of this document as a staff report. This document is the conceptual framework that the authors would have recommended the Board adopt as a Statement of Independence Concepts.

Date: July 30, 2001

To: Interested Parties

From: William T. Allen

The Independence Standards Board was formed in 1997 with the mission "to establish standards applicable to audits of public companies in order to serve the public interest and to protect and promote investors' confidence in the securities markets." One of its objectives was to:

> Develop a conceptual framework for independence applicable to audits of public companies which will serve as the foundation for the development of principles-based independence standards.

To assist in developing a conceptual framework, the Board engaged Henry R. Jaenicke, the C.D. Clarkson Professor of Accounting at Drexel University, to serve as Director of the project, and Alan S. Glazer, Professor of Business Administration at Franklin & Marshall College, to serve as Associate Director. Professors Jaenicke and Glazer worked with Arthur Siegel, Susan McGrath, and Richard H. Towers of the ISB staff, a broad-based project task force formed to advise on the project, a Board-oversight task force, and the Board itself. Professor Thomas W. Dunfee, the Joseph Kolodny Professor of Social Responsibility and vice-dean for the undergraduate division of the Wharton School at the University of Pennsylvania, also assisted on the project. During the course of the project the Board issued a discussion memorandum on auditor independence (DM) and an exposure draft of a Statement of Independence Concepts (ED). On July 9, 2001, the Board with the concurrence of the SEC and the AICPA passed a resolution of dissolution effective July 31, 2001. At that meeting, the Board also directed the staff of the ISB to complete its present work on the draft of the conceptual framework and to make that draft publicly available.

The conceptual framework presented here represents the draft of a Statement of Independence Concepts that Professors Jaenicke, Glazer and Dunfee and the ISB staff submit for that purpose. The document reflects the thinking of the staff, informed by:

- Board deliberations and its preliminary conclusions reflected in the DM and the ED;
- comments received from respondents on the DM and ED; and
- input from the project task force, the Board oversight task force, and other interested parties on drafts of the DM and ED as well as on an earlier draft of this document.

Of course, had the Board met to consider this document, it might have made substantive changes before authorizing its issuance as the Board's Statement of Independence Concepts. Nevertheless in its present state I am confident that this staff document will make a substantial contribution to members of the accounting profession and others who will in the future be required to grapple with the issues that arise from a reflective consideration of auditor independence.

A Conceptual Framework for Auditor Independence

SUMMARY

This document describes a conceptual framework for auditor independence to be used:

- as a foundation for developing principles-based independence standards,
- as a guide for resolving independence issues in the absence of standards or other rules, and
- as a resource to help investors, other users of financial information, and other interested parties better understand how the independence of auditors contributes to audit quality.

The framework contains four interrelated components: a definition of auditor independence, a goal of auditor independence, concepts, and basic principles.

The framework defines auditor independence as both (a) independence of mind—freedom from the effects of threats to auditor independence that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind. Compliance with rules and regulations governing auditor independence is necessary, but may not be sufficient, for an auditor to be considered independent under the definition. An auditor also must be able, and well-informed investors and other users must expect the auditor to be able, to overcome the effects of threats that would compromise objectivity.

Rather than focusing on independence as an end in itself, the framework describes the goal of auditor independence as helping to ensure quality audits in order to support investors' and other users' reliance on the financial reporting process and facilitate the optimal allocation of capital.

The concepts of auditor independence described in the framework comprise a risk model for auditor independence:

- Threats to auditor independence are pressures and other factors that impair an auditor's objectivity. The framework discusses five types of threats to auditor independence—self-interest, self-review, advocacy, familiarity (or trust), and intimidation—that may be posed by various activities, relationships, or other circumstances.
- Safeguards to auditor independence are controls that mitigate the effects of threats. The framework provides examples of safeguards that exist in the present audit environment or that could be put in place in response to threats to auditor independence.
- Independence risk is the likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users. The significance of a threat is the extent to which the threat increases

independence risk and the effectiveness of a safeguard is the extent to which the safeguard decreases independence risk. The framework provides examples of factors that affect the significance of threats and the effectiveness of safeguards.

The basic principles serve as guidelines to assist individuals and organizations that make independence decisions in analyzing independence issues in a wide variety of circumstances.

- Independence decision makers should consider the level of independence risk by analyzing the types and significance of threats to auditor independence and the types and effectiveness of safeguards, assess whether the level of independence risk is acceptably low, and apply appropriate safeguards if it is not. The framework specifies that only a very low level of independence risk should be considered acceptable.

- Independence decision makers should conclude that the benefits of reduced independence risk from applying safeguards exceed their costs. Although the benefits of reduced independence risk and the cost of safeguards are often difficult to identify and quantify, independence decision makers should consider them when assessing the acceptability of the level of independence risk.

- Independence decision makers should consider the views of investors, other users, and others with an interest in the integrity of financial reporting when considering the level of independence risk, when assessing its acceptability, and when considering the costs and benefits of applying safeguards.

A Conceptual Framework for Auditor Independence

Contents

A Conceptual Framework for Auditor Independence

INTRODUCTION—SCOPE AND CONTENT

1. The principal purposes of this conceptual framework for *auditor independence*[1] are:
   a. to help the Independence Standards Board (ISB or Board) meet its responsibilities to set sound and consistent standards by providing direction and structure for resolving independence issues;
   b. to assist other *independence decision makers* in resolving questions about independence;
   c. to help investors, other *users* of financial information, and other interested parties understand the nature, significance, and limitations of auditor independence; and
   d. to focus debate and provide a common language for discussions about auditor independence issues, thereby helping interested parties contribute to the development and application of and better understand the rationale and process underlying, ISB standards.

2. This conceptual framework does not establish rules for auditor independence. Rather, it specifies various components—a definition, a goal, concepts, and basic principles—that together form a conceptual framework. This framework serves as a foundation for the Board to develop principles-based standards to clarify and improve authoritative guidance and current practice. The framework also should assist other independence decision makers in analyzing and reaching conclusions about what is acceptable in the absence of applicable authoritative guidance. The Board expects, over time, to identify and reconsider any existing authoritative guidance that conflicts with this framework. Until any required changes are made, the framework should not be used to justify departures from existing guidance. Appendices to this framework describe the major steps in developing the conceptual framework and the basis for the conclusions expressed in it.

DEFINING AUDITOR INDEPENDENCE

3. *Quality audits* improve the *reliability* and enhance the *credibility* of the financial reporting process, thereby contributing to its usefulness and to the optimal allocation of capital, which serves the public interest. Quality audits are audits performed in accordance with generally accepted auditing standards (GAAS). These standards provide guidance in making significant decisions regarding planning the audit, gathering evidence, and communicating and reporting audit findings. The exercise of sound judgment is an important feature of GAAS, and independence helps ensure that an auditor has the requisite *objectivity* when making significant audit decisions.

4. The quality of an audit depends on many factors, including the personal attributes that individual auditors bring to an engagement, the policies and procedures of the auditing firms in which they work, and the attitudes and actions of the management of those firms, sometimes

[1] Words and phrases defined in the Glossary are set in *italic type* the first time they are used in the conceptual framework.

referred to as the "tone at the top." In addition, various self-regulatory and public regulatory bodies help ensure audit quality. The independence of auditors and the controls that help ensure their independence are only one source, albeit an important source, of quality audits.

5. **Auditor independence is both (a) independence of mind—freedom from the effects of *threats to auditor independence* that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.**[2]

6. The definition of auditor independence recognizes that auditor independence has two dimensions—independence of mind and independence in appearance. Independence of mind is a personal attribute of an auditor that cannot be directly assessed by investors and other users. The definition, therefore, also includes independence in appearance, which is the absence of those activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor's objectivity is compromised.

7. The definition clarifies that an auditor need not be free from all threats that may impair[3] an auditor's objectivity. *Safeguards to auditor independence* may mitigate the effects of threats by eliminating the threats themselves—by prohibiting the activities, relationships, or other circumstances from which threats arise—or by lessening the severity of their effects by other means. Independence requires an auditor to be free only from the residual effects of those threats, after the application of safeguards, that are at a level sufficient to compromise, or that well-informed investors or other users reasonably would conclude is sufficient to compromise, an auditor's objectivity. That level represents a threshold that distinguishes between when an auditor is independent and when an auditor is not.

8. Threats that may compromise an auditor's objectivity arise both from a wide variety of activities, relationships, and other circumstances as well as from various personal qualities and characteristics of auditors that may be sources of bias. Regulatory and standard-setting bodies issue authoritative guidance that limits or proscribes certain activities, relationships, and other circumstances because they believe that those activities, relationships, and other circumstances represent potential sources of bias for auditors generally, even though some individual auditors may be impervious to the effects of the threats that arise in those circumstances. Authoritative guidance applies to all auditors because regulatory and standard-setting bodies believe that it is reasonable to expect that an auditor's objectivity will be compromised in those circumstances. Authoritative guidance is designed to help ensure independence of both mind and appearance. Accordingly, noncompliance with authoritative guidance might not preclude a particular auditor from being objective, but it would preclude the auditor from being independent.

[2] The components of the conceptual framework are set in **boldface type**.
[3] As used in this conceptual framework, an auditor's objectivity is "impaired" if it is negatively affected to any degree; objectivity is "compromised" if the impairment rises to the level of precluding unbiased audit decisions.

9. The definition, however, means that auditor independence is more than just compliance with authoritative guidance—not every threat that may be a source of bias or that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks objectivity can be identified and covered by a rule. To be independent, an auditor must be able, and a reasonable well-informed investor or other user would expect the auditor to be able, to overcome the effects of threats that would compromise objectivity. Accordingly, even if existing authoritative guidance permits, or does not limit or forbid, a particular activity, relationship, or other circumstance—for example, auditing a company in which the chief financial officer is the auditor's close friend—an auditor is not independent if his or her objectivity is compromised, or if well-informed investors and other users reasonably would conclude that there is an unacceptably high risk that the auditor's objectivity is compromised as a result of that activity, relationship, or other circumstance. In other words, compliance with authoritative guidance is a necessary, but may not be a sufficient, condition for independence.

10. Assessing the independence of auditors requires independence decision makers to consider:

- a. threats that might result in the inability to be objective and the significance of those threats;
- b. safeguards that might reduce the impact of those threats and the effectiveness of those safeguards; and
- c. the likelihood that an auditor's objectivity would be compromised by the effects of unmitigated threats, or reasonably would appear compromised to well-informed investors and other users—defined in this framework as *independence risk*.

These concepts are discussed in paragraphs 14-24. Resolving auditor independence issues also requires independence decision makers to consider how best to meet the goal of auditor independence.

GOAL OF AUDITOR INDEPENDENCE

11. **The goal of auditor independence is to support reliance on the financial reporting process by investors and other users and to facilitate the optimal allocation of capital.**

12. The focus of the goal is on independence as one aspect of quality audits—audits that improve the reliability and enhance the credibility of the financial reporting process. Reliable and credible financial information, in turn, helps ensure that investors and other users have confidence in that information. Those outcomes are in the public interest because they help investors, creditors, and other users make more informed resource-allocation decisions.

13 Independence decision makers should make decisions that help ensure that auditors are, and that well-informed investors and other users would reasonably believe that auditors are, independent. If auditors are sufficiently free from bias but investors and other users do not believe that they are, audits may not enhance the credibility of financial information and, as a result, investors or other users may place less reliance on audited financial information. Independence decision makers, however, should not make decisions that might enhance the credibility of financial information but which have unintended consequences that decrease its

reliability. Credible financial information that lacks underlying reliability is undesirable and, in the long term, self-defeating. Therefore, the goal contemplates well-placed user reliance and confidence.

AUDITOR INDEPENDENCE CONCEPTS

14. This section describes three concepts related to auditor independence:

    a. threats to auditor independence;
    b. safeguards to auditor independence; and
    c. independence risk.

These concepts, together with the basic principles of auditor independence described later in this framework, are intended to help independence decision makers analyze auditor independence issues.

Threats to Auditor Independence

15. **Threats to auditor independence are pressures and other factors that impair an Auditor's objectivity.**

16. Threats may arise from various types of activities, relationships, and other circumstances. Identifying the types of threats posed by specific activities, relationships, or other circumstances helps independence decision makers understand the nature of those threats and their potential impact on auditor independence.

17. The following list provides examples of the types of threats that can lead to biased audit decisions. Although the list is not mutually exclusive or exhaustive, it illustrates the wide variety of threat types that independence decision makers need to consider when analyzing auditor independence issues.

    a. Self-interest threats—threats that arise from auditors acting in their own interest. Self-interests include auditors' emotional, financial, or other personal interests. Auditors may favor, consciously or subconsciously, those self-interests over their interest in performing a quality audit. For example, auditors' relationships with *auditees* create a financial self-interest because auditees pay the auditors' fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor's spouse and an auditee.

    b. Self-review threats--threats that arise from auditors reviewing their own work or the work done by others in their firm. It may be more difficult to evaluate without bias one's own work, or that of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat may arise when auditors review judgments and decisions they, or others in their firm, have made.

    c. Advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee or its position or opinion rather than serving as unbiased attestors of the auditees' financial information. Such a threat may be present, for example, if auditors or others in the auditing firm serve as promoters for an auditee's securities.

d. Familiarity (or trust) threats—threats that arise from auditors being influenced by a close relationship with an auditee. Such a threat is present when auditors are not sufficiently skeptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long-standing personal or professional relationship with an auditee.

e. Intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. Such a threat may arise, for example, if an auditing firm is threatened with replacement over a disagreement about an auditee's application of an accounting principle, or if an auditor believes that an auditee's expression of client dissatisfaction would damage his or her career within the firm.

18. The significance of a threat may have both probability and magnitude dimensions, and threats can be significant individually or in combination. The significance of a threat depends on many factors, including the nature of the activity, relationship, or other circumstance creating the threat; the force with which pressure is exerted or felt; the importance of the matter that is the subject of the activity, relationship, or other circumstance; the position and level of responsibility of the persons involved; and the strength of the integrity of the persons involved. Independence decision makers should evaluate these and other factors when assessing threats to auditor independence posed by various activities, relationships, and other circumstances.

Safeguards to Auditor Independence

19. **Safeguards to auditor independence are controls that mitigate the effects of threats.**

20. Safeguards take a variety of forms, including:

a. authoritative guidance that prohibits or restricts certain activities, relationships, or other circumstances or that requires disclosure of such activities, relationships, or other circumstances;

b. auditing firm policies, procedures, and practices;

c. institutional arrangements, such as the threat of disciplinary action and legal liability;

d. environmental conditions, such as the value that auditing firms and individual auditors place on their reputations; and

e. aspects of corporate governance and auditing firm culture, such as effective communications between audit committees and auditors, and appropriate "tone at the top" of auditees and auditing firms.

Because effective safeguards help ensure that auditors are objective in the presence of threats to auditor independence, independence decision makers should consider existing safeguards as well as new safeguards that could be put in place to mitigate those threats.

21. Different safeguards may mitigate different types of threats, and one safeguard may mitigate several types of threats simultaneously. For example:

a. self-interest threats may be mitigated by, among other safeguards, prohibitions against certain financial interests and family relationships between auditors and auditees, restrictions on the percentage of total fees earned from one auditee, and auditing firm disclosures to the audit committee of all services provided to the auditee;

b. self-review threats may be mitigated by, among other safeguards, prohibitions against auditors acting in the capacity of auditee management;

c. advocacy threats may be mitigated by, among other safeguards, prohibitions against and limitations on auditors providing certain services for auditees that involve advocacy roles;

d. familiarity threats may be mitigated by, among other safeguards, mandatory periodic replacement of engagement partners and restrictions on certain employment relationships between auditors' family members and auditees; and

e. intimidation threats may be mitigated by, among other safeguards, concurring partner reviews, internal consultation requirements, and an appropriate "tone at the top" in both auditing firms and auditees.

22. Safeguards may be effective either individually or in combination. The effectiveness of a safeguard depends on many factors, including whether it is suitably designed to meet its objectives, how it is applied, the consistency with which it is applied, by whom it is applied, and to whom it is applied. Independence decision makers should evaluate these and other factors when assessing safeguards that exist or can be put in place in response to specific activities, relationships, and other circumstances that pose threats to auditor independence.

Independence Risk

23. **Independence risk is the likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users.**

24. Independence risk increases in the presence of threats to auditor independence and is reduced by safeguards. Independence decision makers should evaluate the significance of threats posed by activities, relationships, and other circumstances and the effectiveness of safeguards to determine whether additional safeguards are necessary to reduce independence risk. Paragraphs 25-38 describe basic principles that independence decision makers should use to consider and assess the level of independence risk.

BASIC PRINCIPLES OF AUDITOR INDEPENDENCE

25. This section discusses three basic principles of auditor independence:

a. considering the level of independence risk and assessing its acceptability;

b. considering benefits and costs; and

c. considering the views of investors and other interested parties.

The basic principles serve as guidelines for independence decision makers in analyzing auditor independence issues in a wide variety of circumstances.

Considering the Level of Independence Risk and Assessing its Acceptability

26. **Independence decision makers should (a) consider the level of independence risk by analyzing threats and their significance and safeguards and their effectiveness, (b) assess whether that level is acceptably low, and (c) apply appropriate safeguards if it is not.**

27. This basic principle describes a process by which independence decision makers should analyze threats and safeguards to consider the level of independence risk that results from various activities, relationships, or other circumstances. Although it cannot be measured precisely, the level of independence risk for any specific activity, relationship, or other circumstance can be described as a position on a continuum that ranges from "no independence risk," where compromised objectivity is virtually impossible, to "maximum independence risk," where compromised objectivity is virtually certain. When considering the level of independence risk, independence decision makers should consider the views of well-informed investors and other users of financial information.

28. This basic principle also describes the need for independence decision makers to assess the acceptability of the level of independence risk that arises from specific activities, relationships, and other circumstances. That evaluation requires them to judge whether existing safeguards adequately mitigate threats to auditor independence posed by those activities, relationships, or other circumstances. If they do not, independence decision makers should decide which additional or alternative safeguards (including prohibition) would reduce independence risk to an acceptably low level. When assessing the acceptability of independence risk, independence decision makers also should consider the aggregate risk arising from different threats because their effects may be cumulative. The acceptability of a level of independence risk arising from different activities, relationships, and other circumstances will vary based on an analysis of costs and benefits and the views of well-informed investors and other users of financial information.

29. Given certain factors in the environment in which audits take place—for example, that the auditor is paid by the auditee—independence risk cannot be completely mitigated and, therefore, independence decision makers always accept some risk that auditors' objectivity may be compromised. Nevertheless, independence decision makers should consider only a very low level of independence risk to be acceptable. Only such a small likelihood of compromised objectivity is consistent with both the definition and the goal of auditor independence.

30. Some threats to auditor independence may affect only certain individuals or groups within an auditing firm, and the significance of some threats may be different for different individuals or groups. In determining whether independence risk is at an acceptably low level, independence decision makers should identify the individuals or groups affected by threats to auditor independence and the significance of those threats. Different types of safeguards may be

appropriate for different individuals and groups depending on their ability to influence the outcome of the audit.

Considering Benefits and Costs

31. **Independence decision makers should conclude that the benefits of reduced independence risk from applying safeguards exceed their costs.**

32. Although the benefits of reduced independence risk and costs of safeguards are often difficult to identify and quantify, independence decision makers should consider them when assessing the acceptability of the level of independence risk. Because the independence of auditors is important not only in its own right but also in helping ensure that broad public interest objectives are met, independence decision makers should consider costs and benefits to society at large, not just those they may incur or enjoy themselves. Similarly, independence decision makers should consider indirect effects and potential unintended consequences that go beyond the direct impact of specific safeguards. It is not appropriate, however, to ignore a mandated safeguard based on a belief that its costs exceed its benefits.

33. The benefits of applying safeguards result from reduced independence risk. Such reductions help to ensure auditor independence, providing positive direct and indirect benefits that accrue to various parties. Examples of those benefits include:

a. for investors and other users of financial information, auditor independence helps ensure quality audits and the reliability of the financial reporting process, which also may lead to increased confidence in that reliability. These benefits, in turn, help improve investors' and other users' resource-allocation decisions, an outcome that is in the public interest.

b. for auditees, auditor independence helps reduce their cost of capital by reducing the premium that investors and creditors demand as compensation for assuming the risk that they will make incorrect decisions because the financial information used in making those decisions contains material misstatements or omissions.

c. for auditees' boards of directors, audit committees, and senior management, auditor independence helps ensure the reliability of financial information prepared by lower-level management.

d. for auditees and auditors, auditor independence may help reduce litigation and related costs resulting from alleged and actual situations involving unreliable financial information.

e. for individual auditors, auditing firms, and the auditing profession as a whole, independence facilitates the discharge of their responsibility to conduct GAAS audits and may help enhance their reputations and self-esteem.

34. Various parties bear a variety of costs related to safeguards to auditor independence. Direct costs include developing, maintaining, and enforcing safeguards, including the costs of auditing firms' independence-related quality controls and costs related to the systems of public regulation and self-regulation of auditor independence. Indirect costs and unintended consequences of safeguards include possible reductions in audit quality or other negative

outcomes that may result from safeguards that prohibit or restrict auditors' activities and relationships. For example, restrictions on auditing firm personnel's investments and on employment of their family members by auditees may reduce the attractiveness of auditing firms as employers and thereby lead to reduced audit quality. The direct and indirect costs of safeguards may be affected by many variables, including the number of individuals in a firm that will be affected by a safeguard.

Considering Interested Parties' Views in Addressing Auditor Independence Issues

35. **Independence decision makers should consider the views of investors, other users, and others with an interest in the integrity of financial reporting when considering the level of independence risk, when assessing its acceptability, and when considering the costs and benefits of applying safeguards.**

36. Because of its responsibility for issuing independence standards for all auditors of public entities, the ISB''s process of considering interested parties' views is more extensive than the process used by other independence decision makers. The ISB's due process provides opportunities for extensive participation in its standard-setting by various parties, including investors and other users, auditors, educators, regulators, and auditee management. By being informed about the views of various types of individuals and groups, the ISB learns about threats to independence and the potential effects of various safeguards on the reliability of financial information, audit quality, and the broader goal of optimal capital allocation. The ISB also gains insight about the views of well-informed investors and other users of financial information concerning independence risk and its acceptability in specific circumstances.

37. Supporting user reliance on the financial reporting process is an important component of the goal of independence, and the framework's basic principle to consider the level of independence risk and assess its acceptability directs independence decision makers to consider the beliefs of well-informed investors and other users at this point in their decision-making process. Considering the views of well-informed investors and other users does not, however, abrogate the ISB's responsibility to exercise its own judgment in setting independence standards that are consistent with both the definition and the goal of auditor independence and the framework's principle of assessing the acceptability of independence risk in light of costs and benefits. Effective communication of ISB decisions, and of the reasoning that underlies them, also may help ensure that investors and other users of financial information have confidence in the ISB's standard setting process and conclusions.

38. In the absence of specific authoritative guidance, independence decision makers other than the ISB should consider how well-informed investors and other users might view their decisions about the level of independence risk, its acceptability, and the costs and benefits of applying safeguards. Independence decision makers other than the ISB, however, may not have, and would not be expected to have, the benefit of extensive due process in resolving auditor independence issues.

APPENDIX A—GLOSSARY

39. This appendix contains definitions of certain terms or phrases used in this conceptual framework.

Auditees

Entities whose financial information is being audited.

Auditor independence

Both (a) independence of mind—freedom from the effects of threats to auditor independence that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.

Credibility

The quality of information that makes it believable.

Independence decision makers

Individuals, groups, and entities that make judgments about auditor independence issues. Independence decision makers include:

- the ISB and other independence standard setters
- auditing firms in adopting independence policies and procedures in the absence of existing authoritative guidance
- individual auditors in assessing their own independence and in making decisions when faced with situations for which there is neither authoritative guidance nor firm policy
- the management, audit committees, and boards of directors of auditees in meeting their responsibilities to retain auditors who are independent
- regulators in meeting their responsibilities to ensure the independence of auditors.

Independence Risk

The likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users.

Objectivity

The ability to make unbiased audit decisions.

Quality audit

An audit performed in accordance with generally accepted auditing standards.

Reliability

"The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent."[4]

Safeguards to Auditor Independence (Safeguards)

Controls that mitigate the effects of threats.

Threats to Auditor Independence (Threats)

Pressures and other factors that impair an auditor's objectivity.

Users

Investors, creditors, audit committee members, analysts, and others who use audited financial information in making investment, credit, and similar decisions.

[4] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (Stamford, CT: FASB, 1980), "Glossary of Terms."

APPENDIX B—BACKGROUND INFORMATION

40. The ISB was formed in 1997 to establish standards governing the independence of auditors of public entities. As part of its initial charge, the Board was given the task of developing a conceptual framework for auditor independence on which future independence standards could be based. Henry R. Jaenicke, the C. D. Clarkson Professor of Accounting at Drexel University, served as Director, and Alan S. Glazer, Professor of Business Administration at Franklin & Marshall College, served as Associate Director of the project.

41. Discussion Memorandum (DM) 00-1, *A Conceptual Framework for Auditor Independence,* was prepared with input from a broad-based project task force consisting of representatives of investor groups, audit committee members, attorneys, regulators, other independence standard setters, members of the auditing profession, corporate executives, and academics specializing in ethics, accounting, auditing, and other business-related fields. A Board oversight task force provided further direction and assisted in reviewing the DM. The DM was considered by the Board at meetings on January 14 and February 17, 2000 and was released in February 2000 for a public comment period that ended on May 31, 2000. Comments also were solicited directly from specific individuals and groups in the academic, standard-setting, and investor communities. Twenty-two comment letters were received.

42. After considering these letters, and with further assistance from the oversight and project task forces, an Exposure Draft (ED) of a proposed Statement of Independence Concepts was developed. The ED was released in November 2000 for a public comment period that ended on February 28, 2001. Comments were again solicited directly from specific individuals and groups. Twenty-seven comment letters were received. On July 9, 2001, prior to its consideration of the comments received on the ED, the Board with the concurrence of the SEC and the AICPA passed a resolution of dissolution effective July 31, 2001. Professors Jaenicke, Glazer, Dunfee,[5] and the ISB staff (collectively, the staff) revised the ED based on comments received, their own deliberations, and further assistance from project task force members and other interested parties. The conceptual framework was issued on July 30, 2001 as a staff report.

[5] Professor Thomas W. Dunfee, who served as an advisor to the Board on ethical issues and the conceptual framework project, is the Joseph Kolodny Professor of Social Responsibility and vice-dean for the undergraduate division of the Wharton School at the University of Pennsylvania.

APPENDIX C—BASIS FOR CONCLUSIONS

43. This appendix discusses the issues considered by the Board, the project task force, and the staff in arriving at conclusions about the conceptual framework. It describes the staff's reasons for accepting certain views and for rejecting others and includes an explanation of significant changes made to Exposure Draft (ED) 00-2, *A Conceptual Framework for Auditor Independence.*

44. The staff believes that the approach to analyzing auditor independence issues described in this conceptual framework will be useful for independence decision makers. The approach includes a definition that the staff believes most clearly describes auditor independence and a goal describing the fundamental purpose of auditor independence. The other framework components consist of concepts and basic principles to help independence decision makers:

a. examine potential threats to auditor independence;
b. consider the mitigating effects of safeguards;
c. assess the risk that an auditor's objectivity would be, or would reasonably appear to well-informed investors and other users to be, compromised; and
d. analyze whether the level of independence risk is acceptably low.

Defining Auditor Independence

45. A definition provides a common language for all parties to use in discussing auditor independence issues. The definition of auditor independence in paragraph *5* is based on a combination of the personal attributes and the activities and relationships approaches discussed in Section IV of Discussion Memorandum (DM) 00-1, *A Conceptual Framework for Auditor Independence.* The framework defines auditor independence as having two dimensions—independence of mind and independence in appearance. Independence of mind—defined as "freedom from the effects of threats to auditor independence that would be sufficient to compromise an auditor's objectivity"—is a personal attribute that helps ensure that auditors perform quality audits. Independence in appearance—defined as the "absence of activities, relationships, and other circumstances that would lead well-informed investors and other users reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind"—is included to acknowledge the importance to the capital markets of users' beliefs about auditor objectivity. A definition with these two dimensions also was supported by many respondents to the ED, who noted that both aspects of auditor independence are included in the approach used and under consideration by regulators and standard setters in the United States and in other parts of the world.

46. The staff believes that incorporating the reasonable conclusions of well-informed investors and other users helps make the definition operational. Instead of describing auditor independence purely as a personal attribute or state of mind that cannot be observed, measured, or evaluated, a definition that incorporates investors' and other users' conclusions provides independence decision makers with a way to assess when auditors likely possess the personal attribute of independence of mind.

47. The staff considered defining auditor independence solely in terms of the absence of certain activities and relationships. The staff acknowledges that there are some who believe that those definitions are more useful to independence decision makers because they rely on observable external indicators of a lack of independence. The staff concluded, however, that a definition based solely on an activities and relationships approach that did not also include independence of mind would be incomplete. A definition based solely on an activities and relationships approach would indicate how independence can be demonstrated (i.e., by an auditor not participating in certain activities or having certain relationships) but it would not describe what independence represents (i.e., freedom from the effects of threats sufficient to compromise objectivity).

48. The definition describes independence in appearance in terms of the "risk" of compromised objectivity. Well-informed investors and other users cannot observe how threats affect a specific auditor's ability to make unbiased audit decisions, and individual auditors may react differently to the same set of threats and safeguards. As a result, investors and other users rely on independence decision makers to identify and analyze various activities, relationships, and other circumstances that are sources of threats that can reasonably be expected to lead to an unacceptably high risk of biased audit decisions and to apply appropriate safeguards to reduce independence risk to an acceptably low level.

49. Some respondents to the ED suggested that the Board define independence solely as the absence of an unacceptable risk of biased audit decisions or of material bias. The staff concluded, however, that these proposed definitions were incomplete because they do not include consideration of how activities, relationships, and other circumstances appear to well-informed investors and other users of financial statements. In the staffs view, such consideration is necessary to help ensure that the goal of auditor independence is achieved—a goal that includes helping to support user reliance on the financial reporting process.

50. The staff included the phrase "that would lead well-informed investors and other users reasonably to conclude" so that the definition would explicitly state whose views independence decision makers should consider when resolving auditor independence issues. The staff acknowledges that determining what well-informed investors and other users might reasonably conclude may be difficult. The staff believes that such a process involves a good faith determination by independence decision makers about how well-informed investors and other users might view an issue. The staff recognizes, however, that even well-informed investors and other users are likely to have divergent views about specific independence issues. The staff decided, therefore, that in addition to specifying explicitly in the definition whose beliefs are to be considered, the conceptual framework should include a basic principle (see paragraphs 35-38) that describes how the views of interested parties should be considered in addressing auditor independence issues.

51. The phrase "freedom from the effects of threats to auditor independence that would be sufficient to compromise" in the definition means that independence does not require complete freedom from the effects of all threats that an auditor may face—that is not possible. Biases arise from an individual auditor's background, education, and experiences and are part of human nature; they can be either conscious or subconscious and can be either in favor of or against

specific individuals, groups, organizations, ideas, or principles. Nevertheless, threats posed by certain activities, relationships, and other circumstances may endanger the quality of audits if they are sufficient to compromise an auditor's objectivity. The definition of auditor independence in paragraph 5 means that only pressures and other factors, after the mitigating effects of safeguards, that rise to a level that prevent, or can reasonably be expected to prevent, an auditor from making unbiased audit decisions would preclude an auditor from being independent.

52. Several respondents to the ED expressed concern about a definition that could be misconstrued as requiring absolute freedom from threats or that did not consider the effect of safeguards in mitigating threats. The staff considered whether the definition in the ED could be misinterpreted to mean that independence is unconditional or absolute—that is, that independence requires an auditor to be completely free from threats. The staff believes the definition in the ED describes a state that an auditor can attain, namely, the ability to make, and to be seen as making, unbiased audit decisions. Nevertheless, the staff added the phrases "the effects of" and "sufficient to" to the definition in paragraph 5 to emphasize that auditors do not have to be completely free from all threats to satisfy the definition of independence.

53. As noted in footnote 3, the staff used the term "compromise" in the definition to mean that an auditor's objectivity has been affected to such an extent that the auditor can no longer make unbiased audit decisions. The staff considered using the more widely-used term "impair" instead of "compromise" in this context, but believes that compromise more clearly implies that the effect of a threat to auditor independence must rise to a level where an unbiased decision cannot be made. Auditors are affected by a wide variety of threats that may reduce (that is, impair) their objectivity to some degree. Only when the impairment rises to a level at which the auditor cannot make unbiased audit decisions, however, does the auditor lose his or her independence of mind.

54. The staff decided not to include the phrase "independence in fact" in the definition. Including that phrase would have suggested that independence is something that can be objectively determined or unequivocally demonstrated. The staff believes that, although the phrase has been widely used in the literature, it can easily be misinterpreted because it suggests a level of certainty or measurability about the existence of auditor independence that cannot be achieved.

Goal of Auditor Independence

55**.** A goal of auditor independence serves as a guide in setting standards. It also assists independence decision makers in analyzing auditor independence issues when standards or other authoritative guidance do not address particular circumstances that may compromise an auditor's objectivity.

56. The goal in paragraph 11 does not focus on independence as an end in itself but on independence as a means to support investor and other user reliance on the financial reporting process and to facilitate the optimal allocation of capital. Many respondents to the ED supported

a goal with broad purposes, a focus that helps make it aspirational. The staff believes that an aspirational goal will be useful to independence decision makers when they consider auditor independence issues. The goal also provides a basis for independence decision makers to consider the benefits and costs associated with both reliable financial information and optimal capital allocation. For example, allowing auditees to hire individuals previously employed by their auditing firm—subject to certain safeguards—may increase independence risk to some extent, but the skills of those individuals also may facilitate the optimal allocation of capital by helping auditees generate more reliable financial information and by increasing the attractiveness of the profession to high-quality individuals.

Auditor Independence Concepts[6]

57. Paragraphs 14-24 describe three concepts relevant to auditor independence decisions:

   a. threats to auditor independence;
   b. safeguards to auditor independence; and
   c. independence risk.

These concepts are elements of a risk model for auditor independence that the staff believes will assist independence decision makers in understanding and analyzing auditor independence issues. In this model, the level of independence risk is a function of the significance of threats and the effectiveness of safeguards. An auditor is independent when independence risk is at an acceptably low level, as assessed by a particular independence decision maker. As described in paragraphs 35-38, the views of well-informed investors and other users should enter into independence decision makers' analysis of the level of independence risk and of that level's acceptability. Independence decision makers also should consider the basic principle related to costs and benefits described in paragraphs 31-34 when they assess the acceptability of the level of independence risk and when they choose among alternative safeguards.

58. The model acknowledges the importance of materiality by incorporating the significance of threats and the effectiveness of safeguards. Determining the level of independence risk requires analyzing the significance of threats to auditor independence posed by a specific activity, relationship, or other circumstance and the effectiveness of the safeguards that are, or could be put in place to mitigate or eliminate specific threats, and therefore whether an auditor's objectivity would be, or reasonably would appear to well-informed investors and other users to be, compromised. However, because of the large number of potential threats and safeguards that are not susceptible to quantification—for example, the impact of family relationships—the staff concluded that it is preferable to use the more general terms "significance of threats" and "effectiveness of safeguards," rather than "materiality," which is more frequently associated with quantitative measures or guidelines. Some threats and safeguards are susceptible to

[6] The categories of threats described in this conceptual framework and its approach of analyzing threats and safeguards when resolving auditor independence issues are consistent with the systems in use and under development by standard setters in various places outside the United States, including the United Kingdom (Institute of Chartered Accountants in England and Wales), Europe (Federation des Experts Comptables Europeens (FEE) and the European Commission), and internationally (International Federation of Accountants).

quantification, however, and independence decision makers may determine that their significance and effectiveness can be evaluated, in whole or in part, by reference to numeric benchmarks.

59. Some respondents to the ED were concerned because two specific threats used frequently in the independence literature—"acting in the capacity of management" and "having a mutuality of interests with the client"—were not explicitly included in the ED's list of threat types. The staff concluded that the five types of threats described in the ED—self-interest, self-review, advocacy, familiarity, and intimidation—include those specific threats and are more descriptive of the general nature of the threats faced by auditors. The staff also believed that "having a mutuality of interests with the client" can be confusing if it is included as a threat because auditors and their clients should have certain mutual interests, for example, in reliable financial reporting.

60. The conceptual framework defines threats as "pressures and other factors that impair" rather than those that "may impair" an auditor's objectivity because pressures and other factors that do not affect an auditor's objectivity are not threats.

61. The staff recognizes that there are many ways to describe safeguards in addition to the classification described in paragraph 20. For example, safeguards can be described by where they reside:

a. safeguards that exist in the environment in which audits are performed, such as:
   1. the value auditing firms and individual auditors place on their reputations;
   2. peer review programs that assess firm-wide compliance with professional standards and regulatory requirements regarding independence;
   3. general oversight by auditees' audit committees and boards of directors concerning compliance with the regulatory requirement that an auditee's financial statements be audited by auditors who are independent;
   4. other aspects of corporate governance, including an auditee's "tone at the top," that support the issuance of reliable financial information and auditor independence;
   5. rules, standards, and codes of professional conduct governing auditors' behavior issued by public regulatory bodies, such as the Securities and Exchange Commission (SEC) and state boards of accountancy, and by self-regulatory bodies, such as the ISB and the American Institute of Certified Public Accountants (AICPA);
   6. disciplinary actions, and the possibility of such actions, by the SEC, state boards of accountancy, the AICPA, and others; and
   7. the legal liability faced by auditors and other participants in the capital markets.

b. safeguards that exist within auditing firms as part of a firm's quality controls, such as:
   1. maintaining a "tone at the top" that stresses the expectation that auditors will act in the public interest and the importance of quality audits and auditor independence;
   2. maintaining a professional environment and culture that supports

behavior of all firm personnel that is consistent with auditor independence;
3. quality assurance programs that include policies, procedures, and practices directly related to maintaining auditor independence;
4. other policies, procedures, and practices, such as those concerning auditee acceptance and retention, the rotation of engagement management, concurring partner reviews, and requirements for internal consultation on technical issues; and
5. personnel hiring, training, promotion, retention, and reward policies, procedures, and practices that emphasize the importance of auditor independence, the potential threats posed by various circumstances that auditors in the firm may face, and the need for auditors to evaluate their independence with respect to a specific auditee after considering safeguards in place to mitigate those threats.

62. Another way of describing safeguards is by their focus:

a. safeguards that are preventive—for example, an orientation program for newly hired auditors that emphasizes the importance of independence;
b. safeguards that relate to threats arising in specific circumstances—for example, prohibitions against certain employment relationships between auditors' family members and auditees;
c. safeguards that are designed to deter violations of prohibited activities and relationships—for example, reviews of auditors' securities portfolios to detect prohibited investments; and
d. safeguards whose effects are to deter violations by punishing violators—for example, revocations of auditors' licenses by state boards of accountancy.

63. Safeguards that are mandated by independence decision makers can be described by the extent to which they restrict activities or relationships that are considered threats to auditor independence, such as:

a. absolute prohibition—for example, barring auditors from having any direct financial investment in any auditees;
b. permitting the activity or relationship but restricting its extent or form—for example, a restriction that auditors cannot have material indirect financial interests in auditees;
c. permitting the activity or relationship but requiring other policies or procedures that eliminate or mitigate the threat—for example, the mandatory replacement of an engagement partner after the partner has spent a certain period of time on a specific audit engagement to mitigate a familiarity threat; and
d. permitting the activity or relationship but requiring the auditor to disclose information about it to the auditee's management, audit committee, board, or others—for example, disclosure to an auditee's audit committee of the nature of all services provided by the auditor to the auditee and the fees received for such services.

Basic Principles of Auditor Independence

Considering the Level of Independence Risk and Assessing its Acceptability

64. The basic principle described in paragraphs 26-30 requires independence decision makers to analyze threats posed by specific activities, relationships, or other circumstances and safeguards in place to mitigate those threats. The purpose of that analysis is to consider the level of independence risk—defined as the likelihood that an auditor's objectivity would be, or would reasonably appear to well-informed investors and other users to be, compromised. Because an auditor's objectivity cannot be directly observed, and because threats and safeguards will affect, to different degrees, the ability of individual auditors to make unbiased audit decisions, independence risk is expressed as a continuum.

65. As described in paragraph 27, the independence risk continuum extends from one endpoint, at which compromised objectivity is virtually certain, to another, at which compromised objectivity is virtually impossible. The ED suggested that the level of independence risk for a specific activity, relationship, or other circumstance could be described as being either at one of those endpoints or in one of three defined segments of the continuum. Some respondents to the ED, however, found the description of the independence risk continuum confusing and were concerned that the description implied an unrealistic degree of precision. As a result, the staff simplified the description of the independence risk continuum and suggested that independence decision makers do not need to identify a specific position on the continuum but only assess whether that position is acceptably low.

66. As noted in paragraph 18, the significance of threats to auditor independence may have both probability and magnitude dimensions. Certain activities, relationships, and other circumstances may create a high likelihood of auditor bias but the bias may not affect significant audit decisions. For example, independence decision makers may conclude that the likelihood would be high that an auditor would be biased in auditing an appraisal performed by a firm colleague—that is, the unmitigated threat of self-review is significant. If the appraisal involves an asset that is clearly insignificant to the auditee's consolidated financial statements, however, this may result in only an inconsequential increase in the level of independence risk.

67. The basic principle in paragraph 26 requires independence decision makers, after considering all of the relevant facts and circumstances, to analyze threats and safeguards and to reach a conclusion about whether the level of independence risk is acceptably low. The staff believes that a principle based on achieving the "no independence risk" endpoint of the independence risk continuum for all threats to auditor independence is unrealistic and, in some circumstances, may be undesirable. Such a principle would mandate that independence decision makers adopt safeguards that provide "absolute assurance" of auditor independence, a level of assurance that audits themselves are not designed to provide. The staff believes that no safeguard or combination of safeguards can be completely effective in eliminating all independence risk. The staff also believes that, in some cases, the costs (both direct and indirect) of attempting to get closer to the "no independence risk" endpoint on the continuum may exceed the benefits of further reducing independence risk. The staff concluded that the basic principle described in paragraphs 26-30, which establishes an objective of reducing independence risk to a very low

level, will help independence decision makers decide whether additional safeguards are necessary to mitigate threats to auditor independence.

68. The ED contained two separate basic principles concerning independence risk. The staff subsequently concluded that it is more useful to develop one basic principle describing the process independence decision makers should use to evaluate independence risk. As a result, the basic principle discussed in paragraphs 26-30 includes a three-step process: consider the level of independence risk by analyzing threats and safeguards, assess whether that level is acceptably low, and apply appropriate safeguards if it is not.

Considering Benefits and Costs

69. The staff recognizes the difficulty of identifying and measuring many of the benefits and costs of auditor independence, including the potential unintended consequences of maintaining auditor independence. Nevertheless, the staff believes that independence decision makers should, to the extent possible, weigh both the direct and indirect benefits and costs of safeguards they are considering. In many cases, independence decision makers will not need to determine the dollar amount of benefits and costs of a particular safeguard but only whether there are incremental benefits and costs of that safeguard as compared with others.

Considering Interested Parties' Views in Addressing Auditor Independence Issues

70. The ED included a basic principle describing how independence decision makers should consider the views of interested parties. Some respondents to the ED noted that the basic principle was not explicit about when and how independence decision makers should consider the views of various interested parties. The basic principle included in paragraphs 35-38 clarifies that interested parties' views should be considered at certain places in the decision-making process: when independence decision makers consider the level of independence risk, when they assess its acceptability, and when they consider the costs and benefits of applying safeguards. The definitions of auditor independence and of independence risk also have been changed to specify that independence decision makers should consider the likely views of reasonable, well-informed investors and other users.

71. The staff considered three alternative approaches to a basic principle concerning how beliefs about auditor independence should be included in the standard-setting process: develop standards that reflect the views of all interested parties; develop standards that reflect the likely views of reasonable, fully informed investors or some other group or groups of interested parties; or be informed by interested parties' views but base standards on the Board's judgment about how best to reduce independence risk to an acceptably low level. The staff believes that adopting either of the first two alternatives as a basic principle would inappropriately restrict the Board in making independence judgments, especially if those judgments differ from the short-term views of some interested parties, or if interested parties do not appropriately consider costs

and benefits. In addition, because different individuals and groups are likely to have diverse views on auditor independence issues, basing decisions on those views is often impossible or impractical.

72. The staff believes that a basic principle based on the process described in paragraphs 35-38 emphasizes that the Board itself—whose members come from diverse constituencies and are chosen to represent the public interest based on their experience and integrity—is in the best position to establish appropriate independence standards. The Board's due process includes a thorough evaluation of all available information, including obtaining input from interested parties through its task forces, reviewing all responses to documents issued for public exposure, and in other ways. Under the basic principle described in paragraphs 35-38, the Board should neither ignore interested parties' views nor base its decisions solely on those views. The principle of determining independence risk and assessing its acceptability calls for consideration of the beliefs of well-informed investors and other users of financial information at various points in the decision-making process. As a result, the Board will consider the views of this group in light of its own judgment, informed by the views of other interested parties, about the potential effect of alternatives on the reliability of financial information, audit quality, and the broader goal of user reliance and optimal capital allocation.

73. The staff believes that effective communication with all interested parties can help inform them about the Board's agenda, the process used to promulgate independence standards, and the reasoning underlying those standards. The Board provides a variety of opportunities for interested parties to furnish timely input to it—for example, Board task forces and working groups include representatives from many organizations, and the Board distributes discussion memoranda and exposure drafts widely to encourage interested parties to share their views with the Board. At various stages in its standard-setting process, the Board communicates its views on the nature of the threats that it believes are posed in the circumstances under consideration and the reasons why it believes that certain safeguards are the best solution in those circumstances. The Board also explains the bases for its conclusions, both in ISB standards and through other media. These and similar efforts by the Board to ensure effective communications with all interested parties should help increase their confidence in the organizations and processes involved in ensuring auditor independence as well as in the reliability of the financial reporting process and in the independence of auditors generally.

74. The staff believes that when other independence decision makers address auditor independence issues, they also should consider the views of interested parties. Those independence decision makers should ask, in their own informed good faith views, whether well-informed investors and other users would reasonably consider the activities, relationships, or other circumstances in question as precluding the ability to make unbiased audit decisions.