

# Independence Considerations when Contemplating Employment with an Attest Client

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**It is not uncommon for a client to approach a member of the audit firm's team about an employment opportunity in the company, usually in the client's finance, accounting, internal audit or similar group. When this happens, independence concerns crop up and last throughout**

employment negotiations. If employment is accepted, independence concerns can be lasting and even arise long after a professional has left the firm. The independence rules require firms and professionals to apply safeguards, including certain prohibitions, to protect independence in fact and appearance. To pre-empt situations that can tarnish independence, firms should mitigate the risks with appropriate policies, procedures and training that emphasize prompt communication and action. This edition of *Audit*

*Conduct News* uses brief case studies to illustrate how the independence rules apply in these situations. A later edition of the newsletter will discuss practices firms can incorporate to enhance compliance with the rules.

## Case 1 | Impressing the Client

Marco Banks earned his CPA the year before and was a newly-minted manager at RHO, LLC, a mid-sized regional accounting firm located in Kansas City,

Missouri. His fourth year on the audit, his client, Manchester Financial Group (Manchester), thinks highly of him. One day when Marco is at the client's preparing for the upcoming audit, the Controller asks to meet with him for lunch, which Marco happily accepts. During lunch, the Controller informs him that his group is expanding and asks Marco whether he might be interested in applying for the position of Assistant Controller. He briefly explains the position and says he hopes Marco will consider the opportunity. A little surprised, Marco tells the Controller he will consider it. Back home that evening, Marco concludes he should at least interview for the position; if it turns out favorably, he might be ready to leave public accounting.

*What, if anything, does Marco need to do to preserve his independence?*

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The answer lies in the independence rules on employment relationships.

In the United States, the primary professional standards-setter for independence is the American Institute of Certified Public Accountants (AICPA). AICPA independence rules, found in the Code of Professional Conduct (the Code), apply broadly to audits, reviews and other attest services performed under Generally Accepted Auditing Standards, Statements on Standards for Accounting and Review Services, and Statements on Standards for Attestation Engagements (“attest services”) for private companies, not-for-profit, employee benefit plans and governmental entities. Additional independence requirements may apply to audits of certain types of

companies. For example, if a company is registered with the SEC or a public company “issuer,” the auditor must follow the Securities and

Exchange Commission (SEC) and/or Public Company Accounting Oversight Board (PCAOB) independence rules.

Manchester is a private company whose audit is subject to AICPA rules only (ET section 1.279), so Marco should:

- Inform the appropriate person in the firm about the matter, and
- Immediately stop providing services to the client.

To be effective, both actions should be prompt.

Firms should be sensitive to appearance issues that arise in these instances and apply safeguards to counter any undue influence or self-interest threats to their integrity and objectivity. This case involved a member of the audit team, but the rule also applies to those who can influence the engagement, such as quality control personnel or other professionals who manage the firm’s audit practice. The interpretation applies whenever those persons consider employment or another type of association (for example, board member) with an attest client and would also apply to Manchester’s affiliates (ET sections 0.400.02 and 1.224.010.02(c)).

Marco promptly informs the Manchester audit partner, Gina Martinez, who in turn, notifies Jason Chu, the

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firm’s Quality Control Director (whose duties include overseeing the firm’s independence compliance). The firm immediately removes him from the audit team. The interview goes well and Manchester extends an offer, which Marco accepts. He submits his resignation to the firm.

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*Once an employment offer has been accepted, what comes next?*

First to consider: is the position a “key position” as defined in the Code? Firms should look at the substance of the role and not solely the job title. If Marco’s role gives him primary responsibility for significant accounting functions supporting material portions of the financial statements, he prepares Manchester’s financial statements or can exercise influence over the contents of those statements, he’s accepted a key position. He will be responsible for preparing the financial statements and overseeing staff who perform related accounting functions, so this is a key position, which means that Marco and RHO have more to do to protect the firm’s independence.

Several safeguards, which fall into two categories (personal matters and engagement matters), apply under the AICPA rules:



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dependence from the client, creating familiarity and management participation threats. Likewise, a professional who leaves the firm to work for a client in a key position should sever any financial and professional ties to the firm.

threat that can arise if Marco’s benefits were based on his former firm’s revenues or profits, extending his interest in the firm’s performance and putting pressure on the firm to meet its financial obligation to him. With only four years at the firm, at a staff level, Marco’s retirement benefits are not an issue. He has a 401(k) with the firm, which does not impact independence since it is not a firm-funded benefit.

**To pre-empt situations that can tarnish independence, firms should mitigate the risks with appropriate policies, procedures and training that emphasize prompt communication and action.**

**Personal Matters**

A longstanding AICPA independence rule is that the firm may not simultaneously employ professionals who work for their attest clients or have other associations (for example, membership on the client’s board of directors). Such dual associations are inconsistent with the notion of inde-

*Cutting financial ties.* Marco may not have an equity interest in the firm (generally not the case at his level) nor may he continue to participate in the firm’s unfunded, vested retirement plan unless it’s immaterial to the firm and based on a fixed formula and payout schedule. The immaterial, fixed payout mitigates the perceived self-interest

*Disassociating from the firm and its business.* Once Marco leaves the firm and joins the attest client, to protect the appearance of independence, he should no longer participate or appear to participate in the firm’s business or otherwise be associated with the firm. The following actions would run counter to this safeguard:

- He provides consultation to the firm or continues to serve on audits or

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other engagements

- The firm provides him with an office or related amenities (internet access or e-mail service)
- His name is included in the firm's office directory, on its web site or in social media or promotional materials (online or otherwise)

**Engagement Matters**

*Audit effectiveness.* As the engagement partner for Manchester, Gina and her team should consider whether to modify the engagement procedures to mitigate the risk that Marco's knowledge of the audit plan could reduce its effectiveness. If Marco will have significant interaction with the team in his new role, Jason (the Quality Control Director) should evaluate whether the existing team members can deal effectively with him. Issues are more likely to arise when higher level staff and partners join the client but should be evaluated in all cases.

Marco is taking a key position within one year of disassociating from the firm and will have significant interaction with the audit team, so Jason also

should review the subsequent audit engagement to determine whether the team maintained the appropriate level of skepticism when evaluating Marco's representations and work.

**Case 2 | Communication is Key**

Brendan Johnson is another new manager, currently serving on the audit of Riverside Properties, LLP (an SEC registered firm). He hears of an opening in his client's internal audit department and asks Lynn Adams, a manager in Riverside's Internal Audit group, what she knows about the

position. Lynn advises Brendan, saying she will "put in a good word for him" with the Chief Auditor, and he agrees to submit his application online that evening. At Brendan's request, Lynn

agrees to otherwise keep the information in confidence. Brendan continues to perform audit procedures for Riverside and about ten days later, receives an e-mail offering him an appointment to interview with the Chief Auditor. A few days later, Linda Allen, a senior on the audit team, and Marco are working at Riverside when Linda overhears Brendan talking on his phone to the Chief Auditor about the upcoming interview. Linda suspects that others do not know that Brendan is interviewing with the client. She knows that firm policy requires covered members to disclose that information to the engagement partner or Quality Control Director so the correct actions may be taken. Linda admits she overheard his conversation, tells Brendan he is violating the firm's policy and urges him to speak to the audit partner as soon as possible. She shows him the policy (based on AICPA rules) and says that if he does not speak to the audit partner, she will. He reluctantly agrees to do so himself.

**Repercussions**

Brendan is immediately removed from the Riverside engagement and his work reviewed by another firm profes-

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sional. Reprimanding him, the partner informs Brendan that due to his delay, the firm will need to report the incident to the PCAOB as a violation of the rules during its next inspection (specifi-

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cally, the Board's interim independence standard, **Independence Standard No. 3, Employment with Audit Clients**, requires all firm professionals to promptly report all conversations regarding employment with an audit client). Word gets to Riverside's Chief Auditor, who asks about the matter during his interview with Brendan. Expressing his concern that Brendan failed to follow RHO's policies and put his firm's independence at risk, he says he cannot in good conscience recommend Brendan for the job. Later that year, Brendan is sanctioned for failing to apply the firm's policy; he leaves the firm shortly thereafter.

### Case 3 | From Senior Manager to Tax Director

Senior manager Theresa Rose, wrapping up her fourth year on the Liberty Data Corp. (Liberty) audit, asks Jason whether she may consider her client's offer to become its next Tax Director. Liberty is a public company whose audit is subject to SEC and PCAOB independence rules.

Like the first case, an important consideration is whether the position with the client will create independence concerns. In this case, the role of Tax Director is described (in part) as:

#### **Tax Director position** (excerpt)

- *Coordinate and review current and deferred tax account reconciliations, valuation allowance positions, uncertain tax positions, and permanent reinvestment assertions.*

- *Liaise with Financial Reporting and external audit firm with respect to managing close calendars, addressing technical accounting issues, and coordinating tax accounting entries.*

- *Provide technical guidance on income tax issues and support SEC reporting and US GAAP and IFRS accounting issues related to income taxes*

The SEC and PCAOB rules use the term "financial reporting oversight role" (FROR) and "accounting role" which together are quite similar to the AICPA's "key position". Clearly, this job description meets the FROR definition. The Tax Director role would allow Theresa to influence the financial statements and interact with upper management and the audit team, so she will be subject to the most restrictive independence provision. A one-year "cooling off" period will apply before Theresa can accept this position or any other FROR at Liberty. Specifically, the firm must perform at least one annual audit after the last audit she participated in before she can accept an FROR with the client.

#### *What to do?*

Jason tells Theresa there are two possible options: First, if Liberty can make other arrangements to temporarily fill the Tax Director position, RHO can remove her from next year's audit team, so she may meet the cooling-off requirements and accept the position once a complete audit cycle has passed. Another option is for Liberty to place Theresa in a position that is not an FROR, but rather an

accounting role, which is not subject to the cooling-off requirement. She can become the Tax Director once the cooling-off period has ended. Both options require accommodations by the client, so their willingness to be flexible will depend on how badly Liberty wants to hire Theresa. Jason explains that both sides need to ensure that the approach is not merely "window dressing" but a substantive arrangement that enables Theresa to meet the applicable independence requirements.

#### **Conclusion**

While it's not unusual to move from public accounting to private industry, it is complicated when the company is your audit client. Auditors have much to offer their clients in terms of expertise and background, and companies need accounting, finance and internal audit talent. A sensitivity toward the appearance of independence, based on facts and circumstances, is crucial, along with adherence to professional standards and regulations that mitigate appearance issues and potential threats to the firm's independence.

#### **About The Author & Publisher**

**Cathy Allen**, founder of **Audit Conduct, LLC**, develops numerous courses on professional ethics, independence, and related topics, provides specialized training and expert services, consults on critical independence matters, and advises firms on improving their quality controls.

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