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AUDIT CONDUCT NEWS

Promoting Independence Compliance: Advice for Firms

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To maintain independence, an audit firm's professionals need to know the rules, be aware of situations that may violate the rules, and diligently apply them by taking appropriate action(s). The Spring 2018 issue of Audit Conduct NEWS discussed independence considerations when audit firm professionals contemplate employment with an attest client. This issue suggests ways in which firms can encourage compliance with those and other independence rules by promoting knowledge, awareness and diligence.

Knowing the Rules

To state the obvious, a basic understanding of independence principles and rules is essential to avoid violations. This does not mean you should develop a firm of independence "experts" – however, your professionals should know:

- Why independence is important;
- The basic precepts underlying the rules;
- Circumstances that may raise independence concerns; and
- Where to go for more information.

What firms can do to improve knowledge: Current, periodic instruction on independence that emphasizes the "why" behind the rules and takes advantage of feedback from the firm's practices and internal and external inspection results are key to improving knowledge. Instruction should incorporate firm policies and procedures for identifying, addressing and documenting independence issues.

Periodic instruction. First, require all professionals to attend periodic education on independence. Options include:

- Self-study (firm-developed or from an educational vendor);
- Outside conferences, webinars or seminars; and/or
- In-firm training sessions or meetings.

A combination of the above would be quite beneficial.

The objective is to ensure that your professionals are competent in this area and know where to go for help. This is imperative.

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Teach professionals the "why" behind the rules, which adds meaning to the instruction and should result in better understanding and retention. Remind professionals, especially new CPAs and non-CPA entrants to the firm, why independence is important, as this concept is foundational. Make sure they understand the implications of noncompliance, which negatively impacts both the firm and the professional on various levels (e.g., financially, reputationally).

Feedback loop. Take advantage of the firm's "feedback loop." Discuss issues noted in practice or internal or external inspections in training sessions and meetings with appropriate instruction and correction so compliance can improve. Feedback may also lead to changes in policies or procedures (e.g., clarified language or other improvements to enhance effectiveness).

Being Aware

The term "situational awareness" means knowing what's going on around you so you can react well in an emergency, which can also be applied to independence. For example, if a client's CFO approaches an audit manager with a job offer, that manager should recognize the situation as one that triggers an independence concern. The manager may not recall exactly what to do, but if she knows enough to review the policy or call the firm's quality control partner, some action will occur. If she doesn't see an issue, and continues to audit the client, that's where the trouble begins.

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What firms can do to promote awareness: Formal independence training is typically periodic, occurring every 1 - 3 years, so it's critically important to highlight independence in your firm's communications during the normal course of doing business.

Provide reminders. Provide reminders throughout the year(s) so the knowledge stays fresh. Reminders can be communicated in a variety of ways, including in:

- e-mails,
- voice messages,
- "all hands" meetings,
- town hall meetings,
- technical sessions,
- firm retreats,
- sales meetings,
- marketing meetings,
- meetings with companies or clients to discuss new projects

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or initiatives,
- meetings to discuss alliances with other companies.

Vary your methods of communication so independence is kept top-of-mind; it will also help ensure that professionals do not "tune out" the messaging. More than ever, firms are keenly focused on growth and maintaining relevance. They are merging in other CPA practices, acquiring boutique consulting firms, adding new technologies and expanding service lines, which can take attention away from independence. Employees who have not "grown up" in the profession won't have the same appreciation of independence that CPAs have. If independence becomes an afterthought in marketing, sales and other growth initiatives, the margin of error increases dramatically. And it can be very difficult—even impossible—to address and correct an independence violation once it occurs.

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Avoid problems. Keep independence at the forefront to avoid a situation where relationships become problematic, especially when discussing your firm's sales and marketing strategies and alliances. This is particularly important when the firm provides attest services subject to Securities and Exchange Commission (SEC) independence rules, although issues can also arise when work is performed under generally accepted auditing standards (GAAS), government auditing standards (GAS) or other professional or governmental requirements.

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Firms should monitor their professionals' compliance with independence rules to identify potential independence issues before they occur or reduce the impact of a violation, which also provides opportunities to do targeted training and increase awareness. For example, the firm's independence group or quality control partner can review non-audit services proposals as part of the engagement acceptance process or review engagements that have had a change in status (e.g., an engagement that is now subject to SEC/PCAOB independence requirements). Many firms perform routine, randomized audits of the financial interests held by professionals to ensure compliance with the relevant rules.

Diligent action

Recall the CFO's job offer discussed above and assume the manager is interested. What should she do next?

She reads the policy, which leads her to report the matter to the firm's independence partner. The partner removes the manager from the audit engagement and says she may not perform services for the client until employment discussions cease. The manager understands; there would be a significant appearance issue if she were to continue the audit and employment negotiations simultaneously.

What if the manager had not been aware that the offer created an independence issue requiring action and continued to work on the audit? This would create an unfortunate (and totally avoidable) situation likely leading to undesirable consequences for the client, the firm and this manager.

What firms can do to promote diligent action: Just because you've given your professionals the knowledge and training they need to be compliant with independence rules does not mean they will always be diligent in applying them. And despite appropriate training, some may not take training seriously and remain ignorant of the rules. To foster good compliance, firms should embed in their performance evaluations incentives to encourage the desired behavior; those evaluations should drive compensation and advancement in the firm.

Good to great. Reward excellent conduct. One challenge: all professionals must comply with the independence rules, so compliance is expected. Thus, a firm should reward conduct that constitutes going beyond compliance, which is generally easier to measure qualitatively than quantitatively.

A firm could describe certain attributes in the firm's performance evaluation that help define exemplary conduct. For example, the attribute "professionalism," may include addressing independence issues successfully, which preserves the firm's good reputation in the business and regulatory community. Under "risk management," the firm could look for actions that demonstrate skillful evaluation of independence under tough circumstances and protecting the firm from the detrimental effects of impaired independence.

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Breaking bad. Penalize bad conduct, especially ignorance or knowing disregard for the rules. Identifying and penalizing bad conduct typically is a simpler task than rewarding good conduct as rules violations can be easier to quantify and measure than "good conduct". Sanctioning violators may seem overly punitive to some but can be quite effective in avoiding or minimizing noncompliance. However, to be effective, sanctions must be impactful.

Careful design. Use a thoughtful and careful process when designing incentives for good and bad behavior to ensure professionals will view the process and outcomes as fair and equitable to all professionals, regardless of position or status in the firm. Apply rewards and sanctions consistently in accordance with your policies and procedures.

Final Thoughts

Audit firms and their professionals are responsible for maintaining independence and the stakes are quite high. Discovery of an independence violation after-the-fact can be costly to remedy and damaging on many fronts. With careful, proactive action, firms can help their professionals stay on top of these critical requirements.

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.*