

INDEPENDENCE

Perception or Reality?

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A number of years ago, we had the privilege of working with an outstanding accounting professional who was fond of stating, “Perception is reality.” Whether you agree or not, what people perceive is often their view of reality. With the passage of the Sarbanes-Oxley Act (SOX), independence—and the perception of independence—have become extremely significant.

The seeds for this article were sown as we were routinely reviewing several proxy statements. As we began to discuss specifics of the statements, two situations especially caught our attention:

1. A large public company reported that the chair of its audit committee was the retired CEO of a large public accounting firm. The individual’s former firm was also the company’s “independent” auditing firm. Since the company provided no further information, we were left to believe, or our perception was, that this individual wasn’t independent in this role. A letter to the company’s CEO was answered by the company’s

investor relations director and provided additional information about the audit committee chair. In this case, the individual had sought guidance from the Securities & Exchange Commission (SEC) and was advised that if he/she waited two years, took his/her retirement in a lump sum, and severed all involvement with the former firm, they would view the relationship as independent. Yet how many people reading the proxy statement would perceive that this individual shouldn’t be viewed as independent?

2. A large public company identified one of its audit committee members as a “financial expert,” as required. Before retiring, this individual had been one of the top partners of a large public accounting firm. He/she would certainly qualify as a financial expert, but the former firm was this company’s current independent auditor. Again we were left with a perception of a lack of independence.

As a result of these two scenarios, we began a random review of 20 proxy statements for the year 2004,

searching for additional examples of situations that interested parties could possibly perceive as a lack of independence. We will present several examples from the statements that might raise a few questions in the minds of other readers.

REGULATIONS AND STANDARDS

As background before discussing the examples, we present several summaries of the current statements regarding independence that appear in related regulations and standards. See Table 1 for a list of websites where you can find the complete sets of these regulations. Requirements for independence have been modified recently to address corporate scandals, and the effective date for some of the revisions, in certain situations, may not yet be fully implemented.

Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 (SOX) discusses independence of auditors (Title II) and audit committees (Title III). Specifically, Section 301, Paragraph 3, states:

“Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.”...“In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof.”

New York Stock Exchange. The New York Stock Exchange Listed Company Manual, Section 303A.02, Independence Tests, states:

“(a) No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company (directly or as a partner, shareholder or officer of an organization that has a relationship with the company)...
(b) In addition, a director is not independent if...
(iii) (A) The director or an immediate family member is a current partner of a firm that is the company’s internal or external auditor; (B) the director is a current employee of such a firm; (C)...; or (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company’s audit within that time.”

American Stock Exchange. Section 121 of the American

Stock Exchange Company Guide states:

“No director qualifies as independent unless the Board of Directors affirmatively determines that the director does not have a material relationship with the listed company that would interfere with the exercise of independent judgment....The following is a non-exclusive list of persons who shall not be considered independent:...
(f) a director who is...a current partner of the company’s outside auditor, or was a partner or employee of the company’s outside auditor who worked on the company’s audit at any time during any of the past three years.”

NASDAQ (National Association of Securities Dealers Automated Quotation). The NASDAQ Marketplace Rules state that a director isn’t independent if he/she is

“a director who is, or has a Family Member who is, a current partner of the company’s outside auditor, or was a partner or employee of the company’s outside auditor who worked on the company’s audit at any time during any of the past three years.”

Securities & Exchange Commission. Regulation S-X, Section 210.2-01 states:

“Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client....

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section... .

(2) Employment relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(i) **Employment at audit client of accountant.** A current

Table 1: WHERE TO FIND THE REGULATIONS

Sarbanes-Oxley Act: www.pcaobus.org,
specific address www.pcaobus.org/about_us/sarbanes_oxley_act_of_2002.pdf

New York Stock Exchange Listed Company Manual:
www.nyse.com
specific address www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html

American Stock Exchange Company Guide:
www.amex.com
specific location wallstreet.cch.com/AmericanStockExchangeAMEX/AmexCompanyGuide/default.asp

NASDAQ Marketplace Rules: www.nasdaq.com
specific location nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000635

SEC Regulation S-X: www.sec.gov,
specific location
www.sec.gov/divisions/corpfin/forms/regsx.htm

SEC Regulation S-K: www.sec.gov,
specific location
www.sec.gov/divisions/corpfin/forms/regsk.htm

AICPA Code of Professional Conduct: www.aicpa.org
specific location www.aicpa.org/about/code/index.html

partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client.

(ii)...

(iii) **Employment at audit client of former employee of accounting firm.** A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

- (A) Does not influence the accounting firm's operations or financial policies;
- (B) Has no capital balances in the accounting firm; and
- (C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):..."

Regulation S-K, Section 229.401 states:

"(h) Audit committee financial expert.

- (1)(i) Disclose that the registrant's board of directors has determined that the registrant either:
 - (A) Has at least one audit committee financial expert serving on its audit committee; or
 - (B) Does not have an audit committee financial expert

serving on its audit committee.

- (ii) If the registrant provides the disclosure required... it must disclose the name of the audit committee financial expert and whether that person is independent...

(2) For purposes of this Item, an audit committee financial expert means a person who has the following attributes:

- (i) An understanding of generally accepted accounting principles and financial statements;
- (ii) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- (iii) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- (iv) An understanding of internal control over financial reporting; and
- (v) An understanding of audit committee functions.

(3) A person shall have acquired such attributes through:

- (i) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (ii) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (iii) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (iv) Other relevant experience.

AICPA Code of Professional Conduct. The Code's Interpretation of Rule 101 states:

"Independence shall be considered to be impaired if... during the period covered by the financial statements or during the period of the professional engagement, a firm, or partner, or professional employee of the firm was simultaneously associated with the client as a ...Director..."

The Interpretation of Rule 101 continues:

"A firm's independence will be considered to be impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by or associated with that client in a key position unless all the following conditions are met:..." The conditions

include, among other items, that any retirement payments be fixed other than inflation adjustments, that the accounting firm not provide office space and related amenities, and that the current engagement team assess the need to adjust the audit procedures based on the former employee's knowledge of the audit plan.

Now let's look at a few excerpts from various proxy statements to see how they are dealing with independence and financial expert issues.

PROXY STATEMENT EXAMPLES

Many companies have now begun to provide investors with a written policy regarding director independence. One such statement reads:

"Our Board of Directors has adopted Director Independence Standards. These...standards incorporate all of the director independence standards of the NYSE.

These standards require that the director be considered independent only if the director does not have, and generally has not had within the previous three years, any material relationships with the company, including any affiliation with our independent auditors." (*Underlining added*).

A related question about members of audit committees concerns the definition of "financial expert." Clearly, a former partner of a large CPA firm or a former CFO or corporate controller would qualify. But what about the CEO of a large company? Although this person certainly would be financially literate, he/she may not be a "financial expert." Consider the protestations of Bernie Ebbers of WorldCom and Richard Schrushy of HealthSouth that they were "misled," although both would be considered "financial experts" under the definition in Regulation S-K.

Here's a brief vita of a director one company believes to be a financial expert:

"He has served as Chairman and Senior Fellow with a public policy research institute. He was science advisor to the President and Director of the White House Office of Science and Technology Policy. He holds various honorary degrees and is an honorary professor at a university in Shanghai."

Impressive, but there's no indication of what qualifies him as a financial expert. Once again, perception becomes reality.

Situation 1

Let's go back to our first proxy statement example where the chair of a company's audit committee is the retired

chairman and CEO of a large public accounting firm. The company's independent audit firm is the same firm in which the individual had been employed.

Question: *If companies feel the need to use the services of a public accounting firm partner as a director, member, or even chair of their audit committee, is there an independence issue, in fact or appearance, if the individual is from the same firm that serves as the independent auditor for the company?*

Situation 2

A member of this company's audit committee retired as the chairman of the board of a large public accounting firm several years ago and has since served as chair of a nonaccounting company. The independent audit firm of the company in Situation 2 is a large firm other than the firm at which the individual was employed.

Situation 3

The chair of this company's audit committee retired as the chairman of the board and CEO of a large public accounting firm a few years ago and has since served as CEO of multiple nonaccounting companies. The independent audit firm of this company is a large firm other than the firm at which the individual was employed. The member is one of two identified "financial experts" and also serves on audit committees of three other companies.

Situation 4

This situation is similar to Situation 3 in that one member of this company's audit committee retired as the CEO of a large public accounting firm. But the individual retired in 2003 and became a director and member of the audit committee in 2004. The company's independent audit firm is a large firm other than the firm at which the individual was employed. Additionally, a second member of the audit committee is a former chairman and CEO of another large public accounting firm. Consequently, two of the five audit committee members are former CEOs of large public accounting firms.

Question: *If companies feel the need to use the services of a present or former public accounting firm partner on the board of directors and the audit committee, should the companies broaden their search to seek out individuals from firms of all sizes rather than a firm comparable in size to their own audit firm?*

Situation 5

This situation is similar to Situation 3 in that a member

of this company's audit committee retired as vice-chairman of a large public accounting firm. The individual retired in 2002, became a director in 2003, and is now serving as chair of the audit committee and is identified as the "financial expert." The company's independent audit firm is a large firm other than the firm at which the individual was employed.

Situation 6

A member of this company's (Company A) audit committee and identified "financial expert" was a partner of a large public accounting firm for several years and then left the firm and became EVP and CFO of a large corporation (Company B). Company B's independent audit firm is the public accounting firm at which the individual was a partner. Within four years, the individual was elected a director of Company A. Company A's current independent audit firm is a large firm other than the firm at which the individual was employed.

Situation 7

The board of directors and audit committee of several of the companies we examined contained no individuals from public accounting firms. Audit committee members and chairs included university professors, university presidents, leaders of law firms, CEOs of other firms, heads of consulting firms, etc.

Question: *Companies appear to be able to meet the "financial expert" requirement without the presence of an audit firm partner. Therefore, two questions could be asked:*

- (1) Should companies refrain from having a present or former partner of large public accounting firms on the board of directors and*
- (2) on the audit committee?*

Situation 8

A member of the board of directors and audit committee had been the founder and CEO of Company B, which was acquired by the company in Situation 8 (Company A). The individual, who isn't a current active employee of Company A, holds a large number of shares of stock in the company compared to other directors—second only to the chairman of the board. The individual is described in the proxy statement as being independent. Could this individual truly be considered independent?

Question: *Is a director independent if that director owns a substantial number of shares in that company?*

A MESSAGE FOR COMPANIES

Although we have raised some questions about the "perception of independence," it isn't our purpose to answer them because individuals will arrive at their personal conclusions based on their own perceptions. But we do think that companies should make a special effort to describe the specific factors that make their directors truly independent or truly "financial experts." If readers are left to their own interpretations, perceptions could overcome reality. Although the SEC has determined that a CEO is a "financial expert"—regardless of education, background, or previous experience—it's likely that not all of them would qualify nor would stockholders view them as such.

Given the tainted reputation of both corporate America and the public accounting profession, sensitivity to perceptions could make a major contribution toward improving their images. Recently, a company involved in a major corporate scandal sued its independent auditor for breach of contract, independence, and negligence, among other actions. With all the current events that call into question the integrity of corporations and accounting firms, you might think that companies would err on the side of too much independence to avoid bad impressions. If companies feel that having a representative of an audit firm on their audit committee is desirable to meet the financial expert requirement, maybe they should be asking this question: *In balancing the desire for independence and the presence of a financial expert, do we need an auditor on the audit committee to have a financial expert or not need one to have independence?*

It isn't our intent to suggest that partners or other members of public accounting firms shouldn't serve on boards or audit committees. We are only suggesting that companies need to be careful in the selections they make and then fully describe the rationale for their "independent" and/or "financial expert" selections. Then the reader of proxy statements can clearly see why the individual was so designated. ■

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