

***American Accounting Association ♦ Auditing Section
Auditing Standards Committee***

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Via email to lsnyder@aicpa.org

**RE: Invitation to Comment on Omnibus Proposal of Professional Ethics Division
Interpretations and Rulings**

Dear Committee Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association welcomes the opportunity to comment on the Exposure Draft of *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*. We offer the following comments to address the objectives and substance of the proposed interpretations; we also provide suggestions to enhance the clarity of the proposed interpretations and rulings.

The views expressed in this letter are those of the Auditing Standards Committee members and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

**1. Proposed Interpretation 101-16, Indemnification, Limitation of Liability, and ADR
Clauses in Engagement Letters Under Rule 101, Independence**

Integration of a Conceptual Framework

Overall, we encourage the Professional Ethics Executive Committee (PEEC) to modify the Interpretation so that it presents a strong conceptual foundation, and a clear discussion as to how the issues fall within an independence framework.¹ We recognize that the PEEC is using, as its

¹ We acknowledge that issues related to limitation of liability can be addressed under the auspices of Rule 101 – *Independence*. Such a perspective, however, is not without debate. An alternative argument for the prohibition of certain types of limitation of liability language in engagement letters could be ascertained via the more broad issue of *Due Professional Care*. That is not to say that that due care concerns do not overlap with independence concerns. The omission of audit tests or the failure to follow-up on evidence indicating a misstatement in the financial statements is indeed behavior that may lack objectivity and that may be biased (key components of the independence construct). However, such failures could be considered, first and foremost, to be failures to exhibit due professional care. Deference to the historical view of treating limitation of liability issues as independence concerns, and the fact that other standard setters have viewed these issues in a similar fashion, do not necessarily warrant continuing this treatment. However, if such a treatment is adopted, it should be discussed within the context of a strong conceptual framework.

foundation, the Independence Framework adopted by the PEEC in 2006. However, the substance of the framework could be better integrated into the Interpretation. For example, within the framework, it may be useful to identify exactly how a limitation of liability threatens independence, and why the various proposed exclusions do not constitute such a threat. Discussion of the issues within the conceptual framework will enhance the clarity of the document.

With the framework as the foundation, a discussion on how indemnification, limitation of liability, and ADR clauses in engagement letters might impair independence could be informative. The tone of the ED suggests that additional threats of litigation somehow improve auditor independence. If that is the case, then any attempts to reduce the amount of litigation would seem to impair independence.

Clearly, if the auditor benefits financially from the outcome of an audit, a conflict of interest exists. If the auditor is auditing his/her own decisions, there is also a conflict. But what process takes place for litigation to be linked to independence? One can reasonably make a case that litigation threats might induce auditors to exercise more diligently due professional care. Thus, these issues could be linked to independence from client pressure. If that is the case, why would the AICPA go along with any limitations to litigation? Why would the indemnification or limitation of liability provision for punitive damages be deemed acceptable? The proposed Interpretation should address these important issues.

From a research perspective, the only applicable research of which we are aware is "The effects of formal sanctions on auditor independence" by Shafer, Morris, and Ketchand in the 1999 Supplement of *Auditing: Journal of Practice and Theory*. The paper indicates that auditors facing litigation and peer review risk would be less likely to go along with client pressure on financial statements. If another definition of independence is "less likelihood to agree with the client" then litigation would seem to strengthen independence. Such a finding could support the idea that limitations to litigation are not in the best interest of quality financial reporting.

We would like to see greater specificity of PEEC's goals and objectives, and how its proposed Interpretation accomplishes those goals and objectives. The proposed Interpretation should clearly state whether it is focused on reducing legal liability, or whether the fact that the indemnification does not apply in the event of non-compliance with GAAS is actually designed to increase legal liability. If the proposal is viewed as reducing legal liability, we question whether it is advisable for the PEEC to recommend such changes at this time in the profession's history. We believe that Congress and the public expect the public accounting profession to assume greater, not less, responsibility. If the Interpretation clearly states its goals, the PEEC reduces the likelihood that the Interpretation will result in an increased expectations gap.

"In all material respects"

We have concerns about the inclusion of the phrase "in all material respects" as it relates to adherence to the professional standards. The requirement that indemnification be contingent on performance in accordance with professional standards may substantially lower the value of such clauses, but could be viewed as a necessary and appropriate response to mitigate the threat to independence. We expect that the modification clause "in all material respects" is designed to maintain the integrity of the indemnification clause. However, is this the appropriate modifier to describe compliance with professional standards? The terms "substantial compliance" or "substantially full compliance" are probably appropriate descriptions. A more precise description

might define this term. For example, “in all material respects” could be interpreted to mean that the departure from GAAS would not constitute a deficiency in a peer review.

Nonattest Services

We concur that allowing for the exclusion of nonattest services engagements may be appropriate in some circumstances. However, we question whether the exclusion of nonattest services is appropriate in situations where nonattest services are other than “minor” in comparison to the audit services provided.

Other Comments

We do not have substantive concerns with other provisions of the proposed interpretation.

2. Proposed Revisions to Interpretation 101-3, Performance of Nonattest Services, Under Rule 101, Independence

Expert Witness Services and Litigation Consulting Services

We concur that the provision of expert witness services would create the appearance that a member is advocating or promoting an attest client’s position and, thus would be seen as an impairment to independence.

We agree that a conceptual and theoretical distinction may exist between the performance of expert witness services and litigation consulting services. However, in practice the two are likely similar on many dimensions. In adversarial systems of dispute resolution, alternative ways to portray or argue the “facts” of a matter almost always exist. Clients will seek consultants and experts who portray the “facts” in a manner favorable to them. The determination of “fact” is then left to the trier-of-fact. Prohibiting the member from serving as an expert witness (who the litigation consultants will prepare for trial, etc.), but allowing the member to be a litigation consultant (especially one in consultation with the expert) does little to eliminate the lack of independence in appearance that emerges from this arrangement. Litigation consulting services should be prohibited for the same reason that expert witness services are prohibited – the advocacy threat to independence in appearance for which there is no satisfactory mitigating safeguard.

With respect to litigation consulting services, if such services are permitted, individuals that provide the litigation services should not be involved with the attest function. However, we recognize that this requirement could impose an undue hardship on smaller accounting firms. This hardship could be addressed with modified wording, such as “Where members of the attest engagement team are involved in providing the litigation consulting services, the member and the member’s firm should evaluate whether the litigation consulting services would impair the member’s independence and objectivity.”

Litigation consulting services are described as providing advice about the facts, issues and strategy of a matter without testifying as an expert witness before a trier-of-fact. The establishment of strategy of a matter by a member has the appearance that a member is advocating or promoting a client’s position. If such services are permitted, the member should make it clear to the client and/or the client’s attorney that he or she can not provide expert witness testimony or establish strategy in litigation matters.

Defining Terms

The Exposure Draft includes a number of terms (e.g., arbitrator, mediator, etc.) that do not appear to be explicitly defined. Are the definitions of these terms universally known or would it be useful to explicitly define these terms or provide references to where they are defined?

Standard Setting Process – General Comments

As our observations indicate, we believe that in addition to the comment process, standards should have a strong conceptual foundation. As you consider future standards and interpretations, we encourage you to consult the academic community, including our committee, for a synthesis of relevant research that could shed light on issues being considered.

We hope that our comments and suggestions are helpful and will assist in finalizing the guidance. Please feel free to contact our committee Chair for elaboration on or clarification of any comment.

Respectfully Submitted,

Auditing Standards Committee
Auditing Section, American Accounting Association

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