

602.02.e. Business Relationships

Direct and material indirect business relationships, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity, such as officers, directors or substantial stockholders, will adversely affect the accountant's independence with respect to that client. Such a mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interest would, to some extent, be dependent upon the client. In addition to the relationships specifically prohibited by Rule 2-01, joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests, (except for immaterial landlord-tenant relationships) and sales by the accountant of items other than professional services are examples of other connections which are also included within this classification.

The following cases illustrate the types of inquiries received by the staff in this area:

Example 1

Facts: A computer firm was engaged exclusively in computer processing income tax return data for professional tax return preparers, including various local offices of many national accounting firms. When the computer company was contemplating making a public offering of its stock, an inquiry was made regarding whether an accounting firm which utilized this computer service could be deemed independent with respect to the audits of the financial statements of the computer firm required for the purpose of the public offering.

Conclusion: An accounting firm's independence would be adversely affected if billings for this service from the computer firm to the accounting firm or to the local office which would perform the audit were significant to the accounting firm, its local office, or to the computer firm. Since these computer services are a direct part of the professional tax service rendered by the accounting

firm, any material amount of such computer services would create a mutuality of interests that would impair the appearance of objectivity of the accounting firm necessary for the performance of the audit.

Example 2

Facts: Five covered persons of an accounting firm owned ten percent of the voting interests in a small business investment company which planned to participate with another small business investment company in a loan to a client of the accounting firm. In conjunction with the loan, the lending companies would receive warrants for five percent of the common stock of the audit client.

Conclusion: Independence of the accounting firm would be adversely affected with respect to the audit of the client's financial statements if the covered persons retained their interests in the small business investment company, which would have a creditor relationship with the client and a right to acquire an equity interest as a result of the loan.

Example 3

Facts: An accounting firm inquired whether its independence would be adversely affected with respect to a client if the controlling shareholder became a limited partner in a partnership which is controlled by covered persons of the accounting firm in their capacity as general partner.

Conclusion: The accounting firm's independence would be questioned in these circumstances in as much as the joint business venture would impair the appearance of independence of the accounting firm.

Example 4

Facts: An accounting firm's client, a realtor corporation, was the general partner and ten percent owner in a limited partnership which owned unimproved land held for appreciation in value. The accounting firm also owned a five percent interest in this limited partnership and a covered person in the firm had a two percent interest.

Conclusion: The joint investment with the client was viewed as incompatible with the appearance of independence.

Example 5

Facts: A covered person in a foreign accounting firm that performed the audit of financial statements of a client in the foreign country which was a subsidiary of a company registered with the Commission also owned an industrial equipment company from which the client had ordered an expensive piece of equipment. A large deposit on the purchase commitment was held by the partner's company during the audit engagement. Engaging in commercial transactions with a client

does not conflict with the professional standards for independence of accountants in the foreign country.

Conclusion: The accounting firm's independence was adversely affected since the partner's commercial company was dependent on the client for a profit on the commercial transaction and was in a debtor position in relation to the client as a result of the large deposit. These factors created a question regarding the objectivity of the firm in conducting the audit.

Example 6

Facts: Client of an accounting firm was engaged in the business of selling franchises. Two covered persons of this firm had invested approximately five percent of their personal fortunes to buy one-half of the stock of a corporation which held a franchise granted by this client. Except for the payment of a percentage of sales to the franchisor, the franchisee operated independently.

Conclusion: The firm could not be considered independent because the covered persons had a material investment in the franchisee which had a close identity in fact and in appearance with the client.

Example 7

Facts: Covered persons in accounting firm was also a financial vice president and stockholder of a real estate investment trust. In addition, he was a limited partner in a company which manages the trust. A client of his firm had asked him to help them get a loan from the investment trust.

Conclusion: Independence for future periods would be adversely affected if the company were to obtain the loan from the real estate investment trust. However, no question would be raised as to periods prior to the commencement of negotiations for the loan.

Example 8

Facts: Covered persons in the accounting firm had a common investment with stockholders of a prospective client. These covered persons owned approximately 11 percent of Company A and the other investors who owned approximately 78.5 percent of Company A, also owned 22 percent of the prospective client.

Conclusion: Independence was adversely affected because the common investment which the covered persons of the firm had with the substantial minority shareholders of the prospective client was such a circumstance as could lead a third party to question the firm's objectivity.

Example 9

Facts: An accounting firm planned to construct office buildings in which it would occupy a relatively small portion of the space and would rent

the remainder to other tenants, some of whom might be clients of the firm.

Conclusion: The activity of owning and managing real property is more in the nature of a commercial business activity than of a professional service. Rental of a material amount of space to a client would raise a question of independence since the accounting firm would appear to have a material business relationship with the client. Some reasonable tests which would be applied in determining what constitutes a rental of material amount might be the relationship of a single lease to the fees earned in the office located in the building concerned, total lease rentals from all clients to the firm's total fees, and lease rentals from a particular client to the auditing fee paid by that client for the same period.

Example 10

Facts: Several covered persons of an accounting firm formed a general partnership to build two office buildings which would then be leased to third parties. Would leases entered into between the partnership and present or future clients of the accounting firm impair the firm's independence?

Conclusion: The activities conducted by the covered persons through the general partnership would be attributed to the accounting firm for purposes of independence determinations. Therefore, any material business relationship arising between the general partnership and a client of the accounting firm would impair the independence of the accounting firm as auditors for that client and its affiliates.

Example 11

Facts: An accounting firm had its office in a building which was owned by a client. The accounting firm, which occupied approximately 25 percent of the available office space in the building, was the only tenant other than the client.

Conclusion: The fact that the accounting firm was the only other tenant in the client's building and leased a substantial portion of the available office space are circumstances that would lead a reasonable third party to question the firm's objectivity. Therefore, independence was adversely affected.

Example 12

Facts: Accounting firm planned to rent block time on its computer to a client if the client's computer becomes overburdened.

Conclusion: Renting excess computer time to a client, except in emergency or temporary situations, is a business transaction with a client beyond the customary professional relationship and would therefore adversely affect independence.

Example 13

Facts: A covered person in an accounting firm acquired, and assigned to his minor daughter, a ten percent voting interest in a corporation which owned a retail store franchised from a proposed client that also operated similar stores directly.

Conclusion: Independence of the accounting firm would be adversely affected with respect to the audit of the client's financial statements because the covered person was deemed to have a direct interest in a company over which the client may exercise control through the franchise agreement for operation of the retail store. In addition, the company had a close identity in fact and appearance with the client through the operation of similar retail stores.

Example 14

Facts: An accountant and five persons who were the sole stockholders of the proposed registrant acquired a parcel of real estate for the purpose of selling or leasing it to the company. The total purchase price was \$85,000 of which \$26,000 was paid in cash and the balance by a note secured by a mortgage. In addition to providing his portion of the cash payment, the accountant loaned the others \$21,000 on interest bearing notes to cover their share of the down payment. It was also provided that the accountant would receive 25 percent of any profit arising from sale of the property to an outsider.

Conclusion: Independence was impaired.

Example 15

Facts: A covered person, together with certain officers of the registrant, organized a corporation which purchased property from the registrant for \$100,000 giving the registrant \$25,000 cash and a purchase money mortgage for \$75,000.

Conclusion: Independence was impaired.

Example 16

Facts: Certain covered persons of an accounting firm were to become principals in a finance company whose wholly owned insurance agency would place with an insurance company client of the firm all or a substantial part of the insurance on the chattels financed.

Conclusion: If the insurance were so placed, the accounting firm would not be considered independent with respect to its insurance company client.

Example 17

Facts: The wife of a covered person had a 47.5 percent interest in one of the three principal underwriters of a proposed issue by the registrant.

Conclusion: Not independent.

Example 18

Facts: A consultant to an accounting firm was also a director and member of the audit committee of a client served by the accounting firm. The consultant's compensation from each of these two

involvements was significant in relation to his total earnings.

Conclusion: The apparent conflict of interest which arose from the dual roles of the consultant caused the appearance of the accounting firm's independence to be affected adversely.

Example 19

Facts: A covered person certifying the financial statements of a registered broker-dealer was a co-signer on the broker's indemnity bond.

Conclusion: Independence impaired.

Example 22

Facts: An accounting firm audited the brokerage operations of a financial concern and planned to perform what it considered to be consultative or advisory work for another branch of the business which marketed an estate planning service. This additional work would consist chiefly of developing individual estate planning packages for customers and making recommendations jointly with management to the customers.

Conclusion: The accounting firm's independence would be adversely affected with respect to the audit of the brokerage operations if it performed the additional services for another branch of the business, because it would be participating with management in the development and the sale of a product to be marketed by the company.

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602.02.f. Other

602.02.f.i. Indemnification by Client

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce