


Retired Audit Firm Partners on Boards: Independence Considerations

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Retired audit firm partners represent an attractive pool of potential members for public company boards and their audit committees. By "retired partner," we mean a partner (including a principal or a shareholder) of an audit firm that has reached a certain age and has accumulated a defined number of years of service and has formally retired from the firm.*

Clearly, such individuals can make desirable additions to any board, especially given the new listing requirements of the stock exchanges.

As most directors know, in December 1999, the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and the American Stock Exchange (AMEX) adopted new listing requirements that all members of a company's audit committee, with the exception of a small business filer, must be or must become "financially literate." In addition, at least one member of the committee must possess accounting or financial expertise.

As a result of these new requirements, retired partners are being actively pursued for appointment to corporate boards. But before considering or making such appointments, the audit firm and the company must resolve a number of independence issues.

Consider a recent development in point. The financial collapse of HIH Insurance Limited was widely reported in the Australian press in 2001. Among the many issues that were raised by the extensive press coverage in the wake of the collapse was that two of the company's non-executive (*i.e.*, outside) board members were retired senior partners of HIH's external audit firm, one of the Big Five partnerships. It also came to light that both of these retired partners were members of the board's audit committee, and one was chairman of the committee. The Australian Government has appointed a Royal Commission to investigate and report, and among the issues to which the Prime Minister has directed the Commission's attention is whether the decisions or actions of HIH and its personnel "involved undesirable corporate governance practices."

The practice of appointing retired partners of a company's external audit firm to the company's board, and even to the board's audit committee, is not precluded by any rules and regulations in the U.S. or in such countries as Canada, the U.K., Australia, and New Zealand. In the U.S., the practice is allowed so long as there is no financial dependence, influence, or the appearance of continued association by the retired partners on or with their former audit firm.

Nonetheless, appointing retired partners of a company's external audit firm to its board of directors brings up a number of questions pertaining to independence and objectivity of the audit firm. When, in addition, a retired partner of the company's external audit firm also sits on, let alone chairs, the board's audit committee, these questions become even more serious. Therefore, it is useful to review existing rules pertaining to such matters.

The purpose of this article is to explain rules and regulations in the U.S. that govern these appointment practices and to discuss policies and procedures that safeguard the independence of both the audit firm and the audit committee in such situations. We also recommend additional safeguards and comment on the propriety of appointing retired partners to the audit committee.

SEC Rule and Safeguard Requirements

If a retired partner of an audit firm becomes a member of the board of directors of one of the firm's audit clients, he or she is thrust into an accounting or financial reporting oversight role. Therefore, the Securities and Exchange Commission's (SEC) Rule 2-01(c)(2)(iii), "Employment at Audit Client of Former Employee of Accounting Firm," applies. The rule covers all retired partners from the audit firm without regard to their line of service (audit, tax, or consulting). To maintain its independence the audit firm must:

DIRECTOR SUMMARY

Retired audit firm partners can make excellent corporate directors, but both firms and corporations need to guard against conflicts of interest—particularly when retired partners join the boards and audit committees of their former firms. ◗

*Note: Partners who have resigned, but not retired, from the audit firm may present some of the same issues that are discussed in this article, but such individuals are not discussed herein.

- eliminate any capital balance related to the retired partner
- eliminate any other financial arrangement with the retired partner except for a fully funded fixed-payment retirement account or irrevocable escrow ("rabbi") trust that is not dependent on the audit firm's financial results, and
- ensure that the retired partner has no influence over the audit firm's operations or financial policies.

In addition, the SEC and the American Institute of Certified Public Accountants (AICPA) require the audit firm to have and administer the following safeguards in order to reduce the risk of impairing independence. The required safeguards specify actions that are necessary prior to and after the partner's retirement (called "pre-retirement" and "post-retirement" safeguards). The pre-retirement safeguards apply when the retired partner was in some way associated with the audit engagement prior to retirement. In those situations, the audit firm is required to have policies that obligate the partner to:

- report promptly to the audit firm that a possible appointment to the client's board of directors is being considered, and
- be immediately removed from the audit engagement and any other association related to that engagement.

In addition, the audit firm is obligated to review the partner's work to assess whether the retiring partner exercised appropriate professional skepticism on the audit engagement.

Without regard to whether the retired partner was associated with the audit engagement, the audit firm also must implement certain post-retirement safeguards. These are:

- The on-going engagement team must determine whether the audit plan needs to be modified to control for the risk of circumvention (*i.e.*, the ability of the retired partner to influence the conduct of the audit).
- If, as a member of the client's board of directors, the retired partner will have significant interaction with the audit team, the audit firm should ensure that the audit team has the stature to deal effectively with the retired partner.
- If the retired partner had significant interaction with the audit team and joins the board of the audit client within one year of retiring from the audit firm, the firm must assign one of its professionals, who was uninvolved in the audit, to undertake a separate review of the following year's annual audit.

Requirements Relating to the Appearance of Independence

The AICPA's "Code of Professional Conduct" should also be considered. It prohibits certain practices that would cause a reasonable investor to conclude that the audit firm's independence was impaired. Based on these rules, a retired partner (again without regard to his or her line of service) who joins the board of directors of an audit client will impair the audit firm's independence if the firm:

- includes the retired partner's name under the audit firm's name in an office building directory
- includes the retired partner's name as a member of the audit firm in membership lists of business, professional, or civic organizations
- lists the retired partner's name in the firm's internal directory, unless the individual is designated as retired, and/or
- provides office amenities (*e.g.*, an office, secretarial support, or telephone services) to the retired partner.

The prohibitions listed above are illustrative and do not represent an exhaustive list of practices that would impair independence. The essence of the requirement is that the retired partner should not appear to participate in the activities of, or be associated with, the audit firm.

Required Discussion on Director Independence

Under the requirements of the stock exchanges and the SEC, the external auditor is required, at least annually, to disclose to the company's audit committee, in writing, all relationships between the auditor and the company that may reasonably bear on independence. In addition, the SEC requires the audit committee to state in its annual report to shareholders whether the committee received the external auditor's disclosures about independence and whether the committee discussed independence issues with the external auditor.

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When a retired partner joins a client's board of directors, this matter will certainly require the external auditor to disclose and discuss the issue with the audit committee. During this discussion, the audit committee should, of course, address the pre-retirement and the post-retirement safeguards with the external auditor. In addition, the audit committee should inquire about any practice or relationship between the retired partner and the company that would cause an impairment of independence, including any concerns about the appearance of independence. In fact, the authors believe that it is a good practice for the audit committee to require management or the board to advise the committee of any plans that the company has to appoint any retiring partner to the board of directors. Along with this communication, the audit committee should discuss the actions that the company plans to take to ensure the audit firm's independence.

Issues Relating to the Audit Committee's Independence

The audit committee, among other things, is responsible for overseeing all aspects of the independence of the external auditor, including the performance of non-audit services by the external auditor and whether those services were compatible with maintaining independence. In turn, the board of directors is the guardian of the audit committee's independence.

Clearly, independence is the hallmark of the audit committee. Otherwise, how can the audit committee oversee the quality of the audit, evaluate the performance of the external auditor, and, if needed, replace the external auditor?

If the audit firm and the retired partner were to follow all of the foregoing

A dimension of independence involves the appearance of objectivity.

SEC and AICPA requirements, the audit firm may be deemed to be independent, but the retired partner may not be suitable for service on the audit committee. Therefore, if a retired partner were to become a member of the audit committee of a client of the partner's former audit firm, independence issues relating to the audit committee should be considered.

As noted above, in 1999 the stock exchanges adopted new independence requirements. Those requirements identify directors who should not ordinarily be appointed to an audit committee, because they are not considered to be independent. In general, the requirements address independence from the company's perspective. That is, current employees, certain former employees, the immediate family members of current and former employees, and consultants and others having business relationships with the company are not considered to be independent.

In certain situations, the stock exchanges currently allow one non-independent director to serve on the audit committee when the board determines that it is in the best interest of the company and its shareholders. When such an appointment is made, the company must disclose in its next annual proxy statement the nature of the non-independence relationship and the reasons for the board's decision.

When they established their new independence requirements for audit committee members, the stock exchanges explicitly treated the case of an existing partner in an audit firm who has a business relationship with the company. However, the requirements do not deal with retired partners from audit firms who might serve on the committee. Nor did the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, which laid the foundation for the stock exchange requirements, discuss the possible appointment of retired audit firm partners to an audit committee. In fact, the authors are unaware of any published writings that address the appointment of retired audit firm partners to an audit committee. Although a retired audit firm partner who joins the audit committee of a current client of the partner's former audit firm would not usually run afoul of the explicit stock exchange independence rules, the analysis and discussion should go beyond those requirements.

The essence of an audit committee member's independence is his or her mental objectivity. But a further dimension of independence involves the appearance of objectivity.

A retired partner of the company's audit firm must assure the board that he or she convincingly possesses the attributes of independence, and would, as well, be seen by a reasonable investor as independent, in order to justify appointment to the audit committee. The authors recommend that, at the least, a cooling-off period be used for purposes of such an appointment to the audit committee.

According to current requirements for service on a company's audit committee, a former employee of the company or its affiliate during the last three years is not considered to be independent. Thus, a useful rule-of-thumb to follow as a minimum would be to apply a three-year cooling off period to retired partners from the firm that is the company's external auditor.

In the authors' view, an even longer cooling-off period in such circumstances would be warranted. One assumes, of course, that, after the cooling-off period has expired, the retired partner would possess the requisite mental objectivity to oversee the external audit firm's performance as well as the strength of character to replace that firm if the need arises.

Conclusion

In view of the NYSE, NASD, and AMEX requirements that audit committee members possess financial literacy, retired partners are excellent candidates for appointment to corporate boards and their audit committees. When the retired partner is from a firm other than the company's external audit firm, there are no unique independence issues that call for resolution. However, when the retired partner from the company's external audit firm is appointed to the board, there are a host of independence issues that must be considered to avoid impairing the independence of the audit firm. Of course, the SEC and AICPA requirements and safeguards must be followed in order for the audit firm to be considered independent.

If the retired partner is also appointed to the board's audit committee, even if the audit firm were to satisfy all of the attributes of independence, there could be significant objectivity and independence issues that could weaken the performance of the audit committee. There is an ample pool of retired partners from other audit firms to consider without having to entertain an appointment to an audit committee that may taint the committee's independence. ◗

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