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Threats and Safeguards in the Determination of Auditor Independence

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THREATS AND SAFEGUARDS IN THE DETERMINATION OF AUDITOR INDEPENDENCE[1]

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INTRODUCTION

Neither auditors nor our system of regulating their function has ever received the degree of public scrutiny and skepticism as that which followed the violent collapse of Enron, and the sorry parade of bankruptcies and accounting re-statements in its wake. In the age of innocence that preceded the implosion of Enron, in the booming stock market where momentum investors looked to the thundering herd rather than at fundamental value, the market was not very much interested in auditors. Certainly we all realized that in theory the quality or integrity of financial information was vital to the operation of our capital market centered brand of capitalism. But in practice no one cared very much about them. The Big Five public audit firms had a wonderful brand. Accounting was seen as providing dated and "conventionalized" information that is not of such great use in pricing stocks. There were dissenters from the panglossian view that, by and large the reporting of financial information was just fine. Most notably former SEC Chairman Arthur Levitt dissented. To his credit, Mr. Levitt perceived the risks that were arising from a hot stock market and from auditors who were re-designing their identities. In the old days auditors were risk averse professionals, whose training was to keep people coloring within the lines. But Levitt saw them evolving into sleeker (and financially more ambitious) professionals who wanted out of their old identity and into a new one. Auditors in the 1990s started thinking of themselves as partners with their clients in value creation. Levitt saw the risks that this evolution posed but he could not really interest the market in this issue. In the end Chairman Levitt could not find political support for implementation of his

1. The views expressed in this essay reflect only the views of its authors and do not necessarily reflect the views of any other person with whom they were associated in the work undertaken by the Independence Standards Board.

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view of appropriate public policy with respect to auditor's permissible activities.

For the rest, we simply didn't see what Levitt saw. But in time we, who needed to be hit over the head, were, repeatedly. Finally, our heads were so remarkably lumpy from these rude surprises that Congress tried to call a halt. With astonishing speed and near unanimity it enacted the wide ranging reforms contained in the Sarbanes-Oxley Act of 2002.

Perhaps the most important reform contained in this legislation is the restructuring of the governance of the auditing profession. Now by statute auditors are precluded from providing to their audit clients a long list of non-audit services, including design of information and control systems and internal auditing services. Equally importantly now a new regulatory structure—the Public Company Accounting Oversight Board—will govern the oversight of the auditing profession. (It may now seem quaint to refer to auditors as professionals and not an industry, but this is our habit). Importantly, among the specific responsibilities of the new Board is the assurance of auditors independence and the adoption of rules or standards to assure it.

Thus, auditor independence took a large step forward when the Sarbanes-Oxley Act was passed.[2] In addition, the sad failure of Arthur Anderson as a consequence of its complaint auditing, itself has presumably done much to induce the final four to act with independence and rectitude. Thus auditor independence is presumably stronger today than ever in recent history. Yet threats to independence continue to represent risks to our system. No fact more tellingly establishes that independence remains potentially problematic, even though consulting is now made illegal, than the fact that Arthur Anderson reportedly received approximately $26 million in audit fees from Enron. Worldcoms audit fees were of the same magnitude. Audit fees of this size are alone large enough to tempt audit partners from the narrow path of rectitude. Thus, complex issues of auditor independence do remain after passage of the Sarbanes-Oxley Act.

The existing SEC rule, Rule 2-01 under Regulation S-X[3] which represented a required political compromise, is not adequate to deal with why important remaining independence issues in a rational and comprehensive way. The new Public Company Accounting Oversight Board will have to do so.

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2. Parenthetically that it probably took at least as large a step forward when Arthur Anderson was forced into bankruptcy as a result of its Enron choices its partners made.

3. 17 CFR § 210.2.01.

The essay that follows was written before enactment into law of the Sarbanes-Oxley Act. It attempts a brief explication of an existing conceptual framework for determining issues of auditor independence: that of the staff of the Independence Standards Board and suggests that approach is a much sounder way to address remaining issues of auditor independence than the approach reflected in the existing SEC Rule. Because the new Public Company Accounting Oversight Board is charged with addressing issues of auditor independence it will have to try to think conceptually about what we want from a requirement of auditor independence and what we are willing to forego in order to have it. The SEC should encourage it to do so and allow it to replace the political comprise of the existing Rule.

INDEPENDENCE AND THE AUDITOR'S ATTESTATION

Investors rely on the integrity of the auditor's attestation. Independent expert judgment is the alpha and the omega of the auditing profession. A primary bulwark of this reputation for integrity is the auditing profession's long commitment to independence. Of course, perfect independence of judgment is not possible in this world. The fact that we have always permitted multi-year auditing relationships and, more basically, that auditors are private professionals who receive a fee from clients, means that threats to independence of judgment are unavoidable. Collectively, it is advantageous for the accounting industry to assure the capital market that the auditor's attestation adds real value. Thus, for decades, an important source of professional and regulatory concern has been defining the sorts of relationships or circumstances that may create too great a risk of impairing auditor independence.

This task was made more difficult over the last twenty-five years by the evolution of auditing firms into the providers of multiple professional services to their audit clients. Driven by the expertise (especially information system expertise) within these firms, clients became increasingly likely to call upon these trusted professionals to supply other services—some closely related to preparation of financial statements and some rather removed from the auditors' core expertise. Also, clients increasingly relied on auditing firms because the firms knew their clients, the clients trusted the firms, and the firms were a source of sophisticated business knowledge. In retrospect, it does not seem surprising that these firms would evolve into providers of multiple services. But the growth of multiple relationships began to cast shadows on the vital perception of independence of auditing firms. By the 1990s, it appeared that some overall review of the criterion for evaluating auditor independence would be prudent.

In June of 1997, the Securities and Exchange Commission ("SEC") joined with the major accounting firms and the American Institute of Certified Public Accountants ("AICPA") to form the Independence Standards Board ("ISB").[4] The SEC changed the ISB to review the existing regulation of independence and to promulgate, through a public process, standards for determining auditor independence.[5] Unless explicitly rejected by the SEC, these standards were entitled to *prima facie* validity.[6]

The ISB, in undertaking its task, understood that auditor independence is an instrumental value. We value auditor independence in our market not for its own sake, but because we suppose, quite sensibly, that it is associated with greater auditor objectivity in reviewing financial statements for conformity with generally accepted accounting principles ("GAAP"). Thus, in addition to auditor independence, we want expert knowledge of the audit client and of accounting conventions, objectivity in assessing compliance with GAAP, and efficient review and audit procedures. Achievement of these valid ends, however, may sometimes be in tension with steps designed to increase our belief in the independence of auditors.

Discussion of the subject of auditor independence and the trade-offs that its regulation entails is made difficult, however, because we lack both a common understanding of the terms used and a unifying approach to resolving the issues raised. In short, we lack a conceptual framework within which to assess the relative importance of possibly inconsistent goals. This Article outlines an approach to this problem developed by the Independence Standards Board. In December of 2000, the SEC abandoned the principles-based approach to creating independence standards and rules when it adopted a rule premised on a different approach. We believe that the approach adopted represents a lost opportunity. We, of course, do not disagree that it is vital for our capital markets to be well informed and that the value of the auditors attestation is dependent on the perception of the integrity of that attestation. Nor do we disagree that the independence of the attesting firm and the perception of it are fundamentally important

4. *See* Commission Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence, SEC Financial Reporting Release No. 50 (Feb. 17, 1998), *available at* http://www.cpaindependence.org/textview.php3?doc_id=frr50.

5. *Id.*

6. *Id.*

to the judgment that financial statements are dependable. Thus, our disappointment with the new rule is not premised on a belief that serious threats to auditor independence should be condoned. For us, however, the optimal legal regulation of auditor independence requires a more textured assessment of social costs and benefits than the existing rule contemplates.

This Article outlines some elements of an alternative approach the ISB staff prepared in a public process: the *Conceptual Framework for Auditor Independence*. That framework represents the road not taken by the SEC when it adopted its current rule. The current rule, in fact, is a rushed, pragmatic effort to deal with a series of complex problems. It lacks a coherent conceptual framework to explain its choices and to guide its implementation by thousands of corporate directors, chief financial officers, and auditors.

In this short Article we attempt to articulate some of the differences between the approach taken by the ISB in fashioning independence standards and the approach of the SEC-adopted rule. A fuller understanding of those differences emerges from a review of the *ISB Staff Report* on the ISB conceptual framework for auditor independence.

REGULATING AUDITOR INDEPENDENCE

A key piece in the implementation of the disclosure philosophy upon which Congress premised the Securities Act of 1933[7] and the Exchange Act of 1934[8] was the requirement that issuers subject to these Acts would be required to file financial statements publicly, in a form approved by the SEC. These financial statements must be audited by "independent" professionals.[9] Neither the statutes nor the regulations, however, define "independent." Thus, from the earliest years of this regulatory regime, the SEC and the accounting profession itself have defined what types of activities and relationships create conflicts of interest that could cause the auditor to lose its independence. This process was largely *ad hoc*, with the Ethics Committee of the AICPA and the staff of the SEC both issuing opinions or rulings about whether independence was impaired under various sets of facts.

Not surprisingly, after half a century of this *ad hoc* process, this regulatory terrain was rather anything but smooth. As rules and interpretations became more finely detailed with the evolution of a more

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7. 15 U.S.C. § 77 (2000).
8. 15 U.S.C. § 78 (2000).
9. *See* 15 U.S.C. §§ 77-78 (2000).

complex practice environment, the old regulatory system of *ad hoc* rulings increasingly appeared inadequate. Thus, in recent years, both the SEC and AICPA found that detailed rulemaking was becoming increasingly difficult and time consuming. Furthermore, because there were no unifying principles, practitioners and other interested parties had difficulty applying the existing rules to the large number of new situations that they were facing.

Consequently, in 1997, under the same authority used by the Financial Standards Accounting Board for establishing accounting standards, the SEC and AICPA jointly agreed to the formation of a partly public and partly private agency to establish, through public notice and participation, a principles-based approach to the regulation of auditor independence. The result was the ISB, comprised of eight members: four members were prominent private citizens not associated with the accounting profession, though highly knowledgeable concerning matters of business or finance, and the other four were senior members of the accounting profession.[10] A small staff and an Independence Issues Committee assisted the Board and formed broad-based task forces for each ISB project.[11] The AICPA's SEC Practice Section supplied funding but had no substantive authority over the ISB.

During its tenure the ISB was active, producing three authoritative statements and establishing working groups on a number of other specific projects.[12] The ISB's basic task, however, was the establishment, via public process, of a conceptual framework to remove independence regulation from the morass of *ad hoc*-ism to a principles-based enterprise.

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10. The "public" members of the ISB were: John Bogle, Founder and then Chairman of Vanguard Funds, Inc.; Dr. Manuel Johnson, former Vice Chair of the Federal Reserve Board; Robert Denham, Esq., then-Chairman of Salomon Smith Barney; and William T. Allen, former Chancellor of the Delaware Court of Chancery and now a Professor of Law & Business, New York University. *See* http://www.cpaindependence.org/textview.php3?doc_id=isbrostr.

11. *See id*. for a listing of the members of each of the project task forces.

12. For specific ISB-issued projects, see generally STANDARDS BD., DISCUSSION MEMORANDUM: EVOLVING FORMS OF FIRM STRUCTURE AND ORGANIZATION (1999); INDEPENDENCE STANDARDS BD., DISCUSSION MEMORANDUM: LEGAL SERVICES (1999); INDEPENDENCE STANDARDS BD., INVITATION TO COMMENT: FAMILY RELATIONSHIPS BETWEEN THE AUDITOR AND THE AUDIT CLIENT (1999); INDEPENDENCE STANDARDS BD., STANDARD NO. 1: INDEPENDENCE DISCUSSIONS WITH AUDIT COMMITTEES (1999); INDEPENDENCE STANDARDS BD., STANDARD NO. 2: CERTAIN INDEPENDENCE IMPLICATIONS OF AUDITS OF MUTUAL FUNDS AND RELATED ENTITIES (amend. 2000); INDEPENDENCE STANDARDS BD., STANDARD NO. 3: EMPLOYMENT WITH AUDIT CLIENTS (2000). All of these ISB projects are available at http://www.cpaindependence.org.

THE ISB'S CONCEPTUAL FRAMEWORK PROJECT

The ISB's enabling document charged the ISB with "[d]evelop[ing] a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for the development of principles-based independence standards."[13]

The ISB very early organized to undertake this foundational task in a way that was both deliberative and transparent. The ISB engaged Henry R. Jaenicke, the C.D. Clarkson Professor of Accounting at Drexel University, as director of the Conceptual Famework Project, and Alan S. Glazer, Professor of Business Administration at Franklin & Marshall College, as associate director. Professors Jaenicke and Glazer worked with Arthur Siegel, Susan McGrath, and Richard H. Towers of the ISB staff, and Professor Thomas W. Dunfee, the Joseph Kolodny Professor of Social Responsibility and vice-dean and director of the undergraduate division of the Wharton School at the University of Pennsylvania, who served as an advisor on ethical issues (collectively, "the staff"). In addition to this group the ISB worked through a project task force, a Board oversight task force, and the Board itself. In February of 2000, the Board issued a *Discussion Memorandum* on auditor independence and in November of 2000, it issued an Exposure Draft of its Statement of Independence Concepts.[14] Events in the form of changing political climate and the SEC-adopted rule of December of 2000 led the SEC to abandon its commitment to the ISB as an agency for formulating independence concepts (subject to SEC acceptance). The ISB, at the suggestion of the SEC, dissolved in July of 2001.[15] Before doing so, however, at the ISB's last meeting, the Board issued the draft of its final statement of independence concepts[16] that the staff had prepared for Board consideration.[17]

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13. Independence Standards Board Operation Policies, art. 1, para. 1.B, *available at* http://www.cpaindependence.org/textview.php3?doc_id=isboppol.

14. *See* INDEPENDENCE STANDARDS BD., DISCUSSION MEMORANDUM: A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE (2000); INDEPENDENCE STANDARDS BD., EXPOSURE DRAFT: A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE (2000), *available at* http://www.cpaindependence.org.

15. Press Release, AICPA and SEC, Independence Standards Board to Close (July 17, 2001), *available at* http://www.cpaindependence.org.

16. INDEPENDENCE STANDARDS BD., STAFF REPORT: A CONCEPTUAL FRAMEWORK FOR AUDITOR INDEPENDENCE (2001), *available at* http://www.cpaindependence.org [hereinafter INDEPENDENCE STANDARDS BD., CONCEPTUAL FRAMEWORK].

17. *Id*. at 2. The *Staff Report* therefore reflects the staff's ideology, which was influenced by "Board deliberations and its [unanimous] preliminary conclusions reflected in the DM and the ED; comments received from respondents on the DM and ED; and input from the project task force, the Board oversight task force, and other interested parties on drafts of the DM and ED as well as on an

The ISB *Staff Report on a Conceptual Framework* is the culmination of many months of consideration by the Board, its staff, and a large public task force. Seeking to construct a conceptually-based approach, the framework began with something notably absent from previous efforts: a definition of independence for auditors. The *Staff Report* stated that

> [a]uditor independence is both (a) independence of mind—freedom from the effects of *threats to auditor independence* that would be sufficient to compromise an auditor's objectivity and (b) independence in appearance—absence of activities, relationships, and other circumstances that would lead well-informed investors and other users [of the audited financial statements] reasonably to conclude that there is an unacceptably high risk that an auditor lacks independence of mind.[18]

This definition is notable in that it focuses both on objectivity and the appearance of objectivity. Thus the first prong of the definition is meant to catch (or disqualify) any auditor who in fact is not objective with respect to the audit. The second prong of the definition is meant to disqualify any auditor, even if in fact he is capable of making objective judgments, who is so situated that a reasonable person of ordinary character would be expected to have his objectivity subject to unacceptable risk of impairment.[19] In incorporating the idea of "unacceptable risk," this definition of auditor independence acknowledges that because perfect independence is not possible, judgment is unavoidably present in determining whether an auditor is influenced by forces or circumstances that may impair independence.

Importantly, this definition does not treat auditor independence as a goal in its own right. The ISB began with the premise that the system should not to try to maximize "independence," but rather should optimize the quality of financial statements. Not every potential conflict will, in this view, disqualify an auditor. The ISB conceptual framework uses the term "compromised independence" to identify circumstances in which a relationship or activity deems the auditor incapable of making objective audit decisions. When determining which risks to an auditor's

earlier draft of [the Staff Report]." *Id.*

18. *Id*. at para. 5.

19. The *Conceptual Framework* notes that regulatory and other standard-setting bodies issue authoritative guidance that limit or proscribe certain activities or relationships by all auditors. Therefore, although certain individuals may legitimately claim to be objective even if they have relationships that are proscribed, they must still comply with all of the authoritative rules in order to be independent. *Id*. at para. 8.

compromised judgment are, from the public's perspective, worth bearing and which risks ought to be disqualifying, the conceptual framework first employed a cost-benefit analysis. Second, the conceptual framework recognized that in some circumstances, threats to independence may be reasonably ameliorated in ways other than disqualification; safeguards effectively designed and deployed could effectively assure independence of judgment.

Consider an example. After studying the existing rules prohibiting all partners in an accounting firm and their immediate family members from owning any stock in any audit client, the ISB tentatively concluded that these rules were not justified in cost-benefit terms. The costs were significant. Each of the five largest accounting firms had between two and three thousand SEC registrant audit clients and thousands of partners located throughout the United States and around the world. Thus, although only a handful of partners might actually work on a particular audit or are in a position to influence it, all partners and their family members were disabled from owning stock in the audit client under the existing rule. Especially in a world of two-career families, this rule discouraged people from aspiring to partnership in audit firms. Candidates for partnership and their immediate family members, for example, had to sell shares that they owned in any audit client and pay income taxes on any gains as a "price" of admission to the firm. Also, all partners had to sell any shares that he or she or their immediate family members owned if a firm in which the partner had a passive investment elected to become a client firm, even if that partner had no involvement with that new account. The ISB, seeking optimal—not perfect—independence, concluded that real independence concerns could be well addressed and wasteful costs eliminated by a standard that focused more finely on the risks of stock ownership. In its December of 2000 rulemaking, the SEC agreed with the ISB's conclusion that the costs of the old rule exceeded its benefits. The SEC's new rules, adopted from the ISB's new standard—the concept of "covered person," limits the stock ownership prohibition to the members of the audit team, the "chain of command," and a limited, defined group of others.[20] This liberalization removed a major irritant for partners, thereby improving the quality of people attracted to and retained by the profession, without substantially impairing auditor independence. This change in the prior approach is, however, only a particularization of a broader idea not fully

20. *See* Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008, at 76,062 (Dec. 5, 2000) (codified at C.F.R. pts. 210 and 240).

reflected in the SEC's December rulemaking: that there are costs associated with prohibitions that should be evaluated from a social perspective when regulating behavior.

THE ISB'S THREATS AND SAFEGUARDS APPROACH

The ISB *Conceptual Framework*[21] is an attempt to provide a structure for analyzing problems of this type. Its foundation is the definition of independence discussed above. To achieve a greater assurance of auditor independence, the *Conceptual Framework* constructs a multipart framework that focuses on threats to independence and safeguards to assure independence. The *Conceptual Framework* defines "threats to auditor independence" as "pressures and other factors that impair an auditor's objectivity"[22] and safeguards as "controls that mitigate the effects of threats."[23] The *Conceptual Framework* further identifies five sources of threats to objectivity:

> a. Self-interest threats—threats that arise from auditors acting in their own interest. Self-interests include auditors' emotional, financial, or other personal interests. Auditors may favor, consciously or subconsciously, those self-interests over their interest in performing a quality audit. For example, auditors' relationships with *auditees* create a financial self-interest because auditees pay the auditors' fees. Auditors also have a financial self-interest if they own stock in an auditee and may have an emotional or financial self-interest if an employment relationship exists between an auditor's spouse and an auditee.
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> b. Self-review threats—threats that arise from auditors reviewing their own work or the work done by others in their firm. It may be more difficult to evaluate without bias one's own work, or that of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat may arise when auditors review judgments and decisions they, or others in their firm, have made.
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> c. Advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee or its position or opinion rather than serving as unbiased attestors of the

21. INDEPENDENCE STANDARDS BD., STAFF REPORT: A CONCEPTUAL FRAMEWORK, *supra* note 16.
22. *Id*. at para. 15.
23. *Id*. at para. 19.

auditees' financial information. Such a threat may be present, for example, if auditors or others in the auditing firm serve as promoters for an auditee's securities.

d. Familiarity (or trust) threats—threats that arise from auditors being influenced by a close relationship with an auditee.[24] Such a threat is present when auditors are not sufficiently skeptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity with or trust in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long-standing personal or professional relationship with an auditee.

e. Intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. Such a threat may arise, for example, if an auditing firm is threatened with replacement over a disagreement about an auditee's application of an accounting principle, or if an auditor believes that an auditee's expression of client dissatisfaction would damage his or her career within the firm.[25]

The Report notes that

> [t]he significance of a threat depends on many factors, including the nature of the activity, relationship, or other circumstance creating the threat; the force with which pressure is exerted or felt; the importance of the matter that is the subject of the activity, relationship, or other circumstance; the position and level of responsibility of the persons involved; and the strength of the integrity of the persons involved.[26]

The *Conceptual Framework* also provides various techniques of categorizing safeguards in response to threats. Evidently a variety of responses to threats is possible. The *Conceptual Framework* identifies four levels of response available to a standard setter. These include:

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24. One recalls in Terry Gilliam's brillant movie *Brazil* of some years ago a scene placed in a grim office in a future age, in which privacy and individuality only existed as suspect if not forbidden states. In this scene the players acted out their parts while, unremarked upon, on a wall behind them, hung a sampler with the folk wisdom of that place: "Trust in Haste, Repent at Leisure."

25. *Id*. at para. 17.

26. *Id*. at para. 18.

> a. absolute prohibition—for example, barring auditors from having any direct financial investment in any auditees;
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> b. permitting the activity or relationship but restricting its extent or form—for example, a restriction that auditors cannot have material indirect financial interests in auditees;
>
> c. permitting the activity or relationship but requiring other policies or procedures that eliminate or mitigate the threat—for example, the mandatory replacement of an engagement partner after the partner has spent a certain period of time on a specific audit engagement to mitigate a familiarity threat; and
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> d. permitting the activity or relationship but requiring the auditor to disclose information about it to the audited client's management, audit committee, board, or others—for example, disclosure to an auditee's audit committee of the nature of all services provided by the auditor to the auditee and the fees received for such services.[27]

The *Conceptual Framework* defines "independence risk" as "the likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users."[28] This risk is evaluated both before and after consideration of the affected safeguards.

Finally, the Report directs the consideration of "three basic principles of auditor independence":

> a. consider[] the level of independence risk and assess[] its acceptability;
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> b. consider[] benefits and costs of possible regulation [of threats to independence]; and
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> c. consider[] the views of investors and other interested parties.[29]

Thus, the ISB's *Conceptual Framework* constitutes a comprehensive statement providing a rational and internally consistent approach to independence decisions, both in the formulation of general prescriptions or prohibitions and in the formulation of application decisions that

27. *Id*. at para. 63.
28. *Id*. at para. 23.
29. *Id*. at para. 25.

professionals must make from time to time. The utility of such a comprehensive framework seems apparent. Regarding the Financial Accounting Standards Board framework, one observer has noted:

> Without the underlying guidance of a conceptual framework, standard-setting would be based on the personal and unarticulated concepts of the individual Board members. This would make agreement on standard-setting issues possible only when the individual frameworks sufficiently converged. Without a single framework, the answers to issues could change as the Board membership changes.[30]

The alternative to working within an expressed conceptual framework is unattractive. Without such a framework, independence issues are heavily dependent on the views of the incumbent chief accountant of the SEC, who, in recent years at least, has been replaced every two or three years. Each chief accountant is required to develop his own approach to auditor independence, without the benefits of some unifying set of criteria. This method is at best inefficient and at worst inconsistent, unpredictable, and unfair to those who must comply with and apply the rules.

THE PRAGMATIC NEW RULE

Concern that the ISB process would not achieve the goals of the SEC in a timely fashion motivated the SEC's new independence rule. Rule 2.01 does not, however, supply a coherent framework that will allow others to understand the lines drawn or those that need to be drawn in the future. In adopting the rule, the SEC adopted much of the specific standard-setting work that the ISB had accomplished. Yet, in fact, the fundamental underpinning of the ISB's approach to setting independence principles—the analysis of threats to and safeguards protecting independence was rejected. For example, in discussing employment relationships, the view was expressed:

> We appreciate the concepts underlying ISB Standard No. 3 and strongly support firms' use of quality controls and "safeguards" to encourage their partners and employees to be aware of and adhere to auditor independence standards. We are concerned, however, that a "safeguards" approach, which is dependent on a firm's self-

30. Independence Standards Board Minutes of Meeting (July 2001) (transcript on file with author).

> analysis and self-reviews, will not provide a definitive standard. In our view, independence is better assured by consistent and uniform rules, rather than by rules that rely on the auditor's assessment of the extent of its own self-interest. Furthermore, it has been our experience that the existence of safeguards or quality controls alone does not ensure compliance with even the most basic independence regulations. Accordingly, we have chosen a more objective standard for employment relationships . . . .[31]

First, this statement is a reflection of what appears to be a genuine belief on the part of the SEC staff that the first attribute of a profession—conscientious self-regulation by men and women of good character—is not a serious part of the staff's conception of the modern auditing industry. Reasonable persons may disagree whether such skepticism is realistic and in the public's interest. While we are not apologists for the auditing industry, our underlying view of the character (and the economic incentives) of members of this profession is different. Moreover, this statement misunderstands the way in which the ISB implemented the threats and safeguards approach. For example, in ISB Standard No. 3,[32] the ISB did adopt "definitive standards."[33] The ISB required, for example, that partners and staff notify the audit firm when they begin employment discussions with an audit client, that the person be removed immediately from the engagement and his or her work be independently reviewed, and that if an offer is accepted, all financial ties with the audit firm must be settled immediately in a specified way.[34] The SEC actually adopted, almost verbatim, all of these requirements and added, in a footnote, "Nevertheless, we encourage, and we expect, firms to follow the steps described in ISB Standard No. 3 . . . ."[35] Those steps were mandated procedures under the ISB standard, not an invitation to auditors to consider their own self-interests.

Although in this case the SEC adopted the same safeguards as the ISB standard, it did so without explicit consideration of the threats that exist in such relationships and an explanatory statement of why the safeguards adopted adequately mitigated such threats. Thus, the SEC left several gaps

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31. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,039 (citations omitted).

32. INDEPENDENCE STANDARDS BD., STANDARD NO. 3, *supra* note 12.

33. *See id*. at para. 2.

34. *Id.*

35. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,039 n.313.

in the promulgated rules. For example, in the area of client employment of immediate family members, the SEC stated that

> the ISB has taken a more restrictive approach in suggesting that independence is impaired if an immediate family member of a person on the audit engagement team is employed by the audit client in any position. We continue to believe, however, that we need only apply our restriction to family members in an "accounting role or financial reporting oversight role" at an audit client.[36]

This is the exercise of judgment, but on what basis? Because the SEC does not analyze the threat posed by "any" employment relationship, its rule fails to consider the threat posed by the emotional attachment and financial dependence issues that could arise from the employment by the audit client of, for example, the spouse of the audit manager in a non-covered but well-compensated role. Those issues led the ISB to conclude that such threats were sufficiently significant to proscribe any employment by an immediate family member of audit team members. The SEC's answer may well be preferable to the ISB's, but to so conclude requires one to consider what constitutes the threat that we seek to protect against.

There are other flaws, we think—or at least unexplained inconsistencies—in the SEC's approach. For example, the SEC prohibits legal services to an audit client only when "the person providing the service [is] admitted to practice before the courts of a United States jurisdiction."[37] As a result, attorneys admitted to practice in foreign countries can provide legal services to their firm's audit clients without affecting their firm's independence, subject only to some specified constraints. However, the threats that exist when attorneys from the audit firm provide legal services to an audit client are not logically linked to where the attorney is admitted to practice. So, we have a rule with a clear prohibition, though it is unclear why. In such circumstances, what reaction should an audit committee have to a proposal that the audit firm provide legal services in France?

The SEC initially proposed a prohibition of consulting services to audit clients involving the design or installation of information technology systems. After considering the comment letters and statements at the public hearings, the SEC's promulgated a rule that allows such services and adopted pre-existing professional rules regarding the necessary

36. *Id*. at 76,040 (citation omitted).
37. Qualifications and Reports of Accountants, 17 C.F.R. § 210.2-01(c)(4)(ix) (2001).

involvement of client officials in the project. The final rule also requires a proxy statement disclosure of the fees paid to the auditor for such services and further requires the audit committee to consider whether such services are "compatible with maintaining the [auditor's] independence."[38] The SEC described its resolution of this issue as "a pragmatic approach to a difficult issue."[39] Pragmatism is a fair description of a process that is not a principled attempt to reason towards consistent rules.

Pragmatism also supplies a convenient basis for regulators who feel free to exercise after-the-fact judgment, but it provides little guidance for those who must act in the future. Thus, in January of 2001, the Chairman of the SEC felt it necessary to send a letter to audit committees of the top five thousand public companies. That letter urged the audit committee chairmen, in evaluating the compatibility question, to determine the answers to a list of questions posed in the report of the Public Oversight Board's Panel on Audit Effectiveness ("O'Malley Panel"). That report stated that "[i]n determining the appropriateness of a particular service, one guiding principle should be whether the service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest"[40] and urged the ISB to provide more specific guidance. The questions themselves, however, do not seem particularly helpful to an audit committee. The SEC has not said which answers to the Panel's questions are "good" answers. More importantly, the Commission does not define the threat that lies at the core of the provision of information technology services to audit clients. Even more confusing, the SEC's stated that "we do not see any significant reason for concern about an audit firm's work on hardware or software systems that

38. *See* Information Required in Proxy Statement, 17 C.F.R. § 240.14a-101(A)(e)(4) (2001). The SEC rule requires disclosure of fees in three categories: (a) "for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q;" (b) for "[f]inancial [i]nformation [s]ystems [d]esign and [i]mplementation" services; and (c) [a]ll [o]ther [f]ees. *Id*. § 240.14a-101(G)(e)(1)-(3). The narrow definition in the first category is quite different from how firms have categorized fees in publicly reporting their revenues and in their reports to the AICPA's SEC Practice Section ("SECPS"). Although there is no uniform definition used by all firms, virtually all of the definitions include in the audit category fees for such services as statutory audits of subsidiaries, assistance in connection with registration statements (including subsequent events reviews and issuance of comfort letters), internal audit services, and due diligence investigations of proposed mergers and acquisitions. Under the SEC rule, these would be included in the "all other fees" category. The result is to enlarge non-audit fees in comparison to audit fees and to make comparisons with other information—that which is reported to SECPS—impossible.

39. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,045.

40. PUB. OVERSIGHT BD., PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS, para. 5.29, at 116 (2000), *available at* http://www.pobauditpanel.org/download.html.

are unrelated to the audit client's financial statements or accounting records."[41] This is perhaps helpful in a few instances, but it does not tell us, the regulatees, why this is not a problem or why other services are problematic. We believe that the independence issues that arise when the audit firm designs and installs the audit client's electronic business system or another critical business system, are similar to those involving the design of accounting systems. The failure to recognize such similarities, we believe, reflects a failure to systematically think through the threats to auditor independence that results from the rush to issue a rule.

Rule 2.01 prohibits the audit firm from providing more than 40% of the audit client's internal audit services if the client has assets of more than $200 million. This, too, is simply a "pragmatic" judgment. The SEC says the $200 million was adopted

> in recognition of the fact that smaller businesses, many of which may be located away from major business centers, could suffer particular hardships if we do not provide some exception. We chose a $200 million threshold for various reasons. From the available data, the $200 million threshold appears to provide a line below which not only are the companies themselves smaller, but the accounting firms that audit them also tend to be smaller.[42]

There are several fallacies with this reasoning. Of course, the fact that a company may be smaller does not change the threats that may come from internal audit services provided by the independent auditor. Making an exception for practical reasons is sensible—it might even meet a cost-benefit test—but the threat remains. If the SEC permits this exception, the SEC should also recognize the increased risks and should place some obligations on both the auditor and the client and its audit committee to mitigate the additional risks. The SEC imposes no such requirements because it rejects "threats-and-safeguards" rationality. Finally, the rationale that "the accounting firms that audit [these smaller firms] also tend to be smaller"[43] is odd. The Big Five firms audit almost thirteen thousand SEC registrants out of a total of about sixteen thousand, and no more than five hundred could be in the Fortune 500.[44] The fact is that the Big Five (now four) audit the vast majority of smaller registrants as well as virtually all of the larger ones.

41. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,046.
42. *Id*. at 76,048 (citations omitted).
43. *Id.*
44. *Id.* at 76,066-67.

Finally, there are important independence issues that were brought to the SEC's attention during the exposure period for which the SEC simply decided to provide no guidance. These issues will be prime candidates for consideration by the PCAOB. The first issue is dependence on an audit client. This issue arises when a client's fees are so large in relation to other sources of income that a well-informed person may reasonably question the objectivity of the auditor. Many years ago the SEC staff said that an independence concern would arise if fees paid by a company or a group of affiliated companies exceeded 15% of an audit firm's gross revenues. The problem is far more complex than can be dealt with under this simple rule. The issues involve matters such as: how the firm is organized and controlled; what are the criteria used to evaluate the partners and staff on the engagement; and what is the importance of the fees to the office or business unit in which the engagement team practices. By failing to address these issues, the SEC has not given appropriate guidance to either firms or audit committees in deciding how to consider and resolve them.

A second important issue for the PCAOB is alternative practice structures. Increasingly, firms are organizing in new and innovative ways to enable themselves to provide a broader range of services, to enter into joint ventures and alliances, and to deal with unfunded pension obligations to partners. The most visible of these arrangements involve (a) American Express, H&R Block, and Century Business Services, (where the non-audit services portions of audit firms were acquired by non-auditor businesses, leaving the audit firms to provide services to buyer clients under contract), and (b) the sale of the consulting business to either a third party (Ernst & Young) or the public (KPMG). These arrangements may take any form and can raise independence concerns. The SEC's new rule recognizes this development, but rather than providing generic guidance, the rule refers readers to previously issued staff letters on these matters (which are very fact specific). They give little generalizable guidance. The SEC also states that "[w]hile the rules we adopt do not provide accounting firms with the certainty of our proposed rule, we are convinced that a more flexible approach is warranted as the types and nature of accounting firms' business arrangements continue to develop."[45] The problem, of course, is that without understanding what factors are deemed to create significant auditor independence risk, firms cannot design structures and arrangements that consider such concerns. Yet when the SEC issued its ruling, it encouraged registrants and accountants to consult with the

45. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,059.

Commission's Office of the Chief Accountant ("OCA") before entering into relationships, including relationships involving the provision of services, which are not explicitly described in the rule. Thus the rule does not offer principled guidance, but instead contemplates *ex ante* government negotiations under unstated principles before innovation may occur.

In sum, there is a fundamental defect in the approach reflected in Rule 2-01. The SEC states rules without providing a rationale. As a result, understanding the principles involved—the threats identified—and why the SEC chose certain safeguards (including prohibition) is not possible. Consequently, those who must comply with the rules every day must resort to memorization, rather than comprehension. This leads people to conclude that particular conduct is permissible so long as it is not explicitly proscribed rather than foster a sense of professionalism. Equally important is that those who are responsible for articulating policies for their firms and for applying the rules by analogy to new situations, are left without tools. Finally, and perhaps also importantly, audit committee members who are now charged by law to evaluate the independence of their auditors are left without principles to guide them.

More generally, the requirement or encouragement of firms to "consult" with the SEC's OCA is a dysfunctional way to regulate the profession. First, it is expensive, because preparing for and attending a meeting with the OCA is not a trivial exercise. It normally involves the preparation of a comprehensive memorandum on the issue, virtually always with the assistance of the auditor and frequently with the involvement of outside counsel. Second, this procedure is time consuming, because not only does the advance preparation take time, but there may be delays in arranging a meeting with the OCA, as well as further delays in getting a decision from the chief accountant. Third, those decisions are made behind closed doors, and the only input is from the OCA staff, the accounting firm, and the registrant. The broader issues and the views of other interested parties are not solicited and therefore are not considered. Perhaps most importantly, government officials are normally risk averse. Because they are criticized when things go wrong, they tend to take the most conservative position. But this may not be in the public's interest. Furthermore, the OCA is short term in its orientation, it frequently resists change because change has to be justified, and it tends to ignore the collateral effects of its decision, including the frequently predictable, yet unintended, consequences.

Notwithstanding these shortcomings, we would be remiss if we did not acknowledge some of the important benefits of the SEC's new rules.

Previously, the Commission's auditor independence rules were a combination of very general guidelines, many detailed rules, and a host of interpretative letters, all of which were fact sensitive and inconsistent. Furthermore, some of the letters were unpublished, and most were not easily retrievable. So the new rules, by being all in one place, significantly improve access and consistency. The new rules also eliminate some of the dysfunctional, out-of-date provisions, particularly in the areas of financial interests and family relationships, as previously discussed. Finally, the process of proposing and adopting the new rules engaged a lot of people outside of the accounting profession more deeply in auditor independence matters than ever before. Raising the profile of this important issue with these constituencies can only have long-term benefits.

In the end, however, we see the SEC's approach as flawed and the enactment of the Rule 2.01 (with its abandonment of the ISB process) as a misjudgment that wasted an opportunity to create a more rational and principled basis for this important subject. Perhaps more importantly, the *ad hoc* approach of this Rule is also different from the approach adopted recently by the International Federation of Accountants. Section 8 of its Code of Ethics, approved in November of 2001, states:

> This section of the Code of Ethics (this section) provides a framework, built on principles, for identifying, evaluating and responding to threats to independence. The framework establishes principles . . . to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level.[46]

As the Chairman's letter to audit committees shows rather clearly, the existing approach to the determination of auditor independence lacks a useful conceptual framework. In arguing that a textured and principled approach to issues of auditor independence is superior to pragmatic fiat, we should not be mistaken for apologists for the accounting profession. The ISB and its staff were committed to maintaining and improving the fact of auditor independence and its perception in the market place. But effective regulation of independence, in the end, will require recognition of the fact that audit firms have huge investments in their reputations for integrity—expertise is all they sell.

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46. INT'L FED'N OF ACCOUNTANTS, IFAC ETHICS COMM., IFAC CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS para. 8.7, at 28 (2001), *available at* http://www.ifac.org/downloads/ethics.

Both before and after passage of Sarbanes—Oxley Act, the main problems of independence that arise within these firms today do not, we believe, arise because *firms* in search of greater income chose to trade away their independent judgment. That trade would put too much at risk for too little benefit. But that same calculation will not hold for all of the *individuals* within firms. For individuals, a rational cost-benefit analysis may be much more likely to lead them to compromise their judgment. Thus, the public and the auditing firms most often have closely aligned interests. The main sources of independence threats arise from inadequacy in the control and compensation systems of the firms themselves. These threats cannot be optimally treated by the impoverished choice of either a broad prohibition or a mandated *ex ante* negotiation with the SEC. The more textured, principle-based approach of the ISB process had, we believe, much greater hope of ultimately constructing a system that offered high assurance of integrity.

So long as we continue with private auditors who are paid a fee for services, issues of independence will arise and answers will be necessary. Now it is the Public Company Accounting Oversight Board that will be charged with that duty, at least in the first instance. We suppose that that Board will in time be required to return to some deliberative effort to try to provide those answers in a less pragmatic and a more principled way than Rule 2.01 has done. The ISB's *Conceptual Framework*[47] will, we believe, be revisited at that time and will provide a thoughtful starting place for such an effort.

47. INDEPENDENCE STANDARDS BD., CONCEPTUAL FRAMEWORK, *supra* note 16.