

APPENDIX D – PRIOR CONSIDERATIONS OF NON-AUDIT SERVICES

1 In its 1957 annual report, the SEC voiced one of the earliest concerns about the breadth of services that auditors provide and whether an auditor could become so closely identified with the client that the auditor would make decisions that should be made by management. In 1959, the SEC's Chief Accountant commented on the possibility of an auditor's becoming so deeply involved in performing managerial services for a client that the auditor would lose the objectivity needed for an audit.¹

2 In 1961, two educators studied non-audit services and concluded that management and tax services tended to cloud the appearance of independence.² They recommended that the audit function be sharply separated from other services provided by a firm. The AICPA's Committee on Professional Ethics issued Opinion No. 12 in 1963, reasserting a 1947 statement by AICPA Council that independence is an attitude of mind. However, the committee recognized that maintaining public confidence required avoiding relationships that might have the *appearance* of a conflict of interest. Opinion No. 12 added that there is no ethical prohibition against a CPA's performing management advisory services (MAS) for an audit client "so long as he does not make management decisions or take positions which might impair objectivity."

3 Opinion No. 12 was followed by a spate of articles and studies on whether auditors can appropriately perform MAS for audit clients.³ Most expressed concerns about the appearance of a conflict. In an address to the AICPA at its 1966 annual meeting, the chairman of the SEC chided the profession over certain types of non-audit services – such as executive recruitment – that he believed raised independence questions.⁴ (Following the Metcalf Subcommittee report in 1977,⁵ the SECPS adopted a rule prohibiting members from providing executive recruitment services to SEC clients.) At the same time, the chairman sought to distinguish "management services" related to financial processes or to information and control systems, which he felt raised no serious threat to independence, from other types of services.

4 In 1966, an AICPA committee began a study of auditors' scope of services and issued its report in 1969.⁶ The committee found no evidence that non-audit services impair

¹ Andrew Barr, *Accounting – Changing Patterns: The Impact of Regulatory Agencies*, address presented in Chicago, November 11, 1959.

² R. Mautz and H. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961).

³ For example, A. Schulte, "Compatibility of Management Consulting and Auditing," *Accounting Review* (July 1965); A. Briloff, "Old Myths and New Realities in Accountancy," *Accounting Review* (July 1966); and J. Carey and W. Doherty, "The Concept of Independence – Review and Restatement," *Journal of Accountancy* (January 1966).

⁴ Manuel F. Cohen, address before AICPA annual meeting, October 5, 1966.

⁵ Subcommittee on Reports, Accounting and Management, Committee on Government Affairs, United States Senate, 95th Congress, 1st Session, *Improving the Accountability of Publicly Owned Corporations and Their Auditors* (Committee Print 1977) (Senate Report).

⁶ AICPA Ad Hoc Committee on Independence, "Final Report," *Journal of Accountancy* (December 1969).

independence *in fact*, but found that some users believed that such services created an *appearance* of lack of independence.

5 There have been a variety of studies and investigations since then. In 1974, the AICPA formed an independent commission (the Cohen Commission) to study several aspects of the accounting profession and published its findings in 1978.⁷ The Cohen Commission recommended, among other things, that the board of directors (or its audit committee) consider all services provided to the company by the auditor, and that the auditor fully inform the board of all such services and their relationship, or lack thereof, to the audit function. That same year, the SECPS adopted that disclosure recommendation as a membership requirement.

6 Shortly after the Cohen Commission was formed, the United States Senate, through the Subcommittee on Reports, Accounting and Management (Metcalf Subcommittee) of the Committee on Governmental Operations, launched a broad-scale inquiry of the accounting profession, including a review of the nature of services furnished by accounting firms.⁸ The resulting staff report (*The Accounting Establishment*), published in 1977, generally concluded that MAS furnished to audit clients created a conflict of interest. After holding hearings on the staff report, the Metcalf Subcommittee concluded that the only MAS it believed appropriate to provide to public audit clients were “certain computer and systems analyses...necessary for improving internal control procedures of corporations.”⁹ The Metcalf Subcommittee also concluded that certain types of services, such as executive recruitment, marketing analysis, plant layout, product analysis and actuarial services, should not be provided to audit clients.

7 The profession reacted promptly to the Metcalf and Moss subcommittee reports by undertaking a new program of self-regulation, including forming the SECPS, introducing required peer reviews and establishing the Public Oversight Board to oversee the SECPS and peer reviews. The SECPS adopted criteria for scope of services and specified that an auditor may not provide the following services to a public audit client: psychological testing, public opinion polls, merger and acquisition assistance for a finder’s fee, executive recruitment, and actuarial services to insurance companies.

8 Over the years the SECPS has instituted several disclosure requirements related to non-audit services. As noted above, SECPS members must report annually to the audit committee of each SEC client the amounts and nature of MAS rendered. Also, each member’s annual report to the SECPS must include MAS fee data for SEC clients, indicating the number of clients by ranges of such fees as a percentage of audit fees (i.e., the number of clients for which MAS fees were 0% of audit fees, 1-25% of audit fees, 26-50%, 51-100%, and over 100%).

⁷ Commission on Auditors’ Responsibilities, *Report, Conclusions, and Recommendations* (1978).

⁸ Although not focused on non-audit services, in 1978 a House subcommittee (the Moss Subcommittee) also looked into the role of the SEC in establishing accounting principles and overseeing the profession.

⁹ Senate Report (see note 5).

9 Further, Standard No. 1 of the Independence Standards Board (ISB), issued in January 1999, requires auditors (1) to disclose, annually in writing, all relationships between the auditor and the audit client that may reasonably be thought to bear on independence and (2) to confirm their independence. The auditor also must meet with the audit committee to discuss the auditor's independence.¹⁰ The SEC issued a complementary rule in December 1999 that, among other things, requires that proxy statements include reports by audit committees that state whether the committee has received the disclosures required by Standard No. 1 and discussed the auditors' independence with them.¹¹

10 In 1978, the SEC adopted requirements that certain disclosures related to non-audit services be made in the annual proxy statements of public companies.¹² The disclosures included the percentage relationship of fees for all non-audit services to the audit fee, the percentage relationship of the fee for each non-audit service to the audit fee (describing the service if more than 3%), and whether the audit committee or board had approved the services and considered the possible effects on independence. The SEC described the disclosure requirements as an interim step and stated it would not propose any rules limiting scope of services but would await the conclusions of a study by the POB.

11 The POB concluded an extensive study on the issue in 1979.¹³ The POB studied the history of concerns over scope of services and held public hearings, noting that with one exception there were few uniform views. The exception was that almost all agreed that providing MAS was perceived by some persons as creating a situation in which an auditor's independence is impaired. In its report, the POB reviewed the concerns but also balanced them with the many benefits that appeared to accrue from MAS, even citing a comment letter from a former Chief Accountant of the SEC.¹⁴ The former Chief Accountant related some of his own positive experiences, including those as a staff accountant, to illustrate the benefits that he believed MAS brought to the audit process.

12 The POB found it difficult to assess the effects of MAS on independence:

From the voluminous record before the Board, it is apparent that documented evidence of MAS abuses or impairment of independence through the use of MAS is virtually nonexistent.^a Many concerned persons point to a feeling that "it doesn't look right" or a speculation that some services "might" or "could" impair independence, but no one can counter the demonstrated benefits of MAS with some proof that specific practices lead to actual impairment...

¹⁰ In Practice Alert 99-1, *Independence Discussions with Audit Committees*, the SECPS issued guidance designed to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating to audit committees those judgmental matters that may reasonably be thought to bear on the auditor's independence.

¹¹ *Audit Committee Disclosure* (Release No. 34-42266), December 22, 1999.

¹² *Disclosure of Relationships with Independent Public Accountants* (Accounting Series Release [ASR] No. 250, June 29, 1978).

¹³ *Public Oversight Board Report – Scope of Services by CPA Firms* (AICPA, 1979).

¹⁴ Letter from John C. Burton, p. 17 of POB scope of services report (see note 13).

...[T]he absence of any known cases, while comforting, does not serve to prove conclusively that independence has not been, or will not be, impaired due to the furnishing of MAS to audit clients.

...[T]he problem ... is not so much lack of independence in fact as the appearance of lack of independence.¹⁵

^a Specific evidence of loss of independence through MAS, a so-called smoking gun, is not likely to be available even if there is such a loss.

13 The POB concluded that no rules should be imposed to prohibit specific services. In light of the disclosure requirements of ASR No. 250 and the SECPS membership rules, the POB believed it better to rely on public disclosure, supplemented by the admonition to auditors to exercise restraint and judgment before venturing into new MAS areas. The POB also concluded that:

There are many potential benefits to be realized by permitting auditors to perform MAS for audit clients that should not be denied to such clients without a strong showing of actual or potential detriment...

[M]andatory limitations on scope of services should be predicated only on the determination that certain services, or the role of the firm performing certain services, will impair a member's independence in rendering an opinion on the fairness of a client's financial statements or present a strong likelihood of doing so.¹⁶

14 In ASR No. 264 the SEC responded to the POB's report, stating that the report "did not adequately sensitize the profession and its clients to the potential effects on the independence of accountants of performance of non-audit services for audit clients," and invited comments on factors the Commission identified as important to an evaluation of whether non-audit services could impair independence.¹⁷ In 1981, the SEC rescinded ASR No. 264,¹⁸ followed almost immediately by the SECPS's adopting the aforementioned requirement for member firms to disclose the extent of MAS fees and activity in their annual reports to the SECPS. The SEC repealed ASR No. 250 in 1982, citing the new SECPS disclosure requirements and having concluded that the disclosure required by ASR No. 250 "was not generally of sufficient utility to investors to justify continuation."¹⁹

15 In 1986, the POB, having noticed that non-audit services had continued to proliferate despite its admonition that the firms exercise self-restraint and judgment before venturing into new areas of MAS, commissioned a survey of attitudes of various groups toward

¹⁵ POB scope of services report, pp. 33-36 (see note 13).

¹⁶ POB scope of services report, pp. 4-5 (see note 13).

¹⁷ *Scope of Services by Independent Accountants* (ASR No. 264), June 14, 1979.

¹⁸ *Relationships Between Registrants and Independent Accountants* (ASR No. 296), August 20, 1981.

¹⁹ *Relationships Between Registrants and Independent Accountants* (ASR No. 304), January 28, 1982.

non-audit services and independence.²⁰ The POB issued the survey without comment, but reaffirmed that it knew of no instance in which it could be demonstrated that MAS had interfered with auditor independence. The survey results indicated continued concerns that MAS could impair auditor objectivity and independence.

16 Shortly thereafter, the Treadway Commission concluded that the audit committee should oversee management's judgments relating to the independence of accountants by reviewing management's plans for engaging its auditors to perform MAS, considering both the types of services that might be rendered and the projected fees.²¹

17 In March 1994, in response to a Congressional request, the Office of the Chief Accountant (OCA) of the SEC reexamined the existing independence rules and considered whether any changes were needed. The OCA acknowledged the continuing increase of non-audit service offerings by firms and undertook to continue to be alert to the development of problems of auditor independence, but concluded that:

... the extensive systems of independence requirements issued by the Commission and the AICPA, coupled with the Commission's active enforcement program, provide to investors reasonable safeguards against loss due to the conduct of audits by accountants that lack independence from their audit clients. The enactment of detailed legislation or the promulgation of additional rules is not necessary.²²

18 The POB continued to analyze "extended audit services" such as internal audit outsourcing and to monitor the firms' expansion of non-audit services. The POB had concluded that extended audit services need not impair independence if they were properly and carefully structured. The POB suggested that the profession consider whether the Code of Professional Conduct provides an adequate framework and guidance for addressing in a timely manner the implications of new service lines, and organizational structures to provide them, on the traditional concepts of independence.²³

19 In response, the AICPA has issued or revised several ethics interpretations and ethics rulings, including:

- Interpretation 101-3, *Performance of Other Services* – lists many activities that would be considered to impair independence
- Interpretation 101-13, *Extended Audit Services* – discusses circumstances in which internal audit outsourcing and similar services would or would not

²⁰ *Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients*, a research report prepared for the POB by Survey Division, Audits & Surveys, Inc., November 1986.

²¹ *Report of the National Commission on Fraudulent Financial Reporting*, October 1987.

²² SEC, *Staff Report on Auditor Independence*, March 1994.

²³ POB, *Annual Report 1994-1995*. A task force of the SECPS Executive Committee studied the issue of non-audit services. Although no report was issued, its findings were submitted to the then newly formed Independence Standards Board.

impair independence

- Interpretation 101-14, *The Effect of Alternative Practice Structures on the Applicability of Independence Rules* – discusses the extent to which independence rules apply to certain persons outside the “traditional” auditing firm
- Interpretation 102-2, *Conflicts of Interest* – offers guidance when a conflict occurs and on activities that should cause a CPA to consider whether others could view the relationship as impairing objectivity
- Interpretation 102-6, *Professional Services Involving Client Advocacy* – discusses tax, consulting or other engagements that involve acting as an advocate for the client

20 In a 1996 report to Congress,²⁴ the GAO stated that it believed that measures that would limit auditor services are outweighed by the value of traditional consulting services, but added that concerns over independence would grow as firms moved to provide new services that go beyond traditional services. The GAO also urged the profession to be attentive to independence concerns in considering new services.

21 Since then the shifting mix of practice has been a continuing source of concern and has been noted frequently by the SEC. The Chief Accountant of the SEC recently asserted, “These firms no longer advertise themselves as auditing firms, but as one-stop financial services firms that offer a full range of services.”²⁵

22 Recently, the success of the firms’ consulting practices, the explosive growth in technology, and regulators’ concerns over auditor independence have converged and resulted in the Big 5 firms exploring new business strategies for the future. These strategies, which have attracted attention from the regulators with respect to the issue of auditor independence, include:

- Restructuring and separating consulting practices from accounting and tax services
- Fully or partially divesting the restructured practices
- Planning public offerings of the consulting practices to obtain capital

²⁴ United States General Accounting Office Report to the Ranking Minority Member, Committee on Commerce, House of Representatives, *The Accounting Profession – Major Issues: Progress and Concerns*, September 1996.

²⁵ Lynn E. Turner, *Shifting Paradigms in Self-Regulation*, address to the Securities Regulation Institute, January 27, 2000.

23 Some other firms have sold their non-attest practices to other financial services firms and have a variety of alliances with those firms (see Appendix B).

24 The agenda of the Independence Standards Board includes alternative practice structures, as well as appraisal and valuation services, outsourcing engagements and legal services for public audit clients. (Currently, there are certain independence restrictions on the performance by audit firms of legal services for SEC audit clients.) In July 2000, the ISB indicated that it would defer action regarding non-audit services pending the outcome of the SEC's rule-making proposals on independence (see Chapter 5).

