

CHAPTER 5 – AUDITOR INDEPENDENCE

5.1 Independence is fundamental to the reliability of auditors' reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, an auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles. As expressed by Council of the American Institute of Certified Public Accountants (AICPA) in a statement adopted in 1947:

Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature.¹

5.2 In an important chronicle of the accounting profession, John L. Carey described independence as a state of mind and a matter of character.² In the early part of the twentieth century, the concepts of integrity, honesty and objectivity were so familiar and ingrained that it was not considered necessary to have formal independence rules. The profession felt that written rules merely would have stated the obvious.

5.3 In 1932, AICPA Council considered prohibitions against auditors serving as officers or directors of clients, and rejected them as unnecessary. However, the proposal indicated the first concerns over a need to preserve the *appearance* of maintaining objectivity, as well as being independent in fact. After the Securities Act of 1933 was enacted, the Federal Trade Commission³ issued regulations stating that it would not *consider* auditors to be independent if they served as officers or directors of, or had any direct or indirect interests in, public audit clients.⁴ The concern was that these client relations might subconsciously impair the auditor's objectivity. This in effect introduced the *appearance* as well as the fact of independence as an independence concept. Carey later noted that no one would accuse an auditor who owned a few shares in a client company of losing integrity, but "what would other people think – what would the public think?"⁵ In 1941 the AICPA adopted similar prohibitions applicable to all clients, not just public companies.

5.4 The combination of well-developed accounting standards and independent audits has helped make the U.S. capital markets a national asset. Because the auditor's objectivity is critical to investor confidence, regulators and others become concerned when they detect any actions that may impair, or appear to impair, independence.

¹ John L. Carey, *The Rise of the Accounting Profession: To Responsibility and Authority, 1937-1969* (New York, 1970), p. 182.

² Carey, p. 175 (see note 1).

³ The Federal Trade Commission administered the federal securities laws until the SEC was established in 1934.

⁴ In 1936 the SEC changed the bar against "any" financial interest to a "substantial" interest, allowing an auditor to hold an interest in a public audit client of up to 1% of the accountant's personal worth. It was not until 1950 that the SEC removed the word "substantial" and once again barred *any* financial interest by the auditor in a public client.

⁵ Carey, p. 180 (see note 1).

5.5 The Panel examined certain auditor independence issues.⁶ It observed the extent to which an objective, independent view was brought to bear on difficult, complex audit judgments and decisions encountered during the Quasi Peer Reviews (QPRs). In addition, the Panel sought to assess the potential for impaired independence, both in fact and in appearance, resulting from providing non-audit services to public audit clients and from former audit firm personnel being employed as client management.

NON-AUDIT SERVICES

5.6 The potential effect of non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the scope and amounts of non-audit services provided by audit firms.

Prior Considerations of Non-Audit Services and Other Background Information

5.7 The potential impact on independence of an auditor's providing non-audit services to an audit client has been studied by a wide variety of observers. These include the U.S. Congress, the Securities and Exchange Commission (SEC), the Public Oversight Board (POB), the AICPA and academics. Appendix D to this report contains a brief chronicle and summary description of these studies, spanning a period of over 40 years.

5.8 The Panel is not aware of any instances of non-audit services having caused or contributed to an audit failure or the actual loss of auditor independence. However, as the POB noted in its study on scope of services, "Specific evidence of loss of independence through MAS [management advisory services], a so-called smoking gun, is not likely to be available even if there is such a loss."⁷ Many have expressed concerns that these services – and pressures to sell them – may cause an auditor consciously or subconsciously to subordinate his or her judgment to a client's desires. Also, as non-audit services have grown, concern has been expressed that managements of audit firms may have tended to focus more on them than on auditing.

5.9 An early recognition of the expanding scope of services offered by auditors was found in a statement adopted by AICPA Council in 1947. The services described in that statement were tax advice, accounting assistance, advice to businesses in the installation of accounting and cost systems, budgeting and internal control. However, independence concerns were not raised at that time.

5.10 The 1947 AICPA statement suggested that many non-audit services had their roots in the audit practice. They evolved from requests by audit clients for additional services that their auditors seemed best suited or capable of providing, as well as from the special skills needed to

⁶ The Panel notes that the Independence Standards Board (ISB) is developing a conceptual framework for independence applicable to audits of public entities that would serve as the foundation for the development of principles-based independence standards. The first step in the process was the ISB's issuance in February 2000 of a Discussion Memorandum, *A Conceptual Framework for Auditor Independence*.

⁷ *Public Oversight Board Report – Scope of Services by CPA Firms* (AICPA, 1979).

audit new and complex business transactions. Today, effective audits depend more than ever on specialists. For example, specialists used in audits include:

- Technology and systems specialists
- Actuaries, to help evaluate risk management controls, insurance companies' reserves, and pension and other benefit accruals
- Treasury specialists, to help evaluate controls over cash management, financing, currency and derivatives
- Tax specialists, to help evaluate tax liabilities and deferred tax assets
- Valuation specialists, to help evaluate the reasonableness of valuations of financial instruments, stock issued for assets or services, and allocations of the purchase price of acquired businesses

5.11 The evolution of specialty skills into consulting practices was a logical extension of services as firms began hiring specialists for audit support. Expanding the scope of the specialists' activities helped firms attract and retain people with skills that were increasingly important to effective auditing. Providing services beyond the audit was profitable; it also led to increased overall knowledge of the client's business.

5.12 Audit firms' management consulting practices have expanded far beyond the skills required for audit support and the traditional areas related to financial planning and controls.⁸ For example, some firms now offer certain investment banking and legal services, outsourcing of a variety of corporate functions, strategic business planning and business process reengineering advice. Independence questions can arise when these services are marketed to audit clients.

⁸ References to consulting services usually exclude special assurance services. Recently firms have tended to carve out as special assurance practices certain services that require audit skills – for example, transaction-based services such as due diligence studies in connection with proposed business combinations, litigation support and internal audit outsourcing.

5.13 The revenue mix of the Big 5 firms has shifted toward consulting services. The growth of consulting services is illustrated by the following table, showing those firms' mix of practice as a percentage of gross fees⁹:

	<u>1990</u>		<u>1999</u>	
	<u>All</u> <u>clients</u>	<u>SEC audit</u> <u>clients</u>	<u>All</u> <u>clients</u>	<u>SEC audit</u> <u>clients</u>
Accounting and auditing	53%	71%	34%	48%
Tax	27	17	22	20
Consulting	<u>20</u>	<u>12</u>	<u>44</u>	<u>32</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

This indicates that, for SEC audit clients, the ratio of accounting and auditing revenues to consulting revenues dropped from approximately 6 to 1 in 1990 to 1.5 to 1 in 1999.

5.14 For 1999, 75% of the Big 5 firms' SEC audit clients received no consulting services from their auditors, down from 80% in 1990. Four percent of those firms' SEC audit clients had consulting fees that exceeded audit fees, up from one percent in 1990.

5.15 Similarly, the growth of consulting in the next three largest firms is shown below¹⁰:

	<u>1990</u>		<u>1999</u>	
	<u>All</u> <u>clients</u>	<u>SEC audit</u> <u>clients</u>	<u>All</u> <u>clients</u>	<u>SEC audit</u> <u>clients</u>
Accounting and auditing	56%	81%	44%	74%
Tax	33	16	28	16
Consulting	<u>11</u>	<u>3</u>	<u>28</u>	<u>10</u>
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

5.16 For 1999, 79% of those firms' SEC audit clients received no consulting services from their auditors, approximately the same as in 1990. Less than one percent of those firms' SEC audit clients had consulting fees that exceeded audit fees in either 1999 or 1990.

⁹ Compiled from annual reports submitted by the firms to the SECPS. Although consulting has grown significantly, accounting, auditing and tax also have continued to grow and prosper. In fact, in 1999 the growth of the Big 5 firms' accounting and auditing practices was slightly higher than that of their consulting practices ("Special Supplement: Annual Survey of National Accounting Firms – 2000," *Public Accounting Report*, March 31, 2000).

¹⁰ Compiled from annual reports submitted by the firms to the SECPS.

The Panel's Process

5.17 The Panel sought to obtain information about the effects of non-audit services on the independence of auditors. In the QPR process, 37 engagements were identified in which services other than audit and tax had been provided. (This represented 29% of the QPR population, and is similar to the average of 25% of all the Big 5 firms' SEC clients for 1999, as indicated above.) Supplemental questionnaires were completed in these instances, and in some cases the reviewers interviewed the firm personnel who performed the non-audit services.

5.18 The QPR reviewers did not identify any instances in which providing non-audit services had a negative effect on audit effectiveness. On about a quarter of the engagements in which non-audit services had been provided, the QPR reviewers concluded that those services had a positive impact on the effectiveness of the audit. On the balance of the reviewed engagements, the reviewers either were neutral regarding the effects of non-audit services on audit effectiveness or concluded that the services had no impact on audit effectiveness.

5.19 Of the 37 engagements, 15 involved (a) systems or processes used by the client to prepare its financial statements (or management reports directly integrated with its financial statements) or (b) financial statement amounts that were involved in, or derived as part of, the non-audit services. In all 15 of these engagements, the reviewers agreed that the engagement team's audit procedures were sufficient to bring an objective view to the area, provided sufficient competent evidential matter regarding the systems, processes or amounts, and were documented adequately. In addition, the reviewers agreed that the engagement team and/or the firm took appropriate steps to ensure that the non-audit services would not impair the firm's independence and that the auditors' independence was not adversely affected by the non-audit services.

5.20 Also, respondents to the Panel's survey were asked for their views on the matter, and participants at the Panel's public hearings expressed views on the issue. The Panel found that many people continue to be concerned – some very concerned – that the performance of non-audit services could impair independence, or that there is at least an appearance of the potential for impairment. Almost two-thirds of the respondents to the Panel's survey from outside the profession who addressed non-audit services expressed such concerns.

5.21 Respondents to a recent survey commissioned by the ISB indicated the following:

- They believed that the evolution of audit firms into the consulting fields was logical.
- Many felt that the provision of most consulting services was not likely to create a real problem of audit independence.
- However, almost all agreed that the potential for appearance problems was quite significant.¹¹

¹¹ Earncliffe Research & Communications, *Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity*, November 1999. Those interviewed in the survey included public company CEOs, CFOs and audit committee chairs, as well as buy- and sell-side analysts, audit partners and regulators.

Panel Considerations

5.22 The Panel discussed at length the subject of non-audit services and their potential impact on auditor independence. It also debated whether it should consider recommending a ban on some or all non-audit services to public audit clients. During its deliberations the Panel became aware that:

- Many of the major firms have announced that they have split off, or intend to split off, some or all of their consulting practices from their audit and tax practices. The expected results would include the reduction or elimination of potential conflicts of interest and renewed emphasis on core audit services.
- In May 2000 the Chairman of the SEC stated that he had asked the SEC staff to prepare a rule-making initiative related to the expanded non-audit services offered to public company audit clients.¹² He noted that the initiative would address fundamental public policy questions, including whether there should be limits on the types of services that an auditor can render to a public audit client, how firms should be structured to ensure independence, and whether firms should be permitted to affiliate with entities that provide services to the firms' audit clients that the firms themselves would not be allowed to provide to those clients. The Chairman added that any proposal resulting from the initiative would be supplemented by public hearings to solicit the broadest possible input.
- On June 30, 2000, the SEC issued those proposals.¹³ While not proposing to ban all non-audit services, the proposals identify many non-audit services that would be considered inconsistent with independence under four basic principles articulated in the proposal.¹⁴ The proposals cover certain aspects of the following services, some aspects of which are already precluded under SEC, AICPA and SECPS membership rules¹⁵:
 - Bookkeeping and similar services
 - Financial information systems design and implementation
 - Appraisal or valuation services
 - Actuarial services (to determine policy reserves and related accounts)

¹² Chairman Arthur Levitt, *Renewing the Covenant with Investors*, address at New York University Center for Law and Business, May 10, 2000.

¹³ *Revision of the Commission's Auditor Independence Requirements* (Release Nos. 33-7870; 34-42994; 35-27193; IC-24549; IA-1884; File No. S7-13-00). In addition to the scope of services provided by audit firms, the proposals address investments by auditors and their family members in audit clients and employment relationships between auditors and their family members and audit clients.

¹⁴ Situations that the SEC believes reasonable investors would agree impair an auditor's independence are when an auditor (1) has a mutual or conflicting interest with the audit client; (2) audits the accountant's own work; (3) functions as management or an employee of the audit client; or (4) acts as an advocate for the audit client (*Revision of the Commission's Auditor Independence Requirements*, III.B).

¹⁵ *Revision of the Commission's Auditor Independence Requirements*, III.D.1(b). Although the proposals would not prohibit tax services, the SEC is considering whether providing tax opinions for the use of third parties in connection with business transactions between audit clients and the third parties should be precluded.

- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser or investment banking services
- Legal services
- Expert services (expert opinions in legal, administrative, or regulatory filings or proceedings)

The proposals would require registrants to disclose certain fee and services information in their annual proxy statements.¹⁶ Registrants would disclose annual audit fees and the fee paid for each non-audit service, unless the non-audit service was less than \$50,000 or 10% of the audit fee, whichever was smaller. Also, registrants would indicate whether, before each disclosed service was rendered, the audit committee had approved the service and considered the possible effect of the service on the auditor's independence.

- The SEC has requested comments on its proposals and held the first of several public hearings on July 26, 2000, to solicit the views of the public on its proposals. Additional hearings will be conducted in September 2000.

5.23 During its discussions, the Panel agreed that:

- Independence is essential for promoting public confidence in the audit process, and must be monitored continuously.
- So long as auditors provide non-audit services to audit clients, there will be at least an issue with respect to the appearance of independence.
- There has been an explosive growth in non-audit services in recent years, to the point where many large firms' revenues from these services exceed their audit revenues.
- In their zeal to emphasize the array of services that CPAs offer, audit firms and the AICPA scarcely acknowledge auditing services in the public images that they portray. This serves to exacerbate the independence issue and to downplay the importance of auditing.

5.24 Considering the history of the issue of non-audit services and all the prior studies, the Panel asked itself the fundamental question: Is there a conflict here and, if so, how should it be addressed?

5.25 Panel members have two distinct viewpoints on this question, which are presented later in

¹⁶ The proposals also would require disclosure of the percentage of hours worked on the audit engagement by persons other than the auditor's full-time employees, if greater than 50%. This is intended to respond to recent moves by some firms to sell their practices to financial services companies and "lease back" professional auditors from those companies.

this chapter in the sections “Statement Supporting an Exclusionary Ban on Non-Audit Services” and “Statement Opposing an Exclusionary Ban on Non-Audit Services.” Some Panel members believe there should be an exclusionary rule that would prohibit an audit firm from providing non-audit or non-tax services, except in very limited circumstances, to its public audit clients. Under this view, there is a fundamental conflict of interest because, in reality, the audit firm is serving two different sets of clients: management, in the case of management consulting services, and the audit committee, the shareholders, and others who rely on the audited financial statements in deciding whether to invest, in the case of an audit.

5.26 Other Panel members believe that audit firms can provide both audit and non-audit services to the same public audit client, and with the proper safeguards and disclosures, can maintain independence and objectivity. They believe that nothing in the long history of the profession’s providing non-audit services has indicated otherwise. They believe it is incorrect to suggest that the interests of management must be at variance with those of the audit committee and the shareholders, or that the interests of management must be inimical to good financial reporting. The company and shareholders are the primary beneficiaries of consulting services that “benefit management.” Thus, in the absence of compelling evidence of a problem, these members believe that such an extreme measure is unwarranted and could well have a negative effect on audit effectiveness.

5.27 Accordingly, the Panel makes no recommendation regarding an exclusionary rule. However, the Panel did agree on the importance of the independence issue and that audit committees should not await the results of the SEC’s rule-making initiatives to become actively involved in monitoring proposed non-audit services.

5.28 The Panel’s recommendations are intended to assist the SEC in its rule-making initiatives while providing for an immediate plan of action, as described below, that should be implemented by the ISB, audit committees and management pending any SEC rules.

Recommendations

To the Independence Standards Board:

5.29 The Panel recommends that, whatever the outcome of the SEC’s rule-making initiatives, the ISB identify factors to be considered by auditors, audit committees and client management (a) when implementing Independence Standard No. 1¹⁷ and the SEC’s new audit committee disclosure requirements¹⁸ and (b) when determining whether a specific non-audit service is appropriate. In 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. The factors to consider might include:

- Whether the service is being performed principally for the audit committee

¹⁷ Independence Standard No. 1, *Independence Discussions with Audit Committees* (ISB, January 1999).

¹⁸ *Audit Committee Disclosure* (SEC Release No. 34-42266), December 22, 1999.

- The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity’s financial reporting process
- Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support
- Whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity’s business and operations
- Whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor’s role
- Whether the audit firm’s personnel would be assuming a management role or creating a mutuality of interest with management
- Whether the auditors, in effect, would be “auditing their own numbers”
- Whether the project must be started and completed very quickly
- Whether the audit firm has unique expertise in the service
- The size of the fee(s) for the non-audit service(s)

The Panel recognizes that considerable judgment may be required in reaching a conclusion regarding the appropriateness of an audit firm’s performing a specific non-audit service for a specific public audit client.

To audit committees:

5.30 The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors’ services. The threshold should be at a level that ensures that significant services are pre-approved, but not so low that the committee assumes a management function.

When audit committees determine whether to approve specific non-audit services, the Panel recommends that they consider the same guiding principle and the factors suggested above for use by the ISB.

To the SEC and the Independence Standards Board:

5.31 The Panel recommends that the SEC and the ISB evaluate on a continuing basis the effectiveness of the disclosures made under Independence Standard No. 1 and the SEC’s new audit committee disclosure requirements, as well as any new rules issued by the ISB or by the SEC pursuant to its rule-making initiatives.

STATEMENT SUPPORTING AN EXCLUSIONARY BAN ON NON-AUDIT SERVICES

5.32 Some members of the Panel believe that, with very limited exceptions, audit firms and their affiliates should be excluded by rule from marketing and furnishing management services to their audit clients that do not directly advance the interests of investors in objective and reliable financial reports on the stewardship of management. This position rests on the belief of these Panel members in (a) the central importance of independence to the profession of auditing in general, and to the effectiveness of the audit process in particular, and (b) the severe and growing challenges to independence that the audit profession faces in the current environment.

The Exclusionary Rule Described

5.33 For the reasons set forth below, we believe the Panel should recommend a rule (the “Non-Audit Services Rule”) that, with the very limited exceptions described below, bars the provision of non-audit services to an audit client by either (a) the audit firm itself or (b) any firm affiliated with the audit firm, whether by reason of a control relationship or strategic or other business alliance or other arrangement that gives the audit firm or its partners a financial stake in the provision of non-audit services to such audit client by such other firm.

5.34 The Non-Audit Services Rule should be adopted by the SEC, which in turn should in the first instance look to (a) the ISB for the purpose of issuing detailed rules of implementation, and (b) the Public Oversight Board for the purpose of assuring effective enforcement of the Non-Audit Services Rule and the detailed rules of implementation.

5.35 The Non-Audit Services Rule would have application only to SEC registrants. Of course, the profession would be free to adopt the same or similar rules for application more generally to all audits conducted in the United States.

5.36 The Rule would define the category of services (“Non-Audit Services”) to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of an audit. In general, the touchstone for deciding whether a service other than the straight-forward audit itself should be excluded from Non-Audit Services is whether the service is rendered principally to the client’s audit committee, acting on behalf of investors, to facilitate, or improve the quality of, the audit and the financial reporting process rather than being rendered principally to provide assistance to management in the performance of its duties. The range of services, skills and personnel thus permitted to be employed in furtherance of the financial reporting process is in no way limited. The Non-Audit Services Rule adopted by the SEC would provide general guidelines to the ISB in writing detailed rules of implementation, which the Panel expects would evolve over time as the nature of the audit and the services changed. We do not believe the Panel need resolve the many difficult definitional issues that the Rule will undoubtedly create. That would be the task of the ISB.

5.37 Without prejudging, we offer the following brief observations on two types of non-audit services. Tax work, although typically performed for management, is also frequently performed for, and subject to close scrutiny by, the audit committee and has traditionally been thought of as tightly related to audit work. Given the history, we believe tax work that does not involve advocacy should probably be treated as outside the barred category of Non-Audit Services. So too should attest work rendered as auditor in connection with SEC registrations or other SEC filings.

5.38 We believe the SEC's Non-Audit Services Rule should contain a carefully circumscribed exception to permit Non-Audit Services to be rendered by the audit firm to its client where special circumstances justify so doing. Use of the exception would require the following:

- (a) Before any such Non-Audit Service is rendered to the audit client, a finding by the client's audit committee (which must consist only of independent directors) that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm or affiliate to render such Non-Audit Service and that no other vendor of such service can serve those interests as well;
- (b) Forthwith upon the making of such finding by the audit committee, submission of a written copy thereof to the SEC and the POB; and
- (c) In the company's next proxy statement for the election of directors, disclosure of such finding by the audit committee and the amount paid and expected to be paid to the audit firm or affiliate for such service.

Reasons Why the Exclusionary Rule Has Become Necessary to Protect Independence, both Now and Especially in the Future

5.39 There are a number of important and convincing arguments in favor of an exclusionary rule. In contrast, no other solution is likely to achieve the goal of protecting independence from the growing temptations and pressures that exist. A brief outline of the most important arguments appears below.

1. Of fundamental importance in understanding the conflict of interest that arises from the provision of non-audit services to audit clients is the fact that in so doing the audit firm is really serving two different sets of clients: management in the case of management consulting services ("MCS"), and the audit committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest, in the case of the audit. The firm is a fiduciary in respect to each of these client groups, duty-bound to serve with undivided loyalty. It is obvious that in serving these different clients the firm is subject to conflicts of interest that tear at the fragile fabric of loyalty owed to one client or the other. And it is equally obvious that the existence of dual loyalties creates a serious

appearance problem, regardless of whether, in particular cases, the fabric actually tears apart or not.

2. Our concerns with providing non-audit services to audit clients derive only in part from the well developed notions that (a) an auditor, directly or indirectly through others in the firm or affiliates, ought not to be put in the position of reviewing its own work, a concern clustered by the Independence Standards Board¹⁹ around the term “self-review” and (b) an auditor, directly or indirectly, ought not to be put in the position of playing a management role through, for example, the exercise of managerial responsibilities or participation in management decisions. The essence of the concerns is the potential for impairment of independence, both in appearance and in fact, that emanates from the wearing of more than one fiduciary “hat” in the services provided, creating, willy-nilly, a dual set of loyalties. It is for this reason that our concern, and the solution advanced above, extend beyond non-audit services of the types encompassed by (a) and (b) of this paragraph 2.
3. Given the conflict of interest, it is not realistic to expect the firm itself to decide on its own independence. Even if the firm is correct in concluding that the existence of non-audit business with a particular audit client will not impair its independence, the conflict of interest inherent in the firm attempting to address this issue for itself, given its sharp self-interest in an outcome permitting the conduct of non-audit business, creates in the minds of objective observers a serious loss of credibility.
4. Nor is it feasible to expect independence to be assured by approval of the audit committee, because it is impossible to identify when the problem exists, and to challenge the auditor’s judgment on the matter is to challenge its integrity, something audit committees are highly unlikely to do. Independence is a state of mind, necessary to maintain the skepticism and objectivity that are hallmarks of the accounting profession. Being subjective and invisible, it is not something an audit committee can apply any known litmus test to determine. Moreover, the credibility problem would remain whenever there are substantial levels of non-audit services being provided. This problem has long been seen as of profound importance to the public maintenance of confidence in the audit function.
5. In a real sense the audit committee will remain blind to the existence of an independence problem unless the auditor acknowledges its existence. Regardless of the independence of the audit committee, and its willingness to cut back or eliminate entirely the non-audit services that have given rise to conflicting interests, the committee is wholly dependent on the auditor to identify whether a problem exists and how serious it may be. Such

¹⁹ See, e.g., Discussion Memorandum of Independence Standards Board, September 1999, “Appraisal and Valuation Services” and Discussion Memorandum of Independence Standards Board, December 1999, “Legal Services.”

dependency is a very weak reed on which to base a solution that looks to the audit committee to assure independence, case by case, through a “facts and circumstances” test.

6. No one has suggested that the audit committee can be a substitute for clear rules where the problem of conflicts is most serious. Thus, for example there is no suggestion that the audit committee be charged with discretion to assess independence despite the existence of financial interests by the audit firm in its audit client. Stock or other financial interests in one’s audit client have long been viewed as creating too clear a conflict of interest to become the subject of discretion. The need for an exclusionary rule on non-audit services is rooted in the same ground: prospective revenues from the provision of non-audit services, extending into the future, create precisely the kind of financial stake that produces a conflict of interest capable of impairing independence.
7. An exclusionary rule is relatively easy to administer. It does not preclude an audit firm from engaging directly or through affiliates in non-audit services. All business entities other than its audit clients are available for business. Thus, the Non-Audit Services Rule affirms the freedom of audit firms to engage widely in non-audit services and to attract and hold top-flight experts in IT and other non-audit services who must be available to assist in audit work from time to time. As the Panel’s data show, consulting staff and practice have burgeoned in recent years, even though 75% of the Big 5 firms’ SEC clients receive no consulting services from their auditors.

The SEC made the same observation in somewhat analogous circumstances in 1989. In rejecting an application by Arthur Andersen to enter into an MCS venture with a client on the basis of Andersen’s claim of immateriality, the SEC said: “the petition argues that the staff interpretation is anticompetitive in that it denies the accountant an opportunity to compete by providing services in combination with its audit clients. The accountant is precluded only from entering into a direct business relationship with an existing audit client. The accountant is thus free to enter into the relationship with any party unless the direct business relationship is in effect during the period when the accountant is conducting an audit of that party.”

In this same opinion the SEC rejected the argument that an exclusionary rule is contrary to the public interest in denying potential clients their choice of service providers, an argument likely to be advanced against the suggested rule as well. Thus: “the petition also asserts that the staff interpretation is injurious to the public interest because the public is deprived of the efficient delivery of the prime/subcontractor’s technical non-attest services. The public interest with which the Commission is

concerned, however, is the assurance of the integrity of financial statements filed with it. As discussed above, it is this objective which requires independence....” Moreover, the Non-Audit Services Rule allows the ban to be lifted when special circumstances make it compelling to do so.

8. As the Panel’s report indicates under “Personnel Management” in Chapter 4, the system of compensation within the audit firms may not presently give adequate weight to performing the audit function with high levels of skill and professionalism. This fact may well adversely impact audit effectiveness. Success in marketing an audit firm’s consulting services is a significant factor in the compensation system. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently skeptical, cautious and questioning in regard to management’s financial representations. As long as the marketing of non-audit services by auditors to their audit clients is encouraged, expected and rewarded, there will exist a tension counterproductive to audit excellence. An exclusionary rule will eliminate both this tension and its harmful effects.
9. Some have considered addressing the problem of conflicts by banning this or that non-audit service that is thought to be especially troublesome. Legal and valuation services, for example. Our underlying objection to this case by case approach is that it would produce the sort of finely tuned evasion and concomitant enforcement proceedings that always follow from efforts to define narrowly what is a prohibited practice. (The essentially futile rules and re-rules of the FASB to determine when the lease of an asset must be shown on the balance sheet as a liability are a classic case in point.) Consider the recent announcement by one of the Big 5 firms that it will be acquiring a high-profile lobbying concern, one that would, in the words of one of its principals, enable the audit firm to help clients “get a law enacted . . . and work with the actual statutory language.” Are the halls of Congress so different from those of the courthouse that these would be permitted, “non-legal” services, as the acquiring audit firm apparently contemplates? This approach also puts the burden on those seeking to ban a particular non-audit service. We believe it is essential to start with an exclusionary rule for all non-audit services, and then to create limited exceptions where the risk of impairing independence is slight.
10. An exclusionary rule would be effective in rewarding those audit firms most sensitive to the independence issue and most scrupulous in seeking to avoid a real problem or the appearance of a problem. Exhortation and even disclosure, by itself, often encourage those willing to sail close to the line, or even cross over it. This result has the real and perverse impact of hurting the competitive position of the most sensitive and scrupulous audit

firms, and in time encourages even those firms to drop their guard, and exploit the laxness in standards as well.

11. An exclusionary rule is a low cost premium on an important insurance policy for the whole profession, against governmental intervention to deny audit firms the right to do any non-audit work. The rule would go far toward eliminating the possibility of a major audit failure being linked to the influence of non-audit service business on the audit firm's diligence and skepticism, an event that would provide a basis, and possibly the momentum, for some radical solution like a total ban.
12. Independence is given important meaning in many analogous situations where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem entirely. Some observers would describe this strictness as an effort simply to preserve the appearance of independence. We agree, but only in the sense that it is solely by looking to what is observable directly that we can set the bar for the fact of independence, which is inherently indeterminate. Appearances matter, in sum, because the visible conflicts of interest are all that we have to go on. The rules forbidding audit partners from owning stock in the clients they audit and the rules tightly restricting the eligibility of corporate directors to serve on audit committees are but two examples of rules based not on the proven, but rather the presumed, dangers of conflicting interests.

For example, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees determined that, for a director to be independent for purposes of meeting the membership requirements of the audit committee, he or she must not accept compensation from the corporation for any service other than service as a director and committee member. The Blue Ribbon Committee noted that "...common sense dictates that a director without any financial, family or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The parallel to the auditor is both exact and compelling. Compensation for any service other than the audit would impair the auditor's independence.

13. Another useful analog is found in the NYC Bar Association report on law practice within the audit firm. This Statement of Position on Multidisciplinary Practice, appearing in *The Record*, September/October 1999, emphasized the incompatibility of the auditor's independence with the lawyer's duties of confidentiality. As a result, the Executive Committee of the NYC Bar Association stated its belief that "those roles are always intrinsically incompatible, and that any regime permitting MDPs should make clear that the same MDP may not provide both legal and audit services to the same clients." As early as 1962, looking at the

same issue from the auditing side, the SEC decided that the independence of an audit firm was tainted when a partner in the firm rendered legal services to the audit firm's client.²⁰

14. The provision of non-audit services is and can consistently be a profitable business without the door-opener of already serving a prospective client as its auditor. See, for example, Andersen Consulting. As noted in paragraph 7 above, notwithstanding the rapid growth in management consulting services, and the dominant share of firm revenues they now command, the provision of non-audit services to most audit clients remains relatively small. Adoption of the exclusionary rule now would not have as large an impact on firm profits as many in the profession seem to fear. If the rule is put off, however, its likely impact on the firms when ultimately adopted will surely increase. Continued rapid growth in management consulting work is likely to mean an increase in the provision of such work for audit clients.
15. Audit services, standing alone, have been, are often today, and can consistently be a profitable profession in the future. As a statutorily mandated function capable of being performed only by licensed professionals who are organized chiefly in a handful of very large firms, there is ample pricing power to assure profitability. In our hearings, the audit firms claimed their auditing work was profitable, standing alone. Other commentators seemed to dispute this claim, believing the firms too often use auditing as a loss leader for marketing non-audit services. In either case, the rule we recommend will make it unnecessary to treat auditing as any kind of loss leader, because there will be no other services to be cross-marketed. The incentive to compete on price will be sharply reduced. Thus, charges for auditing will be adequate to attract and hold the quality professionals necessary to perform quality audits. Overall the quality of audits should go up. To quote *The Economist* (1/15/00): "Of course, if accountants are barred from selling other services to their audit clients, then the cost of audits may well go up. But companies should be happy that they are not having their arms twisted into buying other sorts of advice from their auditors' colleagues. Auditors too would be freed from the insidious pressure of selling or reviewing colleagues' work. And for shareholders, surely the price of truly independent audits is one worth paying."
16. Whatever its merits in 1978 when ASR 250²¹ was adopted, disclosure of non-audit services will not suffice today or for the future. In 1978 disclosure was widely seen as an indirect way to deter too much non-audit work for audit clients. The use of disclosure to shape substantive behavior

²⁰ *American Finance Company, Inc.*, 40 SEC 1043 (1962).

²¹ *Disclosure of Relationships with Independent Public Accountants* (SEC Accounting Series Release No. 250), June 29, 1978.

has a long and often successful history at the SEC. In repealing ASR 250 in 1982, the SEC noted a lack of “utility to investors.” The question of usefulness to investors is equally true today. How are shareholders expected to deal with the disclosure? For most, this or that piece of consulting work might not seem material, but independence is not for shareholders to choose, one by one. It is a public choice issue, much like clean streets; there is independence for all the shareholders or for none. More importantly, the scale of management consulting work and the pressures to cross-sell that we have described are of such growing magnitude that the less intrusive, and indirect, solutions of an earlier day are no longer adequate. The problem is structural, across our financial markets as a whole, and must be dealt with in those terms.

Using disclosure to assure independence in fact and appearance is a lot like pushing the string rather than pulling it. To some extent, with some clients, it may act as a brake on the growth of non-audit services sold to audit clients. Again, however, it will often serve to harm the most sensitive and scrupulous, while rewarding those willing to push the limits, despite transparency. We conclude, for all these reasons, that a direct rule of exclusion is far superior to the indirect route of disclosure.

17. There are arguments from the perspective of both the service provider and the service user that favor combining audit and non-audit services for the same client. In marketing terms, there is an attractive link between auditing and management consulting. The one provides continuing access and credibility for the other. Auditing provides a matchless opportunity to uncover the competitive opportunities and risks of the client, which the management consulting group is then prepared to address. No other profession has the same ability, year in, year out, to work with large, public clients, on a worldwide basis, division by division. No other profession has the same privileged opportunity to reach regularly into the very sinews of the client, on a basis of complete candor and access. Indeed, for the profession of auditing, the law requires it. But this legally compelled access carries with it responsibilities importantly affected with the public interest. In these terms, management consulting is a business, not different from a host of others, and as the AICPA Professional Standards state, “differ[ing] fundamentally from the CPA’s function of attesting” services. The paramount importance of independence to auditing means that to the extent cross-marketing, however efficient it might be to the audit firm, impairs independence, whether in fact or in appearance, the right to cross-market must give way. For those in the profession who value the audit function, this should be an easy trade-off to make.
18. Audit firms also argue on behalf of their clients that they are simply giving corporate management greater choice. But independence is not about management choice. Corporate management is the client for management

consulting services, but for the audit the clients are shareholders (and the audit committee as surrogate), creditors and the investing public, all of whom need an objective, reliable report on management's stewardship. If offering corporate management a choice of using its audit firm to supply a full range of other services threatens to impair this oversight function, on which the credibility of our markets depends, then the denial of that choice is simply a cost – a minor one at that – of preserving investor confidence in our financial system. Indeed, the proposed rule is the least intrusive method we could imagine for achieving this essential goal.

STATEMENT OPPOSING AN EXCLUSIONARY BAN ON NON-AUDIT SERVICES

Introduction

5.40 Those members of the Panel who oppose a so-called exclusionary rule believe strongly in the absolute need for auditors' independence, objectivity and integrity. However, they believe that audit firms can provide both audit and non-audit services to the same public audit client and maintain independence, objectivity and integrity. Nothing in the long history of the profession's providing non-audit services has indicated otherwise. These Panel members have confidence that audit committees, management and auditors are fully capable of exercising their responsibilities and making rational, appropriate judgments. Thus, there is no need to default to extreme measures that, while well intended, may produce negative unintended consequences.

5.41 These members believe that the conclusion of the POB in its study on scope of services by CPA firms²² is still valid. In that study the POB considered and rejected any broad prohibition against non-audit services as a "draconian measure" that, among other things, would deprive audit clients of services that they obviously deem valuable. The POB noted that "otherwise lawful and productive activity" should not be prohibited unless "clearly in the public interest and no other measures are available."

5.42 Why is the POB's view still valid? First, the Panel has identified no new issues related to consulting services. Although the appearance problem has been spotlighted by the steady growth of consulting services over more than 40 years, there is little, if any, difference in the nature of the issue regardless of the comparative mix of the firms' revenues. These Panel members also note that the cause of much of the recent concern – the continued growth of non-audit services – may in large measure be reversed by the divestiture or planned divestiture of consulting practices by many firms.

5.43 Most importantly, these Panel members are persuaded by the lack of any specific link between audit failures and the rendering of non-audit services, which is consistent with the facts at the time of the POB's study. This is not a momentary phenomenon; for about a century, CPAs have been providing valuable non-audit services without these services being linked to audit failures.²³ These Panel members are reluctant to change the rules in the absence of any compelling evidence of a problem.

5.44 These members believe that many non-audit services are, indeed, both in the public interest and beneficial to audit effectiveness. As one of many examples, a company may seek the

²² See note 7.

²³ In addition to a lack of evidence of a causal relationship between audit failures and non-audit services, the Panel's QPR findings indicated that auditors' independence was not impaired when non-audit services were provided (see paragraphs 5.17-5.19). This is wholly consistent with the results of the regular peer review process. In that process certain engagements where the client also engaged the audit firm for management consulting services are selected, and the peer reviewer must evaluate the effects, if any, on independence. The SECPS staff reported that 67 such engagements were selected during the 1999 peer reviews, and consistent with prior years, no instances were found in which independence or objectivity appeared to have been impaired.

assistance of its auditors to correct control weaknesses identified during the audit. The public interest is served by the controls (and the company's financial reporting process) having been strengthened through the auditors' knowledge of the company and its operations, and audit effectiveness is enhanced through the auditors' increased understanding of the company's systems. Similarly, a pre-acquisition review of a potential target company by the acquirer's auditors provides timely identification of accounting and operations issues to the acquirer, facilitates the combining of two previously unrelated accounting and financial reporting systems, and enables the auditors to plan a more effective audit of the newly combined enterprise.

5.45 Thus, these members question how the public interest is served if auditors are expected to identify problems but have to decline if asked to help solve them. A client should not have to make continual choices about whether it wants a firm solely as its auditors or solely as a provider of other services, and a client should not have to dismiss a firm as its auditors to obtain other necessary services from that firm. Also, these members fear that companies that most need to improve their controls may opt not to do so because of the potential added costs and efforts of identifying and using firms other than their auditors.

5.46 Those who support an exclusionary ban assert that an audit firm has divided loyalties when it provides non-audit services to audit clients because it serves "different clients" in doing so, that is, management in the case of non-audit services, and the board and shareholders in the case of audits. The Panel members opposing such a ban believe that it is incorrect to suggest that the interests of management must be at variance with those of the audit committee or shareholders, or that the interests of management must be inimical to good financial reporting. The company and shareholders are the primary beneficiaries of consulting services that "benefit management."

5.47 In addition to the public interest criterion, the POB believed that a ban could be justified only if no other measures were available. Since the time of the POB study, many additional measures have been instituted, including the establishment of the ISB, enhanced peer reviews, significant strengthening of the role and scope of audit committees, and the combined effects of Independence Standard No. 1 and the SEC's recent proxy statement disclosure requirements for audit committees (described more fully later in this Statement). These Panel members question the efficacy of proposing a whole new rule at the same time other rules to address the issue are being implemented. These rules have been publicly supported by the Chief Accountant of the SEC, who stated that they should "bring independence issues to audit committees' attention and stimulate their participation in identifying and resolving independence issues."²⁴

5.48 Clients voluntarily purchase these services. These Panel members believe that client management, boards and audit committees are in the best position to assess the terms and conditions of these voluntary contracts, which include independence considerations. They view any notions that audit committees have not made or cannot make reasoned judgments about independence matters as unfairly impugning the abilities and integrity of these committees.

5.49 Indeed, a ban might appear to make life simpler for those who would prefer not to accept

²⁴ Report on SEC auditor independence initiatives, Chief Accountant Lynn Turner, January 19, 2000, in a memorandum to SEC Chairman Levitt responding to correspondence from Congressman John D. Dingell.

what these Panel members see as a normal business responsibility. However, given the lack of identified independence impairments, making matters simpler for audit committees would hardly justify depriving clients of needed services. Thus, these Panel members see a proposed ban as potentially punitive to clients, shareholders and auditors. They believe that audit committees should be afforded an opportunity to do their job, and that the current audit committee and disclosure initiatives should be given a chance to work. They note also that, even if a ban were imposed, audit committees would still have to make judgments, albeit less frequently, regarding whether certain services were included in the scope of banned services.

5.50 Other factors supporting this view include:

- Audit firms increasingly need specialists (e.g., information technology and treasury) to provide critical audit support. The QPR results reinforced that access to these resources will only become more vital in the future. Attracting and retaining these resources, and motivating them to provide direct audit support, may well be hampered significantly if they were to be prohibited from providing non-audit services to public audit clients. Further, these professionals maintain and build their skills by providing non-audit services. Thus, another unintended consequence of a prohibition could be to reduce audit effectiveness.
- The ISB and the SEC recently have taken actions to bring independence matters to audit committees and stimulate their participation in identifying and resolving any potential independence issues.²⁵ These actions are consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. They should result in significant additional consideration being given to auditor independence, particularly since the SEC's rule requires audit committees to report on these activities in companies' proxy statements.
- There are demonstrated benefits of non-audit services both to audit effectiveness and to clients, as the POB pointed out in its study on scope of services, to cite one example.²⁶ As noted in this chapter under "Non-Audit Services – Panel Process," the QPR findings indicated that non-audit services had either a positive effect or no effect on audit effectiveness, but no negative effects.
- When timing of a project is critical and requires the rapid deployment of skilled personnel, a company should not be denied access to the services of its audit firm. This is particularly true when the company believes that the firm, because of its knowledge of the company, is best capable of providing the services and of doing so on a timely basis. This is a frequently occurring, very practical consideration that

²⁵ Independence Standard No. 1, *Independence Discussions with Audit Committees* (ISB, January 1999); *Audit Committee Disclosure* (SEC Release No. 34-42266), December 22, 1999. Also, in SECPS Practice Alert 99-1, *Guidance for 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.

²⁶ See note 7.

ought not be overlooked.

- Prior to the SEC's issuance of its auditor independence proposals in June 2000, the ISB had been actively considering the independence ramifications of certain specific non-audit services. These Panel members continue to believe that the ISB is the proper body to evaluate, with due process, the need for any proscriptions on these services.

5.51 Those with this view also point to the POB's having observed in its study on scope of services that there would be occasional trade-offs between avoidance of all conflicts and audit effectiveness:

Integrity is an element of character, and objectivity relates to the ability of an auditor to maintain impartiality of attitude and avoid conflicts of interest. All conflicts of interest are not avoidable and some conflicts of interest produce countervailing benefits. Such conflicts are accepted, consistent with the concept of independence, because of practical necessity and the realization of important benefits, coupled with the fact that auditor integrity and various legal incentives provide adequate public protection. This helps explain public acceptance of the fact that auditors can be "independent" even though the client selects them and pays their fee. It also helps explain why there has been public acceptance of accounting firms furnishing a variety of tax advisory services to audit clients. Recognizing, therefore, that independence in an absolute sense cannot be achieved, when evaluating whether certain services should be prohibited, it is necessary to consider the potential benefits derived from the service and balance them against the possible or apparent impairment to the auditor's objectivity.²⁷

5.52 Opposition to an exclusionary rule does not mean that, after careful study, debate and due process, the SEC or ISB should not proscribe certain types of services in some or all circumstances. Indeed, these Panel members believe that the ISB is the appropriate organization to review the independence ramifications of various specific non-audit services, with the full support of the SEC. However, the standard setter that deals with non-audit services should consider carefully the aforementioned arguments against an exclusionary ban, especially those concerning the potential effects on audit effectiveness and the public interest that could result from prohibiting the services, as well as the factors that follow regarding specialists who provide recurring audit support and audit personnel who provide other services.

Non-audit Services Provided by Specialists Who Also Provide Recurring Audit Support

5.53 These Panel members strongly believe that services that ordinarily are performed by specialists who also provide recurring audit support should not be prohibited. They urge the SEC or the ISB to consider the following:

- Non-audit services by *technology* specialists who also provide *recurring audit support* – Throughout its process the Panel has seen an ever-increasing need for

²⁷ See note 7.

technology skills. Auditors must have access to skills that are as current and sophisticated as the increasingly complex systems and processes they must audit. Technology specialists help the engagement team understand computerized systems and processes, evaluate and test controls, and devise and execute sophisticated computer-assisted audit techniques. Thus, the assessment of the potential benefits of proscribing any services provided by these technology specialists must be balanced against the potentially adverse effects on firms' abilities to use their expertise in support of critical audit support services and to attract and retain them.

- Non-audit services by *others* who also provide *recurring audit support* such as actuaries, treasury specialists and valuation specialists – Similar consideration should be given to evaluating the potential benefits and adverse effects of proscribing any non-audit services these specialists provide to public audit clients.

5.54 Audit firms believe that they cannot attract and retain those with specialty skills if they will be limited to providing audit support. These specialists generally are not CPAs and their primary professional interest is not auditing. They likely will not consider working for an audit firm if they are limited to working only on audits and cannot build their skills and gain job satisfaction by performing other services.

5.55 These Panel members believe, based on discussions with these specialists and others, that these specialists likely would resist audit support assignments if they were prohibited from providing other services to these clients. Further, if they are assigned to provide audit support on such restricted engagements, they would be less likely to demonstrate the same vigor and creativity that they would on an engagement where they could provide other services. This neither enhances audit effectiveness nor serves the public interest. Thus, one question to ask when considering a ban on specific non-audit services is: Do those who ordinarily provide the services also provide recurring audit support services?

Other Services Provided by Audit Personnel

5.56 In addition to asking specialists to provide non-audit services, clients may ask the members of the audit engagement team or other audit personnel of the firm to perform a wide variety of special projects. For example, a client may request that an auditor perform a due diligence review of a potential acquisition. The knowledge gained in such a project enhances the auditor's understanding of the target's business and systems, which is critical to planning and performing an effective audit. Also, audit personnel enhance their inventory of skills in these special projects, which broadens their business knowledge and audit capabilities.

5.57 Again, in evaluating other services that auditors typically perform, practical considerations are essential. The most effective audits will be performed by the most competent auditors. But attracting and retaining those people requires providing them with work that is interesting and intellectually challenging. The more their professional experiences expand their business acumen, the better auditors they become and the more likely they will be satisfied with their jobs.

Other Considerations

5.58 In arriving at this position, these Panel members are mindful that, in its study on scope of services,²⁸ the POB admonished the profession to exercise restraint and judgment before entering into new areas of service. These members believe that that advice continues to be appropriate and seems particularly timely as many of the major firms are about to undergo significant restructurings and have an opportunity to reemphasize their core audit services. One could argue that, despite the profession's enviable track record in having performed both audit and non-audit services, the current outcry over non-audit services would not be so shrill had the profession better heeded the POB's advice. These members urge the profession to give serious consideration to this advice.

5.59 Also, these members believe that the SEC's rule-making initiatives can be a constructive exercise to analyze the fundamental policy questions raised by Chairman Levitt. They expect a complete, fair and non-biased airing through means such as the comment process on the SEC's independence proposals released in June 2000 and related public hearings.²⁹ They believe that the SEC is capable of reaching a reasoned conclusion after gathering all the relevant evidence and hearing from all sides. However, these members urge the SEC to be wary of proposals whose principal thrust appears to be more punitive than practical and that have the real potential to damage audit effectiveness. They hope that, consistent with the concept of self-regulation under a strengthened POB, the SEC will exercise restraint in its rule-making authority by delegating to the ISB the determination of any services that audit firms may not provide to their audit clients.

²⁸ See note 7.

²⁹ *Revision of the Commission's Auditor Independence Requirements* (see note 13).

FORMER FIRM PERSONNEL IN CLIENT MANAGEMENT

Introduction

5.60 The partners and professional staff of an audit firm have always represented an attractive pool of potential employees for industry, clients and non-clients alike. In fact, most personnel who join audit firms eventually move to a job in industry. Industry views public accounting as a unique training ground because it offers a broad variety of industry and client experiences, as well as the development of specialty skills. Further, dealing directly with auditors gives clients the ability to assess the abilities of individuals far better than any process of interviewing prospective employees.

5.61 From the standpoint of the auditor, once he or she accepts a position in industry, it is likely to be at a higher level in the company than he or she would have attained at the same point in his or her career without the public accounting experience. One of the attractions of the profession has always been the opportunity it provides individuals for professional and financial success, either by remaining in the profession or by accepting an attractive offer outside the profession. In fact, AICPA members in business and industry outnumber those in public accounting.³⁰

5.62 There are concerns about threats to independence when clients hire firm personnel. For example, did the individuals exercise appropriate audit skepticism prior to departure? Would the departing auditor's knowledge of the audit allow him or her to circumvent it as a member of the client? Will the former auditor be able to exercise undue influence over the audit team? Further, there have been instances where the former engagement partner or manager joined the client in a high-level position and was alleged to have become involved subsequently in a fraud scheme.

5.63 The degree of concern depends primarily on the stature of the auditor in the firm, the former auditor's new position with the client, and whether the former auditor had been involved in the audit of the client. For example, a client's hiring the audit engagement partner to become its CFO would generate more concerns than the client's hiring a staff member (who is not assigned to the audit) onto its corporate staff.

5.64 AICPA Ethics Ruling No. 77 on Independence, Integrity and Objectivity, *Individual Considering or Accepting Employment With a Client*, requires that, while considering an employment offer from a client, an auditor remove himself or herself from the engagement. Also, the firm should consider whether any procedures performed by a former partner or staff should be reperformed or additional procedures performed. Several firms have policies and procedures to assist firm personnel in complying with this ruling, and to provide guidance on additional or reperformed procedures.

³⁰ Members in business and industry represented 46.2% of the AICPA's membership in 1999, up from 39.9% 10 years earlier. Members in public accounting were 39.5%, down from 45.8% in 1989 (AICPA, *1998-1999 Annual Report*). Moreover, only a fraction of those in public accounting participate in audits of public companies.

5.65 AICPA Ethics Interpretation 101-2, *Former Practitioners and Firm Independence*, describes the required severing of financial and other firm ties with a former partner in order for the firm to maintain its independence.

5.66 The Panel sought to assess the potential for threats to independence when clients hire former audit firm personnel. In the QPR, 16 engagements were selected in which a former partner or manager of the firm had accepted a position in client management³¹ within the past three years. The reviewers were asked to complete a supplemental questionnaire to evaluate any effects on independence. Also, survey respondents and participants in some focus groups were asked for their views on audit personnel taking jobs with clients.

Findings

5.67 In all but one of the 16 QPR engagements, the reviewers agreed that the engagement team and the firm had put appropriate safeguards into place or had taken appropriate steps to make sure the audits were effective. In one instance the reviewer believed that additional steps should have been considered, although the reviewer did not believe that the effectiveness of the audit had been impaired.

5.68 Focus group participants and respondents to the survey generally did not view this as an area of major concern. Several noted that a client's hiring audit personnel is a benefit to the client and very important to attracting good people to the profession. Some believed that safeguards are necessary and a few suggested a "cooling off" period after employment, during which contact with the former audit firm would be restricted.

5.69 In July 2000 the ISB issued Independence Standard No. 3, *Employment with Audit Clients*. The Panel observes that the ISB has captured the concerns and has described safeguards that firms should implement when their professionals consider joining or have joined audit clients. The standard also specifies the circumstances in which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.³² The Panel believes that the ISB has dealt with the issue appropriately.

5.70 Also, under "Communicating with Audit Committees" in Chapter 2, the Panel recommends that audit committees require that the auditor and management advise the committee of (a) plans to hire any of the audit firm's personnel into high-level positions, and (b) the actions, if any, the auditor and management intend to take to ensure that the auditor maintains independence.

³¹ Chairperson, CEO, CFO or Controller.

³² The SEC's June 2000 independence proposals (see note 13) also include similar steps that would have to be taken to disassociate an auditor from the firm to maintain independence. Under the proposal, the former auditor must not (a) influence the firm's operations or financial policies, (b) have a capital balance in the firm, or (c) have a financial arrangement with the firm, other than a fully funded, fixed-payment retirement account.