

112-8

M E M O R A N D U M

DATE: May 18, 1979

TO : The Commission

FROM : The Division of Enforcement *EM*

SUBJECT : Proposed Accounting Series Release on
"Scope of Services of CPA Firms" sub-
mitted by The Office of the Chief
Accountant

RECOMMENDATION : That the Commission:

- (a) Decline to issue the proposed Accounting Series Release in the form submitted by the Office of the Chief Accountant;
- (b) Issue a release which indicates that the performance of certain management advisory services by an auditing firm for its audit client will render the audit firm not independent with respect to that client;
- (c) Independently examine the issue of the performance of certain management advisory services and their effect on auditor independence; and
- (d) Require detailed disclosure in Registrant's proxy statements of all services provided by its auditors and the amounts of related fees.

The Office of the Chief Accountant has submitted for issuance by the Commission a release which comments on and is generally supportive of the report by the Public Oversight Board of the American Institute of Certified Public Accountants on "Scope of Services by CPA Firms" (the "POB Report"). The Division of Enforcement has reviewed the POB Report and for the reasons set forth herein has concluded that the POB Report fails to adequately discharge the responsibilities with which the POB was charged, that the tenor of the proposed

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release fails to recognize this fact, and, that the release if issued in its present form would amount to a substantial change in previously expressed Commission policy. We also believe that certain management advisory services, on their face, are inconsistent with the duty of an auditor to remain independent of his audit client and that any release issued by the Commission should express this view. We believe that other management advisory services raise serious concerns of whether they conflict with an auditor's duty to remain independent and that those services should be independently examined by the Commission.

BACKGROUND

The Commission has considered the independence of the auditors who certify the financial statements filed with the Commission as central to the effective execution of the federal securities laws for over thirty years. 1/ More recently, in response to the rise in the last decade of the performance of management advisory services by audit firms, the Commission has been concerned with the effect of the performance of management advisory services on the independence of public auditors and on the resulting reliability of the financial statements certified by those auditors and filed with the Commission. Although the issue has been widely debated, the Commission has heretofore adopted a restrained wait-and-see approach, preferring instead to give the accounting profession the opportunity to self-regulate the scope of non-audit services that an audit firm may provide to its audit clients. 2/

1/ In various Accounting Series Releases ("ASR"), beginning with ASR 47, dated January 25, 1944, the Commission has provided guidance through examples of relationships and circumstances which it would consider indicative of a lack of independence on the part of a public auditor.

In addition, the Commission in Regulation S-X, Rule 2-01, put the profession on notice that it: "Will not recognize any certified public accountant as independent who is not."

2/ Testimony of Chairman Williams at the Hearings before the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs United States Senate, June 13, 1977 (hereafter the "Metcalf Committee Hearings").

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In 1976, a study prepared by the staff of the Senate Subcommittee on Reports, Accounting and Management (the "Metcalf Committee") concluded that management advisory services was the "primary problem area" regarding services offered by the "Big Eight" accounting firms (the "Staff Study"). ^{3/} The Staff Study also concluded that performance of management advisory services created a conflict of interest on the part of the auditing firm by giving it a direct professional interest in the success of its recommendations. The Staff Study was wary of how an audit firm could remain independent in dealing with executives it had recruited or in reviewing actuarial or marketing analyses it had prepared. As a result of the performance of management advisory services, the Staff Study concludes, "there may be reasonable doubts as to the thoroughness of the independent auditor or the suitability of accounting standards, used in preparing a client's financial statements." ^{4/} Thus, the Staff Study recognized that auditing is a highly subjective, judgmental practice.

In 1977, the Metcalf Committee began hearings, based on the Staff Study, with its stated purpose: "To explore ways to make certain that auditors of major corporations are independent in fact and appearance and that they serve the public interest rather than the narrow interests of their clients." ^{5/} One commentator, in testimony before the Metcalf Committee decried what he saw as the accounting profession's lack of concern for the public interest and recommended that to strengthen independence, public companies be required to periodically change accounting firms. ^{6/} The commentator concluded:

^{3/} The Accounting Establishment, A Staff Study, prepared by the Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, United States Senate.

^{4/} Id. at 51.

^{5/} Metcalf Committee Hearings, at 2.

^{6/} See testimony of Admiral Rickover, Id. at 1653.

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"There is no logical justification for permitting public accounting firms to provide management advisory, and recruiting services to the very same clients they audit. The conflict is self-evident."

In June 1977, Chairman Williams (the "Chairman"), testified before the Metcalf Committee. The Chairman's statement cited the lack of independence ("the auditors losing sight of his role") as the cause of many of the problems the Commission has faced with respect to accountants. 7/ The Chairman in his testimony noted that: "There is a serious question whether the financial incentive furnished by these consulting services is too great a threat to the appearance, if not the fact of independence." The Chairman in his testimony also recognized that time was running out on the profession and its opportunity to reform itself. 8/ The Metcalf Committee Report, however, criticised the Commission for its restraint suggesting instead that time had already run out on the profession. The Metcalf Committee stated, with respect to management advisory services:

"The best policy in this area --- and the policy which is presently followed by most accounting firms --- is to require that the independent auditor of a publicly owned corporation perform only services directly related to accounting. Non-accounting management services such as executive recruitment, marketing analysis, plant layout, product analysis and actuarial services . . . should be discontinued. 9/

7/ Id. at 1764.

8/ Id. at 1757.

9/ Report of the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs of the United States Senate, "Improving the Accountability of Publicly Owned Corporations and Their Auditors" 95th Cong. 1st Sess., November 1977, at 16.

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However, the Chairman in his testimony had recommended, and the Metcalf Committee ultimately concurred, that the profession be given a fixed period of time (one year) to take "positive and effective action" to cure the problems identified in the Staff Study and committee hearings. 10/ The Metcalf Committee advised the profession, however, that the freedom to self-regulate carried with it the "corresponding responsibility of self-restraint from engaging in activities which detract from professional ideals." 11/

While the Metcalf Committee Hearings were proceeding, a distinguished forum commissioned by the AICPA, The Cohen Commission, attempted to tackle the issues facing the accounting profession. The Cohen Commission recognized that the loss of independence actual, or perceived, was a "cause for concern" and that the professions procedures for assuring independence were in need of improvement. 12/ But in the final analysis The Cohen Commission could not find empirical evidence that the performance of management advisory services in fact impaired auditor independence. The Cohen Commission also concluded that the accounting profession should be given the opportunity to adopt meaningful self-regulatory guidelines to meet the concerns expressed by various commentators. The Metcalf Committee Report, while generally supportive of The Cohen Commission believed that in the area of management advisory services, it had not adequately addressed some important concerns.

10/ Senator Percy asked Admiral Rickover what he thought of giving the accounting profession one year to take its own action. Admiral Rickover replied:

"What they are saying is like repeating a phonograph record. They have had more than 40 years to clean house. Had they done so you would not be holding these hearings.

With the record of the past, what reason would a prudent man have to believe that the accountants have had a change of heart after 40 years or that the subcommittee's staff report by itself is sufficient to jar the profession into acting on behalf of the public." Metcalf Committee Hearings at 1670.

11/ Metcalf Committee Report, at 16.

12/ Report of the Conclusions and Recommendations of the Commission on Auditors' Responsibilities.

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In 1978, the Commission reported to Congress on the accounting profession and the Commission's oversight role. In its report, the Commission recognized the serious threat that management advisory services posed to the independence of auditors and suggested the kind of action it expected the profession to take:

"There is both a real and perceived need to create a buffer between managements and the independent auditors and to limit (emphasis added) the non-audit services that auditors may provide to their audit clients ... " 13/

In recognition of the serious concerns posed by the issue of management advisory services, the Commission has permitted the accounting profession to take the lead and develop its own guidelines. On three separate occasions in 1978, the AICPA proposed for consideration by the staff of the Commission rules governing this area. On each occasion, after meeting with the AICPA representatives and expressing its concerns, the staff concluded that the proposed rule was inadequate, and therefore it was not recommended for Commission consideration. The staff then considered whether to propose its own rules. However, after the POB requested time to act, the staff determined to await the outcome of the POB hearings. 14/

In September 1977, the Commission issued for comment proposed amendments to Schedule 14A of the Securities Exchange Act of 1934. 15/ The proposed amendments would have required disclosure of all non-audit services performed by an independent auditor for its audit client as well as the specific fees charged for each non-audit service. As is indicated in Release No. 5869, the Commission sought this disclosure to

13/ Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, July 1978.

14/ The POB's decision to act was a reluctant one, prodded by the Commission. See Chairman William's letter to John McCloy, June 2, 1978.

15/ Securities Act Release No. 5869 (September 26, 1977).

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"provide objective evidence of the types and amounts of services being provided by auditors," and to permit shareholders to compare fees paid by similar companies for similar services. Several persons submitted comment letters to the Commission on the proposed amendments which objected strongly to this additional disclosure. The Commission, on the recommendation of the OCA, adopted a limited version of the proposed amendments. 16/ As adopted the amendments require the disclosure of the percentage relationship between audit and non-audit services. No disclosure is required for individual services which account for less than 3% of the total fee. The amendments do not require disclosure of the specific fees related to each service.

THE POB REPORT

In August 1978, the Office of the Chief Accountant ("OCA") reported to the Commission on the progress of the POB hearings. In its memorandum, the OCA summarized the comments of the commentators at the POB hearings. The summary indicated then, that the accounting industry was uniformly opposed to any limitations on management advisory services. Even more disconcerting were the comments by the POB members themselves which indicated that they, even then, had a predisposition against the regulation of management advisory services. 17/

The POB Report itself, merely restates a 1969 report issued by the AICPA Ad Hoc Committee on Independence (the "1969 Report") 18/ The 1969 Report, which was based on interviews with commentators, auditors, and financial statement users conceded, albeit reluctantly, that whatever problem of independence existed as a result of the performance of management advisory services, was with the "appearance" of independence rather than the fact. The 1969 Report concluded, as does the POB Report, that existing limitations on management advisory services, presently contained in US Section 101 of AICPA, Professional Standards Vol. 1, are sufficient.

16/ This Division recommended adoption of the amendments as proposed and in a memorandum dated June 20, 1978, (attached hereto as Attachment "A"), we set forth our objections to the revisions to the amendments.

17/ Memorandum to the Commission, August 30, 1978.

18/ Final Report of Ad Hoc Committee on Independence, The Journal of Accountancy, December 1969.

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MS Section 101, cited by the POB Report, in fact encourages "all" certified public accountants to perform "the entire range of management services" The only limitation on the performance of management advisory services imposed by the AICPA is contained in subparagraph .03 of MS Section 110, which states: "A practitioner may undertake only those engagements in which he can maintain an independent mental attitude." This limitation gives the accounting firm the greatest discretion possible to determine what in its view might create a conflict of interest in fact. 19/

The Commission's proposed release (and its draft 1979 annual report to Congress) adopts and supports the POB Report which:

- (1) Repudiates the recommendation of the Metcalf Committee.
- (2) Proposes no new guidelines or limitations on performance of management advisory services,
- (3) Adopts a restricted basis for ever limiting the performance of management advisory services by independent auditors, and
- (4) Recommends the removal of current limitations on performance certain management advisory services.

The POB Report asserts that there are many benefits to be derived from the performance by audit firms of management advisory services for their audit clients. The POB Report asserts that the knowledge, experience and organization of audit firms allow them to perform management advisory services more efficiently and at a lower cost to their audit clients than could other firms. The POB Report also states that the performance of management advisory services increases audit quality (although it concedes that persons testifying at the POB Hearings could not express a coherent reason as to why the performance of management advisory services results in better audits.) Another advantage, according to the POB Report, to the performance of management advisory services is that it allows audit firms to attract

19/ In light of the continuous public debate on this issue, we believe it was fair to expect a different response from the accounting profession in 1979 than that in 1969.

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the "best and brightest" students from business schools. 20/ Finally, the POB Report states that performance of management advisory services permits an auditor to improve the underlying structure of what is being audited.

The Division of Enforcement does not agree with the POB that all of the foregoing benefits arise from the performance of management advisory services. Moreover, even if they do exist, we do not believe that they outweigh the importance of maintaining the independence of public auditors. It is somewhat ironic that the very evidence that could support the lower cost argument of the POB, the disclosure of the dollar amounts of fees for non-audit services, was vigorously opposed by the accounting profession. 21/ In view of the fact that many audit firms maintain separate staffs to perform management advisory services, there should be no benefit in terms of knowledge of the company and efficiency, in having the same firm that performs the audit also providing management advisory services. Many of the services require skills which are unrelated to the normal expertise and experience of accountants (e.g., actuarial services) and involve services for which adequate specialty firms exist. 22/

20/ It is significant, that the POB's views are not shared by all members of the accounting profession. Harvey Kapnick, Chairman, Arthur Anderson & Co. in testimony before the Metcalf Committee stated:

"The scope of practice should be limited to auditing, accounting, taxes and administrative services, including the design and installation of systems (such as computer-based systems and procedures) and the performance of studies related to accounting, general record-keeping, and control processes.

However, the following should be eliminated: executive recruitment; plant layouts; product analysis; actuarial services; and marketing studies that involve interviewing the general buying public, analyzing psychological behavior, or making sales forecasts. It is the policy of Arthur Anderson & Co. not to practice in these areas. If there are similar peripheral areas that should be eliminated because they are determined not to be in the public interest, we will voluntarily eliminate them." Metcalf Committee Hearings at 1209.

21/ See the comment letters received in response to Release No. 5869.

22/ See letter to Harold Williams from Buck Consultants, Inc. (April 11, 1979), attached hereto as Attachment "B".

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The POB states that it sought empirical evidence that performance of management advisory services impaired auditor independence. The POB hearings, however, were not designed to discover facts that would constitute evidence that the performance of management advisory services, in fact, impaired auditor independence. The POB hearings were designed to, and did merely elicit the opinions of the profession and other commentators on whether to impose restrictions on the performance of management advisory services. Moreover, the Commission in numerous enforcement actions has been witness to how the subtle pressure of seeking to uphold management decisions has led to the filing of materially false and misleading financial statements by registrants. It may be impossible to establish a definite nexus between false and misleading financial statements and management advisory services. The POB Report, however, did recognize that performance of certain services could impair the image of the profession, and result in the appearance of a lack of independence. We do not believe that the finding of empirical evidence that certain services do cause a conflict of interests should be the basis for barring services that place the audit firm in a position of reviewing its own work or acting as an advocate on behalf of a client. We are equally concerned with the impairment of the appearance of independence.

The POB Report concludes that existing limitations placed on auditors by the SEC Practice Section of the AICPA are sufficient. ^{23/} However, the POB Report disagrees with Section IV(3)(i) of the SEC Practice Section Organization Document which asks that audit firms place a primary emphasis on skill related services. The POB Report indicates that the SEC Practice Section bars members from performing services that will impair independence and adds the "requirement" that the services performed require skills related to auditing and accounting. The SEC Practice Section, however, does not define those services that will impair independence, and far from requiring that the services provided require accounting or auditing skills, the SEC Practice Section asks only that members place a "primary emphasis" on accounting and financially related areas. The SEC Practice Section asks that members "refrain" from performing services such as: psychological testing, conducting

^{23/} POB Report, page 5.

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public opinion polls, and acting as finders (for a finders fee) in mergers and acquisitions, which, as the POB Report indicates, it is unlikely they would be asked to perform in the first instance. (In a proposed amendment to the Organization Document, even these specific limitations have been deleted.)

The POB Report (and proposed Commission release) places tremendous reliance on audit committees as a safeguard against audit firms performing services that would impair their independence. While the involvement of audit committees will certainly be helpful, we do not believe that such an approach is a complete answer to this problem. Audit committees are primarily concerned with the cost of services, and may not be equipped to address the question of the independence of auditors. In fact, no adequate definition exists upon which an audit committee could rely in determining that independence would likely be affected by the performance of certain services. The proposed Commission release does not provide the necessary guidance, and may be read as making cost the primary factor to be considered in determining whether a company's auditors should also be engaged to perform management advisory services. This Division does not believe that the issue of independence should be decided by a cost benefit analysis. Additionally, we believe that placing the audit committee in the role of arbiter of the independence of public auditors is a reversal of the historical approach which places the responsibility for making such ethical determinations on the party providing the service. The audit firm providing such services, as opposed to an audit committee, is in the better position to determine what services could interfere with its duty to remain independent.

Executive Recruiting: The SEC Practice Section purports to limit executive recruiting by member firms, but allows member firms at the request of a client to interview candidates for the client and to advise clients on the prospective executives. The SEC Practice Section also does not bar member firms from recommending their own CPA personnel for positions with a client. Executive recruitment even as limited by the SEC Practice Section abrogates the special place occupied by independent auditors under the federal securities laws. Independent auditors should owe their primary allegiance to the investing public (whom we believe are their true clients), not to the executives for whom they may have secured positions.

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The audit firm must maintain an arms-length relationship with a company's management. The Metcalf Committee Report recommended that all executive recruiting be prohibited including the placement of the audit firms own CPA personnel.

Marketing Consulting: This service involves performing studies to determine the feasibility of selling a clients products or services to a particular market, and may include identifying customers and areas of excess disposable income, conducting opinion polls, and psychological testing. The SEC Practice Section does not bar marketing consulting except again in areas where it is unlikely accounting firms have ever performed services (such as product development and design). This service perhaps more than any other gives an audit firm a direct interest in the success of its corporate client and diminishes the public confidence that the auditors are in fact independent.

Actuarial Services: This involves forecasting the cash flow of employee pension and medical plans to determine the ultimate cost to the client of such plans as well as the amount of earnings that must be used to fund the various plans. The SEC Practice Section and the POB Report permit audit firms to perform actuarial services for their audit clients (except insurance companies.) This raises the spectre of auditors reviewing their own work product, acting as an advocate on behalf of a client, and impairs the confidence in the conduct of the audit. In addition, actuarial science is a speciality performed by trained actuaries. We fail to see the need for audit firms to provide this service.

Plant Layout and Design Services: This service may involve the total design of a facility, including architectural, geological, and engineering consulting, as well as acting as a general contractor on a project. We believe that these services are totally unrelated to accounting and that when combined with other services may be so lucrative that they place undue pressure on an audit firm to please management in order to retain the account.

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Tax Services: Although the performance of tax services was not treated as a management advisory service, and thus is not adequately discussed in the POB Report, the Division believes that the performance of such services may impair an audit firms independence. Performance of tax services places the auditor in the position of an advocate for the corporation or its executives. Acting as a partisan is not an appropriate role for an independent auditor. While some benefits may result from having a company's auditors prepare the company's tax return, we can see no benefit resulting from having the same firm perform tax services for the company's executives, and believe that this latter practice should be prohibited.

Financial Management Services: This involves setting up forecasting models, inventory controls, computer and other internal accounting systems. We recognize that certain benefits may result from having an audit firm perform these services, but are concerned that this may involve an audit firm in self-review. We believe that further analysis of this area is necessary.

The POB Report refuses to accept even the minimal prohibitions of the SEC Practice Section. The POB Report notes that the services limited by the SEC Practice Section are probably not performed by accounting firms but goes further and concludes: "Inasmuch as the Board recommends that the skill related criterion not be imposed, it would recommend that the specific proscriptions concerning those services contained in the Organization Document and Proposal (of the SEC Practice Section) be deleted." An amendment to the Organization Document drops the limitations. 24/

DISCUSSION

The POB report, rather than objectively dealing with a complex and important issue, merely states the arguments the accounting industry has consistently proffered, that existing regulation is adequate, and no evidence exists that the independence of auditors is affected by performance of management advisory services. The POB Report ignores the concern that auditors be independent not only in terms of

24/ POB Report at 46.

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the conduct of the audit but also in terms of the audit firm's relationship with management.

The POB Report relies, in part, on public disclosure to police management advisory services. While we do not totally agree with this view, we believe that if disclosure is to play a significant role in regulating this area that additional disclosure beyond the adopted amendments to Schedule 14A are necessary. We believe the Commission should reconsider requiring disclosure of all non-audit services and the related fees, as was originally proposed in Securities Act Release No. 5869.

As long as the issue of the performance of management advisory services remained unresolved, that uncertainty served as a limitation on audit firms expansion of such services. With the POB Report, however, the uncertainty has been removed, and we have seen signs of an increase in activities by audit firms seeking to provide management advisory services. For example, the Peat Marwick Mitchell & Co. "Executive Compensation Consulting Practice" pamphlet, is a sales document designed to solicit executive compensation program business, and is evidence that the profession will not refrain from performing services (such as this) which appear to impair the independence of the audit firm. 25/

In view of the concerns expressed by the Commission for maintaining the independence of public auditors, and the likely impact of the POB Report on the profession, the Division of Enforcement believes that the Commission should issue a release which:

(1) Recognizes that the POB Report fails to adequately address the concerns which prompted the POB hearings;

(2) Takes the position that certain management advisory independence (i.e., executive recruiting, actuarial services, psychological testing, profit planning, budget consulting, and market analysis) are inconsistent with the maintenance of independence;

25/ A copy of the PMM Pamphlet is attached hereto as Attachment "C".

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(3) Takes the position that certain other services (i.e., tax services, and systems design services) raises serious questions which will be independently examined by the Commission; and

(4) States that the Commission intends to require additional disclosure of management advisory services along the lines contemplated by Release No. 5869.

Given the special role of independent auditors under the federal securities laws, the Division of Enforcement believes that accountants who certify financial statements filed with the Commission, should be held to a standard of ethics which would bar the auditor from engaging in conduct which creates even the appearance of a professional impropriety. The public interest should be given as high a regard by public accountants as are their clients interests. The Division is deeply concerned with the statement in the POB Annual Report concerning management advisory services, which indicates that: "The Board is reluctant to support prohibitions against useful services which are based primarily on appearance without an adequate basis in fact." This is a rather peculiar viewpoint from a public body charged with assuring the integrity and objectivity of the accounting profession in the discharge of its public responsibilities.

The Division believes that certain management advisory services are inconsistent with auditor independence and the performance of those services by an audit firm for its audit clients should be prohibited. In this category, we place:

- Actuarial services
- Psychological testing
- Consumer surveys and opinion polls
- Executive recruitment
- Acting as a finder for mergers and acquisitions
- Representing a client in rate hearings or before other public service commissions
- Tax services for executives
- Plant layout services
- Employee compensation consulting

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Other services should be carefully examined by the Commission. In this category we place:

Tax services for the client
Accounting systems design
Data processing services
Profit planning
Financial forecasting

We believe our proposal is a modest one that will foster integrity and independence within the accounting profession. The Staff Study reported that management advisory services accounted for an average of 11 percent of the revenue of the "Big Eight" accounting firms. 26/ We believe our proposal will have only a minimal affect on this source of an audit firms' revenue. If, as the accounting profession has asserted, it is providing a useful and needed service, then companies will continue to employ audit firms to provide those services, however, they will not be the same firms that audit the client's financial statements.

We concur with the view expressed by some early commentators that auditing for publicly held companies is a speciality which must remain segregated from the nonaudit functions of public accountants. 27/ Auditors who audit the financial statements filed with the Commission have a duty to users of financial statements, the investing public, and the accounting profession to assure that their audits have been conducted, in fact, and appearance, with the highest integrity and objectivity. Auditing requires not only independence in fact, but also in appearance.

One of the Commissions' important responsibilities is to ascertain that the financial statements filed with it present fairly the financial condition of public corporations. For this task the Commission must rely on the auditors who certify those financial statements.

26/ The Metcalf Committee Report noted that the majority of accounting firms do not perform management advisory services.

27/ R. K. Mautz and Hussein A. Sharaf, "The Philosophy of Auditing," American Accounting Association (1961).

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Unable to monitor on a regular basis these auditors, the Commission must rely on mechanisms in place which will serve to promote and insure that independent auditors have the incentive and freedom to make objective judgments on the financial statements of those they audit. In view of the POB's failure to provide such a system, the Commission must begin its own independent review of this issue.

CONCLUSION

In view of the foregoing, the Division of Enforcement recommends that the Commission: (a) Decline to issue the proposed Accounting Series Release in the form submitted by the Office of the Chief Accountant; (b) Issue a release which indicates that the performance of certain management advisory services by an auditing firm for its audit client will render the audit firm not independent with respect to the client; (c) Independently examine the issue of the performance of certain management advisory services and their effect on auditor independence; and (d) Require detailed disclosure in Registrant's proxy statements of all services provided by its auditors and the amounts of related fees.

Attachments

TALevine . 51520
EDHerlihy 51508
SIGoldfarb 51540

TAL *12/4/78*

DATE: June 20, 1978

ATTACHMENT "A"

FILE NO: _____

MEMORANDUM

TO : The Commission
FROM : The Division of Enforcement *TAL*
RE : Disclosure of Audit Services and Fees

RECOMMENDATION: That the Commission require full disclosure of the nature and extent of the non-audit services performed by an auditor for an audit client and of the audit and other fees received by the auditor.

I. INTRODUCTION

An independent auditor is one of the critical participants in the capital formation process relied upon by the Commission to assure the reliability and accuracy of the financial information provided to the investing public. Increasingly, the investing public has focused upon the assurances that the independent auditor provides and upon the credibility of the accounting profession itself as reflected by its independence. 1/

As indicated in the Draft Report of the Office of the Chief Accountant, the credibility of the accounting profession has come under severe scrutiny and public confidence in the

1/ The Commission has relied on the fact that the auditor is truly independent as a keystone to the corporate auditing process, and disclosure under the Federal securities laws. See Regulation S-X, Rule 2-01, which states:

The Commission will not recognize any certified public accountant as independent who is not."

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integrity of American business and its auditors has been strained. 2/ The public's focus has been on both the appearance and the fact of independence. Central to this issue is the performance of a variety of so-called "management advisory services" by an auditor for its audit clients.

The Office of the Chief Accountant has addressed the issue in its proposal that the relationship of non-audit services performed for audit clients be disclosed where such services account for over 20% of total fees paid to the auditor and where individual services account for more than 3% of the fees.

The Division of Enforcement believes that audit fees and the nature and extent of non-audit services and related fees should be disclosed as proposed by the Commission in Rel. 33-5869 (September 1977).

The Chief Accountant has also discussed the question of the appropriate scope of non-audit services in its Draft Report which would announce that the Commission is still awaiting effective private sector initiatives. While we have no objection to the Commission deferring action pending the Public Oversight Board ("POB") focusing upon this issue, we are concerned over the prior reluctance of the profession to adequately address it. The Commission staff has discussed three separate proposals of the SEC Practice Section of the Division for CPA Firms of the AICPA, all of which failed to satisfy the Commission's expectations. It subsequently asked the POB to consider the matter. The POB first attempted to defer the question, but after the Commission suggested it readjust its priorities to "reflect the urgency of its consideration of the auditors' performance of management advisory services" 3/ the Board announced that it is considering holding public hearings on the subject this Summer. 4/ In view of the private sector's

2/ Draft Report to Congress on The Accounting Profession and The Commission's Oversight Role, Overview p. 1 ("Draft Report").

3/ Chairman William's letter to John McCloy, June 2, 1978.

4/ Letter of John McCloy to Chairman Williams June 14, 1978.

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record on this issue, we suggest that the Commission, in its July 1 Report, strongly restate its concern over the need for positive action on this issue and that it set a general time frame by which it expects to receive the private sector's response. 5/

II. BACKGROUND

The concept of disclosure as it applies to audit fees and the provision of non-audit services by auditors to their audit clients has been considered in various forums and recognized as appropriate by a wide variety of distinguished spokesmen.

The Metcalf Committee Report recommended the discontinuation of non-accounting management services. With respect to accounting related management fees it noted that the Committee had received suggestions for prohibiting all management services and requiring disclosure of all fees for services as well as the nature of such services. It endorsed a SEC public rulemaking proceeding to review the scope of management services provided by independent auditors. (p. 17)

5/ See the Report of the Subcommittee on Reports, Accounting and Management of the Committee on Government Affairs of the U.S. Senate "Improving the Accountability of Publicly Owned Corporations and Their Auditors" ("Metcalf Committee Report") 95th Cong. 1st Sess., November 1977, which stated:

"The best policy in this area -- and the policy which is presently followed by most accounting firms -- is to require that the independent auditor of a publicly owned corporation perform only services directly related to accounting. Non-accounting management services, such as executive recruitment, marketing analysis, plant layout, product analysis and actuarial services are incompatible with the public responsibilities of independent auditors, and should be discontinued. Management services related to accounting are confined to the limited area of providing certain computer and systems analyses that are necessary for improving internal control procedures of corporations." (pp. 16 - 17)

The American Assembly Report, 6/ among other steps for strengthening the audit process, recommended that "Audit fees should be disclosed to shareholders, and the choice of auditors should be ratified by shareholders." (p. 8)

The Cohen Commission, in its Summary of Tentative Conclusions 7/ with respect to "Maintaining the Independence of Auditors" recommended that "The nature and extent of other services provided by the auditor should be disclosed in proxy statements." (p. xxi)

In its Final Report, the Cohen Commission called for disclosure by all companies of the information called for in the SEC's proposals, if adopted, in the management report accompanying the annual

6/ The Final Report of the 54th American Assembly, Corporate Governance in America ("American Assembly Report") (April 1978).

7/ The Report of Tentative Conclusions of the Commission on Auditor's Responsibilities ("Cohen Commission, Tentative Conclusions") (1977). This recommendation was more fully set forth in the body of the Report, as follows:

"Disclosure of Other Services. As noted earlier, the concern of users that provision of other services impairs the auditor's independence decreases as their knowledge about the services increase. The best way to dispel concerns of any potential conflicts of interest is to disclose the facts. The proxy rules for publicly owned companies already require disclosure of the interests of management and others in certain transactions. The Commission recommends that public companies also disclose, in the proxy statements issued to shareholders that include selection or ratification of the election of independent auditors, information on the nature of other services provided to the companies by their independent auditors." (p. 101)

financials (rather than in the proxy statement) and stated that if management failed to make such disclosure, the auditor should make appropriate disclosure in his report (p. xxix). 8/

In the Commission's testimony before the Metcalf Committee, Chairman Williams stated that:

"There is a serious question whether the financial incentive furnished by these consulting services is too great a threat to the appearance -- if not the fact of independence. Accordingly, the Commission

8/ Its full recommendation regarding "Disclosure of Other Services" stated:

"... the concern of users that provision of other services impairs the auditor's independence decreases as their knowledge about the services increases. The best way to dispel concerns of any potential conflicts of interest is to disclose facts. The Commission recommends that all companies disclose in their management report information on the nature of other services provided to them by their independent auditor.

The Securities and Exchange Commission has recently made proposals calling for disclosure of certain information on other services provided by independent auditors in proxy materials. If these proposals are adopted, companies would be required to make such disclosure in their proxy statements. However, some users may have difficulty in obtaining proxy materials, therefore, the Commission believes that all companies should disclose the information it has called for in the management report accompanying the annual financial statements.

If management fails to disclose the nature of the other services provided to the company by their independent auditor, the auditor should make appropriate disclosure in his report." (p. 104)

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intends to initiate a rulemaking proceeding to consider requiring detailed disclosure in a registrant's proxy statement of all services which its independent accountant performs, together with a listing of the fees that the registrant has paid for such services."

He explained further:

"Such disclosure would provide objective evidence of the type and amount of services being performed by accounting firms for their clients, disclose the relationship between the fees received for the collateral services and those paid for the audit, and permit investors to decide for themselves whether, in light of these non-audit relationships, the auditor can realistically be considered fully independent." (Statement of Chairman Williams) (June 13, 1977) (p. 7)

Similarly, the Commission's Notice of its proposed Rule, 9/ after reciting the tentative recommendation of the Cohen Commission (quoted above) in favor of disclosure of information on the nature and extent of other services provided to companies by their auditors, stated that:

"Disclosure in proxy statements of all services provided to public companies by their auditors and the related fees will provide objective evidence of the types and amounts of services being provided by auditors..." (Emphasis added.)

The release went on to state the reason for disclosure of audit fees when no other services are rendered. It included the argument that "the absolute amount of the fees paid may be significant in that they can be compared to fees paid by similar companies." It also recognized that:

"While the relationships may vary for a variety of reasons, (e.g. poor internal control, centralization of accounting, number of operating divisions, etc.) the amount may serve as the

9/ Securities Act Rel. No. 5869 (September 26, 1977).

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basis for questions by shareholders. In addition, the relative importance of the audit fee to the auditor may provide information as to the auditor's economic dependence on the company." (Footnote omitted)

III. THE PROPOSAL OF THE OFFICE OF CHIEF ACCOUNTANT

The proposal of the Office of the Chief Accountant has several critical flaws:

(1) Instead of disclosing all non-audit services (and related fees) provided during the last fiscal year by the companies' independent auditors, no disclosure of the nature and extent of any non-audit service provided is required unless the fees for such non-audit services exceed 20% of total fees (for both audit and non-audit services) incurred by a registrant in the last fiscal year. (Instruction 1)

(2) Instead of disclosing the dollar amounts of fees for audit and non-audit services, only the percentage relationship which they bear to total fees incurred by the registrant for services performed by such accountant need be disclosed. (Item 8(g)) This means, of course, that no fee disclosure need be made where the audit is the only service performed.

(3) In cases where total nonaudit fees exceed 20% of fees for all services, neither the amount of the fees for particular services nor the percentages need be disclosed for those fees for individual services which, individually, are each less than 3% and which aggregate less than 20% of total fees. In other words, if six services are each 2.9% of total fees and another service is 4%, only the latter service need be identified, and its percentage (4%) need be disclosed. We assume that the six services which account for 17.4% would show up as "Other - 17.4%." (Instruction 2)

The proposed rule of the Office of the Chief Accountant does not provide the protections originally described to Congress by the Commission and which are necessary to fulfill our responsibilities to the investing public.

(1) It does not provide the necessary facts to enable shareholders or the investing public to evaluate for themselves the independence of the auditor. There would be no way under the proposal for the public to determine what the "financial incentive" furnished to the auditor who provides "consulting services" would be. Thus, users would not be able to gauge whether the "financial incentive" is too great a threat to the appearance, if not the fact, of independence.

(2) There would not be "detailed disclosure in a registrant's proxy statement of all services which its independent accountant performs" ^{10/} and the quantity and quality of the "objective evidence of the type and amount of services being performed by accounting firms for their clients" would be reduced.

(3) There would be no opportunity under this proposal to compare the absolute amount of fees paid by similar companies; ^{11/} or for such amount to serve as a basis for questions by shareholders. ^{12/} Nor will it elicit information about the auditors' economic dependence on the company.

^{10/} Cf. Statement of Chairman Williams supra and Release 33-5869.

^{11/} Thus, if an auditor had performed services such as executive recruitment or accounting advocacy (raising issues of sufficiency of detachment) or had performed actuarial services, or plant layout (raising issues of review of its own work), this information would not be revealed if the 3% test were not met, although it is clearly significant.

^{12/} Cf. Release 33-5869.

As Rel. 33-5869 pointed out, the Cohen Commission recognized that "the best way to dispel concerns of any potential conflicts of interest is to disclose the facts." 13/

IV. THE STATED REASONS FOR LIMITING DISCLOSURE ARE NOT COMPELLING

A. The Amount of Audit Fees

The commentators objected to disclosure of the amount of audit fees because that would result in comparison between companies of amounts which were not comparable (for various reasons including the use of different accounting systems and the number of locations of accounting records and assets). Pressure to reduce fees which ultimately would result in poorer quality audits was also cited.

The Division believes the question is not comparability or lack of comparability of audit fees, but whether disclosure of the total amount of fees paid would focus attention on the importance of the fees to the accountant and on whether or not they effect his independence. For this purpose, it should not matter to the user of the information whether one company has a different accounting system, or whether records are kept at different locations. The dollar amount is the fundamental question. Moreover, the stated rationale of the Office of the Chief Accountant is inconsistent with similar Commission-disclosure requirements dealing with analogous matters, e.g. disclosure of fees by investment bankers rendering opinions.

It is absolutely consistent with the philosophy of the proxy rules to require information about the cost to the issuer of audit services at the time an independent accountant is selected, or being recommended to shareholders for election, approval or ratification. Compare, for example, the detailed disclosure of remuneration of directors and officers and other potential conflict situations, under Item 7 of Schedule 14A. 14/ Moreover, the information may be disclosed without

13/ Id.

14/ Item 7(a)(1) requires an issuer to furnish information in tabular form:

" ... as to all direct remuneration paid by the issuer and its subsidiaries during the last fiscal year to the following persons for services in all capacities:

(1) Each director of the issuer whose aggregate direct remuneration exceeded \$40,000, and each of the three highest paid officers of the issuer whose aggregate direct remuneration exceed that amount, naming such director and officer."

extra cost to the issuer, so no question of costs outweighing benefits should arise.

The second argument -- the possibility that disclosure will lead to pressure to reduce fees and thus to lower quality audits -- is not realistic. In the first place, management already knows what its auditing fee is and can already bring pressure to bear on the auditor to reduce the size of that fee. In our view, accounting firms will not yield to pressure to provide lower quality audits merely because disclosure of fees is required. ^{15/} We retain some degree of hope that the sense of belonging to a profession will provide an accounting firm with the necessary ethical spirit to avoid succumbing to such pressures. This hope is buttressed by reference to Commission authority to enforce the law and to the strengthened peer review process which, purportedly, is soon to commence. Thus, the benefits of disclosing audit fees far outweigh any assumed burdens.

B. Disclosure of Other Services and Fees

The argument against disclosure of other services and fees is that "such disclosures would be unfair to small registrants and small accounting firms since some small registrants have limited breadth of expertise available internally and rely upon their accountants to provide a wide range of services." Thus, to the extent that disclosure of the amount of such fees would create a pressure to reduce such fees or services, such disclosure would have a more direct impact on such small registrants and small accounting firms. According to the commentators, this would unfairly discriminate against smaller accountants and smaller registrants.

In the view of the Division, the fact that small registrants are not able to generate such services themselves and may rely upon and work more closely with their external auditors for such services is the best reason to disclose the existence of the close and possibly intimate relationship between the small auditor and small client arising out of the nature and extent of the services which the auditor renders to that client. The

^{15/} Certain issuers who file with this Commission under Section 12 of the Exchange Act, also have filed with the ICC and the FERC (formerly FPC) for several years and have been required to disclose the amount of their audit fees. They have done so without any apparent hardship.

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particular type services rendered under the circumstances ought to be disclosed so users can evaluate for themselves how prejudicial they may be to the auditor's independence and, in particular, whether they result in the auditor's reviewing his own work.

Disclosure of the amount of fees, under these circumstances, without a 20% test would not only present objective, easily understandable data, but would also appear to place less pressure on small registrants and small accountants than the 20% ceiling does. Any pressure to artificially reduce services or fees could come from attempts to meet the 20% figure. Whereas disclosure of the actual dollar amounts of the fees would make clear the relatively smaller size of the fees involving smaller registrants and accounting firms and would eliminate any special pressure on smaller firms to come under the artificial 20% floor.

If the Commission decides that other services and related fees paid for them ought to be disclosed, a percentage test serves little purpose. It could hide significant information about the types of services rendered, where (as with smaller registrants) that information may be particularly relevant. It could generate artificial pressure to limit fees and services both for small and large registrants and small and large accounting firms in order to avoid disclosure. At the same time, because it does not give any sense of the magnitude of the fees involved, it could create the misleading impression that huge sums are being paid to accountants of small registrants.

The 3% - 20% exclusionary rule would create similar mischief. It could create artificial floors and allocations of fees and services designed to avoid disclosure; it gives no impression of the magnitude of fees involved and it permits the existence and extent of particular advisory services and their related fees to remain undisclosed.

RECOMMENDATION

Based on the foregoing, the Division of Enforcement recommends that the Commission adopt the rule relating to a disclosure of audit fees and non-audit services and related fees as proposed.