

MEMORANDUM

July 17, 2000

TO: Chairman Levitt

FROM: Lynn E. Turner  
Chief Accountant 

RE: Correspondence Regarding Auditor Independence from  
Senator Schumer, Senator Bennett, and Senator Bayh

In their letter dated May 25, Senators Schumer, Bennett and Bayh raise the issue of the impact of the New Economy on the regulation of the securities markets, including the regulation of the accounting profession and auditor independence. Attached to their letter is a list of questions, which are addressed below.

Two general points in the Senators' letter deserve particular comment. The first is the connection between the provision of non-audit services to audit clients, auditor independence, and audit quality; and the second is whether an examination of recent changes in the economy should occur before, or as part of, the Commission's rulemaking process.

The letter states that the Senators "are eager to understand the basis for the Commission's [auditor independence] proposal – specifically, the foundation for the premise that providing additional services conflicts with audit quality." While the question is an important one, the premise of the Commission's proposed rules is not the one stated. Although some argue that, to be independent, auditors should not provide *any* non-audit services to their audit clients,<sup>1</sup> the Commission's proposed rules on non-audit services do not go nearly that far. Indeed, the Commission's proposing release expressly recognizes that the provision of *some* non-audit services may enhance audit quality, such as by increasing knowledge of the client's business.<sup>2</sup>

Instead, the Commission's proposed rules on non-audit services merely provide that, to be independent, auditors may not provide *certain* non-audit services to their audit clients. The only non-audit services covered are those that would result in the firm auditing its own work, having a mutual or conflicting interest with its audit client, taking

<sup>1</sup> See, e.g., John H. Biggs, Op-Ed, "Auditors and Consultants Shouldn't Be Too Close," Wall Street Journal (July 13, 2000); compare The Panel on Audit Effectiveness, "Report and Recommendations: Exposure Draft," at 5.31 – 5.38 (May 31, 2000) (Separate Statement of Some Members of Panel Supporting an Exclusionary Ban on Non-Audit Services).

<sup>2</sup> See "Revision of the Commission's Auditor Independence Requirements," Release No. 33-7870, at III.D.1.b.ii. (June 27, 2000) ("Proposing Release") (discussing services in connection with the assessment, design, and implementation of internal accounting and risk management controls).

on the role of management or employee of its audit client, or acting as an advocate for its audit client.<sup>3</sup> The proposed rules identify ten non-audit services that are incompatible with these basic principles when provided to an audit client, eight of which already are deemed to impair an auditor's independence under existing rules of the Commission or the SEC Practice Section of the AICPA. The other two non-audit services are restricted to some extent by existing AICPA or SEC rules.

Moreover, audit quality, by itself, is an incomplete measure of the significance of auditor independence. The Commission and the profession have long rejected the view that a failure of independence is harmless unless it is shown to have caused an audit failure. The independence requirement assures investors that an unbiased professional, divorced from the success or failure of the company, has examined the accounting records of the company and its financial statements, and has signed an opinion stating that those statements have been prepared in conformity with generally accepted accounting principles and provide a fair presentation of the company's financial position. An independence failure undermines these assurances; it strikes at the investor confidence on which our markets depend.

On the subject of the New Economy, the Senators' letter asks whether the Commission should continue its rulemaking on auditor independence "prior to a thorough examination, by both the Commission and the Congress, of the changes wrought by the New Economy, their impact on the existing securities regulatory framework, and the different roles and responsibilities that they may entail for the various participants in that framework, including, but not limited to, the accounting profession."

The Commission historically has been receptive to new ideas and points of view expressed in public comments on its rule proposals. The comment process provides the Commission with an opportunity to obtain additional data, to make sure it has considered reasonable alternatives and selected the most appropriate one, and to better understand the costs and consequences, both intended and unintended, that would flow from adoption of the proposed rules. Accordingly, although the issues in the Commission's auditor independence proposals have been discussed for over 20 years by the accounting profession, academia, regulators, and Congress,<sup>4</sup> the Commission's proposals are not intended to end the debate. They are, rather, a call to interested parties to join that dialogue, not only by sending in written comment letters, but also by participating in the public hearings that the Commission will hold. We believe, therefore, that engaging in rulemaking at this time is appropriate.

Responses to the Senators' questions follow. Because the genesis of the Senators' letter is the Commission's rulemaking on auditor independence issues, the responses focus on accounting, auditing, and auditor independence. Where a response addresses more than one question, the questions have been combined.

<sup>3</sup> See proposed rule 2-01(b)(1) - (4).

<sup>4</sup> See Proposing Release, section II.C.2(a) and The Panel on Audit Effectiveness, "Report and Recommendations: Exposure Draft" (May 31, 2000), Appendix D.

*1. Please identify and provide all studies or analyses undertaken by the Commission assessing whether existing corporate reporting and financial disclosure models need to be modernized in light of changes in technology, globalization and the like. In particular, please identify any provisions of the 1933 and 1934 Securities Acts that should be amended to reflect such need for modernization.*

The Commission and its staff are continuously monitoring trends, such as the rapid pace of technological change and increasing globalization, and analyzing whether such trends warrant any changes in either the federal securities laws or the rules and regulations promulgated under those laws. In the area of corporate reporting and financial disclosure, the Commission has issued a number of studies and releases in the last three years exploring whether such changes are needed. For instance:

- In October 1997, pursuant to § 510(a) of the National Securities Markets Improvement Act of 1996, the Commission staff reported to Congress on the impact of technology on the securities markets. The study, entitled "The Impact of Recent Technological Advances on the Securities Markets," includes a discussion of the effect of technology on corporate communications, including corporate reporting and financial disclosures.
- In November 1998, after several years of study,<sup>5</sup> the Commission issued a proposing release soliciting comment on significant revisions to our regulations under the Securities Act of 1933. "The Regulation of Securities Offerings," Release No. 33-7606A; File No. S7-30-98 (Nov. 13, 1998). The release included proposed changes to the corporate reporting framework, including measures to expedite the reporting of information to investors.
- In February 2000, the Commission issued a concept release seeking comment on the use of international accounting standards in light of the increasing globalization of the securities markets. "International Accounting Standards," Release Nos. 33-7801, 34-42430; International Series Release No. 1215; File No. S7-04-00 (Feb. 16, 2000).
- Most recently, in April 2000, the Commission issued its third interpretive release on the use of electronic media. "Use of Electronic Media," Release No. 34-42728, File No. S7-11-00 (Apr. 28, 2000). The release provides guidance on the use of electronic media in several areas, including an update of the Commission's previous guidance on the use of electronic media to deliver documents under the federal securities laws and a discussion of an issuer's liability for web site content. In addition, because technology is evolving rapidly, the release seeks comment on

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<sup>5</sup> A number of the proposals in the Commission's proposing release on the regulation of securities offerings stemmed from the June 1995 report of the SEC's Advisory Committee on the Capital Formation and Regulatory Processes.

seven issues related to technological change to assist the Commission in determining whether further regulatory action is necessary.

Also, in 1999, you asked Professor Jeffrey Garten, Dean of Yale's School of Management, to gather a group of leaders from the business community, academia, the accounting profession, standard-setting bodies, and corporate America to discuss whether our business reporting framework can more effectively capture recent changes in the United States economy. Following the completion of that group's work, the staff may recommend changes in the Commission's forms or regulations, or, if necessary, the federal securities laws.

*2. Please identify and provide all studies or analyses undertaken by the Commission assessing whether existing disclosure requirements adequately identify all necessary information pertaining to the recognition and measurement of the assets and liabilities of organizations.*

Generally accepted accounting principles (GAAP) require the recognition and measurement of the assets and liabilities of organizations. These principles continually are under review to determine whether all necessary information is considered in the accounting process.

In addition, the Garten Committee, noted above, and a committee formed by the Financial Accounting Standards Board ("FASB") to study the business-reporting model are developing separate recommendations for disclosures of nonfinancial information by companies in certain industries, which may be useful in making investment decisions. Once the recommendations have been submitted, the Commission and its staff will review them and determine whether further action is warranted.

*3. Has the Commission undertaken any studies during the past three years of the degree of investor reliance on historical financial statements for investor decisions? Has the Commission undertaken any studies during the past three years of the degree of investor reliance on Internet-based information for investor decisions? Please provide all such studies.*

*4. As investors and other market participants increasingly rely in their decisionmaking on information outside traditional historical financial statements, what consideration has the Commission given to the role of auditors in providing assurance on such information?*

Questions 3 and 4 raise the issue of extending the attest function beyond the historical financial statements and to data or information presented outside the financial statements. As noted above, the Garten Committee and the FASB Business Reporting Committee are studying recent developments in the use of nonfinancial information to value companies in the market place. We will study their recommendations carefully.

5. *In particular, what studies or analyses has the Commission undertaken to identify the range of skills that accounting firms will need to provide additional assurance to investors?*

6. *How would scope of practice restrictions impact the firms' ability to provide assurance against nontraditional financial measurements, e.g., intangibles? against nonfinancial measurements?*

7. *How would these restrictions impact audit firms' ability to provide real-time assurance against company information made available online?*

Questions 5, 6, and 7 ask about accounting firms' capabilities to provide additional or new assurance services in the future and any effect of the Commission's proposed rules on the firms' capabilities. It should be noted that auditors currently provide assurances related to intangible assets and similar items to the extent they are incorporated in financial statements that have been subject to the auditor's review or audit. Some argue that prohibiting accounting firms from providing additional non-audit services could, for various reasons, harm the quality of audits now or in the future. As noted in the Proposing Release, approximately 75% of Commission registrants do not purchase non-audit services from the auditors of their financial statements. No one, however, has alleged that the audits for these registrants are deficient or of a decreased quality. Moreover, the Commission's proposed rules would not prohibit accounting firms from providing any service to entities other than their audit clients. In addition, to be independent, accounting firms could not provide to their audit clients only those non-audit services that are inconsistent with the four basic principles in the proposed rules.

Nonetheless, the Proposing Release reviews and considers whether the proposed rules would impose costs of the sort identified in the Senators' questions, and invites the public to comment on these issues and any other anticipated costs or benefits of the proposed rules.<sup>6</sup> We expect that interested parties will provide information and views as to whether the proposed rules would have any effect on the ability of accounting firms to provide new assurance services.

Extension of the attest function beyond the financial statements would add value to the financial reporting system only if investors were confident that the firm examining and reporting on the information had no inappropriate ties to the company and management and also had no involvement in the creation of that information. The Commission's proposed rules on non-audit services should enhance investors' confidence in the integrity and objectivity of the firms' audit and attest functions and enhance the firms' ability to provide investors with assurances related to financial and nonfinancial measurements.

8. *Please identify all empirical studies or analyses undertaken by the Commission to evaluate whether the provision of each of the following services by accounting*

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<sup>6</sup> See Proposing Release, section V.B.2.b.

*firms to their audit clients has increased the number of financial reporting problems.*

- (a) Information technology services.*
- (b) Computer risk management services.*
- (c) Financial and commodity risk services.*
- (d) Fraud and integrity risk services.*
- (e) Valuation services.*
- (f) Tax services.*
- (g) Internal audit outsourcing services.*

*9. Please identify all empirical studies or analyses undertaken by the Commission to evaluate whether the provision of each of the following services by accounting firms to their audit clients has reduced the number of financial reporting problems.*

- (a) Information technology services.*
- (b) Computer risk management services.*
- (c) Financial and commodity risk services.*
- (d) Fraud and integrity risk services.*
- (e) Valuation services.*
- (f) Tax services.*
- (g) Internal audit outsourcing services.*

The Commission's proposing release notes that some argue that there is no evidence that providing non-audit services leads to false financial reporting and that, therefore, the Commission should not take steps to protect auditor independence in the area of non-audit services.<sup>7</sup> The proposing release explains both the basis of the Commission's concerns and the reasons why empirical evidence on this topic may be hard to come by.<sup>8</sup> In short, as the POB noted over 20 years ago, "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."<sup>9</sup>

The proposing release also discusses a number of studies that document investors' growing concerns about the impact of nonaudit services on auditor independence.<sup>10</sup> The

<sup>7</sup> The Commission's proposed rules do not include the services in items (b), (c), (d), and (f) as services that are per se incompatible with auditor independence. The ISB has issued an interpretation and Discussion Memorandum regarding (e), valuation services. The Proposing Release does ask questions about the impact of each of these services on auditor independence.

<sup>8</sup> See Proposing Release at II.C.2.d.

<sup>9</sup> POB, Scope of Services by CPA Firms, at 34 n.103 (March 1979). The release also cites a study showing how the characteristics of the auditing relationship lead auditors' judgments to be biased in favor of their client's interests. See Proposing Release at II.C.2.d (citing Max H. Bazerman, Kimberley P. Morgan, and George F. Loewenstein, "The Impossibility of Auditor Independence," Sloan Management Review, at 89-94 (Summer 1997)).

<sup>10</sup> Proposing Release, section II.C.2(d).

provision of nonaudit services to audit clients was a concern expressed in Congress in the late 1970s.<sup>11</sup> Although Congress did not take legislative action, it suggested that non-accounting management services be discontinued.<sup>12</sup> For several years thereafter, fees from nonaudit services, while remaining a sensitive issue, were far exceeded by fees from the "core" services rendered by major accounting firms.

Recently, however, there has been a major increase in nonaudit services provided by the firms. In 1993, nonaudit services provided 32% of the major firms' revenues; in 1999, nonaudit services provided 51% of those firms' revenues. The average annual growth rate for such revenues was 26%, compared to a 9% annual growth rate for audit revenues and 13% for revenues from tax services. From 1996 to 1999, the percentage of SEC registrants that paid the auditors of their financial statements more fees for nonaudit than audit services rose from 1.5% to 4.6%, an increase of over 200%. Today, for the five largest accounting firms, the fees from providing nonaudit services to audit clients that file reports with the Commission amount to 22.8% of the firms' consulting and nonaudit revenues, and 10% of the firms' revenue from all sources.<sup>13</sup>

Several private sector studies have focused on a growing public concern regarding the objectivity and independence of auditors, in light of the expansion in non-audit services being performed by auditing firms for their audit clients. For instance, the September 1994 report, Strengthening the Professionalism of the Independent Auditor, by the Advisory Panel on Auditor Independence (the Kirk Panel) states that, "Growing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function ... and by seeing the audit function as necessary just to get the benefit of being considered objective and to serve as an entrée to sell other services."

The 1994 report, Improving Business Reporting--A Customer Focus: Meeting the Information Needs of Investors and Creditors, by the American Institute of Certified Public Accountants' ("AICPA") Special Committee on Financial Reporting (the Jenkins Committee) states that, "Users are concerned about current pressures on auditor independence. They believe the need to maintain a good business relationship with clients in a competitive audit environment could, over time, erode auditor independence .... Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship."

In addition, the 1999 study sponsored by the Independence Standards Board ("ISB"), and conducted by Earncliffe Research & Communications noted that, "Most

<sup>11</sup> See Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess., at 16-17 (Comm. Print Nov. 1977).

<sup>12</sup> Id.

<sup>13</sup> See Proposing Release, section II.C.2. and Appendix B.

[interviewees] felt that the evolution of accounting firms into multi-disciplinary business service consultancies represents a challenge to the ability of auditors to maintain the reality and the perception of independence .... While some believe that perceptions of the independence of auditors is already suffering some corrosion, more people take the view that damage is inevitable in the future if greater precautions are not taken to protect the perception of independence.”

Taken together, these studies indicate that investors see a connection between the provision of nonaudit services and auditor independence. Accordingly, the release solicits comments and requests that commenters submit empirical data on the impact of services, such as those listed in questions 8 and 9, on auditor independence.

It also may be noted that the Commission periodically issues accounting and auditing enforcement releases that discuss auditor independence issues. These disciplinary and enforcement actions focus on individuals' and firms' noncompliance with specific auditor independence regulations. It is generally difficult to allege, however, that a lack of independence alone caused a misstatement in an entity's financial statements or a financial loss by investors. After completion of the case involving the company's financial statements, therefore, the Commission considers whether the auditor adhered to Commission and professional standards during the conduct of its audit and, when appropriate, will sanction an auditor for noncompliance.

*10. What studies has the Commission undertaken to evaluate the impact of your proposal on competition in the consulting sector? Please provide the Committee with your legal analysis to demonstrate that this proposal does not constitute a restraint of trade.*

In its proposing release, the Commission considered whether the proposals would have any anticompetitive effects, as required by sections 3(f) and 23(a) of the Exchange Act, and sought comment on these issues. In the Cost-Benefit section of the release, the Commission discusses the impact that the proposals may have on competition among consulting firms and public accounting firms.<sup>14</sup> Three major points discussed in that section are that:

- Our proposals should improve competition for consulting services in that any competitive advantage currently enjoyed by the auditor of the client's financial statements would be removed,
- Although some additional consulting work may be obtained by consulting firms, in general the overall impact of the proposals may be to re-distribute work among the public accounting firms, and

<sup>14</sup> Proposing Release, section V.B.1(c) and (d).

- The proposals apply only to the provision of nonaudit services for audit clients that file financial statements with the Commission; nonaudit clients are not within the scope of the proposals.

The Commission asks several questions and solicits comments on its analyses of these issues. The Commission also solicits general comments on the potential competitive impact of the proposals in accordance with sections 3(f) and 23(a) of the Securities Exchange Act of 1934.<sup>15</sup>

The letter also asks for a legal analysis demonstrating that the proposals are not a “restraint of trade.” I understand from our Office of General Counsel that, absent a requirement for joint action or some other anticompetitive device, the rule would not effect any restraint of trade.

*11. What empirical studies have been performed to demonstrate a negative correlation between nonaudit services and audit quality? Specifically, please provide a complete list of all audit failures attributable to the provision of nonaudit services to audit clients for the last 10 years.*

For a discussion of why a list of audit failures directly attributable to the provision of nonaudit services does not exist, please see the response to questions 8 and 9.

*12. Compromising audit quality because a firm provided nonaudit services to audit clients risks lawsuits and firm reputation. Please identify all studies or analyses undertaken by the Commission to evaluate the effectiveness of these disincentives to compromise audit objectivity.*

Please see the responses to questions 8 and 9.

In general, the risk of lawsuits based solely on a lack of auditor independence is remote, in part because of the difficulty in establishing that a lack of independence caused a particular auditing misjudgment, which in turn caused the investor’s loss.<sup>16</sup> For example, in one recent case, the court was quite forceful as to the auditor’s manifest lack of independence, but discussed the difficulties in establishing that the audit caused the plaintiff’s loss.<sup>17</sup> The court remanded the case for further findings on the foreseeability aspects of loss causation.

Regarding the firm’s reputation, when the auditor provides both audit and nonaudit services to the same entity, there are competing incentives to preserve the firm’s reputation. When providing nonaudit services, the firm must preserve its reputation as a

<sup>15</sup> 15 U.S.C. 78c(f) and 78w(a)(2).

<sup>16</sup> See also 1979 POB Report, at 35 (“Not all situations where an auditor’s objectivity is compromised will result in a lawsuit.”).

<sup>17</sup> AUSA Life Insurance Company v. Ernst and Young, 206 F.3d 202 (2d Cir. 2000).

valuable asset to management. By providing services that are of value to management, the firm encourages (1) additional engagements by management, (2) management to refer other potential consulting clients to the firm, and (3) an enhanced reputation in the market place for consulting services as a highly competent and valued consultant. In contrast, when providing audit services, the firm seeks to preserve its reputation as an independent and unbiased examiner. It is the interplay between these two conflicting messages – that the firm is, at the same time, an active participant in helping management achieve its goals and an independent and objective “outside” observer of management – that causes confusion and concern for investors.

*13. Please identify all studies or analyses evaluating whether insurance brokers or insurance companies associate increased liability risk with accounting firms that perform nonaudit services for audit clients. Please provide any historical evidence compiled by the Commission in this regard.*

Please see the responses to questions 8, 9 and 12 for a discussion regarding why auditor independence issues may not have a direct impact on an accounting firm’s liability risk.

*14. Please detail how your proposal would account for the planned divestitures and partial divestitures of consulting practices by large audit firms.*

The proposing release describes the publicly announced plans of some firms to dispose of portions of their consulting practices and raises several questions about the auditor independence implications of those transactions.<sup>18</sup> How each transaction might be treated under the proposals depends on, among other things, whether the entity purchasing or acquiring the consulting practice would continue to be considered to be an affiliate of the accounting firm.<sup>19</sup> In addition, to allow the firms sufficient time to comply, the proposed rule contains a two-year transition period before its restrictions on the provision of non-audit services apply.<sup>20</sup>

Perhaps more significant to these transactions, however, is a Commission staff “no-action” letter issued to Ernst & Young LLP on May 25, 2000. In that letter, the staff indicated that it would not recommend enforcement action to the Commission solely because the purchaser of E&Y’s consulting practice, Cap Gemini Group SA, enters into business relationships with, or invests in, E&Y’s audit clients, provided certain conditions are met. These conditions include, among several others, E&Y reducing its equity investment in Cap Gemini to zero within five years, E&Y having no role in the corporate governance of the resulting consulting company, and E&Y having no co-marketing arrangements with the consulting company.

<sup>18</sup> See, e.g., Proposing Release, sections II.C.2.b.; III.C.1.a.

<sup>19</sup> See Proposed rule 2-01(f)(4)(C)-(F) and Proposing Release section III.I.3.

<sup>20</sup> See Proposed rule 2-01(c)(4)(ii).

*15. What regulatory analysis have you undertaken that shows that any benefits outweigh the costs?*

Please refer to the cost-benefit analysis in section V. of the Proposing Release.

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The Office of the Chief Accountant would be pleased to brief congressional staff, at their convenience, on the issues discussed in this memorandum or in the Commission's auditor independence proposing release or to provide copies of any of the documents cited in this memorandum.