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STAFF REPORT ON AUDITOR INDEPENDENCE

A Re-examination of the Background and Need for Auditor Independence, the Current Rules and Interpretations of the Securities and Exchange Commission, the American Institute of Certified Public Accountants, and Other Nations Relating to Auditor Independence, and Recent and Proposed Changes in Those Rules and Interpretations.

OFFICE OF THE CHIEF ACCOUNTANT

SECURITIES AND EXCHANGE COMMISSION

March 1994

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I. EXECUTIVE SUMMARY

This staff report responds to the March 18, 1993 request from Congressman Edward J. Markey, Chairman of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, that the U.S. Securities and Exchange Commission ("Commission" or "SEC") study the need for, and any impediments to, the independence of public accountants in performing their responsibilities under the Federal securities laws. Chairman Markey requested that the Commission provide the Subcommittee with any recommendations for legislation that the Commission may consider appropriate or any conclusions regarding changes in the Commission's rules that may be required for the protection of investors or in the public interest. Chairman Markey's letter is reproduced at Appendix I.

This report, prepared by the staff of the Office of the Chief Accountant of the Commission ("OCA"), provides background information on the issue of auditor independence (section II), discusses the Commission's independence rule and related interpretations (section III) and pronouncements of the American Institute of Certified Public Accountants (section IV) and other nations' independence requirements (section V), and, finally, discusses recent and certain current proposals regarding independence issues (section VI).

The staff of the OCA does not, at this time, recommend (a) enactment of additional legislation or (b) promulgation of additional rules by the Commission with respect to the independence of external auditors to public companies. The Federal securities laws require that the financial statements of public companies be audited by independent accountants. The Commission has the authority under those laws to define the term independent. The Commission has adopted a rule to implement the statutory requirement and, from time to time, has provided formal interpretations of the term. The Commission staff has, from time to time, provided both written and oral interpretations of the term. The Commission, when necessary, has instituted formal complaints against auditors that it has found not to be independent. Lastly, the Commission has resorted to the Courts, when necessary, to enforce the Commission's interpretations of the term. The staff of the OCA believes that no further legislation or rules or regulations are necessary for the protection of investors.

II. BACKGROUND

Summary

Prior to the enactment of the Federal securities laws, many in the accounting profession recognized the need for auditors to be independent from their audit clients if their audit reports were

to add credibility to the financial reporting process. This requirement for auditors to be independent was written into the Federal securities laws and the Commission, since its inception, actively has enforced it. At least 40 enforcement actions, more than ten interpretive releases, and various releases in which the Commission proposed or adopted disclosure items, such as the auditor change disclosures required to be filed on Form 8-K, discuss auditor independence issues. Also, as noted elsewhere in this report, the Commission staff responds to requests for oral advice on auditor independence issues almost daily, and maintains a public file of responses to written requests for such advice.

The Need for Auditor Independence

The independence of accountants who audit the financial statements included in filings with the Commission is crucial to the credibility of financial reporting and, in turn, the capital formation process. The public confidence in the reliability of issuers' financial statements that is provided by the performance of independent audits encourages investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent professionals who have neither mutual nor conflicting interests with their audit clients and who exercise objective and impartial judgment on all issues brought to their attention.

The Federal securities laws recognize the importance of independent audits by requiring, or permitting the Commission to require, that financial statements filed with the Commission by public companies, investment companies, broker/dealers, public utilities, investment advisers, and others, be certified (or audited) by independent public accountants,1/ and by granting the

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1/ For example, items 25 and 26 of Schedule A to the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. 77aa(25) and (26), and §17(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m, §§5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79e(b), 79j, and 79n, §§8(b)(5) and 30(e) of the Investment Company Act of 1940, 15 U.S.C. 80a-8 and 80a-29, and §203(c)(1)(D) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Accordingly, the Commission has required that certain financial statements be audited by independent accountants. *See, e.g.*, Article 3 of Regulation S-X, 17 CFR §210.3-01 *et seq.*

Commission the authority to define the term "independent."2/ Currently, more than 13,000 public companies file audited, annual financial statements with the Commission under the Exchange Act alone. In addition, audited financial statements were used in 1992 in the United States in connection with the public issuance of $718 billion of securities, a 46 percent increase from the prior year.3/ Given the large volume of filings made with the Commission by public companies and other entities, the Commission staff is not able to review each financial statement in detail. During 1992, however, the Commission's Division of Corporation Finance reviewed approximately 3,058 reporting issuers' financial statements and related disclosures.4/ These reviews by the staff, barring an enforcement inquiry, were limited to documents filed with the Commission (or provided supplementally to the staff) and are not a substitute for the testing of the account balances and transactions and an evaluation of events, conditions, and circumstances underlying financial statements that comprise an audit. By necessity, the Commission relies heavily on the accounting profession 5/ to be primarily responsible for examining

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2/ Section 19(a) of the 1933 Act, 15 U.S.C. 77s(a), §3(b) of the Exchange Act, 15 U.S.C. 78c(b), §20(a) of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79t(a), and §38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act.

3/ *See* Testimony of Arthur Levitt, Jr., Chairman, U.S. Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, Concerning the Commission's Authorization Request for Fiscal Years 1994-1995, at 2 (July 29, 1993).

4/ U.S. Securities and Exchange Commission Fifty-Eighth Annual Report, at 54-55 (1992).

5/ Due in part to the franchise granted under the Federal securities laws to the accounting profession to audit the financial statements of public companies, the accounting profession has grown and prospered. The six largest firms are international service organizations generating $11.6 billion in annual U.S. revenues, $31.3 billion in annual worldwide revenues, and having approximately 8,350 partners and 71,700 professional staff in the U.S. Five of the six firms derive approximately half of their revenues from accounting and auditing services. Public Accounting Report at 1, 3-5 (March 31, 1993).

the huge volume of financial data that forms the cornerstone of the Commission's full disclosure system.6/

The Independence Concept

Much of the U.S. theory of auditing and independence appears to have come from the United Kingdom.7/ U.S. accounting firms generally began conducting audits in order to report to foreign entities, principally in the United Kingdom, on the status of their U.S. investments.

As their auditing practices grew and the demands of U.S. investors for financial information increased, accountants in this country began to recognize the same importance in obtaining the public's confidence (as opposed to the confidence of their clients' managements) that had been recognized a generation before in the U.K.8/ For example, Charles Reckitt stated in The Public Accountant (Philadelphia), in January 1900:

> A public accountant acknowledges no master but the public .... A public accountant's certificate, though addressed to president or directors, is virtually made to the public, who

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6/ *See* Touche Ross & Co. v. Securities and Exchange Commission, 609 F.2d 570, 580-581 (2d Cir. 1979), which states:

> The role of the accounting and legal professions in implementing the objectives of the disclosure policy [in the Federal securities laws] has increased as the number and complexity of securities transactions has increased. By the very nature of its operations, the Commission, with its small staff and limited resources, cannot possibly examine, with the degree of close scrutiny required for full disclosure, each of the many financial statements which are filed. Recognizing this, the Commission must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors.

7/ For a general discussion of the historical development of the concept of auditor independence, *see generally,* Previts, The Scope of CPA Services (John Wiley & Sons, 1985).

8/ D. Causey, Duties and Liabilities of Public Accountants, at 30-31 (Dow Jones-Irwin, rev. ed. 1982).

> are actually or prospectively stockholders. He should have ability, varied experience and undoubted integrity.9/

Arthur Lowes Dickinson, a British accountant, who soon after his arrival in this country was chosen to head Price Waterhouse's U.S. operations, foresaw the development of legislation in this country that would be patterned after the British example. In an article published in 1902, he stated:

> It may well be that legislation will eventually be necessary before complete protections are assured to the public. But all those who are against government interference with private enterprises, while desiring to compel reasonable publicity in the affairs of commercial undertakings, can direct this legislation to safe channels by using their influence to so firmly establish the principle of independent audits by public accountants that the state will merely have to make compulsory a course of action already adopted by the majority of well-managed enterprises.10/

The use of independent audits did increase in the U.S. and by April 1932 all corporations applying for listing on the New York Stock Exchange ("NYSE") were asked by the NYSE to agree to have their future financial statements audited by independent public accountants.11/ When the Securities Act of 1933 (the "1933 Act") was adopted, the financial statements of eighty-five percent of the companies listed on the NYSE were audited by independent public accountants.12/

9/ Previts, *supra*, at 33.

10/ *Id.* at 30 quoting Dickinson, "Duties and Responsibilities of the Public Accountant," in The English View of Accountants' Duties and Responsibilities: 1881-1902, ed. Michael Chatfield, New York: Arno, 1978, at 153-160.

11/ L. Rappaport, SEC Accounting Practice and Procedure, 26.3-26.4 (The Ronald Press Company, 3d ed. 1972). Attempts by the NYSE to require all listed companies to have their financial statements audited, however, had failed. *See*, Part 4, Stock Exchange Practices: Hearings on S. Res. 84 and S. Res. 239, Resolutions to Thoroughly Investigate Practices of Stock Exchanges with Respect to the Buying and Selling and the Borrowing and Lending of Listed Securities, the Values of Such Securities and the Effects of Such Practices, Before a Subcommittee of the Senate Committee on Banking and Currency, 72d Cong., 2d Sess., 1356-1358 (January 11 and 12, 1933).

12/ See, Hearings on S. 875 Before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., at 60 (1933) ("1933 Senate Hearings").

Prior to the enactment of the 1933 Act, however, there were few if any professional rules in this country defining the scope of auditor independence. This may have been because practitioners considered independence to be a "habitual state of mind," or a "cultural ought."13/ It was believed unwise to assume someone was independent merely if he or she followed a few specific rules; just as it was considered unwise to assume that anyone who participated in a particular activity always would not be independent.14/ Also, as there was no legal requirement to be independent of audit clients, there was no compelling need for clear tests of independence.

Despite the lack of specific rules prior to 1933, the meaning and scope of "independence" actively was being debated. As today, a main controversy concerned the expansion of advisory services versus the need for public confidence in the audit process. In 1925, Arthur Andersen (founder of the firm bearing his name) said:

> [T]he businessman has found that advice from an accounting viewpoint may have high cash value in the form of taxes saved or refunded, war contracts liquidated, in recapitalizations and refinancings effected advantageously.... The present-day accountant who is alert will grasp every opportunity to foster this attitude by increasing the constructive value of all normal work and seeking newer and broader fields of service to business management.15/

Herbert Freeman, however, cautioned that accountants should not accept engagements that "lead them into the executive field" or "charge them with the responsibilities of administration" until the "status of the profession is established by legislative action."16/ That legislative action began in 1933.

When members of the accounting profession appeared before Congress in 1933 to argue that the financial statements of public companies should be required to be audited by "independent

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13/ Previts, *supra*, at 42-43.

14/ *Id.* As late as 1932, the accounting profession disapproved a proposed professional resolution indicating that dual roles of auditor and director or officer of a corporation tend to destroy the auditor's independence. Rappaport, *supra*, at 26.2-26.3.

15/ Previts, *supra*, at 45 quoting reprint of the address, A. Andersen, "The Accountant's Function as Business Adviser," The Journal of Accountancy, at 18-19 (January 1926).

16/ *Id.* at 46-47.

accountants," Congress was able to find support for their arguments in British law and the practice of eighty-five percent of NYSE companies.17/ With these examples, and what Congress undoubtedly felt was a lack of controversy in requiring such audits, it is not surprising that the issue is not addressed in House, Senate, or Conference Reports regarding the initial adoption of the Federal securities laws.18/ At related hearings, however, Congress briefly did consider establishing a corps of government auditors who would verify corporate account balances of public companies and review company books. After hearing testimony from representatives of the accounting profession that the profession could perform such tasks more effectively, and at less cost, Congress chose to entrust the accounting profession with the responsibility for auditing the financial statements of Commission registrants.19/

The Federal Trade Commission, immediately following adoption of the 1933 Act and prior to the formation of the SEC, issued a regulation under the 1933 Act providing that an accountant would not be considered independent with respect to any person with whom the accountant had any interest, directly or indirectly, or with whom the accountant was connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or a person performing a similar function.20/

Practically since its inception, the Securities and Exchange Commission has addressed auditor independence issues. For example, in the 1936 case of In the Matter of Cornucopia Gold Mines,21/ the

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17/ 1933 Senate Hearings at 56-60. *See generally,* J. Wiesen, The Securities Acts and Independent Auditors: What Did Congress Intend? (a research study prepared for the Commission on Auditors' Responsibilities, AICPA, 1978).

18/ *Id. See also,* B. Committee, Independence of Accountants and Legislative Intent, 41 Ad. L. Rev. 33, 37 (1989).

19/ 1933 Senate Hearings at 55-60. During one hearing, Col. A.H. Carter, then president of the New York State Society of Certified Public Accountants, stressed the fact that outside accounting firms would be independent of management. During this discussion, Col. Carter, in differentiating between controllers employed by companies and independent accountants, stated, "the public accountant audits the controller's accountant." Senator Barkley then asked, "Who audits you?" Col. Carter's often quoted reply was, "Our conscience." 1933 Senate Hearings at 58.

20/ Federal Trade Commission, Rules and Regulations Under the Securities Act of 1933, Article 14 (July 6, 1933).

21/ 1 SEC 364 (1936).

Commission referred to several business relationships 22/ between the accountant and the registrant and determined that the accountant was not independent. In response to arguments by counsel for the accountants that the certification was not material to investors, the Commission stated:

> A certification is a material fact. It signifies that the contents of the financial statements to which it is appended have been checked and verified within the limits stated in the certificate. To make such certification truly protective of the interests of security holders and investors the requirement under the Securities Act of 1933, as amended, is that it be made by an "independent public or certified accountant." The insistence of the Act on a certification by an "independent" accountant signifies the real function which certification should perform. That function is the submission to an independent and impartial mind of the accounting practices and policies of registrants. The history of finance well illustrates the importance and need for submission to such impartial persons of the accounting practices and policies of the management to the end that present and prospective security holders will be protected against unsound accounting practices and procedure and will be afforded, as nearly as accounting conventions will permit, the truth about the financial condition of the enterprise which issues the securities. Accordingly, the certification gives a minimum of protection against untruths and half-truths which otherwise would more easily creep into financial statements. Hence a statement which serves such a high function cannot be dismissed under the Act as a mere "tag" attached to financial statements. It is a material fact, for it gives meaning and reliability to financial data and makes less likely misleading or untrue financial statements.23/

Later in the same year, the Commission found an accountant to have "consciously falsified the facts" and therefore not to be

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22/ Among other things, the accounting firm received a set fee plus one percent of the registrant's sales of certain metals for one year. The accounting firm installed the registrant's accounting system and furnished the registrant with office space, as well as audited the registrant's financial statements. In addition, the person in charge of the audit simultaneously was made comptroller of the registrant and owned shares of the registrant's common stock. *Id.* at 365-366.

23/ *Id.* at 367.

independent.24/ In discussing the independence issue the Commission said:

> [T]he methods and results of his auditing work cause us to doubt whether any presumption of independence, which the absence of relational or contractual connection with registrant would normally justify, can be indulged here.... [W]here the accountant has consciously falsified the facts, as here, an inference of actual absence of independence would seem to be justified.... Protection of investors in these situations requires not only that these fiduciaries be free of entangling alliances which relational and contractual connections with registrants frequently engender, but also that they approach their task with complete objectivity - critical of the practices and procedures of registrants, and unwilling to aid and abet in making statements which the facts do not warrant.25/

From the very beginning, therefore, the Commission emphasized the need for auditors to be independent. On May 6, 1937, the Commission issued Accounting Series Release No. ("ASR") 2. In this release, the Commission stated:

> The Securities and Exchange Commission from time to time has been called upon to determine whether, in a particular case, the relationship existing between a registrant and an

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24/ In the Matter of American Terminals and Transit Company, 1 SEC 701, 707 (1936).

25/ *Id.* The reference by the Commission in this excerpt to the independent accountants as "fiduciaries" is consistent with section 11(c) the 1933 Act. As originally enacted, this subsection stated that the "degree of reasonableness" required of those persons listed in section 11, including accountants who prepare or certify any part of the registration statement, "shall be that required of a person occupying a fiduciary relationship." *See* H.R. Rep. No. 85, 73rd Cong., 1st Sess., 5 (1933), which states that "the essential characteristic [of the civil liabilities imposed by the 1933 Act] consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary." In 1934, this language was amended to state that the standard of reasonableness shall be that required of a prudent man in the management of his own property. *See* H.R. Rep. No. 1838, 73rd Cong., 2d Sess., 41 (1934), which states, "The amendment to section 11(c) [of the Securities Act of 1933] removes possible uncertainties as to the standard of reasonableness by substituting for the present language the accepted common law definition of the duty of a fiduciary."

accountant was of such a nature as to prevent him from being considered independent for the purpose of certifying financial statements to be filed in connection with the registration of securities under the Securities Act of 1933 and the Securities Exchange Act of 1934.

In response to such requests, the Commission has taken the position that an accountant can not be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.26/

In February 1940, the Commission consolidated several sets of accounting instructions from various forms into a single accounting regulation, Regulation S-X.27/ Article 2 of this Regulation was entitled "Certification," with Rule 2-01(b) stating that the Commission would not recognize any accountant as independent who is not in fact independent. This rule further stated,

> An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

With various amendments, this rule continues today.28/

26/ The Federal Trade Commission rule specifying that an auditor would "not be considered" independent if certain relationships exist, and the SEC's early use of language regarding a "presumption" of independence, an "inference of actual absence of independence" (In the Matter of American Terminals and Transit Company, *supra*), and when an accountant "can not be deemed" to be independent (ASR 2, *supra*), suggest that the appearance of independence, as well as the fact of independence, was a consideration in initial independence determinations. Subsequently, the need for auditors to maintain the appearance of independence was written expressly into the Commission's interpretations and the auditors' professional literature. *See, e.g.*, ASR 126 (July 6, 1972), ASR 165 (December 20, 1974), ASR 296 (August 20, 1981), and the discussion of the AICPA's independence requirements, *infra*.

27/ ASR 12 (February 21, 1940); *see* SEC, Sixth Annual Report of the Securities and Exchange Commission, at 170-171 (1940).

28/ *See* discussion of SEC independence requirements *infra*.

The Commission continued its consideration of auditor's independence in cases such as McKesson & Robbins, in which it talked of the "degree of independence which [the Commission] deem[s] necessary for the protection of investors" and described procedural safeguards (such as the use of audit committees) that would enhance auditor independence.29/ In this case, the Commission emphasized the philosophy under the Federal securities laws that auditors are to be governed primarily by their responsibilities to public investors, rather than by any obligations the auditors previously may have felt were owed to management. The Commission stated:

> In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to managers or owner-managers, he must now recognize fully his responsibility to public investors by including the activities of the management itself within the scope of his work and by reporting thereon to investors....
>
> Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure ... that accountants will be more independent of management.30/

In the Hollander case the following year, the Commission discussed situations that "may cast grave doubts on the independence of an accountant."31/ In this case the Commission also said:

> [O]ne of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his nonprofessional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting procedure is the result of bias or lack of independence that

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29/ In the Matter of McKesson & Robbins, ASR 19 (December 5, 1940).

30/ *Id.*

31/ In the Matter of A. Hollander & Son, Inc., 8 SEC 586, 612 (1941).

> this Commission has in its prior decisions adopted objective standards. Viewing our requirements in this light, any inferences of a personal nature that may be directed against specific members of the accounting profession depend upon the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards.32/

The Commission noted significant stockholdings by the auditors in the Hollander companies and stated that these holdings "preclude [the accountants] from being regarded as an independent public accountant with respect to the registrant ...."33/

In 1944, the Commission issued a release summarizing additional independence rulings, stating:

> Certain relationships between an accountant and his client appear so apt to prevent the accountant from reviewing the financial statements and accounting procedures of a registrant with complete objectivity that the Commission has taken the position that existence of these relationships will preclude its finding that the accountant is, in fact, independent.34/

32/ *Id.* at 613.

33/ *Id.* at 614. ASR 22 (March 14, 1941) restated many of the ideas in the Hollander case and reviewed other cases where relationships and situations, beyond those set forth in Rule 2-01(b), had prevented an accountant from being considered independent for the purpose of certifying financial statements filed by a particular registrant. These situations included being an unsalaried employee of the registrant, being a shareholder of the registrant, being an employee of a shareholder of the registrant, consciously falsifying facts, being completely subordinate to the judgments of the registrant, making loans to and receiving loans from officers and directors of the registrant, and receiving a letter of indemnification from the registrant.

34/ ASR 47, "Independence of Certifying Accountants - Summary of Past Releases of the Commission and a Compilation of Hitherto Unpublished Cases or Inquiries Arising Under Several of the Acts Administered by the Commission" (January 25, 1944). These rulings also emphasized the disqualifying aspects of interests held by an accountant's spouse and partners in the accounting firm.

In addition, in its Annual Report for 1944, the Commission elaborated on the importance of auditor independence.35/ The Commission stated, in part:

> The maintenance of high standards of professional conduct on the part of the public accountants who certify financial statements is a matter of the utmost importance to persons who rely on these statements. The reader of a financial statement has a right to expect that the certifying accountant has done his work expertly and impartially and that his opinion as to the financial statements is forthright and unbiased....
>
> One cornerstone of proper professional conduct is that the accountant shall be independent of the client whose financial statements he certifies. This view has long been held by many individual accountants but was explicitly introduced in the Securities Act of 1933 as a necessary prerequisite to the certification of financial statements filed under that Act. This need for independence has also been given statutory recognition in the other principal acts administered by the Commission. The goal of such a principle is obvious--the accountant's opinion, if it is to be valuable to the reader of financial statements, must be arrived at objectively and expressed impartially.
>
> ... The Commission, however, has viewed the requirement of independence not only as a safeguard against conscious falsification but also as a preventive of impalpable and unprovable biases in the exercise of his professional judgment which may arise as a result of incompatible interests or relationships. Consequently, the Commission has found an accountant to be lacking in independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on the questions confronting him.36/

During this time period, the accounting profession also continued its consideration of auditor independence issues. In 1947, Mr. John L. Carey, the American Institute's former chief staff officer, wrote the following, insightful definition of independence:

> Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the

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35/ SEC, Tenth Annual Report of the Securities and Exchange Commission, 205-207 (1944).

36/ *Id.* at 205.

> certified public accountant. Essentially, it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means, in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course. Everyone will applaud this ideal, but a cynical world requires more than a mere declaration of intention if it is to stake its money on the accountant's word. Therefore, the profession has laid its heaviest penalties on those who breach the unwritten contract of independence, and, in addition, has proscribed specific acts and modes of behavior which might raise a question as to the independence of its members. In other words, the rules do not only provide for punishment of members who are not independent; they also prohibit conduct which might arouse a suspicion of lack of independence. Objective standards of independence have thus been introduced into the code. It is not enough for the member to do what he thinks is right. He must also avoid behavior which could lead to an inference that he might be subject to improper influences. The accounting profession must be like Caesar's wife. To be suspected is almost as bad as to be convicted.37/

Over the years, the Commission has maintained the course plotted by these early rationale. For example, in 1964, the Commission, in issuing a stop order under the 1933 Act, stated:

> The requirement in Schedule A [of the 1933 Act] of certification by an independent accountant is intended to secure for the benefit of public investors the detached objectivity of a disinterested person. Rule 17 CFR 210.2-01(c) of our Regulation S-X, which sets forth the requirements applicable to the form and content of financial statements filed as part of a registration statement, states that in considering the independence of certifying accountants we will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the certifying accountants and the registrant or any affiliate of registrant. "The certifying accountant must be one who is in no way connected with the business or its management and who does not have any relationship that might affect the independence which at times may require him to voice public criticisms of his client's accounting practices."38/

37/ John L. Carey, Professional Ethics of Public Accounting 7 (AICPA 1947).

38/ In the Matter of South Bay Industries, Inc., 42 SEC 83, 87 (1964), quoting American Finance Company, Inc., 40 SEC 1043, 1049 (1962).

ASR 296, issued on August 20, 1981, reaffirmed the Commission's dedication to the task of assuring auditor independence in fact and appearance. The Commission states in this release:

> An auditor is deemed to be independent if he is independent in fact and if he appears to be independent. He must act in an unbiased and objective manner and he must be free of any financial or other interest which would create the perception that he may not be independent.
>
> "Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence." [Quoting Statement on Auditing Standards No. 1.] The Commission continues to endorse and require scrupulous adherence to these principles. The Commission views both the fact and appearance of independence as essential in order that the public may justifiably view the audit process as a wholly unbiased review of management's presentation of the corporate financial picture.... Absent independence, in fact and appearance, investors will have little confidence in public companies as investment vehicles.... If the auditor is predisposed, or even appears predisposed, to blindly validate management's work rather than subjecting it to careful scrutiny, the ultimate result will be a diminution of public confidence in the profession and the integrity of the securities markets.
>
> The independence of the public accountant - both in fact and appearance - is critical to his role under the federal securities laws. Independence is the essential attribute of the auditor because, absent independence, the auditor's skills and services are of little value. The Commission has the responsibility and authority under the securities laws to assure that accountants who practice before it are independent and, therefore, is prepared to take further action if either the fact or appearance of accountants' independence is questioned seriously in the future.

Three years later, the U.S. Supreme Court also emphasized the role of the independent auditor under the Federal securities laws.39/ In finding that there is no accountant work-product immunity for accountants' tax accrual workpapers, and no Federal accountant-client privilege, the Court contrasted the role of the accountant versus that of a lawyer. The court stated that a lawyer is a confidential adviser and advocate, with a duty to present the client's case in the most favorable light. The court then stated:

39/ United States v. Arthur Young & Co., 465 U.S. 805 (1984).

> An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.40/

The Court in this case also noted that the Commission requires that financial statements of registrants be audited "in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries."41/ The Court then emphasized the vital importance of the appearance of an auditor's independence to the investing public, by stating:

> It is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. Endowing the workpapers of an independent auditor with a work-product immunity would destroy the appearance of auditor's independence by creating the impression that the auditor is an advocate for the corporate client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.42/

Recent Enforcement of the Commission's Independence Requirements

From the 1936 cases of In the Matter of Cornucopia Gold Mines and In the Matter of American Terminals and Transit Company discussed above, to cases under investigation today, the Commission consistently has taken and is taking enforcement and disciplinary action when registrants and their auditors have violated the independence requirements in the Federal securities laws. Within the last five years the Commission has brought such actions when,

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40/ *Id.* at 817-818.

41/ *Id.* at 819 n. 15.

42/ *Id.*

in its view: auditors lacked the appropriate degree of professional skepticism when auditing clients' financial statements,43/ auditors had financial interests in audit clients,44/ auditors have borrowed money, directly or indirectly, from their audit clients,45/ audit clients had material lease arrangements with partnerships composed of partners in the accounting firm,46/ auditors acted as nominee shareholders for officers or directors of audit clients,47/ auditors performed functions that should have been performed by management,48/ auditors assumed the incompatible role of legal counsel for the company,49/ auditors acted as the company's internal accountant and attempted to audit their own accounting work,50/ auditors have been financially dependent on the audit client,51/ and in other situations.

For example, on July 15, 1993, the Commission settled a disciplinary proceeding pursuant to Rule 2(e) of its Rules of

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43/ In the Matter of Fred V. Schiemann, CPA, Accounting and Auditing Enforcement Release No. ("AAER") 488 (September 29, 1993).

44/ In the Matter of D. Spencer Nilson, CPA, AAER 364 (March 31, 1992). *See also* In the Matter of Bill R. Thomas, AAER 192 (May 27, 1988).

45/ In the Matter of Robert J. Iomazzo, CPA, AAER 437 (January 12, 1993) and AAER 385 (May 22, 1992); SEC v. Ernst & Young, AAER 301 (June 13, 1991); and In the Matter of Frederick D. Woodside, AAER 244 (August 21, 1989).

46/ SEC v. Ernst & Young, AAER 301 (June 13, 1991).

47/ SEC v. Superior Resources, Inc., et al., AAER 419 (September 22, 1992).

48/ In the Matter of Michael R. Ford, CPA, AAER 302 (June 17, 1991) and AAER 297 (May 6, 1991).

49/ In the Matter of Samuel George Greenspan, CPA, AAER 312 (August 26, 1991) and AAER 298 (May 23, 1991).

50/ In the Matter of Thomas P. Reynolds, LTD. and Milton A. Netcher, AAER 333 (September 16, 1991); In the Matter of Terrance M. Wahl, AAER 321 (September 30, 1991); and In the Matter of Noemi L. Rodriguez Santos, AAER 246 (September 1, 1989).

51/ In the Matter of Bernard Tarnowsky, AAER 467 (July 15, 1993) and In the Matter of Terrance M. Wahl, AAER 321 (September 30, 1991).

Practice 52/ in which the auditor was alleged to have violated the Commission's independence requirements by being financially dependent on the registrant and making decisions normally made by company employees.53/ The Commission determined that the auditor in this case derived approximately seventy-five percent of his annual income from the registrant, which was the auditor's only audit client. The Commission also found that the auditor was the registrant's sole source of expert advice on accounting matters and that the auditor, rather than the registrant's employees, made certain decisions regarding the preparation of the registrant's financial statements. The auditor was denied the privilege of practicing before the Commission with the right to apply for permission to resume such practice after 18 months and the fulfillment of certain specified conditions.

In another recent case, the Commission found that an auditor was not independent because of certain loans he had received from his audit client.54/ The Commission ordered that this auditor be

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52/ 17 CFR §201.2(e).

53/ In the Matter of Bernard Tarnowsky, AAER 467 (July 15, 1993).

54/ In the Matter of Robert J. Iommazzo, CPA, AAER 437 (January 12, 1993). In related private litigation, the court, ruling on defendants' motion to dismiss the complaint for failure to state a claim upon which relief can be granted and failure to plead fraud with particularity, stated that the allegation that an "auditor working in a secondary review capacity had owed outstanding debts to [the thrift] ... fuels plaintiffs' contention that the [thrift] defendants and [the accounting firm] engaged in a joint attempt to fraudulently inflate the price of [the thrift's] stock." Lerch v. Citizens First Bancorp., Inc., et al., [Current] Fed. Sec. L. Rep. (CCH) ¶97,258, at page 95,171 (D.N.J. 1992). The court further held that plaintiffs' complaint plead fraud in sufficient detail by, among other things, "explaining the context of [the accounting firm's] sending as one of its auditors of [the thrift] an individual in default of substantial money to [the thrift]." *Id.* The court noted:

> First of all, it is undisputed that Robert Iamuzzo (sic), [the accounting firm's] auditor working in a secondary capacity on [the thrift's] audit, was indebted to [the thrift] for millions of dollars. If [the accounting firm] knew of this indebtedness, then it clearly did violate the requirement that an auditor be independent. Moreover, once such a suspicious scenario is alleged, it is perfectly reasonable to inquire, through discovery, about the extent of the relationship between [the thrift]

(continued...)

denied for a period of ten years the privilege of appearing before the Commission as an independent public accountant, and denied for a period of five years the privilege of appearing before the Commission as a preparer of financial statements. The Commission's opinion in this case stated:

> [I]ndependence of public accountants is critical to the Commission's reporting process and to the securities markets which the Commission regulates. The entire framework of the federal securities laws is premised on fair and adequate disclosure of material facts. Audits by independent accountants are an important method by which the disclosure requirements are implemented. As the Commission previously has said, "The Commission has historically considered the independence of the auditors who examine financial statements filed with the Commission as central to the effective implementation of the federal securities laws." [Quoting ASR 296.] Audit reports by independent accountants "provide the assurance of an outside expert's examination and opinion, thereby substantially increasing the reliability of financial statements." [Quoting ASR 165.]

These cases are typical of the Commission's strong, persistent enforcement presence in the area of auditor independence.

While the Commission has adequate statutory authority to maintain these efforts, certain pending legislative initiatives could serve to strengthen the Commission's enforcement program regarding auditor independence as well as other areas of fraudulent financial reporting. For example, current legislative initiatives by Congressmen Markey, Dingell, and Wyden, Senator Kerry, and others, further may enhance auditor independence by providing auditors with the means, and requiring auditors under penalty of law, to report directly to the Commission certain uncorrected illegal acts by their audit clients.55/ This legislation also may

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54/(...continued)

> and [the accounting firm], particularly between [the thrift] and any particular employees of [the accounting firm].

Id. at n. 12, pages 95,171-95,172.

55/ H.R. 574, 103rd Cong., 1st Sess. (1993), and S. 630, 103rd Cong., 1st Sess. (1993), would require each audit under the Securities Exchange Act of 1934 to include, "in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission," procedures regarding the detection of certain illegal acts, procedures for the identification of certain related party (continued...)

have broader enforcement implications. In another vein, the Commission has sought an exemption from the asserted application of certain procurement requirements to its engagement of expert witnesses to testify in auditor independence and other cases. Such an exemption would clarify the Commission's contracting authority, facilitate the retention of the most credible witnesses to support the Commission's cases, and avoid the risk of premature disclosure of the staff's litigation theory and strategies. The staff encourages continued consideration of a statutory exemption in this area.

Disclosure Requirements

In addition to considering independence from an enforcement and interpretive vantage point, over the years the Commission has undertaken several rulemaking proceedings that have had the effect of strengthening auditors' independence. Examples include disclosures related to the use of audit committees, the resignation or dismissal of a registrant's primary auditor, and the auditor's provision of management advisory services.56/

Audit Committees.

The Commission historically has encouraged the use of audit committees composed of independent directors.57/ An effective

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55/ (...continued) transactions, and an evaluation regarding the registrant's ability to continue as a going concern. These bills also would require a registrant to notify the Commission within one business day after its auditor reports to the registrant's board of directors that the auditor reasonably expects either to resign or to qualify its audit report due to an illegal act, committed by the registrant, that has a material effect on the registrant's financial statements. If the registrant would fail to notify the Commission that the board of directors received such an "illegal acts report" from its auditor, then the auditor, within the next business day, would be required to provide a copy of that illegal acts report directly to the Commission.

56/ Additional proxy statement disclosures, whenever there is to be an election of directors or the election, approval, or ratification of the auditors, include whether the auditors will attend the shareholders' meeting and have the opportunity to make a statement, and whether the auditors will be available to respond to questions at that meeting. Item 9, Schedule 14A, 17 CFR 240.14a-101.

57/ *See* In the Matter of McKesson & Robbins, Inc., *supra*; and ASR 123 (March 23, 1972).

audit committee may enhance the auditor's independence by, among other things, providing a forum apart from management where the auditors may discuss their concerns, recommending or approving the selection of the independent auditors, and facilitating communications among the Board of Directors, management, and internal and independent auditors.58/

Accordingly, the Commission requires disclosure, in connection with the solicitation of proxies, of information concerning an audit committee's members, functions, and number of meetings.59/ Additional information that must be disclosed regarding audit committees includes whether a registrant's audit committee recommended or approved a change in accountants, and whether the audit committee consulted with the former accountant concerning disagreements with management and certain other matters.60/

Also, pursuant to the Commission's rulemaking and oversight authority, the Commission has approved the national securities exchanges' various audit committee requirements. Currently, the New York Stock Exchange and the Chicago Board Options Exchange require listed companies to have audit committees composed entirely of independent directors.61/ The National Association of

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58/ *See* SEC Division of Corporation Finance, Staff Report on Corporate Accountability, printed for the use of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 96th Cong., 2d Sess., 486-510 (1980); Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, Prepared for the Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, 95th Cong., 2d Sess., 96-101 (1978); Letter from SEC Chairman David S. Ruder to Mr. Joseph R. Hardiman, President, National Association of Securities Dealers, Inc. (December 7, 1988). *See also*, Report of the National Commission on Fraudulent Financial Reporting, at 41-42 and Appendix I, "Good Practice Guidelines for the Audit Committee" (October 1987), and J. Bacon, The Audit Committee: A Broader Mandate (a research report prepared for The Conference Board, 1988).

59/ Item 7(e) of Schedule 14A, 17 CFR 240.14a-101.

60/ Item 304 of Regulation S-K, 17 CFR 229.304; item 304 of Regulation S-B, 17 CFR 228.304.

61/ The original petition by the Chicago Board Options Exchange ("CBOE") contained a recommendation that listed issuers maintain audit committees composed of independent directors. The final rules were strengthened to require all listed issuers to maintain such committees. Exchange Act Release No. (continued...)

Securities Dealers, with respect to all national market system companies, the American Stock Exchange, with limited exceptions, and the Chicago Stock Exchange, with respect to all companies, require that listed companies have audit committees with a majority of independent directors.

Auditor Resignation or Dismissal.

Since the early 1970s, the Commission has required disclosures that have discouraged the practice of changing auditors to obtain more favorable accounting treatment,62/ and provided a forum for the auditor, upon leaving the audit engagement,63/ to note material events and disagreements with management that may not have been disclosed by the registrant.

In 1971, the Commission first proposed that registrants disclose whenever a new principal auditor was engaged and "the reasons for the change" in auditors.64/ Commentators, however, objected to stating in each instance the "reasons for the change" in auditors, and the adopted disclosure was limited to "disagreements" between the auditor and the registrant that are related to the purposes of the Federal securities laws. Specifically, disclosure was required of:

> any disagreements with the former principal accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing procedure, which

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61/ (...continued)
28556 (October 19, 1990) [55 FR 43233]. The Commission release states, "The Commission ... believes that independent audit committees should enhance the reliability of financial disclosures and the credibility of financial information." *Id.* at 55 FR 43237.

62/ ASR 165, *supra*.

63/ In an ongoing auditor-client relationship the auditor may publicize its material concerns regarding the financial statements in a modified audit report. When the auditor resigns or is dismissed before a current audit report is issued, however, that opportunity to alert the public is not available. The Commission's regulations fill this gap by providing a reporting mechanism upon the change in a registrant's independent accountants.

64/ Exchange Act Release No. 9169 (May 6, 1971). In this release, the Commission noted that it was considering whether the registrant's statement of the reason for the change and the letter from the former accountant should be made public or treated as non-public.

> disagreements if not resolved to the satisfaction of the former accountant would have caused him to make reference in connection with his opinion to the subject matter of the disagreement.65/

These disclosure requirements have been amended on several occasions. For example, in 1974 the Commission extended the disclosure requirement to: (1) be triggered also by (i) the resignation or dismissal of the principal accountants or their declination to stand for re-election after completion of the current audit (previously, disclosure was required only upon the engagement of a new auditor) and (ii) changes in the independent accountants for significant subsidiaries on whom the principal accountant expressed reliance in its audit report, (2) include a statement regarding whether the audit reports for either of the last two years contained an adverse opinion or a disclaimer of opinion, (3) cover changes in accountants during the two most recent fiscal years (the previous period was eighteen months), (4) include a description of all disagreements, even those disagreements that have been resolved to the former accountant's satisfaction, and (5) construe the definition of the term "disagreements" broadly to include, among other things, situations where the accountant has advised the registrant that either the registrant lacks sufficient internal controls necessary to develop reliable financial statements or the accountant has discovered facts that have led the accountant to be willing no longer to rely on management's representations or to be associated with management's financial statements.66/

65/ Exchange Act Release No. 9344 (September 27, 1971). Approximately seven years later, the Commission reconsidered whether to require disclosure of the "reasons for all changes in independent accountants" rather than disclosure of only "disagreements." ASR 247 (May 26, 1978). Commentators again opposed this disclosure for a variety of reasons, arguing that the disclosure would not be useful and that meaningful information would not be presented. These commentators indicated that disclosure would be boiler-plate (for example, "auditor rotation policy," "need a fresh look," "poor service," or "high fees"), that such disclosures would obscure the disclosure of disagreements then required, and that candid disclosures would not be made for fear of litigation involving libel or other allegations. They also argued that the proposal might tend to inhibit changes in accountants. The Commission stated that it did not endorse all the arguments made by the commentators. Nonetheless, disclosure of the reasons for all changes in accountants was not adopted. *Id.*

66/ ASR 165, *supra*, which states:

(continued...)

In April 1988, the Commission further expanded these disclosures to include certain potential opinion shopping situations, to clarify the circumstances in which registrants are deemed to have had disclosable disagreements with their former accountants, and to require disclosure of both "reportable events" 67/ and certain issues the registrant discussed with the newly engaged auditor prior to the date of engagement.68/

Currently, item 304 of Regulation S-K contains the substantive disclosure requirements concerning changes in a registrant's certifying accountant.69/ Although this item is incorporated into several forms and reports,70/ the disclosure generally is made under Item 4 of Form 8-K 71/ due to the requirement that this form must be filed within five business days after the resignation,

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66/ (...continued)

It is essential that both the fact and the appearance of independence be sustained so that the confidence of the investing public in the reliability of audited financial statements and the integrity of the public accounting profession will be maintained. To this end, the Commission has concluded that it is desirable to increase the level of disclosure regarding the relationships between independent accountants and their clients.

67/ Reportable events involve situations where the accountant has advised the registrant that it: questions the reliability of the registrant's financial statements or management's representations; believes that sufficient internal controls do not exist to develop reliable financial statements; needs to expand the scope of the audit to investigate certain matters; or, has concluded that certain information that has come to its attention materially impacts the fairness or reliability of current or past audit reports or the financial statements underlying those reports. See item 304(a)(1)(v) of Regulation S-K, 17 CFR 229.304(a)(1)(v).

68/ Financial Reporting Release No. ("FRR") 31 (April 12, 1988).

69/ 17 CFR 229.304. Substantially the same disclosures are required of small business issuers under item 304 of Regulation S-B, 17 CFR 228.304.

70/ Item 304, Regulation S-K, information is required by Forms S-1, S-2, S-4, and S-11 under the Securities Act of 1933 and Forms 10 and 10-K and Schedule 14A under the Securities Exchange Act of 1934. Item 304, Regulation S-B, information is required by Forms SB-1, SB-2, 10-SB, and 10-KSB.

71/ 17 CFR 249.308.

dismissal, or declination of the former accountant to stand for re-election, or the engagement of a new certifying accountant.72/

As noted above, item 304(a) disclosures include, among other things: whether the former accountant resigned, declined to stand for re-election, or was dismissed, and the date thereof; whether the former accountant qualified his or her audit report or disclaimed an opinion during the past two years; whether the change in accountants was approved by the audit committee or the board of directors; and whether in connection with the audits of the two most recent fiscal years (plus any subsequent interim period) there were any "reportable events" or disagreements concerning accounting, auditing, or financial disclosure issues, which, if not resolved, would have caused the auditor to refer to the issue in connection with its report.

The registrant currently is required to provide the accountant with a copy of the Form 8-K no later than the day the Form 8-K is filed with the Commission, along with a request to provide the registrant with a letter (addressed to the Commission) that the registrant must file as an exhibit to that Form 8-K.73/ In that letter, the accountant should state whether he or she agrees with the registrant's disclosure and, if not, the respects in which he or she does not agree. As noted above, under the 1988 amendments to the item 304(a), certain issues discussed with the new accountant also must be disclosed. When this occurs, the new accountant is provided the opportunity to review these disclosures and submit to the registrant a letter (addressed to the Commission and to be filed as an exhibit to the Form 8-K) clarifying the registrant's expression of the accountant's views, providing new information, or stating the respects in which the accountant disagrees with the registrant's disclosure.74/

72/ In FRR 34 (March 2, 1989), the Commission accelerated the timing for filing Forms 8-K related to changes in registrants' independent accountants to five business days from 15 calendar days.

73/ Under item 304(a)(3) of Regulation S-K (and Regulation S-B), if the accountant's letter is unavailable at the time the Form 8-K is filed, the registrant must request that the accountant provide the letter as soon as possible, so that the registrant may file the letter with the Commission within ten business days after the registrant files the Form 8-K with the Commission. Notwithstanding this ten business day period, the registrant must file the accountant's letter with the Commission within two business days of receipt. *See* FRR 34, *supra*, in which the Commission reduced the relevant time period from 30 calendar days to ten business days.

74/ Item 304(a)(2)(D) of Regulation S-K (and Regulation S-B).

A disagreement with the former accountant reported under Item 304(a) raises a "red flag" for shareholders, investors, and the Commission staff 75/ that the accounting, auditing, or disclosure issue was of such importance that, had it not been resolved to the accountant's satisfaction, it would have been mentioned in connection with the auditor's report. It also triggers both additional disclosures pursuant to Item 304(b) of Regulation S-K 76/ and disclosure of any discussions with the newly engaged accountants that occurred prior to their engagement and concerned the subject of the disagreement. 77/

Subsequent to the Commission's 1989 revisions to accelerate the timing requirements for filing Forms 8-K regarding changes in registrants' certifying accountants, 78/ the SEC Practice Section ("SECPS") of the American Institute of Certified Public Accountants' ("AICPA") Division for CPA Firms, with the encouragement of the Commission, adopted a membership requirement for its members to send a letter to the Commission's Office of the

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75/ The Division of Corporation Finance commences a full review of all incoming Forms 8-K indicating a change of auditor no later than the first day following the date they are received by the Division's branches. This review may result in a referral to the Division of Enforcement, examination of the current or next financial statements on a high priority basis, or disposition according to the routine comment process. The Division of Enforcement also conducts a general review of Forms 8-K indicating a change of auditor and makes appropriate inquiries when it receives referrals on these matters from the Division of Corporation Finance.

76/ 17 CFR 229.304(b). This disclosure includes the former accountant's opinion as to what the accounting for a particular transaction or event should have been, if it differs from the accounting being followed for that transaction by the registrant.

77/ Disclosure also is required of communications with the newly engaged accountant if those communications were subject to Statement on Auditing Standards No. 50, "Reports on the Application of Accounting Principles" (July 1986). This statement establishes performance and reporting standards to be used when accountants provide written reports (or oral advice in certain circumstances) to non-audit clients on the application of generally accepted accounting principles or the type of opinion that may be rendered on a specific entity's financial statements. *See*, FRR 31, *supra*.

78/ FRR 34, *supra*.

Chief Accountant when a change in accountants occurs.79/ This membership requirement became effective May 1, 1989. The SECPS letter is intended to alert the Commission staff that the SEC Form 8-K system for reporting a change in accountants has been triggered.80/

Management Advisory Services.

As noted previously, accounting firms have provided management advisory services ("MAS" or "non-audit services") 81/ to audit clients for decades, predating the enactment of the Federal securities laws. Revenues from these services are a significant part of the major accounting firms' revenues.82/

Whether the performance of MAS by auditors has an impact on auditor independence is a legitimate concern. Because of this concern, the Commission, in 1978, adopted a proxy disclosure

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79/ On January 9, 1990, the AICPA announced that its membership had voted to make SECPS membership mandatory for its members with SEC audit clients. Under the new provision, if a firm with an SEC audit client does not join the SECPS, the firm's partners will be expelled from the AICPA. According to the SECPS Annual Report for the year ended June 30, 1992, there are 1,203 SECPS member firms, 789 of whom are auditors to 14,643 SEC registrants. SEC Practice Section, Public Oversight Board, Combined Annual Report: Year Ended June 30, 1992, at 18 and 26. The remaining 414 SECPS member firms do not have SEC audit clients. *Id.* The SEC staff has estimated that approximately 300 small accounting firms practicing before the Commission (auditors to an estimated 500 public companies) currently are not SECPS members.

80/ For a discussion of legislative initiatives that would apply to changes in accountants, *see* the discussion of H.R. 574 in Recent Enforcement of the Commission's Independence Requirements, *supra*.

81/ The work of accounting firms generally is broken down for statistical purposes into three categories: accounting and auditing, tax, and MAS.

82/ Five of the six largest accounting firms derive from 20 to 28 percent of their total U.S. net revenues from the provision of MAS. Over 44 percent of the remaining firm's U.S. revenues come from MAS. Public Accounting Report, at 1 (March 31, 1993). Approximately 20 to 27 percent of the six firms' U.S. revenues are provided by tax services, with the remainder coming from accounting and auditing services. *Id.*

requirement related to such services.83/ This disclosure described each non-audit service provided by the auditor. It also included a statement of the percentage of the fees for *all* non-audit services to total audit fees, the percentage of the fee for *each* non-audit service to total audit fees, and a statement whether each non-audit service was considered and approved by the audit committee of the board of directors or by the board. Further, the Commission published an interpretive release 84/ describing certain factors that independent accountants, audit committees, boards of directors, and managements should consider in determining whether the independent accountants should be engaged to perform non-audit services. These factors included the auditor's dependence on MAS fees, the possibility of auditors supplanting management's role in making corporate decisions, the possibility of creating a situation where an auditor may be required to review his or her own work, and the relation of the MAS activity to accounting and auditing skills. The interpretive release also recognized, however, the potential economic benefits to the corporation, and the potential increased audit quality, that may result from the auditor's gaining a greater understanding of the corporation's business through the performance of MAS.

The reaction to the Commission disclosure requirement and interpretive release was unexpectedly severe. The interpretive release contained a request for comments on the factors set forth in the release and on the experience of the profession and the corporate community in applying them to concrete fact patterns. Accounting firms responded to the request for comments by indicating that the disclosure requirement and interpretive release had resulted in an unwarranted curtailment of non-audit services. They stated that (1) the Commission appeared to be deprecating the benefits that may inure to corporations by having MAS performed by

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83/ ASR 250 (June 29, 1978). Prior to the implementation of this disclosure requirement, a private commission established by the AICPA (The Commission on Auditor's Responsibilities, also known as the "Cohen Commission") reviewed the performance of MAS by auditors. The Cohen Commission found that outside of executive search and placement services there was no evidence that the performance of MAS compromised auditor independence. In spite of this finding, the Cohen Commission urged the accounting profession to take steps to diminish the concerns of a "significant minority" and recommended that the performance of non-audit services be evaluated by audit committees or boards of directors, and that registrants or auditors appropriately disclose such services. The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations, 100-104 (a research study prepared for the AICPA, 1978).

84/ ASR 264 (June 14, 1979).

their independent accountants,85/ (2) it appeared that the Commission might question the independence of an auditor based solely on the percentage relationships between audit and non-audit services disclosed in the proxy statements, and (3) there was confusion as to whether the Commission was concerned with all non-audit services (including tax services) or only MAS. It also was revealed that some registrants apparently had set arbitrary maximum percentage fee limits on the amount of non-audit services that could be provided by their independent accountants. These companies reportedly were deciding whether to engage their auditors for MAS activities based on these maximum fee limits, and were not considering the more important issues regarding the nature of the proposed services and their possible impact on the accountant's independence.

Mindful of these reactions to the disclosure rule and interpretive release, the Commission studied the 1979, 1980, and 1981 proxy disclosures. Approximately 1,200 proxy statements were reviewed. Of those reviewed, approximately 91 percent in 1979 and 92 percent in 1980 disclosed that the independent accountants had been engaged for some type of non-audit service, with the most frequently disclosed services being in tax related areas.86/ Few of the registrants reported that their independent accountants had performed the services the Commission had mentioned as being particularly sensitive, such as consumer surveys, plant layout, and actuarial services. The Commission also reviewed the magnitude of fees for non-audit services in relation to audit fees, and found the following:

Percentage relationships of fees for non-audit services to audit fees	Percentage of companies in the sample	
	1979	1980
0 - 25%	68%	74%
26 - 50%	22%	15%
51 - 100%	7%	8%
Over 100%	3%	3%

Proxy disclosures in this sample also revealed that the percentage of companies having audit committees increased from 81.7 percent in 1979, to 84 percent in 1980, and 86.4 percent in 1981. The survey further revealed that in 1980, 50.7 percent of the audit committees approved each MAS service. In 1981, this percentage rose to 53.9. In 1980, 84.9 percent of all companies had no

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85/ In ASR 264, *supra*, however, the Commission specifically recognized such benefits.

86/ As noted elsewhere, however, the provision of tax services generally is considered to be a separate category of service, apart from MAS.

employee directors serving on audit committees. This percentage rose to 86.9 in 1981.

In addition to reviewing the required proxy disclosures, the Commission monitored the efforts taken by others in this area. For example, the Commission noted that the SECPS required its members to report total MAS fees to the audit committee or board of directors of each SEC audit client, and to describe the types of services rendered. The SECPS and the Public Oversight Board ("POB") 87/ also indicated that they would monitor MAS through the profession's peer review program and "comment ... if the magnitude of [MAS] appears to increase to an extent that it threatens professional image generally."88/ Finally, the Commission recognized that summarized information, similar to what is presented in the table on page 32, regarding the relationship between MAS and audit fees was provided to the SECPS by member firms and was publicly available.

Although the Commission's concerns regarding the provision of MAS remained unchanged, based on, among other things: (1) the unexpected reaction to the proxy disclosure requirement and the Commission's interpretive release and the arbitrary limitation of non-audit services being performed by auditors based on the amounts of fees for such services rather than the nature of the services rendered, (2) the proxy survey that indicated (i) audit committees consisting principally of non-employee directors actively were reviewing MAS activities and (ii) auditors generally were not performing those services believed to have an impact on their independence, and (3) the actions taken by the private sector to monitor MAS and make information regarding those services publicly available, the Commission determined to rescind the formal

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87/ Because the peer review process for public companies is performed and administered by the accounting profession, the AICPA, when it was developing the peer review program in 1977, determined that public confidence in the process would be increased if an independent board composed of prominent individuals oversaw and reported on the peer review program. The POB was created to serve this purpose. Today, the POB also reports on other matters bearing on the integrity of the audit process. The POB, whose activities are funded by the AICPA, maintains its independence from the AICPA by selecting its members and staff, setting their compensation, and choosing the POB Chairman. The current Chairman of the five member board is A.A. Sommer, a former SEC Commissioner.

88/ 1979-1980 Annual Report of the Public Oversight Board, at 22.

interpretive release 89/ and the MAS proxy disclosure requirement.90/

89/ In withdrawing the interpretive release, the Commission reaffirmed its views regarding the need for caution in the provision of MAS. The Commission stated, in part:

> Although the Commission's views expressed in [the interpretive release] are unchanged and registrants and accountants must continue to carefully evaluate their relationships to ensure that the public maintains confidence in the integrity of financial reporting, the Commission is withdrawing that release because it may confuse independent accountants, audit committees and others who are trying to evaluate services performed or to be performed by the accountants. Moreover, the Commission believes it has achieved its objective in issuing [the interpretive release]. Accountants and their self-regulatory structure, audit committees, boards of directors and managements are aware of the Commission's views on accountants' independence and should be sensitive to the possible impact on independence of nonaudit services performed by accountants. The Commission believes it should be able to rely on these persons to ensure adequate consideration of the impact on accountants' independence of nonaudit services because they share the responsibility to assure the public maintains confidence in the independence of accountants.

ASR 296, *supra*.

90/ *Id.*; ASR 297 (August 20, 1981); and ASR 304 (January 28, 1982). Approximately two-thirds of the 140 commentators expressed support for the rescission of the MAS proxy disclosure requirement. The commentators suggesting that rescission was not appropriate made two basic arguments. The first argument was that accounting firms providing computer or actuarial services to their audit clients would not be independent because they would audit the systems they design, develop, and implement. The second argument was that rescission would provide accounting firms with an unfair competitive advantage that would threaten the existence of computer and actuarial service companies. The second argument was rejected by the Commission because it felt that the retention of a disclosure requirement simply to affect competition in the consulting industry would be considered an inappropriate use of the Commission's statutory authority. The first argument was reviewed in light of the information discussed above and the absence of evidence that (1) investors (continued...)

The public accounting firms that are members of the SECPS continue to provide the summarized information concerning the level of MAS activities. The SECPS also has adopted certain restrictions regarding types of MAS services that would impair an auditor's independence, if provided to an audit client. In this regard, SECPS membership requirements currently prohibit firms from performing services for their audit clients such as psychological testing, public opinion polls, merger and acquisition assistance for a finder's fee, executive recruitment services, and certain actuarial services to insurance companies.91/ These membership requirements also provide for member firms to report annually, among other things, the number of audit clients for which MAS is performed within various percentage ranges.92/ Information included in the SECPS/POB Combined Annual Report for the Year Ended June 30, 199293/ indicates the following levels of MAS services:

Percentage Relationships of fees for non-audit services to audit fees	Percentage of companies in the range
0%	80.2%
1-25%	15.9%
26-50%	1.8%
51-100%	1.1%
over 100%	1.0%

When these percentage relationships are compared with those derived in 1979 and 1980, as set forth above, it appears that the percentage of SEC audit clients receiving significant MAS services may have fallen. For example, in 1980, fees from non-audit services were from 0 to 25% of the audit fee for 74% of the surveyed companies. According to the 1992 POB report, 96.1% (80.2% + 15.9%) of the SEC registrants whose financial statements are audited by SECPS members would fall into this category.

90/(...continued)
wanted or used the disclosed information and (2) performance of MAS impaired auditors' independence. After full consideration, the Commission rescinded the proxy disclosure requirement. *Id*.

91/ Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for Firms, Section IV.

92/ *Id.*

93/ SEC Practice Section, Public Oversight Board, Combined Annual Report, Year Ended June 30, 1992, at 18.

The staff also monitors the level of MAS activity provided to audit clients through other means. For example, Accounting Today annually publishes information on the "Top 60" accounting firms.94/ This information indicates that the level of MAS fees for the six largest accounting firms, measured as a percentage of the overall fees received by each firm, from 1991 to 1993 is as follows:

Firm	1991	1993
Arthur Andersen	44%	46%
Ernst & Young	23	26
Deloitte & Touche	18	23
KPMG Peat Marwick	20	15
Coopers & Lybrand	25	25
Price Waterhouse	28	30

The 1993 Accounting Today "Top 60" report also indicates that from 1992 to 1993 the percentage of aggregate fees attributable to MAS work to total revenues for both the six largest accounting firms and the top 60 firms remained steady at 28.9%. By way of comparison, this report indicates that in 1989 MAS fees for the top 60 firms were 24.1%, and for the top six firms they were 25.4%, of total fees received.95/

The percentages reflected in the "Top 60" report include fees for MAS, and total revenues for services, provided to both SEC audit clients and all other parties. Combining the statistics in the POB report with those in the Top 60 report may indicate that, although over time there has been an increase in MAS services, much of that increase may be for parties other than SEC audit clients.

Today, the SEC staff generally does not object to the provision of MAS to audit clients provided the services do not result in the accounting firm's auditing its own work, making decisions for management of the client, or recovering client assets, for example collecting past-due accounts receivable. For example, the staff has raised independence issues where the auditor performed certain valuation services and feasibility studies, or prepared financial forecasts, or functioned in a management capacity. In these cases, the client presumably would rely on the auditor's work to make business decisions and the auditor would have to review the outcome of those decisions as part of the audit.

The nature of MAS provided by accountants continues to change and expand. Large-scale information systems implementation and integration and litigation support engagements are becoming more

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94/ Accounting Today, "The Sixth Annual Top 60; 1993," (a supplement to the December 13, 1993 edition).

95/ Id.

common. Although it appears that the significant majority of these services are performed for parties other than SEC audit clients, the staff is mindful of the potential impact of MAS on auditors' independence, in light of the increasing role of non-audit personnel (who are not bound by the accounting profession's Code of Ethics) at the top management levels of the firms, the need for capital to finance growth in areas such as computer system installation services, and the increasing possibility of firms offering services that are incompatible with the audit function. The staff will continue to be alert to the development of problems of independence that may be caused by MAS. The lack of an apparent, dramatic increase in MAS provided to SEC audit clients, however, suggests that a fundamental change in the Commission's regulations is not necessary at this time.

Client Advocacy.

In addition to the numerous independence issues that surround the conduct of an audit, the SEC staff is concerned that certain accounting firms may have compromised their objectivity with respect to proposed or actual client accounting treatments with the SEC staff. The Commission staff wishes to stress that the number of instances in which questionable client advocacy has been established is very small in relation to the number of audited financial statements filed with the Commission. The staff continues to believe that the vast majority of audits are conducted in an appropriately skeptical manner. The staff also appreciates that reasonable people may come to different conclusions on accounting issues and, in good faith, hold and represent views that differ from those of the staff. The OCA encourages registrants and their auditors to discuss and resolve financial accounting and reporting issues with the staff. A different situation arises, however, when high levels of authority within major accounting firms appear to argue unfounded positions before the staff.96/ Some of these instances cause the staff to question the appearance of auditor independence.

The staff believes that these events raise questions about whether the auditor has maintained an appropriate relationship to his or her audit client. The staff recognizes, however, that the problem of an appearance of "client advocacy" may not be susceptible to correction through additional, objective independence interpretations or rules. The current sanction for this type of conduct is a possible reduction in credibility before the public on the accounting issue being considered. This is a serious sanction, indeed. To prevent such a loss of confidence in a firm's views, the firm, when accompanying audit clients to

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96/ See generally, address by Chief Accountant Walter P. Schuetze, AICPA Twenty-first Annual National Conference on Current SEC Developments (January 11, 1994).

meetings with the Commission staff or providing written substantiation for the proposed accounting, should present positions that are well-founded in, or logical extensions of, authoritative accounting literature.97/

As in all areas of independence, the auditor should remember that his or her duty to the public overrides any responsibility owed to the audit client. The first definition of "client" in Webster's Seventh New Collegiate Dictionary is "a person under the protection of another." Clearly, the investing public looks to the auditor for comfort regarding the reliability of registrants' financial statements 98/ and the public, not the company paying the firm's fee, must be the true "client" of the firm. Accordingly, any "advocacy" by the firm should be in support of positions that are intended to benefit and protect investors and the public.

III. SEC RULES AND INTERPRETATIONS

Rule 2-01 of Regulation S-X

As previously noted, the Federal Trade Commission, prior to the formation of the Securities and Exchange Commission, adopted the first rule implementing the statutory requirement that auditors must be independent of registrants that file audited financial statements pursuant to the Federal securities laws.99/ This rule

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97/ The staff recognizes that the complexity of some accounting standards and, in some instances, the lack of concise, workable definitions of accounting terms may contribute to this problem. The staff has encouraged standards-setters, to the extent practicable, to adopt simple, bright-line accounting principles and auditing standards. See, e.g., Testimony of William R. McLucas, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, Concerning Private Litigation Under the Federal Securities Laws, at 10 n.15 (June 17, 1993).

98/ See, United States v. Arthur Young, *supra*.

99/ *See* Background in part I of this study for a discussion of the evolution of the Commission's independence requirements. The Federal Trade Commission rule stated, in part:

> The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not

(continued...)

initially was incorporated into the SEC's registration forms and in February 1940, when the Commission centralized many of its accounting requirements in one regulation, into Rule 2-01 of Regulation S-X.100/ As then adopted, Rule 2-01, entitled "Qualifications of Accountants," stated that the Commission would not recognize any accountant as a certified public accountant or as a public accountant who was not duly registered, in good standing, and entitled to practice in the place of the accountant's residence or principal office. The rule also stated that the Commission would not recognize any accountant as independent who was not in fact independent, and then set forth situations where an accountant would "not be considered" independent. These situations included those where the accountant had any direct or indirect substantial interest in the registrant or was connected with the registrant as a promoter, underwriter, voting trustee, director, officer, or employee.101/

Over the years, Rule 2-01 has been amended on several occasions. For example, in 1942 the rule was revised to make it clear that, in determining whether "certifying accountants" are independent as to a particular registrant, there should be taken into account not only the work done in auditing the financial statements but also other work done for the registrant.102/ In 1958 the Commission amended the rule to recognize that in some instances, such as relationships between the auditor or his or her family and "remote affiliates" of the registrant, "some latitude for judgement is necessary" in evaluating the accountant's independence. The rule, therefore, was revised "to permit a test of materiality to these borderline areas."103/ Finally, the rule

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99/(...continued)

be considered independent with respect to any person in whom he has any interest, directly or indirectly, or with whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function.

Federal Trade Commission, Rules and Regulations Under the Securities Act of 1933, Article 14, "Accountants" (July 6, 1933).

100/ 17 CFR §210.2-01. *See*, Accounting Series Release No. ("ASR") 12 (February 21, 1940).

101/ *Id.*

102/ ASR 37 (November 7, 1942).

103/ ASR 79 (April 8, 1958).

was amended in 1972, and again in 1983, to clarify which "members" of the accounting firm must meet the independence criteria.104/

Current Rule 2-01 states as follows:

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of §210.2-01(b), the term "member" means (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and (iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant

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104/ ASR 125 (June 23, 1972) and Financial Reporting Release No. ("FRR") 10 (February 25, 1983).

circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

Interpretations

Rule 2-01 does not contain comprehensive guidance for determining whether accountants are independent because, as stated in subparagraph (c) of the rule, such a determination must be made in view of all the circumstances of a particular case. Since its inception, the Commission and its staff have been called upon to make such determinations and periodically the Commission has published its opinions to apprise the public of its views.105/

In 1982, the Commission conducted a complete review of its accounting and auditing releases, including those concerning auditor independence issues. This review led to the publication by the Commission of the "Codification of Financial Reporting Policies" ("CFRP" or the "Codification").106/ The Codification provided in one document, organized in a logical manner, information officially published by the Commission since 1934 that continued to be relevant to preparers, users, and auditors of registrants' financial statements. Section 600 of the Codification is entitled "Matters Relating to Independent Accountants" and contains statements by the Commission related to the role of independence in the auditing process, Commission requirements and interpretations relating to independence, disclosures about independent accountants, the relation of the performance of non-audit services to auditor independence, accountants' liability for reports on unaudited interim financial information under the 1933 Act, and certain certification requirements. Since 1982, whenever the Commission has issued a release addressing an auditor independence issue, section 600 of the Codification has been amended to include, in the appropriate subsection, relevant

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105/ *See, e.g.*, ASRs 2 (1937), 22 (1941), 37 (1942), 47 (1944), 81 (1958), 112 (1968), 126 (1972), 234 (1977), and 291 (1981). See part I of this study for a description of the Commission's opinions.

106/ FRR 1 (April 15, 1982). This release also announced that the Commission would no longer publish ASRs. Instead, the Commission would publish one series of releases regarding accounting and auditing enforcement cases, called "Accounting and Auditing Enforcement Releases" or "AAERs," and another series containing other information regarding accounting and auditing matters related to financial reporting issues, entitled "Financial Reporting Releases" or "FRRs."

excerpts from the release.107/ Today, Codification section 600 provides extensive interpretations, guidelines, and examples for registrants and auditors to use in evaluating independence issues.

In addition, the Commission staff responds to numerous oral and written requests for informal advice on the application of the Commission's independence requirements.108/ During fiscal year 1993, the staff issued eleven interpretive letters following full consideration of the requestors' written submissions and, in many instances, meetings with the requestors and their representatives. The staff also responded to over one hundred phone calls regarding independence issues. Written responses to requests for such advice are placed in a file that is available in the Commission's public reference room.109/ Many of these letters also are reproduced by private publishers of financial information.

Recent issues addressed by the staff include whether an accounting firm's independence is impaired when (1) an independent auditor of an Argentinean company acts as that company's statutory auditor,110/ (2) the Chief Financial Officer of an audit client in New York City is the brother of a partner in the accounting firm's Boston office, or (3) an accounting firm acquires a French law firm that provides legal representation to the accounting firm's audit clients.

107/ For example, when the Commission in 1988 and 1989 expanded and accelerated the disclosure requirements regarding changes in registrants' independent accountants, relevant portions of the adopting releases were inserted at sections 603.02.d and 603.06-08.a. of the Codification. These requirements are discussed in part I of this study.

108/ Unless republished in a Commission release, staff responses do not bind the Commission. The staff responses usually are in the form of a representation that the staff of the Office of the Chief Accountant either considers the auditor's independence to be impaired or will not raise a question regarding the auditor's independence based on the facts, circumstances, and representations made to the staff in that particular case. If the person requesting the staff's advice disagrees with the staff's position, that person may ask the staff to seek an informal statement of the Commission's views. Granting the request for such a statement, however, is entirely within the Commission's discretion. 17 CFR 202.1(d).

109/ *See* FRR 33 (November 25, 1988) and FRR 4 (October 14, 1982).

110/ Letter from John M. Riley, Deputy Chief Accountant, to Mr. Richard Dieter (April 8, 1993) (indicating that independence would be deemed to be impaired).

Further information regarding the Commission's disclosure, interpretive, and enforcement efforts to enhance auditors' independence is set forth in part II of this study. Disclosure requirements discussed in that section include information regarding audit committees of boards of directors, and changes of independent auditors. Interpretive releases set forth decisions made by the Commission and the staff in specific situations, and expand upon the Commission's requirement for "scrupulous adherence"111/ to the fact and appearance of auditor independence. Finally, enforcement cases discussed in part II display the Commission's willingness to take appropriate action when auditors fail to fulfill the independence requirements.

In addition, particular aspects of the Commission's independence rule and interpretations are discussed in detail in Appendix II to this study, which contains a comparison of SEC, AICPA, and other nations' independence requirements.

IV. PRONOUNCEMENTS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The American Institute of Certified Public Accountants ("AICPA") 112/ promotes the concept of auditor independence. The AICPA's auditing standards, adopted by its Auditing Standards Board ("ASB"),113/ and the AICPA Code of Professional Conduct (the "Code"), as interpreted by the AICPA's Ethics Division, firmly establish auditor independence as one of the organization's fundamental principles.

The accounting profession, however, was relatively slow to establish specific requirements that define independent conduct.114/ For example, although a resolution to prohibit auditors from acting as officers or directors of audit clients was

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111/ ASR 296 (August 20, 1981).

112/ The AICPA is the largest national professional institute of Certified Public Accountants ("CPAs") with over 310,000 members in public practice, industry, and academia.

113/ A resolution of the AICPA Council designates the ASB as the body empowered to promulgate auditing and attest standards and procedures. See Rule 202 of the Code of Professional Conduct, ET §202.01, and Appendix A to the Code. The ASB's 15 members are partners in large, medium, and small accounting firms and an academic. Each serves on the ASB on a part-time basis. The eight ASB staff are employees of the AICPA, and funding for the ASB is provided by the AICPA.

114/ See part II of this study for the historical development of United States independence standards.

first introduced at an annual meeting of the American Institute of Accountants (the predecessor to the AICPA) in 1931 115/ a final rule prohibiting such relationships was not adopted by the AICPA until 1961, 116/ well after the enactment of the Federal securities laws and the Commission's imposition of such a requirement in Rule 2-01 of Regulation S-X. In addition, the profession's adoption in 1941 of a rule prohibiting auditors from owning securities issued by their publicly held audit clients simply echoed the Commission's Rule 2-01.117/ And it was not until 1947 (14 years after enactment of the independence requirement in the Federal securities laws) that the Executive Committee of the AICPA issued a "tentative statement" on accountants' independence, which was intended to provide guidance to the profession, the public, and others.118/ This statement read, in part:

> A most important function which the certified public accountant performs in our economic life today is the part he plays in the maintenance of mutual confidence which is necessary in business relationships and transactions. The relationship may be that between management and stockholders, especially in publicly-held corporations.... It has become of great value to those who rely on financial statements of business enterprises that they be reviewed by persons skilled in accounting whose judgment is uncolored by any interest in the enterprise, and upon whom the obligation has been imposed to disclose material facts. With the growth of business enterprises, the public accountant makes a vital contribution in meeting the need for independent, impartial, and expert opinions on the financial position and results of operations.119/

Today, the AICPA maintains its independence requirements apart from those of the Commission. In many areas, the Commission, rather than adopting a position similar to an AICPA requirement, simply refers registrants and their auditors to the AICPA requirement as an appropriate interpretation of the Commission's auditor independence rules. In other areas, the Commission's interpretive guidance is more expansive or more explicit than the AICPA's requirements, resulting in certain inconsistencies between

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115/ L. Rappaport, SEC Accounting Practice and Procedure, 26.2-26.3 (The Ronald Press Company, 3d ed. 1972).

116/ D. Causey, Duties and Liabilities of Public Accountants, 26 (Dow Jones-Irwin, rev. ed. 1982).

117/ *Id.*

118/ Rappaport, *supra*, at 26.6-26.7.

119/ *Id.* quoting 84 The Journal of Accountancy 51 (1947).

the two sets of regulations. These differences may be, in part, because the Commission's views are more relevant to larger issuers who are seeking capital in the public markets, while the AICPA's rules apply to auditors of the financial statements of smaller, private companies as well as those of public companies.

Generally Accepted Auditing Standards

As noted above, generally accepted auditing standards ("GAAS") 120/ require that auditors be independent. General Standard No. 2 states, "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."121/ Interpretations of GAAS, issued as Statements on Auditing Standards by the ASB, further emphasize the importance of the concept of auditor independence. Statement on Auditing Standards No. ("SAS") 1, states:

> It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation or interest in the client, its management, or its owners....

120/ In February 1941, the Commission amended Rule 2-02 of Regulation S-X, 17 CFR §210.2-02, to require that the auditor state in his or her report "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." Accounting Series Release No. ("ASR") 21 (February 5, 1941). In this release, the Commission defined "generally accepted auditing standards" to mean the application of "generally recognized normal auditing procedures" with professional competence by properly trained persons. The Commission defined "generally recognized normal auditing procedures" to be those normally employed by skilled accountants and those prescribed by authoritative bodies dealing with the subject of auditing, such as the various accounting societies and governmental bodies having jurisdiction in the area. *Id.* Following this addition to the Commission's rules, the relevant professional committee at the time, the Committee on Auditing Procedure, began a study to determine which auditing standards should be included within "GAAS." In 1948, the membership of the AICPA's predecessor organization approved ten standards as constituting GAAS, including three general standards, three standards of field work, and four standards of reporting. *See* AU §150.02.

121/ AU §150.02.

> Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence [italics in original].122/

Code of Professional Conduct

In practice, however, the regulations and interpretations promulgated pursuant to the Code, rather than the auditing standards, embody the AICPA's specific independence requirements and regulations. These regulations unconditionally support the concept of auditor independence by stating, in part:

> The public expects a number of character traits in a certified public accountant but primarily integrity and objectivity and, in the practice of public accounting, independence.
>
> Independence has always been a concept fundamental to the accounting profession, the cornerstone of its philosophical structure. For no matter how competent any [Certified Public Accountant] may be, his opinion on financial statements will be of little value to those who rely on him - whether they be clients or any of his unseen audience of credit grantors, investors, governmental agencies and the like - unless he maintains his independence....
>
> To sum up, CPAs cannot avoid external pressures on their integrity and objectivity in the course of their professional work, but they are expected to resist these pressures. They must, in fact, retain their integrity and objectivity in all phases of their practice and, when expressing opinions on financial statements, avoid involvement in situations that would impair the credibility of their independence in the minds of reasonable men familiar with the facts.123/

The Bylaws of the AICPA require members to conform with the Code and provide that members may be disciplined for violations of the Code.124/ The AICPA's Professional Ethics Executive Committee provides interpretations of the independence requirements in the Code, and occasionally issues ethics rulings. Accordingly, the Ethics Committee, rather than the ASB, is the generally recognized authority within the AICPA in the area of auditor independence.

In addition, individual accounting firms are required by the AICPA to have internal procedures that monitor compliance with independence standards and rules. The AICPA's Statements on

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122/ AU §220.03.

123/ ET §§ 52.01 and 52.19.

124/ AICPA Bylaws, §§ 2.3.2 and 7.4.1, respectively.

Quality Control Standards provide general guidance that the firms use in developing specific policies and procedures. Many firms have their partners annually sign statements attesting to the absence of any situations that may impair the firm's independence. Firms also may distribute new client lists, instructing members of the firm to divest any disqualifying interest in those entities, and provide various levels of independence training.125/

Relationship of SEC and AICPA Requirements

The Securities and Exchange Commission exercises essentially no oversight of the AICPA's Ethics Division. Although the AICPA ethics staff and the Commission staff routinely discuss individual independence situations on an informal basis,126/ historically, the Ethics Division consistently has not sought Commission input into the development of its independence interpretations and rulings and, on the occasions when the Commission staff has expressed an opinion different from that of the Ethics Division on an issue, the AICPA generally has not been receptive to the staff's views. Further, as the AICPA's disciplinary proceedings are closed from public view, the Commission staff has not been able to form an opinion as to the efficacy of the profession's enforcement of its independence requirements. In a similar respect, the Commission and its staff have been comfortable assessing the facts from the viewpoint of a "reasonable investor" and making their own auditor independence determinations without formal consultation with the profession. This has led to two sets of independence requirements that auditors to public companies must follow.127/

The existence of multiple requirements sometimes leads to difficulties, particularly in cases when an entity's financial statements are required for the first time to be included in a filing with the Commission. For example, when a private company determines to make a public offering of its securities (or when the

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125/ *See,* R. Kay and D. Searfoss, Handbook of Accounting and Auditing, 5-18 (Warren, Gorham and Lamont, 2d ed. 1989).

126/ As noted above, in areas where the AICPA has established an independence requirement, and the Commission has not, the Commission may look to the AICPA requirement as the appropriate guidance.

127/ Not all auditors to Commission registrants, however, are members of the AICPA. Although the auditors to the vast majority of Commission registrants are firms whose partners are members of the AICPA, AICPA membership is not mandatory for an accountant to practice before the Commission. The financial statements of an estimated 500 public companies filing with the Commission are audited by an estimated 300 firms whose partners are not members of the AICPA.

company is acquired by a public company), the company may discover that the report of its auditor is unacceptable because the auditor did not meet Commission independence requirements at the time of the audit, even though the auditor was in compliance with the AICPA requirements. In such cases, it may be necessary to engage another accountant to audit and report on the company's financial statements, or, in rare cases where another accountant is unable to perform the audit, the company may be unable to complete an offering. This problem is exacerbated by the fact that, while many of the larger firms have charged specific partners with the continuous duty to be aware of both Commission and AICPA independence requirements and to assure compliance with those requirements, it frequently is difficult for smaller firms to stay current as to the AICPA and SEC requirements and the differences between the two.

The Commission staff recognizes the merits of minimizing, to the extent possible, the differences between the two sets of requirements. The staff and representatives of the Ethics Committee recently met on a trial basis to discuss differences between the Commission's and the AICPA's independence rules and interpretations. While no decisions were reached, the staff and the division representatives have decided to continue such meetings.

Many of the differences between the SEC and AICPA requirements may not be resolved easily. For example, the AICPA, in recognition of the lack of adequate accounting personnel in many small, privately held companies, permits auditors to perform certain bookkeeping tasks without negatively affecting the auditors' independence. The Commission, however, has taken the view that this practice results in auditors auditing their own work, destroying the possibility of a critical outside look at companies' financial statements, and impairs auditors' independence. This issue and further differences between the Commission's and the AICPA's independence requirements are explained in detail in Appendix II to this study.

V. OTHER NATIONS' INDEPENDENCE REQUIREMENTS

Domestic registrants increasingly conduct international businesses with operations in countries that are serviced by local offices, or affiliates, of their independent accountants. In addition, a record number of foreign registrants have become subject to the Commission's registration requirements.128/ The

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128/ In 1992, more than $34.6 billion of securities of foreign issuers were filed for registration under the Securities Act of 1933. These issuers included 87 new foreign companies from 21 countries, including the United Kingdom, France, Australia, (continued...)

Commission generally has required auditors of the financial statements of domestic registrants with non-U.S. operations, and auditors of the financial statements of non-U.S. registrants, to comply with the U.S. auditing and independence requirements when their audit reports are to be included in Commission filings.

The first time an audit report of a non-U.S. auditor is to be filed with the Commission, the staff may ask the auditor for information regarding that auditor's familiarity with U.S. generally accepted accounting principles ("GAAP"), U.S. generally accepted auditing standards ("GAAS"), and U.S. independence requirements. If the auditor is not sufficiently knowledgeable about U.S. standards and requirements, the staff may suggest that the registrant or the auditor engage an affiliate of a U.S. accounting firm either as a consultant to the non-U.S. auditor or to assist directly in the audit.129/

The Commission's insistence on a U.S. GAAS audit and compliance with U.S. independence requirements is based on the view that U.S. investors are entitled to the same level of assurance from an audit, irrespective of where it is performed. One of the more controversial issues facing the Commission today is the extent that the Commission, when making independence determinations, should take into account the customs, laws, and culture of the nation in which the audit is conducted. The Commission's staff has been reluctant to acquiesce to arguments based on representations that "this is how it is done in the registrant's home country," because the staff has looked at auditor independence issues from the point of view of the reasonable investor in the United States who will be asked to invest his, her, or its funds in the

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128/ (...continued)
Brazil, Korea, and Singapore. At the end of 1992, there were 496 foreign companies from 35 countries filing reports with the Commission. U.S. Securities and Exchange Commission Fifty-Eighth Annual Report to Congress, 52 (1992).

129/ The staff may send a letter to the registrant or the accounting firm asking for information demonstrating the firm's independence requirements for its professional employees, that the firm is in good standing and professionally qualified in the jurisdiction in which the report is issued, and that the firm's professional members and staff are knowledgeable regarding and have followed in this engagement U.S. GAAP, U.S. GAAS, and U.S. independence requirements. When a consultant is engaged, the consultant may be asked to provide the staff with a letter describing, among other things, the foreign auditor's compliance with the independence and reporting requirements in Article 2 of Regulation S-X, 17 CFR §210.2-01 *et seq.*

registrant's securities.130/ This "reasonable investor" is entitled under the Federal securities laws to the assurance provided by an independent audit.131/ In countries where the level of assurance provided by an audit falls below that contemplated under U.S. law, the requirement for independently audited financial statements may be deemed to have not been met, regardless of disclosure of the differing requirements. In addition, comparable audits and independence requirements contribute to an "even playing field" in the competition for U.S. investors' funds.132/

The Commission, however, has been involved in and supports efforts to harmonize international accounting, auditing, and independence requirements.133/ The Commission staff is participating in the efforts of the International Federation of Accountants ("IFAC") 134/ and the International Organization of

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130/ This staff study on auditor independence issues should not be read as expressing any position of the Commission or the staff on the issue of foreign listing requirements on U.S. exchanges. This study speaks only to balancing the protection of U.S. investors afforded by the U.S. auditor independence requirements against the possible denial of investment opportunities in securities issued by foreign entities whose auditors fail to satisfy those requirements.

131/ *See* part II of this study regarding "The Need for Auditor Independence" and "Background" of the development of the independence requirement in this country. As noted in that section, the U.S. Supreme Court has stated that the independence requirement is "to obviate the fear of loss from reliance on inaccurate information" and, accordingly, it is "not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate." United States v. Arthur Young & Co., 465 U.S. 805, 819 n. 15.

132/ Limited exceptions to the U.S. independence requirements have been provided in interpretations issued by the Commission where foreign law requires that an auditor have a financial interest in its audit client, and for certain *de minimis* or immaterial services provided to foreign divisions, subsidiaries, or investees of domestic registrants provided such services are consistent with the local professional ethics rules. *See* Appendix II to this study.

133/ *See, e.g.,* U.S. Securities and Exchange Commission Policy Statement, Regulation of International Securities Markets, 8-10, International Series Release No. 1 (November 1988).

134/ IFAC is an organization of over 100 accounting professional organizations representing 78 countries. IFAC has the broad (continued...)

Securities Commissions ("IOSCO") 135/ to resolve differences in these standards. In 1992, at its XVIIth Annual Conference in London, IOSCO adopted a resolution recommending that its member nations accept unified auditing standards developed by the International Auditing Practices Committee, an IFAC technical committee. This resolution, however, notes that, at present, there is no consensus on issues regarding auditor qualifications and independence, among others, and that these areas therefore are not included within the recommendation. IFAC is continuing to work on these issues.

Independent of IOSCO, the Commission has adopted a multijurisdictional disclosure system ("MJDS") with Canada.136/ Prior to the implementation of this system, the Commission studied in considerable detail the Canadian independence requirements. The Commission ultimately concluded that the Canadian requirements were sufficiently close to the U.S. independence requirements that U.S. investors could rely, to some extent, on the Canadian standards. As a result, under the MJDS, in order to make an initial public offering in the United States, Canadian auditors to Canadian registrants need to comply with the U.S. independence requirements only with respect to the audit of the financial statements of the most recent fiscal year prior to the offering.137/ Once a U.S. offering is made, however, the auditor must continue to comply with the U.S. independence requirements.138/

134/ (...continued)
objective to develop and enhance a coordinated worldwide accountancy profession with harmonized standards.

135/ IOSCO is an organization of over 50 national securities commissions resolved to ensure better regulation of markets, to exchange information, to promote the development of domestic markets, to unite in an effective surveillance of international securities transactions, and to ensure effective enforcement against securities law offenses.

136/ Securities Act Release No. 6902 (June 21, 1991).

137/ As a general rule, all three years of a registrant's financial statements included in a Commission filing must be audited by an accountant who is in compliance with U.S. independence requirements. *See* Articles 2 and 3 of Regulation S-X, 17 CFR §§210.2-01 and 210.3-01 *et seq.*

138/ *See, e.g.*, General Instruction III. B. to Form F-10, 17 CFR §239.40, which states:

> The Commission's rules on auditor independence, as codified in Section 600 of the Codification of Financial
> (continued...)

The OCA, with the assistance of foreign regulators and accounting firms with offices or affiliates outside the United States, has reviewed the independence requirements in other jurisdictions. The staff's review was intended to identify specific differences between nations' requirements and procedures by which the requirements are established and enforced. This review has indicated that the U.S. independence requirements, as implemented by the Commission and the American Institute of Certified Public Accountants,139/ tend to be more specific and more restrictive than those of other nations. Reasons for this different level of standards may include that independent audits in some nations are conducted by statutory auditors, who are directly responsible to shareholders, and that, in certain other

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138/ (...continued)

> Reporting Policies, apply to auditor reports on all financial statements that are included in this registration statement, except that such rules do not apply with respect to periods prior to the most recent fiscal year for which financial statements are included in the registration statement .... Notwithstanding the exception in the previous sentence, such rules do apply with respect to any periods prior to the most recent fiscal year if the issuer previously was required to file with the Commission a report or registration statement containing an auditor report on financial statements for such periods as to which the Commission's rules on auditor independence applied.

The Commission staff has been willing to work with Canadian auditors to address difficulties in meeting the MJDS independence requirement in limited areas. For example, when Canadian auditors of "Schedule I" Canadian banks, which may wish to make offerings in the U.S. under the MJDS, indicated that they would not be able to comply with the time table for phasing-in revised U.S. independence requirements regarding auditors' loans from financial institution audit clients, the staff indicated that it would not object to a limited extension of the compliance deadline. Letter to Messrs. Robert D. Brown, Alan J. Dilworth, and W. Ross Walker from Mr. Walter P. Schuetze, Chief Accountant (May 19, 1993).

139/ For a discussion of the auditor independence requirements of the American Institute of Certified Public Accountants, *see* part IV and Appendix II of this study.

nations, the audit may be conducted primarily for a purpose other than financial reporting.140/

Many of the specific differences among nations' independence requirements are discussed in detail in Appendix II to this study.

VI. RECENT AND CURRENTLY PROPOSED CHANGES

In a manner similar to the SEC staff's continuous re-examination of its independence rules and interpretations, the accounting profession reviews its independence requirements. For example, in 1991 the AICPA noted that its Interpretation 101-1, which generally prohibited auditors from having any material, unsecured loan to or from an audit client, needed to be restated in view of alleged abuses of the permissible exceptions stated in the rule. This rule prohibited auditors from having any loan to or from an audit client except for loans from financial institutions that were made under normal lending procedures, terms, and requirements and were (1) not material to the borrower's net worth, (2) home mortgages, or (3) other secured loans. The AICPA amended its rule so that the only loans that an auditor may obtain from financial institutions that are audit clients are (1) automobile loans and leases collateralized by the vehicle, (2) credit card and checking account advances with an aggregate unpaid balance of $5,000 or less, (3) loans on the cash surrender value of insurance policies, and (4) loans fully collateralized by cash deposits (passbook loans). Loans complying with the prior rule, however, were "grandfathered" under the new rule.

Others also stand watch on the quality of independence requirements. For example, the POB recently issued a special report containing, among other things, "Recommendations to Strengthen Independence and Professionalism."141/ The POB suggests, among other things, 1) that the AICPA "sharpen further the distinction between client advocacy and client service and incorporate that distinction into the profession's Code of Professional Conduct," 2) that "accounting firms take special care to ensure their participation in the standards setting process is characterized by objectivity and professionalism" rather than acting as "hired guns" for their audit clients, and 3) that, to prevent audit engagement partners from supporting a client's policy on an accounting matter in discussions with the SEC staff when "that policy is clearly an unreasonable application of generally

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140/ For example, it is the staff's understanding that in Germany and Japan an entity's financial statements form the basis for annual tax accounts.

141/ POB, In the Public Interest: A Special Report by the Public Oversight Board of the SEC Practice Section, AICPA, 43 (March 5, 1993).

accepted accounting principles," an engagement partner should consult on accounting issues with partners at the appropriate level in that partner's firm before engaging in discussions with the SEC staff.142/

In addition, the AICPA Board of Directors, in its June 1993 paper entitled Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, noted steps "to improve the value of financial information and the public's confidence in it," 143/ including enhanced measures "Assuring Auditor Independence."144/ The AICPA Board of Directors recommendations include (1) the adoption of rules by the SEC and other regulators that would "prohibit public companies and other organizations with public accountability from hiring the partner responsible for their audit for one year after the partner ceases to serve that client," and (2) the use of mandatory audit committees, composed entirely of independent directors whenever practical, that are charged with specific responsibilities, including overseeing the company's financial reporting process and recommending the appointment of the company's independent accountants.145/

The Commission, as explained in part II of this report, historically has encouraged the use of independent audit committees and the national exchanges, under the Commission's oversight, have adopted various audit committee requirements.

The recommendation regarding the one-year ban on a company hiring the engagement partner that has been responsible for the audit of the company's financial statements, however, poses several difficult legal and policy concerns. As suggested by this recommendation, there are reported cases where significant frauds have been discovered in companies that have hired former engagement partners to be chief financial officers or chief accounting officers, or for similar positions. The implication is that audit engagement partners may be hesitant to challenge managements' positions on accounting and reporting matters if the partners anticipate the opportunity to be hired by management.

It would be difficult, if not impossible, however, for the Commission administratively to prohibit a company from hiring

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142/ *Id.* at 43-46.

143/ AICPA Board of Directors, Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession, 1 (June 1993).

144/ *Id.* at 4.

145/ *Id.*

anyone, including the individual that the company believes is the most qualified candidate for any position within the company.146/ Further, it would appear that the time for the greatest risk to investors is while a compliant or conspirator engagement partner remains with the accounting firm and in control of the audit of the company's financial statements. Once the partner leaves the engagement and joins the company, a new engagement partner, with a fresh view of the company, may be more willing to challenge corporate management. In other words, if management and the engagement partner have the intent to perpetuate a fraud, the partner may remain with the firm rather than risk turning the audit engagement over to another individual who may uncover the conspiracy. In addition, if management wants to compensate the engagement partner for his or her role in a fraud, a ban on hiring the engagement partner for a certain period of time may not prohibit the company from providing payments to the partner, after he or she resigns from the accounting firm, through consulting contracts or other means.

The heaviest burden of such a prohibition on hiring former engagement partners may fall on small corporations that are in need of inside accounting expertise provided by someone familiar with their business and industry. Due to these complex issues, it may be advisable for the AICPA, who has advocated such a restriction, to consider the adoption of an ethics rule in this area before the Commission takes action. The AICPA may be in a better position to analyze the detriments to smaller businesses and smaller accounting firms of such a ban on employment opportunities. The Commission will continue to pursue enforcement action whenever it uncovers fraudulent financial reporting that has been facilitated by a "revolving door," and the staff will monitor the AICPA's efforts in pursuing an ethics rule in this area.

Another argument that sometimes is advanced is that the Commission should adopt a rule mandating periodic rotation of accounting firms conducting the audits of the financial statements of public companies. The theory behind that argument is that the

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146/ As a result of these difficulties, the implementation of such a restriction more likely would be in the form of a Commission or staff interpretation that if a corporation hires the former partner in charge of the engagement to audit the corporation's financial statements, then the partner's former firm would not be considered independent for a number of years from the date the corporation hired the former partner (or, possibly, from the date the partner resigned from his or her former firm). If the Commission or staff issued such an interpretation, the major firms might attempt to amend their partnership or other agreements to have each individual, when he or she becomes a partner in the firm, agree not to accept a subsequent position that will impair the firm's independence.

auditors will not have the opportunity to develop the long-term, close relationships that could cause an auditor's independence to become impaired and that auditors would be more likely to force clients to make more disclosures and adopt more conservative accounting policies or practices. The SECPS currently has requirements establishing a maximum term over which an individual partner may serve a particular audit client, in order to address that possibility. That term currently is seven years. There is no current requirement, however, for a periodic rotation of independent accounting firms.

Mandatory rotation of independent accounting firms has been examined before. The Commission on Auditor's Responsibilities' (known as the Cohen Commission) Report, Conclusions, and Recommendations, issued in 1978, expressed several concerns about such a policy.147/ The Cohen Commission indicated that mandatory rotation of firms could increase considerably the cost of audits as there would be frequent duplication of audit start-up costs and learning time to become familiar with a company. Further, the Cohen Commission's study of cases of substandard audits found that there may be a "higher peril" associated with new audit clients; it stated that once an auditor becomes "well acquainted with the operations of the client, audit risks are reduced."148/ The Cohen Commission also indicated that mandatory rotation of independent accounting firms could lead to further issues caused by "excessive competition" among accounting firms.149/ The conclusion reached by the Cohen Commission was,

> Since the cost of mandatory rotation [of independent accounting firms] would be high and the benefits that financial statement users might gain would be offset by the loss of benefits that result from a continuing relationship, rotation should not be required.150/

147/ The Commission on Auditors' Responsibilities, Report, Conclusions, and Recommendations, 108-109 (AICPA 1978).

148/ *Id.* at 109.

149/ "Excessive competition," as discussed by the Cohen Commission, could occur due to the similarity of the "products" provided by the firms and the difficulty of investors' evaluating differences in the quality of audits among the firms, among other things. These factors contribute to competition based principally on the price of the audit, which, in turn, may lead to limited budgets for conducting audits. The Cohen Commission indicated that these limited budgets may lead to time pressures that set the stage for faulty audit work. *Id.* at 101-118.

150/ *Id.* at 109.

The Cohen Commission further indicated that a company's audit committee is in the best position to decide when it is appropriate to change auditors.151/

The Commission staff is aware of only one country, Italy, in which rotation of accounting firms is required. The Italian securities regulator, CONSOB, also has the authority to approve the selection of a company's auditors and to establish the audit fee. That additional authority might mitigate the fear that further increased competition for audits, which often are won by cutting fees, would cause a reduction in audit procedures and audit quality. In addition to the Italian situation, the staff is aware that, prior to 1992, Tier I Canadian banks' financial statements were required to rotate accounting firms every two years under the Canadian Bank Act. The Bank Act was amended in 1992 to delete that requirement along with the requirement that Tier I Canadian banks' financial statements be audited jointly by teams of two auditors.

The OCA currently is of the view that the SECPS requirement for a periodic change in the engagement partner in charge of the audit, especially when coupled with the SECPS requirement for second partner reviews,152/ provides a sufficient opportunity for bringing a fresh viewpoint to the audit without creating the significant costs and risks associated with changing accounting firms that were identified by the Cohen Commission. The OCA recognizes that a well-informed, independent audit committee may be in the best position to decide when the benefits of a change in auditors outweighs the costs. Several hundred companies make this determination each year and change auditors.153/ Accordingly, the staff does not, at this time, recommend legislation or rulemaking to mandate rotation of independent accounting firms.

151/ *Id.*

152/ A "concurring partner" or "second partner" review is a review of the audit workpapers and related information by a partner (or other SECPS approved reviewer) other than the partner in charge of the audit. Among other things, the second partner objectively should review accounting, auditing, and financial reporting issues from the perspective of someone who has not dealt with the client on an ongoing basis and is less susceptible to pressure from the client. For many firms, the second partner's approval is a prerequisite to the issuance of the audit report.

153/ For a discussion of the disclosures required upon a change in independent accounting firms, see Auditor Resignation or Dismissal in part II of this report.

VII. CONCLUSION

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

The OCA believes that further legislation or fundamental changes in the Commission's regulations are not necessary at this time for the protection of investors.

-END-

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U.S. House of Representatives
Committee on Energy and Commerce

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

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Washington, DC 20515-6119

March 18, 1993

The Honorable Richard C. Breeden
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

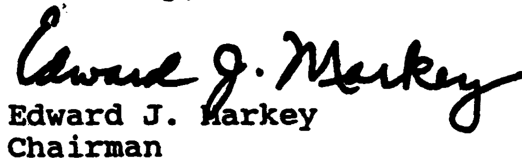
Dear Chairman Breeden:

On February 18, 1993, you testified before the Subcommittee on Telecommunications and Finance in support of H.R. 574, the "Financial Fraud Detection and Disclosure Act." In that testimony, you referred to an ongoing case, SEC v. Ernst & Young, in which the Commission is seeking a permanent injunction against Ernst & Young (as successor to Arthur Young & Co.) for certain securities violations resulting from Arthur Young's lack of independence as outside accountant for RepublicBank Corporation. This morning, the Subcommittee reported H.R. 574 to the full Energy and Commerce Committee. This bill represents an important step in making the auditing industry more truly accountable to the investing public. It is important that this new level of statutory accountability not be undercut by a lack of real-world independence.

I understand that the Commission's existing rules regarding independence address a situation like that which arose in the Arthur Young context, where more than fifty Arthur Young partners were members of real estate partnerships that borrowed over $15.8 million from the audit client, RepublicBank, and where at least twenty-seven Arthur Young partners received more than $5 million in personal loans from that institution. However, this case and others highlight the importance of protecting the independence of auditors from their auditing clients. Despite changes that appear to have occurred in both the auditing industry and in the preparation and use of audited financial statements, the Commission has not formally reviewed its independence rules for some time. Accordingly I request that the Commission prepare a study of the need for, and any impediments to, the independence of public accountants in the preparation and certification of financial statements for purposes of the Federal securities laws.

The Commission should provide the members of the Subcommittee with this study, accompanied by any recommendations for legislation the Commission considers appropriate or any conclusions as to rule changes that may be required for the protection of investors or the public interest, as soon as possible, but not later than one year from this date. If the members of the Commission or the Commission staff have any questions about this request, they should contact Elise Hoffmann of the Subcommittee staff at (202) 226-2424. Thank you for your attention to this matter.

Sincerely,



Edward J. Markey
Chairman

cc: The Honorable Jack Fields, Ranking Republican Member
Subcommittee on Telecommunications and Finance

Members, Subcommittee on Telecommunications and Finance

The Honorable John D. Dingell, Chairman
Committee on Energy and Commerce

The Honorable Carlos J. Moorhead, Ranking Republican Member
Committee on Energy and Commerce

Comparison of Commission, AICPA, and International Independence Requirements

The Commission staff responds to numerous oral and written requests for informal advice on the application of the Commission's independence requirements. In responding to those requests, the Commission staff evaluates the specific facts and circumstances of each situation and renders its views based on the independence requirements of both the Commission and the AICPA. Thus, auditors to U.S. public companies must comply with two sets of independence requirements--AICPA requirements and Commission requirements. Likewise, auditors to transnational issuers seeking to list securities on a U.S. exchange or offer securities to U.S. investors generally would be required to comply with both U.S. and home country independence requirements. The significant independence requirements are discussed below in detail including a discussion of the significant differences between the Commission's requirements and the AICPA's requirements, the requirements contained in the Code of Ethics for Professional Accountants promulgated by the International Federation of Accountants ("IFAC Code"), 1/ and requirements prevalent in other parts of the world. 2/

1/ The IFAC Code was developed by IFAC's Ethics Committee and was proposed for public comment on June 1, 1989. It provides guidance for member countries to consider in setting their own local independence requirements. The IFAC Code was issued in July 1990 and revised in July 1992.

2/ The examples of other countries' standards have been drawn from the Commission staff's review of selected portions of those countries' laws and professional literature. This presentation is of necessity incomplete and may not reflect fully all technical interpretations or their application in practice.

A. Applicability of Standards to Accounting Firm Personnel

The principal difference between the SEC and AICPA requirements is the applicability of the Commission's requirements to all firm employees that provide any professional services to the client, not limited solely to those employees working on an engagement requiring independence.

Australia, France, 3/ Italy, and the Netherlands have adopted rules that can be read to apply to all employees of the firm. The IFAC Code and Germany's requirements extend to all partners and certified professional personnel, as well as all other employees participating on the engagement. Canada's requirements 4/ generally are applicable only to partners, while key Japanese 5/ and British requirements generally are applicable only to personnel participating in the audit.

B. Financial Interests

1. Direct and Indirect Interests

The AICPA's requirements state that a member's independence will be considered to be impaired if during the period of a

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3/ Examples of French requirements cited are those applicable to the Order des Experts Comptables et des Comptables Agrees which represents qualified practicing accountants. Additional requirements apply to statutory auditors in certain circumstances.

4/ Independence requirements in Canada are established by the provincial institutes of chartered accountants. The requirements of the Institute of Chartered Accountants in Ontario are being used here as representative of Canadian requirements.

5/ Examples of Japanese regulations cited are those applicable to the independence of audit corporations auditing consolidated financial statements.

professional engagement or at the time of expressing an opinion, a member or a member's firm had or was committed to acquire a direct or material indirect financial interest in the [client]. (AICPA Ethics Interpretation (Interp.) No. 101-1)

A direct or indirect financial interest held by a spouse or dependent person is ascribed to the member (Interp. 101-9)

The Commission's requirements are similar to the AICPA's except that a direct financial interest includes one held by persons other than the accountant's spouse who are resident in the member's household, and any person subject to the accountant's supervision or control. Materiality is determined primarily by reference to the net worth of the accountant, his or her firm, and the client. No specific level is specified as being material. (Codification of Financial Reporting Policies (FRP) Section 602.02.b.i)

The IFAC Code, and requirements in Canada and Germany, are essentially the same as the AICPA. Australia, France, the Netherlands, and Japan have adopted rules that prohibit material financial interests in clients, but permit direct or indirect immaterial financial interests. Italy's rules prohibit any financial interests, while Britain prohibits direct financial interests.

2. <u>Relationships with Trusts Holding Financial Interests</u>

The AICPA's requirements state that a member's independence will be considered to be impaired if during the period of a professional engagement or at the time of expressing an opinion, a member or a member's firm was a trustee of any trust or executor of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the [client]. (Interp. 101-1)

The Commission's requirements also prohibit such relationships with minor exceptions for foreign auditors. (FRP 602.02.g, examples 18 and 19)

The IFAC Code prohibits auditors from serving as trustees of trusts holding interests material to the audit client or to the holdings of the estate or trust. The Australian, Canadian, and British standards are similar to the IFAC Code. Italy prohibits holding a controlling financial interest in a client, while the Netherlands and Germany prohibit any such relationship. Rules in France and Japan do not address the subject.

3. Joint, Closely Held Investments

The AICPA's requirements state that a member's independence will be considered to be impaired if during the period of a professional engagement or at the time of expressing an opinion, a member or a member's firm had a joint, closely held investment with the [client] or with any officer, director, or principal stockholder thereof that was material in relation to the net worth of the member or the member's firm. (Interp. 101-1)

The Commission would consider such a relationship to constitute a direct business relationship with a client or persons associated with the client. Such a relationship impairs independence, irrespective of materiality. (FRP 602.02.g)

The rules in Canada, France, Italy, and Japan are silent on this issue. The Netherlands has rules that are similar to the AICPA's, while Australia prohibits "mutual business interests" with clients and their officers and employees. The IFAC Code, Germany, and Britain urge caution, noting that such relationships may impair independence.

4. Loans

The AICPA's requirements state that a member's independence will be considered to be impaired if during the period of a professional engagement or at the time of expressing an opinion, a member or a member's firm had any loan6/ to or from the [client] or any officer, director, or principal stockholder of the [client]. The following loans from a financial institution7/ when made under normal lending procedures, terms, and requirements8/ are not

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6/ A loan includes a guarantee of a loan, a letter of credit, and a line of credit. A loan to a limited partnership in which members have a combined investment exceeding 50% of the total limited partnership interests is considered a loan to these members.

7/ A financial institution is considered to be an entity that, as part of its normal business operations, makes loans to the general public.

8/ Normal lending procedures, terms, and requirements relating to a member's loan from a financial institution are defined as those that are reasonably comparable with those relating to loans of a similar character committed to other borrowers during the period in which the loan to the member is committed. In making such comparison and in evaluating whether a loan was made under "normal lending procedures, terms, and requirements," the member should consider all the circumstances under which the loan was granted, including:

a. The amount of the loan in relation to the value of the collateral pledged as security and the credit standing of the member or the member's firm.

b. Repayment terms.

c. Interest rate, including points.

d. Closing costs.

e. General availability of such loans to the public. (Interp. 101-5)

(continued...)

considered to impair independence. Such loans, however, must be kept current at all times as to all terms.

a. Automobile loans and leases collateralized by automobiles.

b. Loans of the cash surrender value under terms of a life insurance policy.

c. Borrowings fully collateralized by cash deposits at the same financial institution.

d. Credit cards and cash advances on checking accounts with an aggregate balance not paid currently of $5,000 or less.

The following types of loans obtained from a financial institution under that institution's normal lending procedures, terms, and requirements, and (i) that existed as of January 1, 1992, (ii) that were obtained from a financial institution prior to its becoming a client requiring independence, (iii) that were obtained from a financial institution for which independence was not required and that were later sold to a client for which independence is required, or (iv) that were obtained from a firm's financial institution client requiring independence, by a borrower prior to his or her becoming a member with respect to such client also would not be considered to impair independence. Such loans must, at all times, be current as to all terms and such terms shall

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8/(...continued)
This definition applies in the cases of both loans that currently may be made and to the loans that were "grandfathered" as of January 1, 1992, which are discussed below.

not be renegotiated after the latest of the dates in (i) through (iv) above.

e. Home mortgages.

f. Other secured loans. The collateral on such loans must equal or exceed the remaining balance of the loan at January 1, 1992 and at all times thereafter.

g. Loans not material to the member's net worth.

Furthermore, an auditor may borrow from the non-client parent of an audit client, provided that the audit client is not material to the lender. (AICPA Ethics Ruling No. 98)

The Commission has not adopted requirements in addition to those of the AICPA in this area.

The IFAC Code is similar to the AICPA's requirements. Australia, Canada, and Britain have adopted rules similar to the IFAC Code. France and Italy prohibit any loans while Japan and the Netherlands prohibit material loans.

5. Interests in Non-Clients

The AICPA's requirements state that a member's independence may be affected if he or she has a financial interest in a non-client that has an investor9/ or investee10/ relationship with the

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9/ The term "investor" means a parent, a general partner, or a natural person or corporation that has the ability to exercise significant influence, as defined in Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," through the financial interest.

client.11/ Where a brother-sister common control situation exists between a client and a non-client, an immaterial investment in the non-client generally would not impair independence. In a joint venture situation, an immaterial financial interest in the non-client investor generally would not impair independence with respect to the client investee, provided that the member could not significantly influence the non-client investor. (Interp. 101-8)

The Commission requires an accountant to be independent of an audit client and all of its parents, subsidiaries, and affiliates.12/ (S-X, 2-01(b))

Interpretations by the Commission's staff prohibit investments by a member (as defined in Rule 2-01(b) of Regulation S-X (S-X)) in a non-audit client if the member has knowledge of an investment or intention to invest by an audit client, or a person identified with an audit client, in the same or an affiliated entity. If such an investment is made without knowledge of similar action by a client or person identified with the client (and the investment is not a jointly, closely held investment), upon learning of the client's involvement, the investment may be retained by the member

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10/(...continued)
10/ An investee is defined as a subsidiary or an entity subject to the significant influence of the investor.

11/ For example: where a non-client investee is material to a client investor, any direct or material indirect financial interest in the non-client by a member would impair independence; and where a client investee is material to a non-client investor, any direct or material indirect interest in the non-client by a member would impair independence.

12/ An affiliate is defined as a person (an individual, corporation, partnership, association, joint-stock company, business trust, or unincorporated organization (S-X, 1-02(p))) that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. (S-X, 1-02(b))

provided that the investment is immaterial to the member. If the investment represents 5% or more of the member's net worth, it must be sold to an unrelated party to avoid an independence problem.

The IFAC Code and British requirements do not address this issue. Australia, Canada, and Italy generally proscribe such holdings. France, Japan, and the Netherlands prohibit material financial interests in investors or investees of an audit client. Germany proscribes the ownership of shares in any company owning more than 20% of an audit client.

C. Appointments in Clients

1. Persons Currently Associated with the Accountant

The AICPA's requirements state that a member's independence will be considered to be impaired if during the period covered by the financial statements, during the period of a professional engagement, or at the time of expressing an opinion, a member or a member's firm was connected with the [client] as a promoter, underwriter, or voting trustee, as a director or officer, or in any capacity equivalent to that of a member of management or of an employee or was a trustee for any pension or profit-sharing trust of the [client]. (Interp. 101-1)

A member's firm will not include an employee (as opposed to a proprietor, partner, or shareholder) solely because he or she was formerly associated with the client in any of those capacities, if that employee has disassociated himself or herself from the client and does not participate in the engagement for the client covering any period of his or her association with the client. Similarly, the term "member's firm" shall include all individuals who provide services to clients and are located in an office participating in a significant portion of the engagement, for purposes of applying this rule. (Interp. 101-9)

A member may serve as the honorary director or trustee of a not-for-profit client of a charitable, religious, civic, or similar nature so long as he or she holds a purely honorary position and is identified as holding such in all letterheads and externally circulated materials in which he or she is named as a director or trustee, restricts participation to the use of his or her name, and cannot vote or otherwise participate in management functions. (Interp. 101-4)

The Commission's requirements are substantially the same; however, the exception regarding persons formerly associated with a client differs somewhat. The Commission applies that exception to a person formerly associated as an officer or employee who is employed by or becomes a partner, shareholder, or other principal in the firm when such individual has completely disassociated himself or herself from the client and its affiliates and does not participate in the audit of the financial statements covering any period of his or her employment by the client. (S-X, 2-01(b))

The IFAC Code and all of national rules studied by the Commission staff contain restrictions similar to those included in the AICPA requirements.

2. <u>Former Partners</u>

The AICPA rules state that a former practitioner who is connected with the [client] as a promoter, underwriter, or voting trustee, as a director or officer, or in any capacity equivalent to that of a member of management or of an employee or as a trustee for any pension or profit-sharing trust of the client, also would impair the firm's independence with respect to the client with which the former partner is associated unless certain provisions are met. Those provisions are (i) the payment of the amounts due to the former practitioner for his or her interest in the firm and

for unfunded, vested retirement benefits according to the payment schedule in effect should be such that the payments do not cause a substantial doubt about the firm's ability to continue as a going concern for a reasonable period of time, (ii) such payments must be fixed as to amount and payment dates and may be adjusted only for inflation, (iii) the former practitioner does not participate in the firm's business or professional activities, whether or not compensated for such participation, and (iv) the former practitioner does not appear to participate in the activities of, or be associated with, his or her former firm; however, a former partner may be provided an office and related amenities without violating this requirement unless he or she is in a position of significant influence with the audit client. (Interp. 101-2)

The Commission's rules also require that the former partner's capital balances be paid in full prior to commencement of an engagement by the auditor or acceptance of the position of director by the former partner, whichever is relevant. An independence problem also may exist when the former partner was closely associated with the provision of services to a client within a short period of time (two years) prior to accepting a position with, or substantial ownership interest in, the client. (FRP 602.02.f)

If a former partner proposes to accept a responsible position (officer) with a client of his or her former firm, the former partner must terminate all relationships with the former firm, including the full payment of any retirement benefits payable to him or her.

The IFAC Code does not address the issue of former partners. Canada's rules are similar to those of the AICPA. The rules in France, Japan, Britain, and Germany do not place any restrictions on such appointments. The rules in the Netherlands state that the firm and the retired partner must determine whether such an

appointment would impair the independence of the firm. In Australia, all independence requirements apply to retired partners, referred to as principals in Australia, who are required to render services to their former firm when asked to do so. In Italy, a three-year period must expire before a former partner may take a position with an audit client.

D. Other Professional Services

1. Bookkeeping

Under the AICPA's requirements, a member performing accounting services for an audit client must meet the following requirements to retain the appearance of independence in the eyes of a reasonable observer.

a. The client must accept the responsibility for the financial statements as his or her own. The client must be sufficiently informed of the enterprise's activities and financial condition and the applicable accounting principles so that he or she can reasonably accept such responsibility, including specifically, fairness of valuation and presentation and adequacy of disclosure. When necessary, the accountant must discuss accounting matters with the client to assist the client in understanding such matters.

b. The accountant must not assume the role of an employee or of management conducting the operations of the client's business.13/

13/ For example, the accountant shall not consummate transactions, have custody of assets, or exercise authority on behalf of the client. The client must prepare the source documents on all transactions in sufficient detail to identify clearly the (continued...)

c. The accountant must comply with generally accepted auditing standards including an examination of financial statements prepared from books and records that he or she has maintained completely or in part. (Interp. 101-3)

The Commission's position is that the accountant cannot be deemed independent with regard to auditing financial statements of a client if the accountant has participated closely, either manually or through its computer services, in maintenance of the basic accounting records and preparation of financial statements, or if the accountant performs other accounting services through which he or she participates with management in operational decisions. Where source data are prepared by the client and the accountant's work is limited to processing and production of listings and reports, independence will be affected adversely if the listings and reports become part of the basic accounting records on which, at least in part, the accountant would base his or her opinion. (FRP 602.02.c)

The IFAC Code is generally consistent with the AICPA rules, with the further proviso that personnel who provide bookkeeping services normally should not participate in the audit. Rules in the Netherlands are similar to the IFAC Code. Japan and Germany appear to prohibit bookkeeping services for audit clients. Canada and France permit bookkeeping services without regard to which personnel perform such services, although France proscribes such

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13/ (...continued)
nature and amount of such transactions and maintain an accounting control over data processed by the accountant such as control totals and document counts. The accountant should not make changes in such basic data without the concurrence of the client.

services by statutory auditors. 14/ Australia and Britain prohibit bookkeeping for public companies, but permit it for private companies with provisions similar to those of the AICPA. Italy's rules do not include bookkeeping services among the allowed services that may be performed by auditors.

2. Other Services

The AICPA states that an accountant performing advisory services relating to the implementation of an information and control system must take reasonable precautions to restrict his or her supervisory activities to initial instruction and training of personnel. The client must make all significant management decisions relating to the implementation of the project. (Ethics Ruling No. 55.)

Performance by a member of appraisal, valuation, or actuarial services, the results of which may be incorporated to the client's financial statements, would not impair a member's independence if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results of those services. (Ethics Ruling No. 54.)

The SEC Practice Section of the AICPA Division for CPA Firms prohibits member firms from providing executive recruitment and certain actuarial services to the member firms' public audit clients.

The Commission, in Accounting Series Release 264, identified several criteria that should be considered in determining whether

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14/ Statutory auditors are required for certain entities under the laws of a number of countries. The duties of statutory auditors are prescribed by law and frequently extend beyond an examination of the financial statements.

the performance of specific non-audit services would impair an auditor's independence, either in appearance or in fact. Included among those factors are:

a. The dependence of the auditor on management advisory service ("MAS") fees (for example, the relationship between total MAS revenues and total firm revenues and between MAS revenues from an individual client to the client's audit fee),

b. Avoidance of supplanting the role of management as the result of an MAS engagement, and

c. Avoidance of self-review by the auditor, including the effect on objectivity of auditing the product of systems designed by the auditor.

The Commission's staff has raised questions regarding the independence of accountants who have provided certain types of management advisory services to audit clients. Those services include:

d. Preparation of prospective financial information and feasibility studies,

e. Issuance of fairness opinions and valuation reports, and

f. Mergers and acquisitions related services where the accountant participated in negotiations or decision-making on behalf of, or with, the client.

The IFAC Code does not cover these services specifically, nor do the rules of any country studied by the Commission staff. However, the IFAC Code and the rules in Australia, Britain, and Germany state that the auditor should not perform executive

functions while rendering non-audit services to audit clients, and in the Netherlands auditors are cautioned to assure that independence is not impaired by non-audit services. The staff is aware that services involving the issuance of fairness opinions and valuation reports, including to audit clients, routinely are performed by auditors in some countries.

E. Litigation

The AICPA states that actual or threatened litigation may affect independence, since the relationship between an auditor and client should be one of complete candor and full disclosure regarding all aspects of the client's business operations.

Litigation between a member and a client may impair independence. When the present management of the client commences, or expresses an intention to commence, legal action against the auditor, the auditor and client may be placed in adversary positions in which management's willingness to make complete disclosures and the auditor's objectivity may be affected by self-interest.15/

15/ For example:

a. the commencement of litigation by management alleging deficiencies in audit work would impair independence;

b. the commencement of litigation by the member alleging management fraud or deceit would impair independence;

c. an expressed intention by management to commence litigation alleging deficiencies in audit work would impair independence if the member concludes that there is a strong possibility that such a suit actually will be filed;

d. litigation not related to audit work for the client for an amount not material to the member's firm

(continued...)

Litigation against a member and the client, or its management, would not have necessarily an adverse impact on independence. These situations must be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the member, or if the member alleges fraud or deceit by present management as a defense.

Litigation by other third parties against a member generally does not impair independence unless the member alleges fraud or deceit by management as a defense. (Interp. 101-6)

The Commission's requirements are generally consistent with the AICPA's, except (i) even the likelihood of litigation between the client and accountant may have an impact on independence if the accountant concludes that there is a strong probability that a suit will be brought, since in those circumstances both parties may be taking actions that are primarily designed to protect their legal positions, which would prejudice effective communication between them, and (ii) independence also may be impaired in situations where management and the accountant are bound so closely together in their defenses of a suit brought by a third party that they have a commonality of legal interest. (FRP 602.02.i.ii)

15/(...continued)
generally would not impair independence; and

e. litigation by security holders against a member and the client or its management may impair independence although the litigation itself may not alter the fundamental relationship between the member and the client's management (e.g., independence may be impaired if cross claims are filed against the member alleging that he or she is responsible for any deficiencies in the financial statements, and independence may be impaired if the auditor alleges fraud or deceit by management as a defense).

The IFAC Code contains advisory language similar to that in the AICPA's requirements. None of the countries studied by the staff addressed this issue.

F. Family Relationships

The AICPA states that a member's independence may be impaired by a family relationship with a person connected with the audit client. Relationships proscribed for the member also are proscribed for his or her spouse and any dependent persons, except that independence normally will not be impaired solely because of the employment of a spouse or dependent person in a position that does not allow significant influence. However, if the member's spouse or dependent relative is in an audit sensitive position16/, the individual member should not participate in the engagement.

The independence of a member and his or her firm also would be impaired as the result of a family relationship when the member participates in the engagement and a non-dependent, close relative17/ of the member (i) can exercise significant influence over the client, (ii) is employed in an audit sensitive position, or (iii) has a material financial interest, which is known by the member, in the client.

16/ A person's activities would be considered audit sensitive if such activities are normally an element of, or subject to, significant internal accounting controls such as cashier, internal auditor, accounting supervisor, purchasing agent, or inventory warehouse supervisor.

17/ A close relative is defined as including non-dependent children, grandchildren, stepchildren, brothers, sisters, grandparents, parents, parents-in-law, and their respective spouses. Close relatives do not include the brothers and sisters of the member's spouse.

The independence of a member and his or her firm also would be impaired as the result of a family relationship when the member is located in an office participating in a significant portion of the engagement and a non-dependent, close relative can exercise significant influence over the client. (Interp. 101-9)

The Commission's requirements state that a presumption of impairment is related directly to the closeness of the family bond. Attention also is directed to other factors such as the positions occupied by the parties in their respective employment. Minor differences between the SEC's and the AICPA's requirements exist in the definition of "close relative." The impairment of independence may be mitigated where there is adequate geographic separation of the individual accountant from the family member and from the engagement to preclude the possibility of contacts and influence that could give rise to a conclusion that the accountant's and his or her firm's independence appeared to be impaired. (FRP 602.02.h)

The IFAC Code states that each member body should decide, in light of social conditions existing in its own country, what degree of relationship with a client should be regarded as too close, and, therefore, should be proscribed to ensure that an objective approach to professional work for that client will not suffer. Family relationships that always pose an unacceptable threat to independence are those in which a sole practitioner or a partner in a practice, or an employee assigned to the engagement relating to the client, is the spouse, dependent child, or relative living in a common household with the client's principal owners, executive directors, or financial officers.

Italy's rules proscribe family relationships between a partner, director, statutory auditor, or general manager of an audit firm and their counterparts in a client organization. Canada's independence requirements proscribe only members of a

partner's household from serving as officers or directors of audit clients. Japan's requirements proscribe the audit engagement partner's immediate relatives from working for the client as officers, officer-equivalents, or other positions related to the client's financial affairs. Rules in Australia, France, the Netherlands, Germany, and Britain note that independence may be impaired by family relationships, but do not address specific family relationships.

G. Fees

1. Magnitude or Concentration

The AICPA does not address this issue.

The Commission's published requirements do not specifically address this issue; however, the Commission's staff raises questions regarding the independence of accountants who derive more than 15% of their total revenues from one client or group of related clients, based on the belief that a concentration of fees in excess of that limit causes the accountant to be overly dependent on the client or group of related clients. Determinations are based on the facts and circumstances of the particular case.

British rules cite a 15% threshold as raising questions about independence. The Netherlands states that an auditor should not report on the financial statements of a client on which the auditor is consistently and to a material extent dependent for income. The IFAC Code, Australia, France, and Germany caution against deriving a substantial portion of a firm's fees from one client or a related group. Canada, Italy, and Japan do not address the subject, although in Italy fees are set in accordance with guidelines established by securities regulators and there is a maximum term for which an auditor may serve a particular client.

2. Unpaid Prior Professional Fees

The AICPA states that the independence of a member's firm may be impaired if, when the report on the client's financial statements for the current year is issued, fees remain unpaid, whether billed or unbilled, for professional services provided more than one year prior to the date of the report. Such unpaid amounts assume the characteristics of a loan. (Ethics Ruling No. 52)

The Commission's requirements have not been updated to reflect the AICPA's requirements, which were revised in November 1990. The Commission's requirements state that unpaid fees that are material with respect to the current year audit fee must be paid prior to the commencement of the current audit. When an unpaid fee problem exists in connection with the audit of financial statements to be included in an annual report as opposed to a registration statement, these guidelines sometimes are modified. The client either may arrange to pay the past due fees prior to the issuance of the audit report or agree to an arrangement to make periodic payments to settle the delinquent fees. In the latter case, the auditor must conclude that there is reasonable assurance that all fees will be paid prior to the commencement of the audit for the ensuing year. (FRP 602.02.b.v) The Commission's staff generally would apply the more restrictive AICPA requirements.

The IFAC Code states that fees unpaid for an extended period may impair independence. France states that fees should be collected in accordance with the auditor's normal billing terms. Other countries do not address this issue.

3. Commissions and Contingent Fees

Under the AICPA's Rules of the Code of Professional Conduct, commissions received for the referral of products or services of

others to a client, payments to obtain a client (referral fees), and contingent fees received under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the amount of the fee is otherwise contingent upon the finding or results of such services, are prohibited by the AICPA if a member or his or her firm provides attest services to the client. The receipt of such fees is prohibited during the period of the attest services engagement and during the period covered by any historical financial statements involved in such attest services. (Ethics Rules 302 and 503)

Fees are not considered to be contingent if fixed by courts or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

The Commission has not adopted requirements in addition to those of the AICPA in this area.

The IFAC Code is similar to the AICPA's requirements. Contingent fee arrangements are permitted in certain circumstances in Britain with disclosure.

H. Goods and Services from Client

The AICPA's requirements state that the acceptance by an employee or partner of more than a token gift from a client, even with the knowledge of the member's firm, may cause the appearance of independence to be lacking. (Ethics Ruling No. 1)

The Commission has not adopted requirements in addition to those of the AICPA in this area.

The IFAC Code notes that hospitality and gifts on a scale beyond that which is commensurate with the normal courtesies of social life should not be accepted. Rules of Australia, France,

Japan, and the Netherlands generally are consistent with the AICPA's rule. Britain permits auditors to acquire goods and services on terms no more favorable than those available to all of a client's employees. The subject is not addressed specifically by Canada, Italy, and Germany.

I. Business Relationships with Clients

In addition to the AICPA's requirements regarding financial interests discussed in section B., the AICPA's requirements state that independence will be considered impaired if, during the period of a professional engagement or at the time of expressing an opinion, a member had any cooperative arrangement18/ with the client that was material to the member's firm or to the client. (Interp. 101-12) A member leasing property to an audit client creates an indirect financial interest in the client that impairs independence if that indirect financial interest is material to that member. (Ethics Ruling No. 58) However, a member leasing property from an audit client does not impair independence if, at the time the lease is entered into, it meets the criteria of an operating lease and is made under normal leasing procedures, terms, and requirements. (Ethics Ruling No. 91) In addition, a member's limited partnership interest in a limited partnership in which a client is the general partner would impair that member's independence with respect to that client if the respective

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18/ A cooperative arrangement exists when a member's firm and a client jointly participate in a business activity. Examples cited are prime/subcontractor arrangements to provide services or products to a third party; joint ventures to develop or market products or services, arrangements to combine one or more services or products of the firm with one or more services or products of the client and market the package with references to both parties, and distribution or marketing arrangements under which the firm acts as the distributor or marketer of the client's products or services or the client acts as the distributor or marketer of the products or services of the firm.

investments in the limited partnership are material to either the client or the member. (Ethics Ruling No. 81) A member's joint interest in a vacation home along with an officer, director, or principal stockholder of an audit client would impair the member's independence with respect to that client if the investment is material to either the officer, director, or principal stockholder or the member. (Ethics Ruling No. 92)

The Commission's requirements state that direct and material indirect business relationships, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity, such as officers, directors, or substantial stockholders, will adversely affect the accountant's independence with respect to that client. In addition to the relationships discussed previously in sections C and D, joint business ventures, limited partnership agreements, investments in supplier or customer companies, leasing interests (other than immaterial landlord-tenant relationships), and sales by the accountant of items other than professional services are examples of other prohibited relationships.

The Commission's rules also state that an accountant cannot maintain margin or discretionary accounts with a broker-dealer audit client, and must take delivery on a timely basis of any cash or securities resulting from transactions executed through a regular cash account with such a client. (FRP 602.02.g)

The IFAC Code does not specifically address this issue. The rules of Australia, Britain, France, Italy, the Netherlands, and Germany variously proscribe, limit, or express concern about business relationships with clients and the clients' personnel. Specifically mentioned among the countries are joint business ventures, mutual business interests, and contractual relationships. Canada and Japan make no specific references to the subject.

J. Incompatible Occupations

The AICPA considers independence impaired if legal services rendered to an audit client result in undue identification with management. (Ethics Ruling No. 51)

The Commission's requirements state that certain concurrent occupations of accountants engaged in the practice of public accounting involve relationships with clients that may jeopardize the accountant's objectivity and, therefore, his or her independence. In general, this situation arises because the relationships and activities customarily associated with the occupation are not compatible with an auditor's appearance of complete objectivity or have primary objectives that are fundamentally different from those of a public accountant. For example, the following concurrent occupations are generally prohibited:

a. Acting as counsel, since a legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interests of the client,

b. Acting as a broker/dealer, since customary activities could involve securities transactions of clients either as issuer or investor, and provide third parties with sufficient reason to question the accountant's ability to be impartial and objective, or

c. Actively engaging in direct competition in a commercial enterprise, since that would appear to third parties to be a conflict of interests that might influence the accountant's objectivity because he or she would have access to the records, policies and practices of a business competitor. (FRP 602.02.e)

The IFAC Code and almost all of the country standards studied by the Commission staff contained some notion of incompatible occupations. However, some did not mention specific occupations, and the occupations specifically identified by others varied widely. For example, Japan prohibits virtually all concurrent occupations other than those directly related to the practice of public accounting. Germany, which also excludes most occupations, specifically permits the practice of law (although not for any audit client), engineering, science, teaching, and rendering financial advice.

K. Indemnification by a Client

The AICPA rules state that the inclusion in engagements letters of a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management would not impair the auditor's independence. (Ethics Ruling No. 94)

The Commission's requirements state that an accountant cannot be indemnified against liability for his or her own negligent acts, whether of omission or commission, since one of the major stimuli to objective or unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. (FRP 602.02.i)

Neither the IFAC nor the requirements of any country studied by the staff address this issue.

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