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## Re: Proposed Rule Making Respecting Auditor Independence: Outline of Testimony, Securities and Exchange Commission

William T. Allen

Independence Standards Board

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# Securities and Exchange Commission

Washington, D.C.

July 26, 2000

## **RE: PROPOSED RULE MAKING RESPECTING AUDITOR INDEPENDENCE**

### Outline of Testimony of William T. Allen

Chair, Independence Standards Board

#### **1. Introduction**

A. Chair of Independence Standards Board which was formed through the cooperative action of the SEC and the AICPA in 1997 and was authorized in February 1998 by SEC FRR 50 to establish standards that have prima facie validity. Other members of Board here with me - John Bogle, Robert Denham and Manuel Johnson. Each will briefly speak.

B. My background is as a judge (Chancellor, Delaware Court of Chancery 1985-97), Professor of Law and of Business (New York University 1997 - date) and as counsel or consultant to a law firm in New York (Wachtell, Lipton, Rosen & Katz). I was asked by the Chairman to serve in this capacity and agreed to do so because I believed that there was opportunity for public service in doing so.

C. Today I speak for myself and not the ISB institutionally..... Nor do I speak for any other institution with which I am proud to be affiliated professionally.

#### **2. Importance of Auditor Independence**

Auditor independence in fact and in appearance is a vital protection to capital market efficiency and thus to economic welfare in our capital market-centered brand of capitalism. On this I think there is universal agreement.

Evolution of the auditing profession into multi-service professional firms plainly gives rise to reasonable concerns that the integrity of financial data is being or may be adversely affected (or at the least markets may become suspicious of that fact and impose an additional discount for such risk).

The ISB has commissioned studies on the perceptions of the investing public respecting the quality of financial reporting and the issue of auditor independence. The most recent report of findings was delivered to the Board last week by the research firm Earncliffe Research & Communications. Stated very broadly the results of that study were rather similar to an earlier study. Both concluded that there was a high degree of trust in the integrity of financial statements and in the auditing process, but nevertheless that the importance of non-audit services to modern audit firms represented a source of concern. The report has been furnished to the SEC staff for its use.

### **3. Independence Standards Board**

Until this rule making, the method adopted by the SEC to try to bring its evolved rulings on auditor independence into a form consistent with the modern economy was the formation in 1997 of the ISB and the delegation to the ISB of responsibility to create principle-based standards for the determination of auditor independence. In February 1998 the SEC issued FRR 50 that officially designated the ISB as having authority to issue standards that would have prima facie authority, unless and until rejected by the SEC. The Board has proceeded on this task diligently since that time. One of the issues that this rulemaking raises for the Board, which is perhaps of secondary importance to the public interest, is what effect is the proposed rule-making intended to have – or will have without regard to intent -- on the role and mission of the ISB going forward. I pass over that point for the moment.

The ISB is making good progress. It recently adopted its 3<sup>rd</sup> Standard – dealing with employment by audit clients of former auditor employees. And it is ready to release its Exposure Drafts dealing with Financial Interests in Audit Clients and Family Relationships and with Appraisals and Valuations. Both of these projects were suspended with the issuance of this proposed rule making that addresses these questions itself.

Generally the Board has suspended its projects at the moment except for its project on a general Conceptual Framework for Auditor Independence. That project was undertaken early on in the Board's operation. *We see this task as important to achievement of a long-term goal of a coherent and effective system of standards.* We retained two academics to act as our reporters and impaneled a Task Force of experts from within and without the accounting profession. That Task Force under Board oversight has almost completed its project after about two years of steady work. This has been a very large and time consuming effort, and we are now within several months of a final statement. At the conclusion of my brief remarks I want to mention my concern that this rule making will render that work and the benefits that might come from a thoughtful conceptual framework illusory.

#### Specific ISB projects.

- A. ISB Standard No. 1: Designed to encourage greater auditor – audit committee interaction with respect to independence.

- B. ISB Standard No. 2: Designed to address a specific appearance problem related to audits of mutual funds and affiliated entities.
- C. ISB Standard No. 3: Designed to modernize independence rules respecting employment of former audit firm partners or employees by audit clients.
- D. Project on Financial Interests of Audit Firm Personnel in Audit Clients: At Exposure Draft stage - thus currently close to completion, but recently deferred due to overlap with this proposed rule making.
- E. Project on Family Relations: At Exposure Draft stage - thus currently close to completion but recently deferred due to overlap with this proposed rule making.
- F. Project on Valuation and Appraisal Services: At Exposure Draft stage – also deferred due to overlap with this proposed rule making. The ISB has tentatively concluded that independence standards should preclude auditor provision of these services where the asset valued (or all such assets valued) have financial statement significance.
- G. Project on Future Firm Structures: This project, unlike the foregoing ones, represents an aspect of the larger question: what forms should firms that provide audit services to public companies be legally permitted to take. This project was deferred in January.

#### **4. Summary of Testimony**

- A. I warmly *support that aspect of the Proposed Rule making that would mandate public disclosure of facts respecting non-audit services provided to audit clients.* Since this change in policy requires amended issuer disclosure it is beyond the authority of the ISB to implement through standard setting. It is nevertheless the most significant single change that can be made in my opinion respecting auditor independence. The wisdom of the original decision to premise our capital markets regulation on disclosure and not government substantive economic judgments has been reaffirmed over the decades. There is no reason that information about non-audit services -- if in fact it is information that relates to the integrity of financial disclosure and thus to financial risk -- will not be priced.

An additional strong reason to support this change in disclosure policy is that the ability of markets to price the risk associated with this information will permit financial economists to conduct studies of the existence of any risk premium associated with this

information. Such information would be extremely helpful; if an informed market does not care about this information, the case for regulating these relationships is reduced. On the other hand if the market does care (i.e., firms that have auditors who perform substantial non-audit services are penalized by a higher average cost of capital) then the activity will to some extent be self-correcting.

Thus, especially in the absence of good social scientific data respecting the costs and benefits of the provision of non-audit services, it is arguable (and I believe) that disclosure is the optimal social policy.

- B. Nevertheless, I *do not oppose the substantive provisions in the proposed rule dealing with scope of permissible services to audit clients*. If forced to make a judgment on current information, I would be inclined to join in this judgment. But, as I am not required by events to make such a judgment now, the lack of good information regarding a correlation between an increase in the provision of non-audit services to audit clients and a decrease in reliability of financial statements precludes me at this time from endorsing this expanded prohibition. Others with more intimate knowledge of the practices followed in the world of auditing would have more dependable intuitions on this subject. In all events in this setting of highly imperfect information, the choice here represents a public policy estimate of where the balance of public interest lies. I know of no facts that make the proposals made unreasonable exercises of policy-making judgment.
- C. With respect to other aspects of the proposed rule, I do respectfully recommend *that the proposal's provisions relating to Employment with Audit Clients be modified to conform to Independence Standard Board Standard No. 3*.

That standard reflects the best judgment of a board comprising experienced individuals and a process that entailed wide public participation. This Commission authorized the ISB to undertake that work and I respectfully suggest that where the product of that process represents a reasonable and good faith balancing of appropriate factors in standard setting, the Commission should limit its options to accepting or rejecting an ISB Standard *in toto*.

Of course the SEC can and should reject a standard that in its judgment is not consistent with the public interest. But I suggest that it ought not to “second guess” specific judgments that are built into an ISB Standard. The SEC should accept or reject a standard. It is not reasonable to expect that senior professional people will continue to dedicate their time to this form of public service if the end result of the lengthy public deliberation process is in effect a proposal to the SEC Staff for modification. Attached is a brief summary of differences between ISB No. 3 and the Proposed Rule’s treatment of the employment with audit clients.

- D. I also respectfully recommend that the SEC *amend those aspects of the proposed rule dealing with Family Relations and Financial Interests to conform to the existing ISB Exposure Draft of Standards* which reflect the best judgment of the Board on those topics

as of this time, *or alternatively defer acting on those aspects of the rule until the ISB has completed its Standard setting process on these subjects* and then adopt or reject those standards. Attached hereto is an appendix that briefly identifies the differences from the proposed ISB ED on these subjects and that of the proposed Rule.

- E. Finally I must *express concern that the adoption of this rule -- with its highly abbreviated and abstract conceptual underpinnings -- will unduly restrict the development of the ISB's Conceptual Framework Project.* That project has been in the works for almost two years and is close to fruition. It has involved a large Task Force of volunteer experts from the accounting and investment communities as well as academics and others. The existing product of the Conceptual Framework Task Force is sophisticated and deeply considered. We are now in the process of considering public comments on that document. It would not be good policy in my opinion to shortcut that process or to constrain its conclusions by the adoption of a brief statement of core threats to independence that is contained in the Proposed Rule.

The framework of the proposed rule is a first step at a conceptual framework, but it is just a first step. I agree that values or principles that form the premise for the proposed rule constitute significant threats to auditor independence. Advocacy, mutuality or conflict of interest, auditing one's own work and performing management functions for an audit client certainly are problematic for auditor independence. But these generalities need much more conceptual refinement before they can be useful guides to standard-setting independence determinations. What constitutes advocacy for example will often not be clear. Mutuality of interest too should be deemed a problem, but always? To the extent of every mutual interest? What about a passive investment in which an audit client also has a passive investment? Say limited partnership interests. This is a mutual interest, does it in all events prevent the auditor from being independent? What if these investments are material to both? Or financially material to neither? What are the factors that count in deciding when it might and when it doesn't? The framework won't help people know.

Thus I tend not to share the optimistic view of the proposal, that its adoption would helpfully clarify the work of the ISB or at least to do so in a way that is consistent with careful, highly textured standard setting. The ISB framework as it is evolving is premised on a principle of defining threats to independence and identifying whether safeguards that comply with stated requirements will be deemed satisfactory to protect against such threats. While in some details – largely adopted from ISB work product – the proposal seems to embrace safeguards, more fundamentally it seems to be a document that is simply prohibitive.

Thus while certain aspects of the proposal – specifically mandated disclosure -- I do warmly embrace and others – specifically scope of services -- I am agnostic about, I do express a concern that the rule making will effect in ways I do not fully appreciate the ISB process which I thought was a well structured way to approach the general topic of modernizing auditor independence rules.

## Independence Standards Board

### Employment with Audit Clients

#### Comparison of the Provisions of ISB No. 3, *Employment with Audit Clients*, and the Recent SEC Rulemaking Proposal

ISB No. 3, *Employment with Audit Clients* (the ISB standard), addresses the auditor independence concerns raised when audit firm professionals join firm audit clients. Briefly, these concerns are that:

- the auditor may have been eager to please the client in an attempt to elicit a job offer;
- the former firm professional may be able to circumvent the audit because of his or her knowledge of the audit's scope, design, or testing strategy;
- the remaining audit team may not exhibit the requisite skepticism when evaluating the work or representations of a former firm colleague;
- if capital and retirement balances owed to the former firm professional are material to the firm, the former firm professional may be able to use these outstanding obligations to influence the firm in the conduct of the audit;
- if unsettled capital and retirement obligations are immaterial to the firm, there may still be an appearance of inappropriate ties between the audit firm and its client.

The provisions of the SEC's rulemaking proposal (the SEC's proposal) dealing with the employment with audit client issues differ from the ISB's standard in several important aspects:

- The SEC's proposal does not require the safeguards mandated by the ISB's standard to address the risk of audit circumvention, or a lack of skepticism on the part of the remaining audit team members. These safeguards include:
  - consideration of the need to modify the audit plan,
  - review of engagement team members to ensure that they have the appropriate stature and relationship with the former firm professional to effectively evaluate his or her work and statements, and
  - review of the subsequent audit to ensure that the engagement team exhibited the requisite objectivity.
- Both proposals would require settlement of capital accounts of former partners joining audit clients. The SEC proposal, however, would only require settlement if the former

partner “is in an accounting or financial reporting oversight role,” whereas the ISB standard would require settlement regardless of the position assumed at the client.

- Similarly, both proposals would require settlement of retirement arrangements of former firm professionals employed at an audit client. The SEC proposal, however, would require settlement of all arrangements unless fixed and fully funded, whereas in general, the ISB standard would only require settlement if the amounts were material to the firm. In developing its standard, the Board concluded because a former firm professional employed at a firm audit client could not use an immaterial obligation of the firm to influence the outcome of the audit, requiring settlement could pose an unnecessary and potentially severe burden on the former firm professional or on the firm. For example, under U.S. tax rules, a retirement benefit owed by a qualified plan could not be “settled” – i.e., paid out – unless that alternative were offered to all former employees participating in the plan. Providing this option for all plan participants could increase the costs of providing benefits, and result in a decrease in the level of benefits offered. In other instances, a requirement to settle even immaterial retirement balances might cause a professional to be unable to accept a job offer, or force the client to hire another audit firm. The Board believed that imposing such costs without offsetting benefits to auditor independence would not be appropriate.



**Independence Standards Board**

**Financial Interests of the Auditor in, and Family Relationships between,  
the Auditor and the Audit Client**

**Comparison of the ISB's Proposed Standard and  
the Recent SEC Rulemaking Proposal**

The SEC proposals on financial interests and family relationships have the same general thrust as those in the ISB draft ED, including a major change in defining the individuals who need to be independent, intended to modernize the current rules. Specifically, both the SEC and ISB proposals dramatically reduce the number of individuals restricted under the “member” approach of the present rules. However, they differ in certain significant respects, including the following.

Financial Interests

The SEC and ISB proposals would prohibit both those on the audit engagement and those in a position to influence the audit from owning any direct financial interest in the audit client. The SEC proposal, however, would include in that group all professionals providing non-audit services to an audit client from owning an investment in the client. In contrast, the ISB proposal would limit those professionals to partners and managers, on the basis that non-audit staff below those categories do not have influence on the audit and therefore need not be restricted.

On the other hand, the ISB proposal would prohibit a person on the audit from having an other close relative (parent, non-dependent child or sibling) from having an investment in the audit client that is material to both the auditor and the close relative, if the auditor knows about it. The SEC proposal does not cover this situation. The ISB believes that knowledge of such a material investment could impact the auditor's objectivity, and therefore prohibits it.

Investments in clients often are related to employment, and because employment of spouses has become much more frequent, impediments to such employment must be justified. In that spirit, the ISB concluded that although other partners in an office participating in the audit should not own client securities, that prohibition need not extend to employer-sponsored benefit plan investments of their immediate family members, given that their employment role also must be evaluated as acceptable. In this case, the threat from such stock ownership was considered minimal, but the inability to participate in the benefit plan would make such employment much less desirable. The SEC proposal has no such exemption.

## Family Relationships - Employment

The SEC proposal would prohibit employment of immediate family members and close relatives in an accounting or financial reporting oversight role, and these restrictions would apply to all categories of “covered persons.”

The ISB proposal applies restrictions based on whether the firm professional is on the audit or in a position to influence the audit, and whether the family member is an immediate versus an other close family member. For example, The ISB proposal would prohibit someone on the audit engagement from having an immediate family member employed in *any* position at the audit client. People frequently develop financial or emotional ties to their employer, and the desire to protect an immediate family member’s employer (and his or her job) may affect the auditor’s objectivity, whatever the relative’s position at the client.

In addition the ISB proposal would prohibit both immediate family members and close relatives from being employed in a key policy-making position at the client, and would also restrict immediate family members from holding a sensitive financial position at the client. Restrictions are targeted to the risks to protect the auditor’s independence, recognizing that overly restrictive rules impose costs that may exceed their benefits.

Finally, for other partners in a work office, where the ISB views the threats as generally being less strong, only specified senior positions are prohibited for immediate family members, and none are for other relatives. The SEC proposal, however, would continue to bar all the oversight role positions for both immediate and other close family members.

**Memo**

To: ISB Members  
From: Hank Jaenicke and Alan Glazer  
CC: Art Siegel  
Date: 7/21/00  
Re: Comparison of ISB's Conceptual Framework with SEC  
Proposed Rule

Here is the comparison Chairman Allen requested of the approach we have been using in the ISB's conceptual framework project and the approach taken in the SEC's proposal on auditor independence. We believe those approaches are fundamentally different: the ISB project contemplates a threats and safeguards approach to assessing independence risk. The SEC's proposal is a compliance-based approach to a bright-line general standard and governing principles.

The purpose of the ISB's project is "to develop a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for the development of principles-based independence standards" [ISB, "Objective and Mission"]. The staff has interpreted that purpose broadly, and the conceptual framework being developed is intended to be useful not just to the ISB but also to other parties, such as auditors, accounting firms and audit committees, who make decisions about auditor independence in situations where no specific rules or standards apply. Unless the Board decides to change the approach described in the Discussion Memorandum, the ISB's conceptual framework will include a definition and a goal of auditor independence. In addition, concepts and basic principles will be provided that describe the process by which independence decision-makers can assess whether auditor independence is impaired.

The process contained in the framework can be applied to a wide range of threats to auditor independence, including those that exist in today's audit environment and new types of threats that might emerge in the future. The ISB's conceptual framework will not contain standards or prescribe safeguards that eliminate or mitigate those threats. The framework is intended to provide direction and structure for resolving independence issues and to

help focus debate and serve as boundaries for discussions on those issues.

The purposes of the SEC's proposal are different. The SEC describes them as follows:

[to] consolidate and make more accessible the standards for auditor independence under the federal securities laws, reemphasize its importance, and provide a comprehensive framework for evaluating auditor independence [Proposed Rule, "Revision of the Commission's Auditor Independence Requirements, Section II.D].

We do not believe that the SEC proposal is intended to provide a conceptual framework for auditor independence, with fully articulated and logically connected components. For example, it does not explicitly define auditor independence or state its goal. Instead, it contains a "general standard" or "basic test for an auditor's independence"—an operational benchmark against which the SEC can measure registrants' and their auditors' compliance with statutory requirements for independence under the federal securities acts. This general standard is as follows:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement [proposed section 210.2-01, paragraph (b)].

The SEC proposal also specifies four "governing principles" that

Incorporate situations that we believe reasonable investors would agree impair an auditor's independence. They are when the auditor:

- has a mutual or conflicting interest with the audit client;
- audits the accountant's own work;
- functions as management or an employee of the audit client; or
- acts as an advocate for the audit client.

[Section III, "Discussion of Proposed Rules"  
(footnotes omitted)].

The final section of the SEC proposal applies the "governing principles" to a large number of specific situations that the SEC believes impair auditor independence. Those situations exist when an auditor (a) has certain financial, employment, or business relationships with, (b) provides certain non-audit services to, or (c) receives contingent fees from the auditor's audit clients and affiliates of those clients. The proposed rule does not consider that, in particular circumstances, the risk of impaired independence might be adequately mitigated by controls other than proscriptions. (The SEC rule does not use the term "safeguards," which is used in the ISB project to describe both controls and proscriptions that mitigate or eliminate threats to auditor independence.) Instead, the SEC proposal: provides "limited exceptions from the rules" if certain conditions are satisfied (e.g., auditing firms have certain quality controls in place); indicates that the rules do not apply to situations that meet specified criteria (e.g., credit card balances of less than \$10,000 held by audit clients); and describes alternatives that the Commission is considering that would limit the applicability of some of the rules (e.g., if an auditing firm were adequately separated into audit and non-audit units, the independence rules would not to apply to services provided to audit clients by the non-audit unit).

The ISB conceptual framework, as we see the project developing, would look on the SEC's "governing principles" as threats to auditor independence. (The Board's conceptual framework would identify and discuss what we believe is a complete list of various categories of threats.) It is likely that the ISB would consider the situations described in the SEC proposal as examples of circumstances that give rise to threats to auditor independence. The ISB conceptual framework, however, would not contain an analysis of specific circumstances or indicate how the ISB should respond to them. We believe that should be part of the ISB's standard-setting process. The Board's conceptual framework would, however, describe the approach that the ISB would use to analyze specific circumstances and develop standards. That approach would involve assessing the level of independence risk posed in specific circumstances by considering both threats to auditor independence and whether safeguards have eliminated or adequately mitigated those threats.

Partly because the approaches described above are so different, we believe that the components of the ISB's framework are likely to differ from the framework contained in the SEC's proposal. It is too early to identify differences in detail because they depend on specific decisions regarding its framework that the Board has not yet made. We do believe, however, that the frameworks are fundamentally different, and that the resulting approach to setting independence standards would be quite different.