The SEC sought to restructure the accounting profession with its new auditor independence rule.

The Push for Auditor Independence

By Zoe-Vonna Palmrose and Ralph S. Saul
University of Southern California *CIGNA Corp. (retired)*

In November of 2000, the Securities and Exchange Commission (SEC) adopted a new rule that prohibits accounting firms from providing certain non-audit "consulting" services to their audit clients. The rule also requires public companies to disclose in their proxy statements the fees paid to their independent auditors for audit and non-audit services. In adopting the rule, the SEC argued that a basic conflict exists in providing both auditing and consulting services to a client. That conflict, the commission claimed, undermines the integrity of audits.

Initially, the SEC sought a major restructuring of the accounting profession by separating auditing from most consulting services. It failed to achieve that objective primarily because of a lack of evidence demonstrating that providing non-audit services does, in fact, compromise auditor independence. Now, it appears that the SEC has indirectly achieved its objective through the fee disclosure requirement. The SEC used that requirement to send a message to public companies and their audit committees that the size of non-audit fees alone indicates a lack of independence.

The events surrounding the genesis of the Auditor Independence Rule were not the SEC's finest hour. As we argue in this article, the episode represents a failure of the regulatory process — one that we witnessed first-hand as members of the Public Oversight Board Panel on Audit Effectiveness (also known as the O'Malley panel). An examination of the episode provides important lessons for the future, not just for the SEC, but also for all regulatory agencies attempting to restructure a regulated industry or profession.

Zoe-Vonna Palmrose is the PricewaterhouseCoopers Professor of Auditing at the University of Southern California. Her research focuses on restatements, audit litigation, audit quality, the pricing of audit services, and the supply of and demand for non-audit services. She can be contacted by e-mail at zpalmrose@marshall.usc.edu.
Ralph S. Saul is a former chairman of the board and co-CEO of CIGNA Corp. He is also a former president of the American Stock Exchange and a former director of the SEC's Division of Trading and Markets.

HISTORY

By late 1998, the SEC had moved earnings management and the quality of financial reporting and auditing to the top of its regulatory and enforcement agendas. Against the backdrop of a rising stock market and increasing pressure on companies to meet analysts' forecasts of earnings or revenues, a series of major enforcement actions involving accounting irregularities prompted the commission to act.

The SEC focused attention on the conduct of external (independent) audits and the role of audit committees. First, it encouraged the formation of the Independence Standards Board (ISB) to establish standards for auditor independence. Then, the SEC pushed for the formation of both the O'Malley panel to improve the quality of audits and a separate blue ribbon committee to improve the functioning of audit committees. Finally, the commission's enforcement chief announced that the SEC would bring other important actions against both public companies and their auditors for accounting fraud.

Those initiatives had an immediate, positive, and lasting effect by forcing corporate managements to focus on the quality of financial reporting, alerting audit committees to their responsibilities to shareholders, and compelling accounting firms to pay far greater attention to auditing and the quality of their audits. In most of the initiatives, the SEC relied upon the private sector and the self-regulatory organizations of the accounting profession to improve financial reporting and the quality of audits. The profession, through the American Institute of Certified Public Accountants (AICPA), endorsed all of the committees and panels, and directly sponsored and financed most of them.

Yet, inexplicably, before the private sector initiatives could be implemented fully or given an opportunity to work, the SEC proposed the Auditor Independence Rule (Securities Act Release No. 33-7870). The June 2000 proposal came

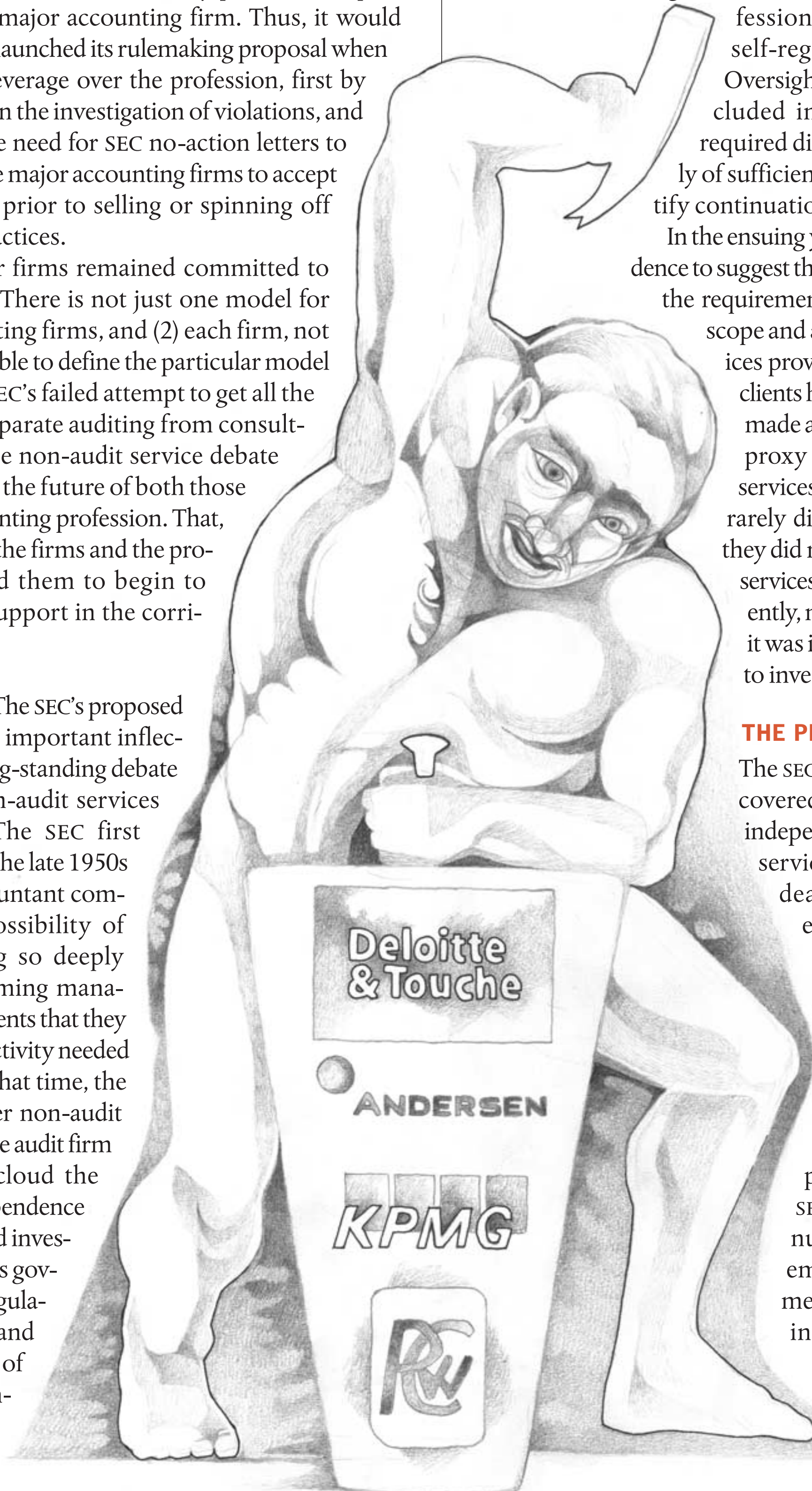
after the commission failed to persuade all five major accounting firms to divest themselves of their consulting activities. (The proposal came at a time when three of the firms, each of which had announced divestiture plans to monetize their investments in consulting, needed relief from current SEC independence requirements to carry out their plans.) The SEC proposal also came at a time when it had found numerous (mostly technical) violations of the existing auditor independence rules relating to financial and employment relationships with audit clients, by partners and professional staff in a major accounting firm. Thus, it would appear that the SEC launched its rulemaking proposal when it had maximum leverage over the profession, first by threatening to widen the investigation of violations, and second by using the need for SEC no-action letters to pressure three of the major accounting firms to accept certain conditions prior to selling or spinning off their consulting practices.

However, other firms remained committed to two principles: (1) There is not just one model for organizing accounting firms, and (2) each firm, not the SEC, should be able to define the particular model for that firm. The SEC's failed attempt to get all the firms to agree to separate auditing from consulting transformed the non-audit service debate into a struggle over the future of both those firms and the accounting profession. That, in turn, galvanized the firms and the profession and caused them to begin to marshal political support in the corridors of Congress.

The SEC's interest The SEC's proposed rule represented an important inflection point in the long-standing debate over providing non-audit services to audit clients. The SEC first voiced concerns in the late 1950s when its chief accountant commented on the possibility of auditors becoming so deeply involved in performing managerial services for clients that they would lose the objectivity needed for an audit. Since that time, the question of whether non-audit services compromise audit firm independence or cloud the appearance of independence has been studied and investigated by numerous government and self-regulatory commissions and committees. None of the studies recommended the separation of auditing from consulting. However, the continuing growth of the revenue mix of the largest firms towards consulting services intensified the debate on auditor independence.

In proposing a new rule related to non-audit services, the SEC reversed one of its prior decisions. In 1978, following congressional investigations of the accounting profession, the SEC adopted a proxy statement disclosure requirement on non-audit services provided by the company's external auditor. But the SEC repealed that requirement in 1982, citing new disclosure requirements of the profession's recently organized self-regulatory body, the Public Oversight Board. Also, the SEC concluded in a 1982 report that the required disclosure "was not generally of sufficient utility to investors to justify continuation."

In the ensuing years, there has been no evidence to suggest that the SEC decision to repeal the requirement was unwise, even as the scope and amounts of non-audit services provided by audit firms to their clients have grown. Few companies made any voluntary disclosures in proxy statements on non-audit services. Perhaps more telling, only rarely did companies disclose that they did not purchase any non-audit services from their auditors. Apparently, most companies did not feel it was important to signal that fact to investors.



MORGAN BALLARD

THE PROPOSED RULE

The SEC's June 2000 proposed rule covered more aspects of auditor independence than just non-audit services. Much of the proposal dealt with financial and employment relationships with audit clients. The existing rules badly needed updating and simplification in light of dramatic changes in the business environment, demographics, and the profession. In response, the SEC proposed to reduce the number of audit firm employees and their family members whose investments in, or employment with, audit clients would impair auditor independence. Both audit clients and the profes-

sion generally welcomed those proposals. Even so, by engaging in rulemaking, the SEC undermined the functioning of the ISB, which had been methodically working to modernize the independence rules.

In another section of the proposal, the SEC listed a variety of proscribed non-audit services. Among them were bookkeeping and management functions, financial information systems design and implementation, appraisal and valuation, actuarial, internal audit outsourcing, human resources, legal, and expert services.

A number of the services were already prohibited, in some form, either under existing SEC rules or the rules of the profession's self-regulators such as the AICPA and the ISB. Still, not all services on the SEC's list were proscribed at that time. Two of the services the SEC proposed to add as banned services — financial information systems design and implementation and internal audit outsourcing — were considered important components in the mix of consulting services rendered by some firms, including the firms that had rebuffed the SEC's attempts to get them to shed their consulting practices.

The SEC also required an annual proxy statement disclosure by SEC registrants of fees paid for each professional service provided by the registrant's independent audit firm, if the fees exceeded $50,000 or 10 percent of the audit fee, whichever was less.

The new restrictions on non-audit services and the fee disclosure requirements were the most controversial sections of the SEC's proposal. They generated tremendous opposition from the profession, many audit clients, some members of Congress, and others. Opponents even threatened litigation and the possibility of legislative preemption.

After a series of public hearings, the commission adopted an auditor independence rule in November of 2000 (Securities Act Release 33-7919). The rule incorporated a series of major compromises from its original proposal.

THE FINAL RULE

The final rule adopted an appearance-based standard to determine whether an auditor is independent. According to the standard, "an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment."

The rule gives four principles for determining whether an auditor is independent:

- An accountant cannot have a mutual or conflicting interest with the audit client.
- The accountant cannot audit his or her own work.
- The accountant cannot function as management or an employee of the audit client.
- The accountant cannot act as an advocate for the audit client.

For the SEC, grafting this appearance-based standard into the definition for determining when an accountant is not independent represented a major victory.

Compromises To satisfy objections from the profession about the vagueness of the new standard, the SEC placed the standard and the principles in a preliminary note to the final rule, rather than in the rule itself. The commission also compromised with opponents by scaling back the scope of the proscribed non-audit services. For example, in the final rule, the language describing the proscribed services more closely tracked extant rules; two services — financial information systems design and implementation services, and internal audit services — were allowed under certain circumstances, and expert services were dropped altogether from the list of proscribed services. However, the final rule emphasized that the specified non-audit services were not exhaustive, with the SEC reserving the right to further define the permissible scope of non-audit services inconsistent with its general standard of independence.

The rule retained a required proxy statement disclosure by registrants of fees paid to the auditing firm for audit and non-audit services. But here again, the SEC modified the proposed rule and required disclosure of fees in three categories: (1) fees for the basic audit, (2) financial information systems design and implementation fees, and (3) all other service fees.

The effect of that categorization is that registrants include in the third category, not the first, audit-related and assurance fees for services such as work performed in connection with registration statements, audits of employee benefit plans, due diligence procedures in connection with mergers and acquisitions, internal control services, and statutory audits. Even though the SEC did not consider those audit-related services or tax services problematic from the standpoint of independence, they "upped" the size of the amounts in the third category by commingling fees for audit, assurance, and tax services together with consulting fees. Thus, the categories fail to distinguish clearly between fees for audit and non-audit services, thereby biasing comparisons of basic audit fees with other fees.

A FAILURE OF THE REGULATORY PROCESS

The SEC's decision to propose and implement an Auditor Independence Rule is troubling for a number of reasons. The commission produced no empirical evidence of abuse. Audit clients voiced no concern to the SEC over auditors providing both auditing and consulting services. Moreover, the SEC had initiated a number of steps to have the profession and the private sector improve independence standards. Instead, by the rule, the SEC suddenly substituted its judgment for those of public companies and their audit committees in contracting for consulting services.

Lack of evidence The SEC's greatest difficulty throughout the process was its inability to produce evidence that the perceived conflict in providing non-audit services to audit clients did in fact impair audits. Our Panel on Audit Effectiveness emphasized that difficulty in late May of 2000 when we issued an Exposure Draft Report that identified no such evidence, even after we examined a large sample of audits. Indeed, our panel's report noted that, in about 25 per-

cent of the engagements in which audit firms provided both audit and non-audit services, the non-audit services had a positive impact on the effectiveness of the audits.

The SEC conceded such a lack of evidence but dismissed the point. In its June 2000 release, the commission asserted that "studies cannot always confirm what common sense makes clear." Again, in its final November rule, the SEC emphasized that "the danger lies in the gray area — where the pressure to bend to client interest is subtle but no less deleterious." In essence, the SEC sought a major restructuring of a business, and then resorted to rulemaking, solely on the basis of perception without demonstrating a negative impact on audit effectiveness.

The commission continues to be sensitive to the lack of empirical evidence to support the rule. In an address last summer to the Center for Professional Education, SEC acting chairwoman Laura S. Unger claimed that a just-announced enforcement action provided the "smoking gun," demonstrating the danger if an accounting firm provides non-audit services to an audit client. However, that action neither alleged a violation of auditor independence rules nor demonstrated a connection between the "failed" audits and the provision of non-audit services. Similarly, in the recent Enron affair, it remains to be seen whether there is any clear evidence to establish such a connection.

Usurping audit committees In the absence of empirical evidence, the commission's rulemaking relied upon appearance-based concerns by "a reasonable investor" to determine whether a non-audit service provided to an audit client might compromise the audit. The major problem with such a test is that "a reasonable investor" is in no position to determine whether a particular non-audit service might compromise an audit. The proxy statement disclosures do not reveal the complex facts that would explain why a client contracted with an auditor to provide a non-audit service. It is unreasonable to expect an investor — no matter how diligent — to obtain and analyze such facts. A reasonable investor can judge the overall quality of financial reporting, but the investor cannot be expected to make judgments about the numerous individual business decisions that enter into providing reliable financial reports.

After studying the issue, our panel emphasized the need for audit committees, acting on behalf of shareholders, to make those judgments on the basis of facts provided by management and the external auditors — facts that would not be available to a reasonable investor. One of the key responsibilities of an audit committee is to represent the "reasonable investor."

Furthermore, the SEC's initiatives had already enhanced that responsibility. As the Blue Ribbon Committee on Audit Committees was finalizing its recommendations, the ISB promulgated its first standard that required auditors to disclose annually to audit committees all relationships between the auditor and audit client that "may reasonably be thought to bear on independence," to confirm independence, and to meet with the audit committee to discuss the auditor's independence. By the end of 1999, the SEC had further strengthened the communication process by requiring audit committees to report on certain of their activities related to auditor independence in company proxy statements. Unfortunately, the SEC never gave those communications time to work before engaging in its rulemaking on non-audit services.

Moreover, the adoption of an appearance-based standard and the SEC's use of the initial wave of proxy disclosures to spread the message that non-audit service fees are relatively too large and indicate a lack of independence, can only give audit committees pause. Rather than have proxy disclosures invite scrutiny by the SEC and others to second-guess their assessments of auditor independence, audit committees are likely to conclude that it is "politically safer" to restrict their companies' usage of external auditors for non-audit services.

Even in the wake of the recent Enron affair, there is no clear evidence that the provision of non-audit services led to an impaired audit.

One final point from an investor or market perspective is noteworthy. Prior to engaging in rulemaking on non-audit services, there was little or no evidence of great public concern about the independence issue. On the contrary, the ISB had commissioned a report to determine if there was any public concern about whether the current business model of accounting firms compromised auditor independence. The vast majority of those surveyed did not find a real independence problem. In the public hearings on their proposal, the SEC sought to drum up support from many well-respected public figures for its conclusion that there was a perception problem. However, beyond an uneasy feeling among many of the witnesses about auditors providing non-audit services, no one came forward with any evidence that non-audit services impaired audits. And even shareholder activist groups were noticeably quiet on the issue.

Audit effectiveness Even if the SEC had evidence linking a failed audit with non-audit services, would that have been enough to warrant the commission's draconian approach? Here, the SEC did not do its homework on how non-audit services can enhance the performance of an audit. Our panel's report showed how, under certain circumstances, non-audit services improved audit effectiveness and rec-

ognized the importance of attracting a staff of non-auditors to provide those services.

In public hearings, most witnesses experienced in investigating financial fraud testified that the issue of auditor independence and non-audit services was rarely even raised in, let alone central to, fraud cases. Our panel reached a similar conclusion after reviewing evidence on audit failures, including the SEC's own evidence from enforcement actions. Moreover, some forensic auditors testified that certain frauds might have been prevented or detected if non-audit services had been provided to the client or if better communication had occurred between non-audit service personnel and the audit engagement team.

What was missing from the commission's proposal was an understanding of how American business now depends upon systems using information technology (IT) to manage and control their complex globalized activities. To audit the systems requires the help of specialists in IT and other areas. The auditing firm often is in the best position to supply a non-audit service that, in the words of our report, "facilitates the performance of an audit, improves the client's financial reporting process, or is otherwise in the public interest."

There was nothing but lip service given in the commission's proposal to the reality that revolutionary changes in the infrastructure of American business have required changes in the way audits are conducted. In our view, the SEC missed an opportunity to educate the investing public about such changes.

Finally, it should be pointed out that some firms that have separated their consulting units from their auditing services have had to rebuild consulting capability within the restructured auditing firms. Having audit support staffs with specialized expertise is critical to audit effectiveness. That expertise, whether for recurring or nonrecurring audit support, often resides with non-audit service personnel. When faced with the costs, inefficiencies, and quality concerns of outsourcing essential audit support, some firms have elected to rebuild their consulting capabilities.

Lack of support The SEC's proposal on non-audit services had little support from audit clients. Some came forward at the public hearings in active opposition to the commission's proposal. Financial Executives International (FEI), representing corporate chief financial officers, declined to endorse the non-audit services section of the proposed rule and urged the SEC to leave the matter with the ISB.

Unlike audits, which are mandated for public companies, non-audit services are voluntary contracts. Audit clients and the FEI pointed out that companies have the capability of choosing whether or not to purchase non-audit services and from whom, and they should continue to have the option of doing so. Some testified that they did not purchase non-audit services from their auditors without discussing the matter with their audit committees.

In the absence of strong public support for the proposal, the SEC launched a public relations campaign intended to drum up concern over auditor independence. The commission made frequent use of the bully pulpit and enlisted the financial press to demonstrate that there was a problem. At one point, while the rule proposal was out for comment, the SEC staff leaked to the press that it had information from current investigations linking failed audits with providing non-audit services. But the commission's final release contained no such information. Public relations could not remedy a defective proposal.

Because the evidence to justify an independence rule was rather weak, the SEC resorted to questionable tactics to achieve its ends.

Weakening self-regulation A final reason for why this episode represents a failure of the regulatory process is that it departed substantially from precedent. The SEC, over many years, has relied extensively on the profession to set standards for auditor independence. Only two years before the proposal, the SEC had recognized the ISB as the self-regulatory body to establish independence standards. The board had a distinguished membership with public members and a capable staff. Inexplicably, the SEC gave no reason for abandoning self-regulation and, in particular, for undermining the work of the ISB, which it had earlier championed. In its final rule, the SEC ironically incorporated much of the work of the profession's self-regulatory organizations, including the ISB.

The SEC further preempted the ISB's work by encouraging registrants and accountants to consult with the commission, not the ISB, before providing services or entering into relationships, including relationships involving the provision of non-audit services not explicitly described in the final rule. That part of the rule, together with the appearance-based test, has far-reaching implications and appears to preempt self-regulation of auditor independence issues. The coup de grâce came last July when the AICPA and the SEC jointly announced that the ISB would discontinue operations.

CONCLUSION

The SEC's rulemaking on auditor independence should be viewed as a failure of the regulatory process. Before a regulatory agency restructures a profession or a business, it

should possess solid, convincing evidence of abuse or market failure. In the absence of strong empirical evidence, accounting firms should be free to establish their own models for organizing themselves, and those models should be allowed to compete in the marketplace. The perception of a conflict is not sufficient to justify the imposition of a new business model through regulatory rule.

Because the evidence to justify a new independence rule was rather weak, the SEC resorted to questionable tactics to achieve its ends. The commission's proposal was issued at a time when some firms were considering selling or spinning off their consulting operations as the bull market in early 2000 encouraged firm managements to seek ways to monetize their investments in consulting. The timing of the SEC's failed attempt to divest consulting from auditing and its proposed rule on non-audit services could not help but raise the question of whether the proposal might give some firms a competitive advantage over others or soften their opposition to the proposal. Moreover, the firms that had decided to retain their consulting businesses found themselves adversely affected by the SEC's proposal.

Few question that the commission issued the proposal in good faith and that its appearance-based concerns were genuine. But the final rule appears to be tainted by the fact that some firms with an interest in favorable rulings from the SEC on divesting their consulting operations were active in the negotiations to fashion a compromise version of the SEC's proposal.

Although the SEC was not successful in enacting wholesale structural changes in the supply of non-audit services, the final rule issued by the agency sought the same result through changes in the demand for them. By implying that the size of fees alone indicates a lack of independence, the SEC sent a very clear message to audit committees of public companies: Do not use your auditors for non-audit services even when such services are cost-beneficial to the client or improve audit effectiveness. The combination of proxy statement disclosures, enhanced audit committee responsibilities, and the uncertainties of an appearance-based test eventually could result in auditors not providing non-audit services to audit clients, needlessly raising audit and non-audit services costs.

Whenever possible, a regulatory agency should rely upon the ability of contracting parties to analyze costs and benefits and, in the case of non-audit services, to make decisions that protect shareholders by insuring the independence of the corporation's auditors. For that reason, our panel's report emphasized the importance of audit committees in determining whether or not there were potential issues, whether perceptual or real, from supplying a particular non-audit service and suggested several factors to be considered by audit committees in making that determination. Even the SEC, after promulgating its final rule, acknowledged that point in a letter it sent to the chairs of audit committees of public companies reiterating the panel's guidance.

One of the most depressing aspects of the whole affair is that the SEC, in its eagerness to obtain an auditor independence rule, weakened self-regulation by the profession. The accounting profession, as gatekeepers to the public securities markets, has a special relationship with the SEC. It is vital that the SEC exercise restraint by not taking actions that diminish respect for the profession upon which the SEC relies. While the SEC, on one hand, prodded the profession to strengthen its self-regulatory structure through the Public Oversight Board, on the other, its proposal undermined that effort by engaging in direct regulation of matters that had traditionally been left to the profession to regulate. Only two years after approving the appointment of the ISB to regulate auditor independence issues, it left that organization twisting in the wind.

In our view, the SEC and the profession should return to self-regulation of auditor independence issues for several reasons. First, the profession's self-regulatory bodies have an extensive knowledge of the accounting business, the ability to adopt flexible responses to independence issues, and an understanding of the importance of maintaining auditor credibility with financial statement users. Second, the current rule (with its appearance test) has exposed auditors and their clients to large compliance uncertainty. New services or relationships could be deemed, after the fact, not to have complied with the general independence standards, subjecting auditing firms to SEC administrative proceedings. Audit clients could find themselves in possible violation of SEC regulations for having filed financial statements not attested to by independent auditors. Third, the current rule (with its basis in the perceptions of a reasonable investor) simply does not provide a basis for regulation because investors cannot have access to the facts upon which to make a judgment. Instead, the standard, in effect, empowers the SEC staff to judge whether a new relationship or service compromises auditor independence. The prior balance between SEC rulemaking and self-regulation needs to be restored and it will be the task of a strengthened Public Oversight Board, the AICPA, and others to restore that balance.

Finally, the auditor independence rulemaking appears to be an aberration; the SEC sought to compensate for the lack of intellectual rigor in its proposal by using other means to achieve its objective. We understand the need for sharp elbows in a tough regulatory battle. But, in this battle, the SEC overreached by using leverage over the profession in unfair ways to reach its goal.

However, it is important to place this episode in a broader perspective. Over the years, the SEC has developed a well-deserved reputation for high professionalism and the quality of its regulatory and enforcement work. The events surrounding the auditor independence rule do not diminish the many positive accomplishments of the SEC during the past several years to improve financial reporting and the quality of audits. Over the long run, those accomplishments will serve as the SEC's enduring legacy to improve accounting and auditing for the protection of investors. R