

Testimony of
the Fédération des Experts Comptables Européens (FEE)
(European Federation of Accountants)
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SEC public hearings on Proposed Rule Regarding Auditor Independence
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The Fédération des Experts Comptables Européens (FEE)¹ (Federation of European Accountants) thanks the Securities and Exchange Commission for the opportunity to testify on this important subject.

FEE, which has always been supporting the principle of global standards both on accounting and on auditing, is very much concerned by the U.S. SEC's proposed rule on auditor independence since:

- It would be applicable to the work of European Union based auditors who have European clients that are registered with SEC or subsidiaries of SEC registrants.

These European auditors are subject to independence requirements that are currently in the process of being developed by the European Union in cooperation with FEE along the same lines as those now being followed by the International Federation of Accountants and by the U.S. Independence Standard Board. FEE's concern is based on the fact that the approach of the proposed rule differs radically from that being applied in the European and worldwide projects. We believe that in the current and developing global economy, more international cooperation and harmonisation must be considered and the profession needs to continually strive for global solutions.

A worldwide general consensus in favour of the framework approach

We share the SEC's view that independent auditors play a key role in providing assurance to investors that the financial information disclosed by issuers is reliable. Furthermore, SEC emphasises the importance of both independence in fact and in appearance for the auditors, which is fully supported from a European point of view.

In 1998 the European accounting profession, through FEE, issued a policy paper called *Statutory Audit Independence and Objectivity*, which sets out a Common Core of Principles concerning independence issues. This paper has been well considered by the EU Commission's

¹ FEE aims to be the leading representative body of the European accountancy profession to the institutions of the European Union. FEE groups together 38 professional accountancy bodies in 26 countries and represents all together near 450 000 individuals.

Committee on Auditing as a basis for developing a European code of conduct and the European Commission has committed itself to a conceptual approach.

FEE has developed a conceptual approach considering the different kinds of threats that arise with respect to statutory audit independence and objectivity and the possible safeguards, including prohibitions, to offset these threats. Because most of the specific situations in which statutory audit independence and objectivity are at risk, or perceived to be so, are common in most of the European Union Member States, the document applies a conceptual rather than a rule based approach.

A very similar approach has been used by the Ethics Committee of the International Federation of Accountants (IFAC) in its proposed current draft revision of the section on independence on its *Code of Ethics for Professional Accountants*.

FEE also participates in ISB task forces and has so far commented on the following subjects using the conceptual approach:

- discussion memorandum on appraisal and valuation services,
- exposure draft employment with audit clients,
- discussion memorandum legal services,
- discussion memorandum conceptual framework for auditor independence.

This approach provides a set of fundamental principles which individual auditors can use to fit ethical dilemmas. Auditors are guided as to which threats they might encounter and which safeguards they might put in place to combat them. This analysis, by way of threats and safeguards, assists auditors in deciding their proper course of action.

FEE expresses a grave disappointment that the SEC proposals seem to ignore the conceptual approach losing the advantages of comprehensiveness and consistency offered by this approach. We consider the main weakness of the prescriptive approach is the need to have a multitude of detailed rules, which cannot cover all possible situations where the auditor's independence might be impaired.

The FEE Common core of principles

The common core of principles on statutory audit independence and objectivity published by FEE in July 1998 outlines in its first part the concepts governing statutory audit independence and objectivity. It explains the notions of independence of mind and independence in appearance and the expectations of those directly affected. The following extract sets out FEE's position on these issues.

The expression of an objective opinion should always be the ultimate goal of the statutory audit. Independence is the main means by which the statutory auditor demonstrates that he can perform his task in an objective manner. In dealing with independence, one must address both:

Independence of mind

I.e. the state of mind which has regard to all considerations relevant to the task in hand but no other; and

Independence in appearance

I.e. the avoidance of facts and circumstances, which are so significant that an informed third party would question the statutory auditor's objectivity.

Objectivity is essential for any professional person exercising professional judgement. This is particularly so for statutory auditors, whose professional opinions are likely to affect rights between parties.

In order to safeguard their objectivity, statutory auditors contemplating any work or engagement requiring objectivity of judgement should consider certain matters before deciding whether to accept a new contract or appointment, or whether to continue an existing appointment. The matters to be considered fall under the following headings:

- **The expectations of those directly affected** by the work and entitled to have a legal interest in its result.
- **The public interest** and its bearing on the work.
- **The environment** in which the work is to be conducted.
- **The threats to objectivity** that may actually arise or may appear to arise because of the expectations and the environment.
- **The safeguards** that can be put in place to offset the risks and threats.

Threats to objectivity can arise in a number of ways, some general in nature and some related to the specific circumstances of an assignment. In identifying threats, a statutory auditor should consider them in the light of the professional environment in which he is working. He should take into account the countervailing factors and the safeguards that assist him to withstand threats to his objectivity.

The risks or threats include the following:

- **The Self-Interest Threat or Risk.** A threat to the statutory auditor's objectivity stemming from a financial or other self-interest conflict.
- **The Self-Review Threat or Risk.** The apparent difficulty of maintaining objectivity in conducting what is effectively a self-review, if any product or judgement of a previous statutory audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching statutory audit conclusions.
- **The Advocacy Threat or Risk.** A risk to the statutory auditor's objectivity, if he becomes an advocate for (or against) his client's position in any adversarial proceedings or situation.

- **The Familiarity or Trust Threat or Risk.** A risk that the statutory auditor may become over-influenced by the client's personality and qualities, and consequently too sympathetic to the client's interest.
- **The Intimidation Threat or Risk.** The possibility that the statutory auditor may become intimidated by a threat, by a dominating personality, or by other pressures, actual or feared, by the client or an associate of the client or by some other party.

Where threats exist, statutory auditors should always consider the use of safeguards and procedures, which may negate or reduce them.

Non-audit services

Crucial to the issue of the simultaneous provision of non-audit services to audit clients is the question of independence in appearance. Perceived independence gives a reasonable interested third party confidence that the independent statutory auditor puts the interests of shareholders and other interested third parties first, responding to his duty towards the public interest. It gives confidence that those interests will not be compromised by any conflicting interest of the statutory auditor or the statutory auditor's client. However, practical experience of new developments in business, the evolution of financial markets, and the consequence for the company management and control of rapid changes in information technologies has demonstrated that in view of the wide range of possible situations, it may be impossible or inappropriate to draw up a comprehensive list of all those situations where the provision of non-audit services to an audit client would no longer be compatible. Secondly, the use of casuistic checklist may foster a mechanical attitude towards compliance with independence requirements.

Considering the benefits of the conceptual approach such as its flexibility to be applied to a wide range of threats and its capacity to reach appropriate decisions to circumstances that are not addressed by specific rules, we do indeed recommend that approach be applied for non-audit services.

Therefore, we disagree to the general rule that an auditor's independence is necessarily impaired if providing non-audit services to an audit client. In our view the provision of non-audit services to an audit client has no impact on the accountant's independence provided there is no involvement of the accountant in any decision-making of either the audit client or its management. In this case a self-review threat cannot be assumed.

The leading advantages of the framework approach

FEE believes that the framework approach is in practice more rigorous than a detailed rule-based approach offering a number of advantages, such as:

- The onus is placed on the auditor actively to consider independence issues for each engagement and to demonstrate that a responsible conclusion has been reached.
- It prevents the use of narrow legalistic interpretations to circumvent requirements.

- It allows for the almost infinite variations in individual circumstances that arise in practice and different legal frameworks.
- It can cope with the rapidly evolving business and audit environments of the modern world.
- It provides for absolute prohibitions where, but only where, no adequate safeguards are feasible.
- It can be useful not just to the auditor but also to other parties who make decision about auditor independence in situations where no specific rules or standards apply.

A conceptual framework, with goals, definitions, concepts, and basic principles, give powerful leverage to auditors or regulators professional experience and judgement when applied to independence matters.