September 9, 2000

TESTIMONY OF BEVIS LONGSTRETH BEFORE THE SECURITIES

AND EXCHANGE COMMISSION

SEPTEMBER 13, 2000

NEW YORK CITY

My name is Bevis Longstreth. I am grateful for this opportunity to address the Commission on its proposed revision to the auditor independence requirements, as set forth in Securities Act Release No. 33-7870. I am here (a) because of the large importance to public welfare of the issues being addressed, (b) because my professional experience and background give me a basis for contributing to the debate and (c) because, being retired, my freedom from entangling private interest -- other than the interest, which all in this country share, in having our investments soundly based on reliable financial information - gives me a chance to be as objective as humanly possible.

I am a retired former partner in the New York City-based law firm, Debevoise & Plimpton, where I spent the bulk of my professional career as a lawyer. I served as a Commissioner of the SEC from 1981 to 1984, an immensely happy duty that I enjoyed at the time and have missed since. Recently I served as a member of the Panel on Audit Effectiveness, which released its final Report and Recommendations, dated August 31, 2000.

The Proposal in General

I first want to congratulate the Commission, and particularly its Chairman, Arthur Levitt, for the vision and boldness embedded in this release and the rules it proposes. To many people away from the narrow corridor extending from the financial capitol of the world in New York City to the separated powers of Government in Washington, the idea that boldness, and, indeed, personal courage, would be required for a governmental powerhouse such as the SEC to propose such an obviously praiseworthy rule is strange. Yet I am convinced that's exactly what it took to propose the rule and that plenty more of the same will be called upon to adopt it.

This battle, and it is, clearly a battle, pits a legally created monopoly, dominated by five global accounting firms, against the SEC. The former, representing solely their private business interests, reject further restrictions on the free play of those interests. The SEC, acting upon the need for greater independence, a need long recognized by virtually every group assigned the task of considering the issue (and there have been many), has proposed a rule to meet this need.

Given the sharpness of the debate, and the transparency in this battle of the private vs. the public interest, there is more at stake in the outcome than just the independence of auditors. The independence of the SEC, itself, is being challenged as the accounting firms do all they can, on Capitol Hill, and throughout the business community, to bring

political pressure to bear against a proposal that can not be defeated by argument on the merits. As the New York Times put it in an editorial supporting the Commission: "The S.E.C. has proposed nothing draconian, only common-sense rules to make sure that outside auditors perform and appear to perform independent audits." In the tumult of the moment, the leaders of the accounting profession seem almost to have forgotten their origins as a profession granted exclusive rights, and reciprocal duties, to perform a vital public service. Although affected by the public interest as much as any public utility, the profession seems to want freedom from serious oversight or constraint. It won't wash. Not in a country where check and balance is king.

Before turning to the proposal itself, allow me also to congratulate the SEC staff, led by Lynn Turner, in turning out such a thoughtful, well considered and thorough set of proposed rules. The details are always important, and in this release there are plenty of them, not all of which I claim to have digested. But the release is good on explanation and inviting of scrutiny, comment and ideas for improvement.

Comments on the Rules Proposed for Non-Audit Service.

As must be evident by now, I am a strong supporter of the proposed rules overall. I think a narrowing of the attribution rules is desirable and so too is a carefully designed exception for inadvertent mistakes. I am going to limit my comments to the area of non-

audit services, however, because it is there that I have a particular interest and more knowledge to draw upon.

After much thought, I have concluded that an exclusionary rule for non-audit services is the best approach in addressing the independence problem. This rule would have limited exceptions. Rather than repeat the case for an exclusionary rule here, I have attached to my written testimony the statement in support of this rule contained in the Report and Recommendations of the Panel on Audit Effectiveness — a statement written and supported by some Panel members, of whom I was one.

The rule proposed in the release takes a more complicated approach in seeking to prohibit only certain types of non-audit services — those considered to be especially threatening to independence.

In section 2(e), the release acknowledges three important arguments against allowing significant non-audit services. These arguments center on the acknowledged difficulty of distinguishing between permissible and impermissible types of services. What is "impermissible" turns on whether the non-audit service meets one or more of the four governing principles for determining when an auditor is not independent. These principles, set out in 2-01(b)(l)-(4) of the proposed rule, render an accountant <u>not</u> independent if, during the period of audit engagement, the accountant:

1. Has a mutual or conflicting interest with the audit client;
2. Audits the accountant's own work
3. Functions as management or an employee of the audit client;
4. Acts as an advocate for the audit client.

The list of non-audit services determined by the Commission to be impermissible under these principles is extensive. And the principles by which this litmus test is informed are sound. Nonetheless, I think the approach incomplete because it ignores a principle as important, and arguably more important, than the four listed above. This principle is the auditor's vulnerability to economic pressure from audit clients. In section C (2) of the release, the Commission addresses this risk with force and effectiveness. It is discussed as a risk separate from the risk to independence arising from inherent characteristics of certain non-audit services. And yet, the governing principles do not address this risk at all. As the release acknowledges, as auditing becomes a smaller percentage of the firm's business with its audit clients, the auditor becomes increasingly vulnerable to economic pressures from those clients. If, for example, non-audit services constitute 80% of a firm's total billings to an audit client, the independence of that firm is called into question whether those services fit within the four principles or not.

It is not only the magnitude of non-audit service fees that creates the problem. It is the fact that a conflict of interest arises from the provision of virtually any kind of non-audit service to an audit client. This conflict derives from the fact that in performing these two kinds of services, the audit firm is really serving two different sets of clients:

(1) management in the case of non-audit services, which typically are commissioned by, and performed for, management, and (2) the audit committee in the case of the audit, which now is by rule commissioned by the audit committee and performed for that committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest. The firm is a fiduciary in respect to each of these two very distinct client groups, duty-bound to serve with undivided loyalty. It is obvious, and a matter of common experience, that in serving these different clients the firm will be regularly subject to conflicts of interest. These conflicts tear at the heart of independence, which is the freedom to exercise undivided loyalty to the audit committee and the investing public. When other loyalties tug for recognition, and they come from those in a position to enlarge or shrink one's book of business, the freedom necessary to meet one's professional responsibilities as an auditor is curtailed, and sometimes eliminated.

It is interesting to note that the proposed rule, in 2-01(C) (1), relating to disqualifying financial relationships between an accountant and its audit client, and (3), relating to disqualifying business relationships between the two, declares an accountant to lack independence for even small investments in the client by the firm or certain of its personnel or any direct business relationship with the client by the firm or certain personnel. One can imagine many, many financial and business relationships with an audit client that would, by these definitions, render an accountant not independent, yet be insignificant to the firm when compared to the revenues, past, present and future,

generated and expected to be generated from non-audit services performed for that client. Yet the definition of business relationships carves out the provision of professional services.

My point is not to suggest that the finely textured concerns over the independence-impairing effects of various financial and business relationships are misplaced. They reflect legitimate, albeit immeasurable, concerns. But they pale in significance when compared to the potential for impairment that comes from the financial and business stake that an audit firm will still be allowed to develop in an audit client through provision of permitted non-audit services.

One important premise on which the proposal argued for in the Report and Recommendations of the Panel on Audit Effectiveness was based was the superiority of a clean rule over a complex, finely textured one. The problems of interpretation, misunderstanding, avoidance and even evasion, now commonplace within the tax thickets of our land, will grow large as the complexity and detail of the rule increases. Here, as in most cases, effectiveness will be best achieved through simplicity.

Comment on Other Alternatives

Beginning on page 37 of the release, you discuss and invite comment on various alternatives to the proposed rule. In regard to the outright prohibition against non-audit services, the release repeats the exception included in the attached Statement, which I

believe gives the necessary room for the use by an audit client of its accountant's non-audit services under special circumstances where it is obvious that the best interests of shareholders will be served.

The segregation alternative, where a firm would separate its audit and nonaudit businesses into separate autonomous units, is not a satisfactory solution to the problem of independence. As long as there is a financial stake in cross-marketing the various services to an audit client there is a problem. It won't be solved by "firewalls" because the profit motive will cross under, over and through those walls to create the economic incentives and pressures that lie at the heart of the problem. For the Commission to struggle to create effective firewalls is to struggle towards artificial, and unnatural, channels of business within which the two units would be forced to operate, channels which are unlikely to be effective, but which, if they were effective, would defeat much of the business purpose behind having the two units within one business group in the first place. For the SEC, it would be very much a case of pushing the string instead of pulling it.

Another alternative mentioned in the release is to state that non-audit services will impair independence only when the aggregate fees for those services exceeds a certain percentage, say 25%, of the audit fee. If the Commission decides against a general prohibition along the lines of the proposal made in the Panel's Report, and attached to my written statement, I suggest that this alternative be adapted to form a fifth "governing

principle." I believe that 25%, however, is too large a number. Something closer to 10% seems about right. Of course, the problem with allowing any non-audit service is that the ability to market non-audit services at all will create the dual loyalty problem to which I referred earlier, and the prospect that some within the profession will be influenced, consciously or unconsciously, by their marketing role to the detriment of their role as independent auditor.

You also ask whether disclosure alone is sufficient to address the problem. I do not think so. I am strongly in favor of the proxy disclosure rule you have proposed, but only as an additional tool in service of the investing public and the financial intermediaries who advise them. I believe the disclosure should be in the proxy statement, because it has important bearing on both the election of directors and the appointment of the auditor. And on a more technical note, I believe the proposed rule, 14a-101, Item 9, should require disclosure of aggregate fees, audit and non-audit, paid to the registrant's principal accountant for all services rendered in each fiscal year. Without this disclosure, one will not be able to evaluate the relationship between audit and all non-audit fees and between disclosed and non-disclosed nonaudit fees.

Other Comments

In regard to the transition proposal, I think the idea a good one, but worry somewhat about having the two year period commence not on the date of the release proposing the

change but on the effective date of the rule. This permits firms at any time up to the effective date to enter into contracts providing for non-audit services to be rendered for up to two years thereafter. This opening would seem to do more than serve the needs of those legitimately disadvantaged by the rule's adoption.

Finally, a word on the authority of the Commission to adopt the proposed rule. I have seen in the press and heard from others that one or more of the accounting firms are gearing up to challenge the rule if it is adopted on the grounds that the Commission lacks authority to define the word "independent" in the Securities Act of 1933. 1 have read the citations in footnote 14 of the release and thought about this question. I think the authority of the Commission in defining the meaning of the term "independent" in reference to the "accountants" required by the Act to audit financial statements of issuers filing under the Act is clear and, indeed, a necessary element of its responsibilities. Were those seeking to overthrow the rule to argue the rule represented an abuse of discretion under the Administrative Procedure Act, they would invite a factual inquiry the conclusion of which, I predict, would not be at all to their liking. As I said at the outset, the principles on which the proposed rule rest are ones that can not be defeated by argument on the merits. Given the case presented by the Commission for adopting a rule along the lines of that proposed, it would only be a mistake of discretion were the

Commission to fail to enact something at least as comprehensive. And I cling to the hope that the approach of a general prohibition will gain your favor.

Bevis Longstreth September 4, 2000