STATEMENT SUPPORTING AN EXCLUSIONARY BAN ON NON-AUDIT SERVICES

5.32 Some members of the Panel believe that, with very limited exceptions, audit firms and their affiliates should be excluded by rule from marketing and furnishing management services to their audit clients that do not directly advance the interests of investors in objective and reliable financial reports on the stewardship of management. This position rests on the belief of these Panel members in (a) the central importance of independence to the profession of auditing in general, and to the effectiveness of the audit process in particular, and (b) the severe and growing challenges to independence that the audit profession faces in the current environment.

The Exclusionary Rule Described

5.33 For the reasons set forth below, we believe the Panel should recommend a rule (the "Non-Audit Services Rule") that, with the very limited exceptions described below, bars the provision of non-audit services to an audit client by either (a) the audit firm itself or (b) any firm affiliated with the audit firm, whether by reason of a control relationship or strategic or other business alliance or other arrangement that gives the audit firm or its partners a financial stake in the provision of non-audit services to such audit client by such other firm.

5.34 The Non-Audit Services Rule should be adopted by the SEC, which in turn should in the first instance look to (a) the ISB for the purpose of issuing detailed rules of implementation, and (b) the Public Oversight Board for the purpose of assuring effective enforcement of the Non-Audit Services Rule and the detailed rules of implementation.

5.35 The Non-Audit Services Rule would have application only to SEC registrants. Of course, the profession would be free to adopt the same or similar rules for application more generally to all audits conducted in the United States.

5.36 The Rule would define the category of services ("Non-Audit Services") to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of an audit. In general, the touchstone for deciding whether a service other than the straight-forward audit itself should be excluded from Non-Audit Services is whether the service is rendered principally to the client's audit committee, acting on behalf of investors, to facilitate, or improve the quality of, the audit and the financial reporting process rather than being rendered principally to provide assistance to management in the performance of its duties. The range of services, skills and personnel thus permitted to be employed in furtherance of the financial reporting process is in no way limited. The Non-Audit Services Rule adopted by the SEC would provide general guidelines to the ISB in writing detailed rules of implementation, which the Panel expects would evolve over time as the nature of the audit and the services

changed. We do not believe the Panel need resolve the many difficult definitional issues that the Rule will undoubtedly create. That would be the task of the ISB.

5.37 Without prejudging, we offer the following brief observations on two types of non-audit services. Tax work, although typically performed for management, is also frequently performed for, and subject to close scrutiny by, the audit committee and has traditionally been thought of as tightly related to audit work. Given the history, we believe tax work that does not involve advocacy should probably be treated as outside the barred category of Non-Audit Services. So too should attest work rendered as auditor in connection with SEC registrations or other SEC filings.

5.38 We believe the SEC's Non-Audit Services Rule should contain a carefully circumscribed exception to permit Non-Audit Services to be rendered by the audit firm to its client where special circumstances justify so doing. Use of the exception would require the following:

(a) Before any such Non-Audit Service is rendered to the audit client, a finding by the client's audit committee (which must consist only of independent directors) that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm or affiliate to render such Non-Audit Service and that no other vendor of such service can serve those interests as well;

(b) Forthwith upon the making of such finding by the audit committee, submission of a written copy thereof to the SEC and the POB; and

(c) In the company's next proxy statement for the election of directors, disclosure of such finding by the audit committee and the amount paid and expected to be paid to the audit firm or affiliate for such service.

Reasons Why the Exclusionary Rule Has Become Necessary to Protect Independence, both Now and Especially in the Future

5.39 There are a number of important and convincing arguments in favor of an exclusionary rule. In contrast, no other solution is likely to achieve the goal of protecting independence from the growing temptations and pressures that exist. A brief outline of the most important arguments appears below.

1. Of fundamental importance in understanding the conflict of interest that arises from the provision of non-audit services to audit clients is the fact that in so doing the audit firm is really serving two different sets of clients: management in the case of management consulting services ("MCS"), and the audit committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest, in the case

of the audit. The firm is a fiduciary in respect to each of these client groups, duty-bound to serve with undivided loyalty. It is obvious that in serving these different clients the firm is subject to conflicts of interest that tear at the fragile fabric of loyalty owed to one client or the other. And it is equally obvious that the existence of dual loyalties creates a serious appearance problem, regardless of whether, in particular cases, the fabric actually tears apart or not.

2. Our concerns with providing non-audit services to audit clients derive only in part from the well developed notions that (a) an auditor, directly or indirectly through others in the firm or affiliates, ought not to be put in the position of reviewing its own work, a concern clustered by the Independence Standards Board[19] around the term "self-review" and (b) an auditor, directly or indirectly, ought not to be put in the position of playing a management role through, for example, the exercise of managerial responsibilities or participation in management decisions. The essence of the concerns is the potential for impairment of independence, both in appearance and in fact, that emanates from the wearing of more than one fiduciary "hat" in the services provided, creating, willy-nilly, a dual set of loyalties. It is for this reason that our concern, and the solution advanced above, extend beyond non-audit services of the types encompassed by (a) and (b) of this paragraph 2.

3. Given the conflict of interest, it is not realistic to expect the firm itself to decide on its own independence. Even if the firm is correct in concluding that the existence of non-audit business with a particular audit client will not impair its independence, the conflict of interest inherent in the firm attempting to address this issue for itself, given its sharp self-interest in an outcome permitting the conduct of non-audit business, creates in the minds of objective observers a serious loss of credibility.

4. Nor is it feasible to expect independence to be assured by approval of the audit committee, because it is impossible to identify when the problem exists, and to challenge the auditor's judgment on the matter is to challenge its integrity, something audit committees are highly unlikely to do. Independence is a state of mind, necessary to maintain the skepticism and objectivity that are hallmarks of the accounting profession. Being subjective and invisible, it is not something an audit committee can apply

[19] See, e.g., Discussion Memorandum of Independence Standards Board, September 1999, "Appraisal and Valuation Services" and Discussion Memorandum of Independence Standards Board, December 1999, "Legal Services."

any known litmus test to determine. Moreover, the credibility problem would remain whenever there are substantial levels of non-audit services being provided. This problem has long been seen as of profound importance to the public maintenance of confidence in the audit function.

5. In a real sense the audit committee will remain blind to the existence of an independence problem unless the auditor acknowledges its existence. Regardless of the independence of the audit committee, and its willingness to cut back or eliminate entirely the non-audit services that have given rise to conflicting interests, the committee is wholly dependent on the auditor to identify whether a problem exists and how serious it may be. Such dependency is a very weak reed on which to base a solution that looks to the audit committee to assure independence, case by case, through a "facts and circumstances" test.

6. No one has suggested that the audit committee can be a substitute for clear rules where the problem of conflicts is most serious. Thus, for example there is no suggestion that the audit committee be charged with discretion to assess independence despite the existence of financial interests by the audit firm in its audit client. Stock or other financial interests in one's audit client have long been viewed as creating too clear a conflict of interest to become the subject of discretion. The need for an exclusionary rule on non-audit services is rooted in the same ground: prospective revenues from the provision of non-audit services, extending into the future, create precisely the kind of financial stake that produces a conflict of interest capable of impairing independence.

7. An exclusionary rule is relatively easy to administer. It does not preclude an audit firm from engaging directly or through affiliates in non-audit services. All business entities other than its audit clients are available for business. Thus, the Non-Audit Services Rule affirms the freedom of audit firms to engage widely in non-audit services and to attract and hold top-flight experts in IT and other non-audit services who must be available to assist in audit work from time to time. As the Panel's data show, consulting staff and practice have burgeoned in recent years, even though 75% of the Big 5 firms' SEC clients receive no consulting services from their auditors.

   The SEC made the same observation in somewhat analogous circumstances in 1989. In rejecting an application by Arthur Andersen to enter into an MCS venture with a client on the basis of Andersen's claim of immateriality, the SEC said: "the petition argues that the staff integration is anticompetitive in that it denies the accountant an

opportunity to compete by providing services in combination with its audit clients. The accountant is precluded only from entering into a direct business relationship with an existing audit client. The accountant is thus free to enter into the relationship with any party unless the direct business relationship is in effect during the period when the accountant is conducting an audit of that party."

In this same opinion the SEC rejected the argument that an exclusionary rule is contrary to the public interest in denying potential clients their choice of service providers, an argument likely to be advanced against the suggested rule as well. Thus: "the petition also asserts that the staff interpretation is injurious to the public interest because the public is deprived of the efficient delivery of the prime/subcontractor's technical non-attest services. The public interest with which the Commission is concerned, however, is the assurance of the integrity of financial statements filed with it. As discussed above, it is this objective which requires independence...." Moreover, the Non-Audit Services Rule allows the ban to be lifted when special circumstances make it compelling to do so.

8. As the Panel's report indicates under "Personnel Management" in Chapter 4, the system of compensation within the audit firms may not presently give adequate weight to performing the audit function with high levels of skill and professionalism. This fact may well adversely impact audit effectiveness. Success in marketing an audit firm's consulting services is a significant factor in the compensation system. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently skeptical, cautious and questioning in regard to management's financial representations. As long as the marketing of non-audit services by auditors to their audit clients is encouraged, expected and rewarded, there will exist a tension counterproductive to audit excellence. An exclusionary rule will eliminate both this tension and its harmful effects.

9. Some have considered addressing the problem of conflicts by banning this or that non-audit service that is thought to be especially troublesome. Legal and valuation services, for example. Our underlying objection to this case by case approach is that it would produce the sort of finely tuned evasion and concomitant enforcement proceedings that always follow from efforts to define narrowly what is a prohibited practice. (The essentially futile rules and re-rules of the FASB to determine when the lease of an asset must be shown on the balance sheet as a liability are a classic case in point.) Consider the recent announcement by one of the

Big5 that it will be acquiring a high-profile lobbying concern, one that would, in the words of one of its principals, enable the audit firm to help clients "get a law enacted ... and work with the actual statutory language." Are the halls of Congress so different from those of the courthouse that these would be permitted, "non-legal" services, as the acquiring audit firm apparently contemplates? This approach also puts the burden on those seeking to ban a particular non-audit service. We believe it is essential to start with an exclusionary rule for all non-audit services, and then to create limited exceptions where the risk of impairing independence is slight.

10. An exclusionary rule would be effective in rewarding those audit firms most sensitive to the independence issue and most scrupulous in seeking to avoid a real problem or the appearance of a problem. Exhortation and even disclosure, by itself, often encourage those willing to sail close to the line, or even cross over it. This result has the real and perverse impact of hurting the competitive position of the most sensitive and scrupulous audit firms, and in time encourages even those firms to drop their guard, and exploit the laxness in standards as well.

11. An exclusionary rule is a low cost premium on an important insurance policy for the whole profession, against governmental intervention to deny audit firms the right to do any non-audit work. The rule would go far toward eliminating the possibility of a major audit failure being linked to the influence of non-audit service business on the audit firm's diligence and skepticism, an event that would provide a basis, and possibly the momentum, for some radical solution like a total ban.

12. Independence is given important meaning in many analogous situations where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem entirely. Some observers would describe this strictness as an effort simply to preserve the <u>appearance</u> of independence. We agree, but only in the sense that it is solely by looking to what is observable directly that we can set the bar for the <u>fact</u> of independence, which is inherently indeterminate. Appearances matter, in sum, because the visible conflicts of interest are all that we have to go on. The rules forbidding audit partners from owning stock in the clients they audit and the rules tightly restricting the eligibility of corporate directors to serve on audit committees are but two examples of rules based not on the proven, but rather the presumed, dangers of conflicting interests.

    For example, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees determined that, for a director to be

independent for purposes of meeting the membership requirements of the audit committee, he or she must not accept compensation from the corporation for any service other than service as a director and committee member. The Blue Ribbon Committee noted that "...common sense dictates that a director without any financial, family or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The parallel to the auditor is both exact and compelling. Compensation for any service other than the audit would impair the auditor's independence.

13. Another useful analog is found in the NYC Bar Association report on law practice within the audit firm. This Statement of Position on Multidisciplinary Practice, appearing in *The Record*, September/October 1999, emphasized the incompatibility of the auditor's independence with the lawyer's duties of confidentiality. As a result, the Executive Committee of the NYC Bar Association stated its belief that "those roles are always intrinsically incompatible, and that any regime permitting MDPs should make clear that the same MDP may not provide both legal and audit services to the same clients." As early as 1962, looking at the same issue from the auditing side, the SEC decided that the independence of an audit firm was tainted when a partner in the firm rendered legal services to the audit firm's client.[20]

14. The provision of non-audit services is and can consistently be a profitable business without the door-opener of already serving a prospective client as its auditor. See, for example, Andersen Consulting. As noted in paragraph 7 above, notwithstanding the rapid growth in management consulting services, and the dominant share of firm revenues they now command, the provision of nonaudit services to most audit clients remains relatively small. Adoption of the exclusionary rule now would not have as large an impact on firm profits as many in the profession seem to fear. If the rule is put off, however, its likely impact on the firms when ultimately adopted will surely increase. Continued rapid growth in management consulting work is likely to mean an increase in the provision of such work for audit clients.

15. Audit services, standing alone, have been, are often today, and can consistently be a profitable profession in the future. As a statutorily mandated function capable of being performed only by licensed

[20] *American Finance Company, Inc*., 40 SEC 1043 (1962).

professionals who are organized chiefly in a handful of very large firms, there is ample pricing power to assure profitability. In our hearings, the audit firms claimed their auditing work was profitable, standing alone. Other commentators seemed to dispute this claim, believing the firms too often use auditing as a loss leader for marketing non-audit services. In either case, the rule we recommend will make it unnecessary to treat auditing as any kind of loss leader, because there will be no other services to be cross-marketed. The incentive to compete on price will be sharply reduced. Thus, charges for auditing will be adequate to attract and hold the quality professionals necessary to perform quality audits. Overall, the quality of audits should go up. To quote *The Economist* (1/15/00): "Of course, if accountants are barred from selling other services to their audit clients, then the cost of audits may well go up. But companies should be happy that they are not having their arms twisted into buying other sorts of advice from their auditors' colleagues. Auditors too would be freed from the insidious pressure of selling or reviewing colleagues' work. And for shareholders, surely the price of truly independent audits is one worth paying."

16. Whatever its merits in 1978, when ASR 250[21] was adopted, disclosure of non-audit services will not suffice today or for the future. In 1978 disclosure was widely seen as an indirect way to deter too much non-audit work for audit clients. The use of disclosure to shape substantive behavior has a long and often successful history at the SEC. In repealing ASR 250 in 1982, the SEC noted a lack of "utility to investors." The question of usefulness to investors is equally true today. How are shareholders expected to deal with the disclosure? For most, this or that piece of consulting work might not seem material, but independence is not for shareholders to choose, one by one. It is a public choice issue, much like clean streets; there is independence for all the shareholders or for none. More importantly, the scale of management consulting work and the pressures to cross-sell that we have described are of such growing magnitude that the less intrusive, and indirect, solutions of an earlier day are no longer adequate. The problem is structural, across our financial markets as a whole, and must be dealt with in those terms.

Using disclosure to assure independence in fact and appearance is a lot like pushing the string rather than pulling it. To some extent, with some clients, it may act as a brake on the growth of non-audit services sold to

[21] *Disclosure of Relationships with Independent Public Accountants* (SEC Accounting Series Release No. 250), June 29, 1978.

audit clients. Again, however, it will often serve to harm the most sensitive and scrupulous, while rewarding those willing to push the limits, despite transparency. We conclude, for all these reasons, that a direct rule of exclusion is far superior to the indirect route of disclosure.

17. There are arguments from the perspective of both the service provider and the service user that favor combining audit and nonaudit services for the same client. In marketing terms, there is an attractive link between auditing and management consulting. The one provides continuing access and credibility for the other. Auditing provides a matchless opportunity to uncover the competitive opportunities and risks of the client, which the management consulting group is then prepared to address. No other profession has the same ability, year in, year out, to work with large, public clients, on a worldwide basis, division by division. No other profession has the same privileged opportunity to reach regularly into the very sinews of the client, on a basis of complete candor and access. Indeed, for the profession of auditing, the law requires it. But this legally compelled access carries with it responsibilities importantly affected with the public interest. In these terms, management consulting is a business, not different from a host of others, and as the AICPA Professional Standards state, "differ[ing] fundamentally from the CPA's function of attesting" services. The paramount importance of independence to auditing means that to the extent cross-marketing, however efficient it might be to the audit firm, impairs independence, whether in fact or in appearance, the right to cross-market must give way. For those in the profession who value the audit function, this should be an easy trade-off to make.

18. Audit firms also argue on behalf of their clients that they are simply giving corporate management greater choice. But independence is not about management choice. Corporate management is the client for management consulting services, but for the audit the clients are shareholders (and the audit committee as surrogate), creditors and the investing public, all of whom need an objective, reliable report on management's stewardship. If offering corporate management a choice of using its audit firm to supply a full range of other services threatens to impair this oversight function, on which the credibility of our markets depends, then the denial of that choice is simply a cost - a minor one at that - of preserving investor confidence in our financial system. Indeed, the proposed rule is the least intrusive method we could imagine for achieving this essential goal.