The CRE Disclosure Alternative
To the SEC's Auditor Independence Rule --
With Sunset Provision

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PREFACE

With the onset of the millennium, command-and-control regulation is being replaced by regulatory approaches based on public disclosure. This disclosure option is being used widely in environmental health and safety regulation, as well as in other areas. CRE's opinion is that if the disclosure approach is adequate to protect the environment and worker health and safety, it is the appropriate vehicle for protecting the wealth of American investors. In short, if disclosure can protect your health, it can protect your wealth.

The enclosed paper is a disclosure alternative to the SEC's command and control proposal. However, recognizing the SEC's concerns in this area, CRE is recommending that the SEC adopt the six options presented with a sunset provision. That sunset provision would require the SEC to examine the efficacy of the policy after five years. If the Commission concluded that these disclosure measures were inadequate, it would then take additional actions, after notice and an opportunity for public comment, including command-and-control regulation.
Procedures for Disclosure of Nonaudit Activities of Accounting Firms:  
A Proposal to Ensure Auditor Independence

Introduction

The SEC’s proposed revision to the rules on auditor independence,¹ would impose serious limitations on the types of nonaudit services that accounting firms may offer their audit clients. A more market-oriented approach requiring disclosure of non-audit services, on the other hand, would build upon existing private sector mechanisms and current SEC standards and safeguards. While command-and-control regulation is certainly one alternative for addressing a perceived need to protect auditor independence, the same result arguably can be achieved through the less onerous alternative of increased disclosure.

William T. Allen, Chairman of the Independence Standards Board (ISB) noted in his testimony on the agency’s proposed rule, that market-oriented disclosure -- not regulation -- is the optimal means to address the auditor independence issue:

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.

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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.

(Statement of William T. Allen before the SEC, July 26, 2000.) The Center for Regulatory Effectiveness (CRE) concurs in this view.

¹ See 65 Fed. Reg. 43,148 (July 12, 2000).
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CRE also believes that a disclosure approach is in keeping with the good government principles outlined in Executive Order 12866, which mandates, "Each agency shall tailor its regulations to impose the least burden upon society." Use of a disclosure-based approach which builds upon existing consensus standards is also consistent with the requirements of the National Technology Transfer and Advancement Act of 1995.³

This paper examines a number of existing market-oriented disclosure procedures and other self-regulatory mechanisms designed to ensure auditor independence. CRE recommends that the SEC adopt these models, or a combination of these models, as an alternative to the sweeping changes on the scope of permissible non-audit services that the Commission has proposed.

Recommended Procedures for Disclosure of Nonaudit Activities of Accounting Firms

(1) Disclosure Through Compliance with ISB Standard No. 1

The Independence Standard Board is a private sector body that arose out of discussions between the American Institute of Certified Public Accountants (AICPA) and the SEC. As noted by the SEC in its Authorizing Release (FRR-50):

After careful consideration, and without abdicating its statutory responsibilities, the Commission intends to look to a standard-setting body designated by the accounting profession – known as the Independence Standards Board ("ISB") – to provide leadership not only in improving current auditor independence requirements, but also in establishing and maintaining a body of independence standards applicable to the auditors of all Commission registrants."

One of the ISB’s first actions was to issue ISB Standard No. 1. The crux of that standard is a requirement that auditors delineate to corporate audit committees any matters – including the provision of nonaudit services – that could impact upon auditor independence. Through such disclosure to the audit committees, the issue of independence is addressed in a forthright manner, and the audit committee may assess potential problems and the need for additional safeguards.

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² Executive Order 12866, § 2866 § 1(b)(11). Even though the Executive Order is not formally binding on rulemaking proceedings conducted by independent agencies, the SEC agreed to abide by its principles a number of years ago.

ISB Standard No. 1 currently states:

This standard applies to any auditor intending to be considered an independent accountant with respect to a specific entity within the meaning of the Securities Act ("the Acts") administered by the Securities and Exchange Commission. At least annually, an auditor shall:

(a) disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;

(b) confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Acts; and

(c) discuss the auditor's independence with the audit committee.

(2) Disclosure Through Compliance with the SEC's Audit Committee Disclosure Rule

As currently required under the SEC's Audit Committee Disclosure rule (Release No. 34-42266, December 22, 1999), companies must certify in their proxy statements that their audit committees have undertaken the relevant discussions with their auditors relating to auditor independence. (The substance of these discussion would not need to be disclosed.)

Specifically, the SEC regulation requires disclosure in the proxy statement whether the audit committee has (i) reviewed and discussed the audited financial statements with management, (ii) discussed with the auditors any matters relating to independence, and (iii) received from the auditors the disclosures required under ISB Standard No. 1.

(3) Disclosure Through AICPA Membership Provision Requiring Reporting of Nonaudit Services and Related Publication

As a condition of membership, the SEC Practice Section (SECP) of the Division of Firms of the AICPA requires member accounting firms to disclose nonaudit service activities for clients that file with the Commission. All member firms must provide the following information in an annual report to the SECP, and this information is available to the public, on a firm-specific basis, upon request:
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- Gross fees for accounting and auditing, tax, and management advisory services from registrants, and management advisory services from all other clients, expressed as a percentage of total gross fees.

- Gross fees for management advisory services, tax and accounting and auditing services performed for SEC audit clients, expressed as a percentage of total fees charged to all SEC audit clients, and the number of clients that receive such type of service.

- A chart indicating the number of clients for whom fees for management advisory services performed for SEC audit clients represent percentages of audit fees charged to such clients in the ranges of:
  - 1% to 25%
  - 26% to 50%
  - 51% to 100%
  - over 100%

- Section members are also required to report annually to the client’s audit committee or board of directors the total fees received from the client for management advisory services during the year under audit and a description of the types of services rendered.

AICPA also published aggregates of this information at one point in a series of SEC Practice Section Annual Reports which were available to investors and other interested members of the public. Specifically, the Annual Report contained a summary table referring to information on nonaudit fees and services for all Section members. Such reporting was discontinued, with the last report issued June 30, 1997, largely due to the publication of nearly identical information by the Public Oversight Board. However, SECPS’ cessation of publishing this information has been cited by the SEC as one reason for its proposed rule on auditor independence.

Responding to criticism at the discontinuation of this information in its SECPS Annual Report, the Section plans to post summary of the above nonaudit services information on the AICPA website for the end of each calendar year. SECPS plans to make the first set of such data available for CY 2000.

(4) **International Disclosure Standards and Other Safeguards Designed to Ensure Auditor Independence**

International ethical standards already exist for maintenance of auditor independence. The approach consistently applied involves monitoring of the accounting firm-client relationship for threats to independence and adoption of various safeguards, as necessary. Rather than categorically prohibiting certain nonaudit functions, in those circumstances (identified on a case-
by-case basis) where no safeguards can overcome the threat to independence, an audit transaction may need to be foregone. However, this outcome is likely to prove the exception rather than the rule.

A. **International Federation of Accountants**

The International Federation of Accountants (IFAC) in its *Code of Ethics for Professional Accountants* has taken the position that provision of nonaudit services to audit clients is both expedient and appropriate provided that adequate measures are taken to ensure auditors’ independence. Section 8.5 of the IFAC Code states in relevant part:

8.5 When a professional accountant in public practice, in addition to carrying out an audit or other reporting function, provides other services to a client, care should be taken not to perform management functions or make management decisions, responsibility for which remains with the board of directors and management.

**Commentary**

It is economic in terms of skill and effort for professional accountants in public practice to be able to offer other financial and management consultancy services to their clients since they already have a close familiarity with the client’s businesses. Many companies (particularly the smaller ones) would be adversely affected if they were denied the right to obtain other services from their auditors....

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The services provided by a professional accountant in public practice in the fields of management consultancy and taxation are advisory services. Such services should not usurp the management functions of client companies. The independence of a professional accountant in public practice is not impaired by offering advisory services, provided there is no involvement in or responsibility assumed for management decisions. The provision of other professional services is not in principle a factor in determining whether the professional accountant in public practice is independent. Nevertheless, the
professional accountant in public practice should be careful not to go beyond the advisory function into the management sphere.

In an Exposure Draft issued in June 2000, IFAC discussed a series of safeguards that reporting accountants can take to resolve or reduce risks to independence. Section 8.18 of that paper lays out these safeguards in three broad categories:

1. Safeguards created by the profession:
   - educational, training and experience requirements for entry into the profession;
   - continuing education requirements;
   - external review of a reporting accountant’s quality control system.

2. Safeguards within the entity that is the subject of the assurance engagement, including the following:
   - the appointment of a reporting accountant by persons other than the entity’s management;
   - the employment of a high-quality staff in sufficient numbers to ensure that a reporting accountant does not make managerial decisions for the entity;
   - internal procedures ensuring objective choice in commissioning non-assurance engagements;
   - a corporate governance structure that provides appropriate oversight and communications regarding a reporting accountant’s services.

3. Safeguards within the reporting accountant’s own systems and procedures aimed at reducing risks to independence, including one or more of the following (as well as other methods not listed here):
   - policies and procedures intended to promote quality control of assurance engagements;
   - policies or procedures that will enable the identification of such interests or relationships between the reporting accountant and assurance clients;
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- ensuring that staff are empowered to communicate to senior levels within the practice any issue of independence and objectivity that concerns them; this includes ensuring that staff are aware of the procedures open to them;

- considering to what extent safeguards exist within the practice;

- involving an additional professional accountant in public practice who did not take part in the assurance engagement to carry out reviews of the work done or otherwise advise as necessary;

- consulting a third party, such as a committee of independent directors, a professional regulatory body or another reporting accountant;

- rotation of senior personnel;

- policies and procedures to assess whether particular risks in specific circumstances can be interpreted as clearly insignificant;

- documenting, for each assurance engagement, whether there have been circumstances and facts that may have impaired a reporting accountant’s independence, how the risks were assessed and which safeguards were taken to avoid, negate or, at least, reduce the risk to an appropriate level;

- refusal to perform, or withdraw from, an assurance engagement where the risks posed by certain activities or interests of a reporting accountant cannot be eliminated or limited by other safeguards and where the reporting accountant chooses not to eliminate those activities or interests.


**B. Institute of Chartered Accountants in England and Wales**

The Institute of Chartered Accountants in England and Wales similarly advocates this identification of risk and “safeguard” approach. With respect to provision of nonaudit services, the Institute takes the following position:

There is no objection to a firm providing advisory services to a company which are additional to the audit. Care must be taken to ensure not to perform management functions or to make
management decisions. It is economic in terms of skill and effort for professional accountants in public practice to be able to provide other services to their clients since they already have a good knowledge of their business. Many companies (particularly smaller ones) would be adversely affected if they were denied the right to obtain other services from their auditors.

(Institute of Chartered Accountants in England and Wales Guide to Professional Ethics, §4.56.)

The Institute’s approach is again to identify threats to auditor independence and take appropriate safeguards, where possible, to eliminate the threat. Section 1.201 of the Institute’s Guide to Professional Ethics deals with “Integrity, Objectivity and Independence,” and in relevant part, paragraphs 3.5 and 3.6 state:

3.5 Steps taken by firms to ensure that threats to objectivity are recognised [sic], documented and mitigated

These might not be disclosed to outsiders unless disciplinary or regulatory follow-up requires it. Examples of internal procedures within firms which may contribute to reassurance that the required audit objectivity has been preserved include:

(i) Arrangements to ensure that staff are adequately trained and empowered to communicate any issue of objectivity that concerns them to a separate principal.

(ii) The involvement of an additional principal (in the case of a sole-practitioner, a qualified colleague) to carry out a review or otherwise advise. (See 3.6 below.)

(iii) Rotation of engagement partners and staff.

(iv) The evaluation of a potential client when a firm is approached to act, to assess such facts as the integrity of the client’s management, company profile, accountancy competence, etc.

(v) Formal consideration and review of the continuance of all engagements before the firm’s name is allowed to go forward for reappointment as auditor.

(vi) An overall control environment, starting with a professional approach towards matters of quality and ethics, and taking in staff training, development and performance appraisal, and the assurance provided by a regularly monitored and evidenced control system.
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3.6 Review Procedures

(i) Wherever the review procedures indicate that an audit assignment should be accepted or continued only with additional safeguards against loss of objectivity, the engagement partner’s decision and the range of safeguards appropriate to the assignment should be subject to independent review by a partner unconnected with the engagement.

(ii) The safeguards to be applied should include, as appropriate, rotation of the audit engagement partner and of senior audit staff. In particular the firm should review annually the possible need for rotation of an audit engagement partner.

(iii) It is a useful practice to keep records of all reviews carried out.

Recognizing the role of public perception, the Institute goes on to state in Section 3.10:

It follows from the preceding paragraphs that the perception of the public (or any section of it) that an auditor’s objectivity may be threatened is not, of itself, a reason why an appointment should be refused. The countervailing pressures and safeguards described above may often override a threat. Members and firms are encouraged to make clients and others outside the profession aware of the extensive and sophisticated compliance procedures that they employ.

CRE agrees with the Institute’s position that while public perception should be kept in mind, it should not be the decisive factor in judging auditor independence or the decision to enter business engagements.

(5) Education of Accounting Professionals Regarding Risks to Auditor Independence and the Importance of Disclosure

Auditor independence is by-and-large treated as an ethical issue among the major national and international accounting professional societies. Thus, concerns with auditor independence should first be addressed to accounting professionals themselves, through education as to the importance of disclosure of activities which could have a bearing on independence and any new disclosure measures which are adopted. Such information could be relayed to the professionals through a variety of means, including:

• Technical releases;
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- Member handbooks;
- Professional journals;
- Newsletters;
- Reports on disciplinary hearings;
- Financial and business trade press;
- Continuing professional education;
- Responses to requests for advice from the relevant committee.

(6) Disclosure Through Additional Reporting Requirements in a Company’s Proxy Statement

As previously noted, the SEC should carefully examine and implement all of the foregoing disclosure models and other safeguards outlined in recommendations (1) through (5), either in the form of a proposed rule or agency guidance. If, but only if, the SEC determines that these recommended safeguards are still insufficient to ensure auditor independence, then additional disclosure in an SEC registrant’s proxy statement may be warranted. The SEC should then retain only those portions of its proposed rule that deal with disclosure. These provisions are very similar to the disclosure requirements which the SEC had in place from 1978 through 1982 under Accounting Series Release No. 250 (June 29, 1978).

As legitimate concerns have been expressed regarding the details of these disclosure elements, the SEC should enter into a dialogue on these elements with the accounting profession, registrants, and other interested stakeholders to determine the nature and level of information which should be reported.

(7) Sunset Provision

The SEC should adopt the foregoing recommendations (1) through (6) either through guidance or regulation. At the conclusion of five years, the SEC should review the impact which the following measures have had on ensuring auditor independence. If the agency determines at that time that these disclosure provisions and related safeguards have not had their desired effect, the SEC would then consider additional measures, including additional regulation.