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THE SEC'S AUDITOR INDEPENDENCE RULE:
MISSING THE BOAT ON INDEPENDENCE

Mark A. Gullotta*

I. INTRODUCTION

The Securities and Exchange Commission ("SEC") is the governmental agency responsible for the regulation of securities traded on public exchanges. Recently, the SEC amended Rule 2-01 of Regulation S-X and Item 9 of Schedule 14A, effective February 5, 2001, to update the independence standards for auditors of public companies in the United States. The change is meant to modernize the independence rules with which audit firms must comply in order to audit annual financial statements of publicly traded companies.

At the heart of the debate is whether accounting firms should be permitted to provide "non-audit" services to their clients. Under the amended rules, the ability of accounting firms to perform such services will be greatly limited. This change will have significant ramifications for the accounting industry, the public companies that rely on their expertise, and the securities markets within the United States.

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3. Id. § 240.14a-101 (mandating disclosures by independent public accountants in proxy statements).
5. See id. at 76,008. A publicly traded company is one whose securities are traded on a national public exchange. For procedural requirements on the registration of securities to be traded on a national exchange, see 15 U.S.C. §781.
7. See id.
The SEC’s response to a perceived problem with auditor independence is misdirected. Private firms should not perform audits at all. The SEC’s response should instead target the heart of problem. The government, rather than private, profit-minded participants, should perform audits. Only then can independence be assured.

II. BACKGROUND

A. The Securities Exchange Act of 1934

Enacted partly in response to the stock market crash in 1929, the purpose of the Securities Exchange Act of 1934 ("Exchange Act") was to restore faith in the security exchange markets.8 One result of the Exchange Act is that all public companies are required to obtain independent audits of their year-end financial statements.9 To prevent companies from manipulating their financial reporting, an accounting firm is asked to review the reports and issue its own report stating, in effect, that the report is reasonably accurate.10 Thus, investors in public securities are not forced to rely solely on the company’s own assurances.

One of the most important requirements of an audit is that an independent accountant, who is free from any bias in favor of the audited company, must perform it.11 The reason for this requirement is simple: the auditor is issuing an opinion regarding whether the financial statements are materially accurate. Therefore, it is important that the opinion be objective and unbiased.12 Even if an auditor who was not independent could be objective, investors and others relying on the audits might not be so easily persuaded.13

B. The Audit Process

All public companies are required by the SEC to report their financial statements and have those statements

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10. See id.
13. See id.
audited. Under the current model, public companies obtain and pay an accounting firm to perform an independent audit. After the audit is complete the auditors issue a letter or opinion stating whether the financial statements materially conform with Generally Accepted Accounting Principles ("GAAP"). If the auditors find that the financial statements do not conform to GAAP, and the public company refuses to make the necessary changes to bring them into conformity, the auditors will issue a letter to that effect, stating the deficiencies.

Auditors are legally accountable for their work. They can be sued both by investors that relied on the auditors opinion, and by the SEC. Violations of the Exchange Act carry penalties including fines, revocation of license to practice accounting, and criminal penalties.

Much of what an audit requires is a review by the auditors of the accounting principles used by the company and an analysis of the estimates made in preparation of the company's financial statements. The application of these principles depends on the particular business situation. Estimates can vary greatly as well. Auditors interview management, confer with outside sources (regarding such topics as valuation), and look to industry standards to determine if the principles applied and the estimates made are reasonable.

17. Materiality is the amount by which a financial statement can be erroneous but not cause an investor to change his mind regarding investing in the company. This standard of review is intended to prevent audits from becoming too costly and time consuming. See id.
18. See id.
19. See DEFLIESE ET AL., supra note 11, at 133.
20. See id. at 143.
22. The Financial Accounting Standards Board ("FASB") establishes the accounting principles used by public companies. These accounting principles are known collectively as generally accepted accounting principles ("GAAP"). Not only is a public company required to adhere to these principles when preparing their financial statements, but they also must abide by SEC rules. While the FASB establishes the standards of accounting, they do so only at the pleasure of the SEC. The SEC has full authority to enforce their reporting requirements, as well as any violations of GAAP. See generally 15 U.S.C. § 78j-1.
23. See id. at 190.
If an auditor's judgment is biased and unreasonable estimates are reported to the public, investors, as well as anyone else in the financial community who relies on the estimates, will likely make poor investment decisions.  

If investors or the financial community begin to believe that the financial statements of public companies are not accurate, they would, over time, be less likely to invest in the stock market.  

This lack of faith and withholding of investments would eventually destroy the financial markets in this country.  

It is this situation which the SEC is attempting to prevent with the auditor-independence amendments.

C. Establishing Independence Standards

State boards of accountancy, state legislatures, bar associations and professional organizations, such as the American Institute for Certified Public Accountants ("AICPA"), generally establish standards for independence. 

Most recently, the AICPA established the Independence Standards Board ("ISB"), which seeks "to provide leadership not only in improving current auditor independence requirements, but also in establishing and maintaining a body of independent standards applicable to the auditors of all Commission registrants."  

In November 2000, after much criticism by the AICPA, the SEC in an unusual move acted in place of these standard-setting bodies and issued the amendment.

D. The Changing Accounting Industry

One catalyst for the SEC's decision to enact the amendments is the changing dynamic of the accounting industry.  

Over the past two decades the eight largest accounting firms

24. See McLucas et al., supra note 6, at 468.
25. See id.
27. See id.
28. See McLucas et al., supra note 6, at 468. See also Defliese et al., supra note 11, at 66.
30. See McLucas et al., supra note 6, at 468.
have consolidated down to only five, also known as the "Big Five." The Big Five perform the lion's share of audits for public companies in this country. Smaller, or regional firms also perform audits for public companies. However, most small firms do not perform this type of audit because of the high risk of litigation involved.

The reduction of firms over the past two decades is the result of mergers between the largest accounting firms. As companies began to operate globally and sell goods and services to markets all around the world, accounting firms have also felt the need to expand. Mergers have allowed accounting firms to increase market share, and to be more competitive in the U.S. and abroad.

E. Non-Audit Services

While accounting firms continue to provide traditional services such as tax services, many have become more multi-disciplinary and now offer new types of services to their audit clients. These new services include internal audits, pension services, financial consulting, administrative services, actuarial services and marketing functions, among others. More


33. Comparing accounting firms with at least 20 SEC audit clients, the Big Five firms had 12,769 SEC audit clients, or 92%, of a total of 13,924 clients. See Independence Focus Shifts to States, PUB. ACCT. REP., Sept. 15, 2000, at 4 tbl.

34. It is also important to note that many public companies prefer to use the Big Five accounting firms because of their reputation. Most large companies find it advantageous to be associated with well known and reputable firms. This association, in turn, lends credence to companies' financial statements.


36. See McLucas et al., supra note 6, at 486.


38. See id.
recently, accounting firms have attempted to expand their services to include certain legal services. However, they are currently prevented from practicing law in the United States by the American Bar Association.

Revenues of the Big Five in the United States for management advisory and similar services amounted to more than $15 billion in 1999. The revenue for such services is now estimated to constitute half of the total revenues for these firms. In contrast, these services provided only thirteen percent of total revenues in 1981. The average growth rate for revenues from management advisory and similar services is twenty-six percent per year, whereas growth in audit services has averaged nine percent per year in audit services.

This means that accounting firms are relying more on non-audit services performed for audit and non-audit clients. Currently, there is no evidence that this trend will slow in the future. However, the SEC fears that as auditors receive more fees from clients for non-audit services, clients will exercise economic leverage over auditing firms to influence their opinion on the financial statements.

F. The Changing Financial Markets

The operation of securities and financial markets is also changing. Public companies are coming under heightened pressure to meet earnings expectations set by analysts. This pressure has led to increased emphasis on corporate earnings in recent years. For example, stock prices routinely rise and

39. Hence, accounting firms' management consulting practices have expanded far beyond the skills required for audit support and the traditional areas related to financial planning and controls including investment banking and legal services. See id. at 76,024-26.

40. According to the ABA model rules, attorneys who partner with non-lawyers, such as in an accounting firm, are prohibited from the practice of law. See MODEL CODE OF PROF'L RESPONSIBILITY R. 5.4 (2000).


42. See id.

43. See id.

44. See id.

45. See id. at 76,014.

46. See id. at 76,013-14.

fall based on whether or not a company meets its projected earnings. Often a company’s stock price will fall dramatically if it fails to meet earnings per share by as little as one cent per share. This trend is causing public companies to manage their earnings. A public company manages its earnings by making financial reporting decisions based on the amount of earnings or losses it wants to report for a particular period.\textsuperscript{48} However, accounting decisions should be made on managerial estimates and business forecasts without regard to what profit or loss the company will have. The pressure to manage earnings increases the likelihood that a company will make estimates that border on the unreasonable.\textsuperscript{49} These situations lead to intense pressure on auditors to go along with the estimates, although they may have some doubt as to their reasonableness. The SEC fears that as these situations become more common, there is a greater likelihood that an auditor’s independence may become impaired.\textsuperscript{50}

G. The Appearance of Independence

Most of the controversy over the new rules comes from the increased importance of “independence in appearance.”\textsuperscript{51} As auditors offer an increasing amount of non-audit services to their audit clients, it is feared that the appearance of independence and objectivity will erode, even if actual independence does not.\textsuperscript{52}

The SEC claims that they are less concerned with whether an auditor would actually allow himself or herself to be influenced by an audit client, and are more concerned with the appearance of bias to the public.\textsuperscript{53} The SEC, in the final draft of the rule amendment, expressed this sentiment.\textsuperscript{54} The concern is that auditors will be seen both by themselves and

\textsuperscript{48.} See id.  
\textsuperscript{49.} See Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. 76,008, 76,014.  
\textsuperscript{50.} See id.  
\textsuperscript{51.} The Revision of the Commission’s Auditor Independence Requirements makes auditor independence in appearance as important as independence in fact. See id. at 76,030. Under this concept, independence is impaired when it would appear to a reasonable investor that the person is not independent, even though, in fact, he is. See id.  
\textsuperscript{52.} See Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,030.  
\textsuperscript{53.} See id. at 76,030-31.  
\textsuperscript{54.} See id.
by others not as exacting, skeptical professionals who must be satisfied before signing off on the financial statements, but more like any other service vendor who must satisfy the client in order to make the sale.\textsuperscript{55}

As evidence of this "growing public concern," the SEC points to a number of reports stating that the increasing volume of non-audit services has the potential to compromise auditor independence.\textsuperscript{56} "We act on the basis of our evaluation of the potential impact of non-audit relationships on audit objectivity and also on the basis of indications that investor confidence is in fact affected by reasonable concerns about non-audit services compromising audit objectivity."\textsuperscript{57}

Similarly, the AICPA cites a study it commissioned that shows concern for "[r]elationships [that] could erode auditor independence."\textsuperscript{58} It is important to note that nowhere in the SEC's ruling does it state that auditor independence is currently in jeopardy.

H. Restrictions on Non-Audit Services

With the mindset that non-audit services create economic incentives that \textit{may} inappropriately influence the audit, the SEC amended the existing independence rules, bypassing the private standard-setting bodies.\textsuperscript{59} Among the aspects of the independence rules that were "modernized" were the definitions regarding which individuals were subject to the independence rules in the first place.\textsuperscript{60} These rules, for the most part, were accepted by the accounting community as a change for the better. However, the main thrust of the amendment, which was the subject of much controversy, was the establishment of a non-exhaustive list of non-audit services that, if engaged in by the auditors, would be an outright impairment of independence. These services are summarized as follows:

1. \textit{Bookkeeping Services}

An auditor's independence is deemed to be impaired

\begin{itemize}
\item \textsuperscript{55} See id.
\item \textsuperscript{56} See McLucas et al., \textit{supra} note 6, at 467.
\item \textsuperscript{57} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,014.
\item \textsuperscript{58} Id. (emphasis added).
\item \textsuperscript{59} See McLucas at al., \textit{supra} note 6, at 468.
\item \textsuperscript{60} See Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,031-32.
\end{itemize}
when the auditor performs bookkeeping services for an audit client, with certain exceptions.⁶¹

2. Financial Information Systems Design and Implementation

The SEC believes that providing certain information technology services to an audit client would impair the accountant’s independence, with some exceptions.⁶²

61. See 17 C.F.R. § 210.2-01(c)(4)(i) (2001). Providing bookkeeping services for an audit client impairs the auditor’s independence because the auditor will be placed in the position of auditing the firm’s work when auditing the client’s financial statements. It is hard to maintain the requisite objectivity about one’s or one’s firm’s own work. This is especially true where finding an error would raise questions about the adequacy of the bookkeeping services provided by the firm. In addition, keeping the books is a management function, the performance of which leads to an inappropriate mutuality of interests between the auditor and the audit client.

Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,043-44. The new rules adopt an exception from the bookkeeping restriction for emergency or other unusual situations, provided that the accountant does not act as a manager or make any managerial decisions. See 17 C.F.R. § 210.2-01(c)(4)(i)(B)(1). An example is the unexpected resignation of a company’s comptroller at the end of the year. See Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,044.

62. See 17 C.F.R. § 210.2-01(c)(4)(ii). The rule imposes five conditions before an audit firm can perform Financial Information Systems Design and Implementation services and remain independent. See id. § 210.2-01(c)(4)(ii)(B)(1)-(5). These “conditions . . . are intended to reduce the likelihood that the auditor will be placed in a position of making, and then auditing, managerial decisions.” Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,045.

(1) The first condition is that the “audit client’s management has acknowledged in writing to the accounting firm and the audit client’s audit committee . . . the audit client’s responsibility to establish and maintain a system of internal accounting controls . . . .” 17 C.F.R. § 210.2-01(c)(4)(ii)(B)(1). “This condition makes clear that this statutory responsibility cannot be shifted to the accounting firm.” Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. at 76,045.

The second and third conditions complement each other:
(2) The audit client’s management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
(3) The audit client’s management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training and conversion plans.

17 C.F.R. § 210.2-01(c)(4)(ii)(B)(2)-(3). “These conditions are intended to ensure
3. Appraisal or Valuation Services and Fairness Opinions

With some exceptions, an accountant is not considered to be independent if the accountant provides appraisal or valuation services, or any service involving a fairness opinion.

4. Actuarial Services

Accountants who provide actuarially oriented advisory services involving the determination of insurance company policy reserves and related accounts are deemed not to be independent under the new rules.

that an audit client that receives information technology services from its auditor does not delegate to its auditor responsibility for 'management decisions' relating to the design and implementation of the system." Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,045.

The fourth and fifth conditions:

(4) The audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system; and

(5) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems.


63. "Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. Fairness opinions are opinions that an accounting firm provides on the adequacy of consideration in a transaction." See Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,046.

64. See id.

The rule also contains an exception for appraisal or valuation services where the accounting firm reviews and reports on work done by the audit client itself or an independent, third-party specialist employed by the audit client, and the audit client or specialist provides the primary support for the balance recorded in the client's financial statements. In those instances, because a third party or the audit client is the source of the financial information subject to the review or audit, the accountant will not be reviewing or auditing his or her own work.

Another exception allows accountants to continue to value an audit client's pension, other post-employment benefit, or similar liabilities, so long as the audit client has determined and taken responsibility for all significant assumptions and data underlying the valuation. Accountants historically have provided pension assistance to their audit clients, and if appropriate persons at the audit client determine the underlying assumptions and data, thus the SEC believes that independence will not be impaired.

Id. (footnote omitted).

65. See 17 C.F.R. § 210.2-01(c)(4)(iii).

66. See id. § 210.2-01(c)(4)(iv). The rule states that an auditor's independ-
5. **Internal Audit Services**

An auditor's independence is impaired if she performs more than forty percent of the audit client's internal audit work related to internal accounting controls, financial systems, or financial statements, unless the audit client has $200 million or less in assets.\(^67\)

6. **Management Functions**

An accountant's independence is impaired with respect to an audit client for which the accountant acts, temporarily or permanently, as a director, officer or employee, or performs decision-making, supervisory or ongoing monitoring functions.\(^68\)

7. **Human Resources**

The SEC has adopted most of the AICPA's rules disallowing certain executive recruiting and human resource services for clients.\(^69\)

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\(^{67}\) Id. § 210.2-01(c)(4)(iv)(A). "All of these conditions are designed to ensure that the accountant does not assume a management function for the audit client." Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,047.

\(^{68}\) See 17 C.F.R. § 210.2-01(c)(4)(v).

\(^{69}\) See id. § 210.2-01(c)(4)(vi).

SEC commentary on this rule states:

[A]n accountant's independence would be impaired if the accountant:
(a) Searches for or seeks out prospective candidates for managerial, executive or director positions with audit clients; (b) engages in psychological testing, or other formal testing or evaluation programs; (c) undertakes reference checks of prospective candidates for executive or director positions with audit clients; (d) acts as a negotiator on the audit client's behalf, such as in determining position, status or title, compensation, fringe benefits, or other conditions of employment; or (e) recommends, or advises an audit client to hire, a specific candidate for a specific job.

8. Broker-Dealer Services

An accountant's independence is impaired if the accountant is connected with the audit client as an underwriter or promoter of the company's securities.70

9. Legal Services

The SEC finds that conflict exists between the role of an independent auditor and the role of an attorney.71 Therefore an accountant is not independent from the audit client if an accountant provides any legal services where the provider of the services must be admitted to practice before the courts of a jurisdiction within the United States.72

I. The Accounting Firms and Public Companies

In contrast to the fears expressed by the SEC, a study commissioned by the AICPA does not seem to support the lack of faith in the existing audit independence rules. This study culminated in a two-part report by Earnscliffe Research & Communications ("Earnscliffe Report") based on research to ascertain opinions on the current and future state of the audit process.73 The report was based on interviews and a series of hypothetical questions.74 Those interviewed included chief executive officers and chief financial officers of public companies, audit committee chairs,75 buy-side investment

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70. See 17 C.F.R. § 210.2-01(c)(4)(viii).
72. See 17 C.F.R. § 210.2-01(c)(4)(ix). No examples were given, as what constitutes the practice of law varies from state to state. See ALAN W. SCHEFLIN, PROFESSIONAL ETHICS FOR CALIFORNIA LAWYERS (forthcoming 2001) (noting that the rule excludes those practices that would constitute the practice of law in any U.S. jurisdiction, not just the jurisdiction one was in at the time).
74. See EARNSLIFFE, PHASE I, supra note 73. A few of the questions include "How would you characterize the relationship between most public companies and their auditors? What about your approach?,” “Based on what you know, are current prohibitions governing the relationship between audit firms and their clients appropriate?” and “Over and above the prohibitions, are there adequate safeguards to help prevent impairment?” Id. at 49-50.
75. An audit committee is a board committee who has the responsibility of
analysts, sell-side investment analysts, audit partners, and regulators. The report focused on several specific areas of concern, as discussed in the following subsections.

1. The Overall Health of Financial Reporting

"The general consensus seemed to be that there might be a slight deterioration of integrity in auditor independence over time, but no more in the financial business sector than in society as a whole." Nonetheless, interviewees felt that "litigation pressures served as a deterrent for those who might be inclined otherwise." Moreover, the participants stated that they "looked upon auditors as an additional check to ensure that their companies were reporting appropriately, to save embarrassment down the road." The report added that for most participants audited financials were a basic requirement, but that "their role in investment decisions was seen as providing confirmation and reassurance about information that was already in the public domain." Even though there was concern about existing independence issues among executives and analysts, most concluded that a debate about standards for auditor independence was legitimate. On the other hand, roughly 30% of the non-regulators and a majority of the auditors felt "that the profile, tone and the tenor of the debate might serve to frighten more than enlighten investors." These comments were meant to be a warning sign that the debate on impairment of independence could become a self-fulfilling prophecy.

hiring the auditors as well as dealing with any findings from an audit. See 1 AICPA PROF'L STANDARDS, AU § 380.01 (American Inst. of Certified Pub. Accountants 2001).

77. See EARNSLIFFE, PHASE I, supra note 73, at 2.
78. Id. at 4.
79. Id. at 5.
80. Id. at 6.
81. Id.
82. See id. at 7.
83. See EARNSLIFFE, PHASE I, supra note 73, at 7.
2. **The Broad View of Auditor independence**

When asked questions regarding auditor independence specifically, the respondents stated that generally they had a positive view of auditors themselves and of their job performance. A "vast majority" believed that auditors currently meet a high standard of objectivity and independence.

At the same time, the same respondents were concerned that the pressures impairing objectivity and independence were increasing with time.

3. **Current Safeguards for Auditor Independence**

When the researchers asked about the effectiveness of the current safeguards, the responses varied depending upon who was asked. The auditors seemed to think that the present safeguards were adequate and only needed fine tuning from time to time. In contrast, the regulators, i.e., the SEC, felt that the current accounting firm model seemed fundamentally unworkable, that the safeguards were inadequate, and that stronger safeguards were needed to protect investor confidence.

When the same questions were asked of chairmen of audit committees, chief executive officers, and chief financial officers, the responses were mixed. The audit committee chairs saw the independence safeguards as works in progress, which required constant attention. Executive officers felt the current safeguards were appropriate, but were inclined to the idea that more guidance might be useful.

Analysts responded that they "felt the combination of safeguards, laws, regulations and litigation pressures were necessary," but acknowledged that due to human temptation, there is always a risk auditors may be influenced to some degree. The researchers noted that while most surveyed had

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84. See id. at 8.
85. See id.
86. See id. at 9. Only 10% of the respondents thought an actual independence problem exists, and 20% believed a perception problem exists. See id. at 10.
87. See id. at 19.
88. See id.
89. See EARNSCLIFFE, PHASE I, supra note 73, at 19.
90. See id.
91. See id.
92. See id.
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opinions on the safeguards, most respondents could not articulate them.93

4. Non-Audit Service in Focus

Respondents believed that the areas that caused the most concern were consulting and non-audit services (the fees from which greatly exceeded audit fees) or any situations where non-audit fees routinely exceed audit fees in general.94 Respondents were also concerned about situations where a particular non-audit service is important to an audit firm, or where a particular client is important to an audit partner (i.e., either for their reputation or the fees the client generated).95 However, it is important to note that the respondents generally felt that as long as audits were being performed by the private sector, the auditors must be afforded a certain degree of latitude in terms of growing their businesses, especially due to the competition in the industry.96

J. Harsh words from an ex-Commissioner of the SEC

Showing a bias on the subject, ex-SEC Commissioner Bevis Longstreth made the following comment during the last phase of SEC hearings before issuing the final amendment:

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 the 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

93. See id. at 20.
94. See id. at 23.
95. See EARNSCLIFFE, PHASE I, supra note 73, at 24.
96. See id. at 25.
can not be defeated by argument on the merits.... 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.97

Clearly this statement illustrates the animosity the SEC feels towards the accounting profession.98 It also helps to shed light on the SEC’s motivations, besides what is blatantly written in the amendment.

III. IDENTIFICATION OF THE LEGAL PROBLEM

As noted above, the SEC believes that there is a genuine problem with auditor independence.99 As expressed by ex-SEC Commissioner Bevis Longstreth, the SEC felt it could not wait for accountants to develop their own policies.100 However, the question is whether the rules enacted by the SEC in regard to non-audit services are the proper steps to take.

As this comment will discuss, the SEC allowed its judgment to be blurred and amended the existing independence rules, which will hurt, rather than protect, investor confidence and the United States’ securities markets.101 As competition among companies increases and as businesses become more global, it is crucial that companies have unrestricted access to the expertise auditors can provide.102 Will the benefits of restricting auditors from providing non-audit services outweigh the costs of lost expertise and reduction of worldwide competitiveness? No. In fact, the cost to public companies will surely be greater than the benefits realized by the public. If the amendments adopted by the SEC are too costly, what is the right solution? What type of reform should the SEC implement to protect the public’s confidence in audit opinions?

98. See McLucas et al., supra note 6, at 504-05.
99. See supra Part II.
100. See Longstreth, supra note 97.
101. See infra Part IV.A.
102. See infra Part IV.B.
without hindering business?

IV. ANALYSIS

It is clear that the SEC believes that the accounting profession is denying the existence of a serious problem, for self-interested purposes, as evidenced by the comments by SEC members in the Earnscliffe Report and by former SEC Commissioner Longstreth made during the SEC hearings. Perhaps the SEC's desire to police the accounting firms has blinded them to a number of countervailing issues.

A. Independence in Appearance Doesn't Seem to be a Problem

The SEC explains in the auditor independence amendments that they are concerned with the appearance of independence of auditors. The regulators interviewed in the Earnscliffe report repeat this sentiment. The concern would appear to be sincere except for the fact that former SEC Commissioner Bevis Longstreth's comment makes the more stringent regulations seem like a vendetta. At the very least, the comments bring into question the SEC's motives for making this amendment.

If the SEC has a genuine concern, this begs the question, where are they getting their data? Nothing is mentioned in the ruling. The SEC held hearings after issuing the proposed amendments, but the only explanation they gave for not allowing time for the AICPA or the ISB to act was a claim that the private bodies were not dealing with the problem of auditor independence.

Regardless of what the SEC believes, the year-long study by Earnscliffe Research paints a different picture. It found that the independence rules are working and most of the people...
ple interviewed had confidence in the system.\textsuperscript{111} Furthermore, during the SEC hearings, the amendment generated primarily negative responses. Thus, the SEC's contention that the current state of auditor independence apparently is deteriorating and is need of reform, appears to be unsupported.

However, one underlying area of concern is that even though the regulations are currently effective, generally all (except the auditors) feel that independence might be compromised in the future.\textsuperscript{112} Therefore, the system in place does, in fact, need reform, however not necessarily to the extent proposed by the SEC.

B. The Negative Effects of the SEC's Amendments

The SEC and the U.S. Congress have allowed private standard-setting bodies to make policy in the past because such organizations are in a much better position to evaluate and proscribe the independence rules.\textsuperscript{113} Organizations such as the ISB are better equipped to set standards for independence that balance the need to be flexible in order to meet the needs of the public against the need for independence in appearance and in fact.\textsuperscript{114}

In its haste, the SEC made amendments to the independence rules that will actually be detrimental to public companies, in contrast to what the SEC would have these companies believe. The restrictions placed on offering non-audit services to audit clients will prevent public companies from gaining access to the wealth of information and services that auditors can provide.\textsuperscript{115} Many efficiencies of scale are created when auditors are allowed to do more than just audits for a company. Because an audit involves obtaining an understanding of how a company operates,\textsuperscript{116} auditors can use this acquired knowledge to consult as well. For example, the rule limiting how much of a larger public company's internal audit services may be performed by an outside accounting firm,\textsuperscript{117}

\begin{itemize}
  \item \textsuperscript{111} See Earnscliffe, Phase I, supra note 73.
  \item \textsuperscript{112} See id.
  \item \textsuperscript{113} See supra Part II.B.
  \item \textsuperscript{114} See supra Part II.C.
  \item \textsuperscript{115} See supra Part II.E.
  \item \textsuperscript{116} See Defliese et al., supra note 11.
  \item \textsuperscript{117} See 17 C.F.R. § 210.2-01(c)(4)(v) (2001). Internal audits are audits, usually in more detail, but are solely for the benefit of the company. The scope of an internal audit is more focused, for example on a single department. There
\end{itemize}
means that an additional accounting firm will be required to provide those services no longer being met by the first firm. If the same firm was allowed to do both, many of the steps for conducting the internal audit and the annual audit, as required by the SEC, must be done only once, thereby saving the company time and money.

Another example of inefficiency occurs when a public company decides to perform its own internal audits so as to avoid strictures upon outsourcing internal audit services. By conducting the internal audit themselves, the cost would be attributable to the lack of expertise that only the more experienced outside auditors can provide.

By preventing auditors from performing such non-audit services, what problems are avoided? First, is the economic relationship between auditor and client avoided? In other words, can auditors avoid the risk of impaired judgment if the audit client threatens to fire them because they do not agree with all of the accounting policies or estimates? This risk cannot be avoided because the client is paying the auditors for the audit services. The economic relationship already exists.

Would the auditors’ reputation cease to be at risk simply because they are performing the additional service of an internal audit? No. Would the auditors cease to be at risk from a lawsuit for performing any additional services to the audit client? Again the answer is no. The auditors’ reputation is at risk and the auditor is subject to lawsuits brought by users of the financial statements no matter what additional services they perform.

Thus, the effect of the SEC’s amendment is to keep auditors from becoming more susceptible to influences than they already are. Even though the amendments would prevent these additional risks, the added costs of compliance outweigh any benefit that might be gained.

Another example of inefficiency created by the new rules is the prohibition on providing actuarial services. An important part of the audit is the review of estimates made by

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118. See 17 C.F.R. § 210.2-01(c)(4)(v).
119. See 17 C.F.R. § 210.2-01(c)(4)(iv).
management. An example of this would be the estimates relating to employee retirement plans or pension plans. In order to determine the expense to record for such a plan, the auditors need to know how long the company's employees will live. This is an actuarial determination, based on life expectancy, sex, current age and other factors. These types of estimates can either be calculated by the auditors or by a third party actuary services. Under the new rules, the auditors will be prevented from doing this actuarial estimate except in limited circumstances. Again, the introduction of a third party will increase costs by prohibiting efficiencies of scale. The work done by the actuary will be duplicated by the auditor. In the end, the auditor will still need to make a judgment as to whether the actuarial estimate appears to be reasonable.

By preventing the auditors from performing this service, are the auditors still subject to economic risk? Are their reputations at stake? Are they at risk of being sued? The answer is yes. Therefore, the new rules do not eliminate the very incentives that the SEC believes impair auditor independence.

C. The Auditors Paradox

Because the amendments enacted by the SEC severely limit accounting firms from performing a number of different non-audit services, the SEC is forcing firms to be increasingly dependent on audit fees for revenue. This dependence on audit revenues causes accounting firms to become more susceptible to economic influences and, arguably, less independent than before. The paradox is that the more you restrict the

120. See supra Part II.B.
121. See DEFLIESE ET AL., supra note 11.
122. See id.
123. See id.
125. See DEFLIESE ET AL., supra note 11.
126. A paradox is a "statement or sentiment that is seemingly contradictory or opposed to common sense and yet perhaps is true." WEBSTERS' 3RD NEW INTERNATIONAL DICTIONARY 1638 (3d ed. 1993).
127. By forcing accounting firms to derive a greater percentage of revenues from auditing, the importance of audit revenues to the firm increases. As the importance of audit revenues increases the greater the pressure will be to please audit clients, and making it harder for auditors to make fully unbiased decisions and to appear independent.
amount of additional services an accounting firm can perform, the more they become dependent on audit fees and less independent of their clients. In essence, any economic interest an auditor has in a client impairs independence. In fact, commentaries to the SEC proposed regulations argued that “because Congress adopted this arrangement in enacting federal securities laws, by choosing the statutory independence requirements rather than creating a corps of government paid auditors, Congress implicitly condoned these types of conflicts.”

D. Benefits of the SEC Amendments

Though the Earnscliffe Report tends to portray executive officers, analysts, and the like, as having faith in the system as it is today, there are growing concerns about the future. Many are worried that as earnings pressures increase and as non-audit revenues become a significant percentage of total revenues, failures will appear in the audit process due to impaired independence.

It is also important to note that not all of the amendments related to non-audit services will have a negative impact. Some changes are a positive step forward. In fact, much of what the SEC included in its ruling codified independence standards set by the private bodies such as the AICPA. Some examples of this are the restrictions on broker-dealers and the restrictions on acting in management functions.

V. PROPOSAL

A. A Need for Change

Based on the analysis above, the amendments to the independence rules will not prevent the loss of confidence in the audit process. This is due to the auditor’s paradox. The

129. See supra Part II.I.2.
131. See supra Part II.H.8.
133. See supra Part IV.
general feeling from executives and analysts, however, is that independence is a "work in process" and that there are "reasons for concern." Therefore, we cannot leave independence rules unchanged.

Instead of requiring audits by independent, private auditors, annual audits should be performed by the government. The government employs auditors in a number of different agencies, such as in the Internal Revenue Service. Yearly audits ought to be conducted by government employees that have no financial interest in the companies they audit.

B. Lack of Financial Interest

By disconnecting the auditors from any financial interest whatsoever, the inherent flaw in the current audit model is eliminated. The auditors could be supplied by the SEC itself or by an agency yet to be formed.

The agency could be funded by establishing statutory fees based on hours incurred to perform the audit. Alternatively, fees could be based on a measure related to the company's size, such as total assets, or another benchmark. Through a fixed fee model, the agency would be forced to act efficiently. Any inefficiency by the agency (which is the usual criticism of government agencies) would not be passed along to the companies.

As an additional safeguard regarding fees, the agency should be an independent establishment of the executive branch similar to the U.S. Postal Service. This model gives the governmental agency the freedom to be innovative, while at the same time it shifts the economic burden away from the average taxpayer.

C. Actual Independence and the Appearance of Independence

Actual independence and apparent independence will be

134. See EARNSCLIFFE, PHASE I, supra note 73, at 19.
136. See 62 AM. JUR. 2D Post Office § 5 (1990). The Post Office has certain powers such as the ability to enter into contracts, execute instruments, and determine the character of and necessity for its expenditures, to acquire, use and dispose of real and personal property, to construct, use and lease buildings, facilities and other improvements on property, to exercise the right of eminent domain and to have the debt priority of the United States. See id. Generally the post office is run fiscally as a separate entity, in charge of its own revenues and expenses. See id.
ensured under this model because the auditors will have no economic interest in the audited company whatsoever. No longer will the threat of being fired be used to influence auditor judgment. Except in situations of fraud or gross negligence by the government, there should be no reason to doubt the integrity and the objectivity of government auditors.

D. Less litigation

As an added benefit, using government auditors would result in less litigation. If the SEC or other subsidiary agency audits each company's financial statements, third party plaintiffs will have a difficult time finding suitable grounds to bring a suit against the government or the company (although there will still be a need to litigate claims of gross negligence or fraud). In essence, the financial statements will be a kind of “safe harbor” for public companies. Cutting down on litigation will save public companies from paying litigation expenses. Reducing litigation will also allow company management to spend more time running their company.

E. Efficiencies Over The Current Audit Model

By switching to a regulatory model, some economies of scale would still be gained. For example, companies currently switch auditors to obtain a better price, or for a myriad of other reasons. Changing auditors is an inefficiency that could be eliminated if the government performed all auditing services. Not only would companies save the time and money they would spend looking for and interviewing new auditors, they would also be spared the task of familiarizing the new auditors with the company.

F. Financial Expertise

The strongest criticism against this proposal to move auditing from the private sector to the public sector is the potential loss of expertise. Some believe it would be unreasonable and implausible to expect private companies to obtain consulting services from the government. Critics fear that government auditors would not be properly trained, nor have the experience to provide consulting advice or perform additional services to public companies. Instead, they believe that consulting and non-audit services would be best left to the private sector.
These objections are without merit. First, private companies can perform any non-audit financial services a company needs. Secondly, current educational and certification processes do not need to cease once the government takes over auditing. As long as auditors are trained and certified as Certified Public Accountants, the quality of audits should not decrease.

G. Accounting Firms

This proposal has significant ramifications for accounting firms. Substantial revenues are generated from audit fees. Implementation of this proposal would force accounting firms to limit their audit services to non-public companies and require them to concentrate their resources in other areas to generate revenue. However, one significant benefit for the accounting firms would be that they would be able to perform any services they wished in addition to their tax services. Therefore, what accounting firms would lose in audit revenue, they would more than make up for by providing the additional services that the proposed rules would prevent.

If the proposed amendment is adopted, it is likely that accounting firms would be forced to merge or form strategic alliances with existing consulting firms. However, it is important to note that already today, three of the big five accounting firms are already divesting their consulting practices because of scrutiny they received regarding independence issues.137

IV. CONCLUSION

There is no easy solution to auditor independence. The best answer is to reform the entire system. The amendments made by the SEC will not restore any lost confidence in the existing system. There was no confidence to lose. Instead the changes will prevent public companies from accessing the expertise that auditors offer. Secondly, they will force companies to pay for services the auditors already provide.

Restricting the services that private accounting firms provide is an inefficient solution. Accounting firms act as any business would, attempting to innovate and expand their

services to generate increasing revenue. The SEC is only harming this country’s securities markets by imposing these new restrictions on accounting firms.

Leaving the rules the way they were and thus allowing the AICPA to set independence standards for the accounting profession has been working well and investor confidence is high as a result. However, if the opinions of those interviewed in the Earnscliff Research study are indicative of the investing public as a whole, waning confidence is a real threat that needs to be addressed. This problem is directly linked to the current systems model, whereby public companies hire and pay accountants for independent audits.

The only real solution is to change the way audits are performed. The government, either through the SEC or another regulatory agency, should take on the responsibility of performing the audits, thus eliminating the financial stake that private auditors inherently have in the audit process. This would effectively sever the link between consulting and non-audit services in the private sector, and allow the government to have “independent” oversight over what public companies report in their annual financial statements. The only way to permanently fix this problem is to turn over the role of auditing to the government, which has no financial interest in public companies. Therefore, government audits of public companies provide the only clear path to true audit independence.