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Securities Regulation: Protecting Auditor Independence from Non-Audit Services — An Evolving Standard

1. Introduction

Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets. Investors are more willing to commit their capital in markets if they believe that the financial information is reliable. Auditors play a key role in the capital formation process by ensuring that the financial information that investors rely upon is as accurate as possible.

These auditors, using Generally Accepted Auditing Standards (GAAS), examine corporate financial statements and express their opinion as to whether the financial statements, taken as a whole, fairly reflect the financial position of a company in accordance with Generally Accepted Accounting Principles (GAAP). An auditor's opinion is not a guarantee that the financial statements are accurate, but rather an assurance that an independent, unbiased professional has strictly examined the financial statements. Auditors must be independent from the companies they audit in order to provide impartial and objective examinations of financial information in which investors can have confidence.

One of the Securities and Exchange Commission's (the Commission) primary roles is to protect the millions of people who invest in the United States' securities markets by ensuring that independent auditors review the financial statements prepared by public companies. This role serves two important public policies. First, it fosters accurate audits by removing or minimizing the possibility that external factors will influence an auditor's judgment. Second, it promotes investor confidence in the reliability and integrity of the financial statements of publicly traded companies. To meet these public policy goals, the Commission must ensure that the auditor independence requirements remain relevant and effective.


6. Id.
On December 5, 2000, the Commission adopted revised auditor independence requirements to Rule 2-01 of Regulation S-X (the Final Rule). The purpose of this note is to examine the provisions of the Final Rule concerning non-audit services provided by the auditor to the publicly traded audit client. This note will (1) inform practitioners of the fundamental importance of independent auditors and of the non-audit services that they may no longer provide to audit clients; (2) analyze the general framework for evaluating independence under the Final Rule; (3) review several of the consequences of the Final Rule; and (4) discuss the effect of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) on the Final Rule.

Part II of this note will examine the vital role that auditors play, discuss the changes that have made auditor independence reform necessary, and illustrate the consequences of a loss of independence. Part III discusses the debate over adopting a provision concerning non-audit services, outlines the format of the Final Rule adopted by the Commission, and discusses some of the changes that have occurred since the bankruptcy of Enron, most notably, the enactment of the Sarbanes-Oxley Act.

II. The Unique Role of the Auditor

A. The Role of the Independent Auditor

1. Independent Auditor Defined

Independence refers to an auditor's state of mind. The American Institute of Certified Public Accountants (AICPA) establishes professional standards that member Certified Public Accountants (CPA) must observe. These standards include both a Code of Professional Conduct and a Codification of Statements on Auditing Standards. Article IV of the AICPA's Code of Professional Conduct states: "A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services." The Code of Professional Conduct further provides: "The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest."

By requiring the auditor to be objective and unbiased, both in fact and appearance, the AICPA's standards regulate the auditor's two primary roles. First,
the standards attempt to provide reliable financial information by requiring rigorous and unbiased examinations.\textsuperscript{13} Second, the standards attempt to assure the investing public that the information is reliable because it has undergone rigorous and unbiased examinations.\textsuperscript{14} If investors do not believe that an auditor is independent of the audited company, both in fact and appearance, they will have less confidence in the financial information that auditors provide, and they will be far less likely to purchase the securities of public companies.\textsuperscript{15}

2. The Auditor's Role in Securities Law

The Securities Act of 1933 and the Exchange Act of 1934 expressly require that independent CPAs audit certain financial statements.\textsuperscript{16} A company desiring to issue stock must have an opinion from an independent auditor to satisfy the statutory requirements that are a prerequisite to selling securities in the market.\textsuperscript{17} In addition, securities law requires publicly traded companies to file audited financial reports on a regular basis with the Commission.\textsuperscript{18}

When Congress passed the Securities Act of 1933, it considered creating a corps of government auditors to review and audit companies' financial statements.\textsuperscript{19} Alternatively, Congress considered mandating federal licensing of all auditors.\textsuperscript{20} Instead of creating a large government entity, Congress entrusted the accounting profession with the responsibility of auditing the financial statements of Commission registrants with the understanding that outside accounting firms would be independent from management.\textsuperscript{21}

As a result of the statutory requirements of obtaining an audit before entering the stock market and filing annual financial statements, in the fiscal year ending September 30, 1999, the Commission received an aggregate of $2.1 trillion in public offering filings and 13,460 annual reports.\textsuperscript{22} In \textit{Touche Ross \& Co. v. SEC},\textsuperscript{23} the Second Circuit Court of Appeals recognized the fact that because the Commission is unable to review in detail the vast amount of annual reports that companies submit, the accounting profession is primarily responsible for the

\textsuperscript{13} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,012.
\textsuperscript{14} See id.
\textsuperscript{18} Id.
\textsuperscript{20} Id.
\textsuperscript{21} Id. at 43,150 n.17 (citing \textit{Hearings on S. 875 Before the Senate Comm. on Banking and Currency}, 73d Cong. 55-60 (1933)).
\textsuperscript{22} Id. at 43,150.
\textsuperscript{23} 609 F.2d 570 (2d Cir. 1979).
integrity of the financial information.\textsuperscript{24} This holding recognizes the fact that it is physically impossible for the Commission to review 13,460 annual reports with the same amount of detailed analysis that one auditor can provide one audit client.

The system that Congress created requires companies to file audited financial statements to gain access to capital markets, while placing primary responsibility for the accuracy of financial statements on auditors rather than on a government agency. This system places the auditor in a position of great public trust. In \textit{United States v. Arthur Young & Co.}, \textsuperscript{25} the United States Supreme Court recognized the unique role of the auditor when it declined to extend to auditors certain confidentiality protections that are available to a lawyer and a client.\textsuperscript{26} The Court stated, "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a \textit{public} responsibility . . . [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public."\textsuperscript{27} The Court went on to say, "This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."\textsuperscript{28} Recognizing the auditor's need for independence from those they audit, the Commission's task in this area is to "address the influences that reasonably could be expected to pose an unacceptable risk that an auditor would lose his or her objectivity or that reasonable persons would perceive a loss of objectivity."\textsuperscript{29}

\textbf{B. The Need For Change}

\textit{1. Changes in the Market and Mentality}

The Commission last amended the auditor independence requirements in 1983.\textsuperscript{30} Since then, the market economy and the accounting industry have transformed dramatically. Accounting firms today have to compete on a global scale and, as a result, have merged into larger corporations that offer a broader array of services.\textsuperscript{31} Accounting firms are changing into primarily business advisory service firms as the number, revenue, and type of non-audit services increase.\textsuperscript{32} Frequently, companies are turning to their auditors to perform services such as internal auditing, evaluating business controls, providing tax services, implementing information system services, designing pension plans, and developing marketing plans.\textsuperscript{33} From 1993 to 1999, accounting firms' revenue for non-audit services grew

\begin{itemize}
\item \textsuperscript{24} \textit{Id.} at 580-81.
\item \textsuperscript{25} 465 U.S. 805 (1984).
\item \textsuperscript{26} \textit{Id.} at 817.
\item \textsuperscript{27} \textit{Id.} at 817-18.
\item \textsuperscript{28} \textit{Id.} at 818.
\item \textsuperscript{29} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 43,148, 43,151 (proposed July 12, 2000) (to be codified at 17 C.F.R. pts. 210, 240).
\item \textsuperscript{30} \textit{Id.} at 43,148.
\item \textsuperscript{31} \textit{Id.}
\item \textsuperscript{32} \textit{Id.}
\item \textsuperscript{33} \textit{Id.} at 43,153.
\end{itemize}
at an average annual rate of 26% compared to 9% for audit services. As a result, revenues from these services comprise an estimated 50% of total revenues for the top five public accounting firms. By comparison, in 1981, these service lines provided only 13% of total revenue.

Coinciding with the market transformation, the mentality of the auditor has changed from that of a "public watchdog" to that of a business consultant. Some accounting firms are beginning to treat the audit merely as a commodity used to acquire the more lucrative non-audit fees. In fact, some of these firms treat audit services as "loss leaders," that is, they sell the audit service below cost to build a relationship with a potential client for the firm's non-audit services.

This change in mentality is blatantly evidenced in an AICPA practice aid entitled Make Audits Pay: Leveraging the Audit Into Consulting Services. Indeed, this guide quotes an AICPA officer as saying, "'We see the greater viability of the CPA going forward as being a strategic business adviser, an information professional being viewed by the public as the person for solid big-picture business advice — applied to a broader information world instead of a financial information world.'" The guide further states that "'[t]he business adviser is a client advocate. The entire business adviser audit process is based on understanding the client's business from the owner's perspective and acting in the owner's best interest,'" which the Commission noted is contrary to the auditor's public duty. The most troubling aspect of this change is that it comes directly from the AICPA, the body primarily in charge of establishing the rules and ethical standards for the accounting industry prior to the establishment of the Public Company Accounting Oversight Board in the Sarbanes-Oxley Act. Part III.D will further discuss this new oversight board.

The Commission believes that the growth in non-audit services jeopardizes auditor independence in two principal ways. First, as the percentage of income from non-audit services increases, auditors face more pressure in challenging a client's accounting practices for fear of losing revenue from the client's non-audit

34. Id.
35. Id.
36. Id.
42. Id. (quoting MAKE AUDITS PAY, supra note 40, at 24).
43. Id.
work.\textsuperscript{45} The Commission is not only concerned with the incentives auditors have to violate their independence requirements, but also that the public will view these incentives as impairments to independence.\textsuperscript{46} Second, certain non-audit services provided by the auditor "create inherent conflicts that are incompatible with objectivity,"\textsuperscript{47} such as providing bookkeeping services or setting up controversial partnerships and then later auditing one's own work.

2. Increased Pressure on Earnings

In 1999, an estimated 48.2\% of U.S. households owned equities, compared to 19\% in 1983.\textsuperscript{48} This change in ownership has focused America's attention, as well as its financial security, on the stock market as never before.\textsuperscript{49} In addition, technology has given investors increasingly direct access to financial information, allowing for quick and decisive action upon almost any change in a company's financial results.\textsuperscript{50} These and other market changes have made Americans "enormously dependent on independent auditors, both to . . . ensure the reliability of the information they use to make individual investment decisions and to ensure the efficiency of the marketplace in assigning value to stocks."\textsuperscript{51} The decision to invest and the extent of that investment both rely heavily on the reliability and accuracy of the underlying financial data.\textsuperscript{52}

In addition to the above changes, the Public Oversight Board's Panel on Audit Effectiveness (the Panel Report) stated:

The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet "street" expectations. . . . These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients.\textsuperscript{53}

\begin{footnotes}
\item[45] Id.
\item[48] Id. at 76,009 n.12 (citing SECURITIES INDUSTRY ASSOCIATION, 2001 BRIEFING BOOK- CAPITAL MARKETS 3 (2001), available at http://www.sia.com/publicationspdf/BBchapter1.pdf (last visited Sept. 12, 2002)).
\item[49] See, e.g., id. at 76,009 n.13 (quoting the testimony of Senator Howard Metzenbaum (Ret.), Chairman, Consumer Federation of America (Sept. 20, 2000), available at http://www.sec.gov/rules/extra/audmin3.htm (modified Oct. 5, 2000)).
\item[50] Id. at 76,009.
\item[51] Id. at 76,009 n.13 (quoting testimony of Senator Metzenbaum, supra note 49).
\item[53] PANEL REPORT, supra note 38, ¶ 1.10, at 2-3.
\end{footnotes}
In short, increased household participation in the stock market, widely available financial information, and drastic stock price changes caused by missed earnings estimates have created tremendous pressure on companies to manage earnings to meet investor expectations. The increased pressure on management and the auditor, combined with substantial non-audit fees, have made it increasingly difficult for auditors to maintain their independence.

C. Consequences of Impaired Independence

"In February 1998, Waste Management, Inc. announced that it was restating its financial statements for the five-year period 1992 through 1996." 54 In the restatement, Waste Management admitted that, through 1996, it had materially overstated its reported pretax income by more than $1.4 billion, which was the largest restatement in the Commission's history — until Worldcom's $3.8 billion restatement in July 2002. 55 During this same period, Arthur Andersen issued unqualified or clean opinions for Waste Management's financial statements. 56 On June 19, 2001, the Commission brought a settled enforcement action against Arthur Andersen LLP (Andersen) and four individuals in connection with Andersen's audits of Waste Management's financial statements. 57

The Commission's complaint alleged that Andersen knowingly or recklessly issued false and misleading unqualified audit reports for Waste Management's financial statements by stating that the statements conformed to GAAP and that the audit was done in accordance with GAAS. 58 For the years in question, Waste Management had improperly increased reported operating income primarily through understating current operating expenses by deferring recognition of expenses into the future. 59 The audit engagement team repeatedly brought this practice, among others, to the attention of the Andersen engagement partner; however, Andersen still issued unqualified opinions on the engagement partner's premise that the misstatements were not material. 60

This conduct took place against the following background: (1) Andersen regarded Waste Management as a "crown jewel" client; (2) every chief financial officer (CFO) and chief accounting officer (CAO) in Waste Management's history had previously worked for Andersen as an auditor; (3) between 1991 and 1997, Andersen billed Waste Management $7.5 million in audit fees and $11.8 million in non-audit fees; (4) a related entity, Andersen Consulting, known now as Accenture, billed Waste Management approximately $6 million in non-audit fees;

55. Id.; WorldCom Comments on Indictment Reports, WALL ST. J., July 26, 2002, at A4 [hereinafter WorldCom Comments].
57. Id.
58. Id.
59. Id.
60. Id.
(5) the engagement partner for the audit was also the marketing director in charge of cross-selling non-audit services to audit clients; and (6) the engagement partner's compensation took into account the firm's billing for audit and non-audit services.61

Given the gravity and duration of the misconduct, the nature and magnitude of the misstatements, and the circumstances of the case, the Commission decided to bring an action against Andersen.62 As a result, Andersen, without admitting or denying the allegations, consented to the entry of a permanent antifraud injunction and the then-largest-ever civil penalty of $7 million.63

As a result of Waste Management's earnings restatement, the firm's stock price declined more than 50%, causing investors to lose millions in equity.64 Soon thereafter, Waste Management settled a shareholder class action lawsuit for violations of federal securities laws for $457 million, and Andersen settled a derivative lawsuit for $20 million.65 In addition, in 2002, after a four-year investigation, the Commission filed a complaint accusing six former Waste Management executives of securities fraud.66 This single occurrence of impaired auditor independence resulted in the loss or unproductive use of hundreds of millions of dollars, years of litigation, and a blemish on the reliability of our financial system.

Waste Management is unfortunately one of several occurrences of impaired independence.67 In 2000, Rite Aid Corporation filed an earnings restatement, admitting that it had overstated earnings by more than $1 billion over two years.68 The resulting lawsuit alleged that KPMG, Rite Aid's auditor, received audit fees that were less than 20% of non-audit fees over a two-and-a-half-year period in the late 1990s.69 In addition, the suit alleged that Rite Aid's then-chairman awarded KPMG consulting engagements worth $1.5 million "as a sweetener and to ensure the accounting firm's continued cooperation."70 The suit alleged that this relationship contributed to the accounting irregularities that caused the restatement.71

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61. Id.
62. Id.
63. Id.
67. For a more expansive discussion see Paul R. Brown et al., Administrative and Judicial Approaches to Auditor Independence, 30 SETON HALL L. REV. 443 (2000).
69. Id.
70. Id.
71. Id.
Ironically, Waste Management and Rite Aid shareholders can consider themselves lucky. These companies continued to exist after the accounting irregularities and restatements so that shareholders could sue and recover some of their losses.\(^{72}\) All too often, the disclosure of massive financial fraud results in the bankruptcy of the corporation, and shareholders are stuck with a majority of the losses.\(^{73}\)

Enron is an excellent case in point. Shareholders and employees observed Enron's stock plunge in value to next-to-nothing after the company filed a financial restatement announcing accounting irregularities related to controversial partnerships set up by Andersen.\(^{74}\) Enron filed for bankruptcy protection, which was the largest in U.S. history\(^{75}\) prior to Worldcom.\(^{76}\) The plunge in stock price has decimated shareholders' equity and employee pension plans heavily invested in Enron stock, leaving some employees with almost no retirement at all.\(^{77}\) Andersen has also incurred substantial losses from this tragedy. A federal jury has found Andersen guilty of obstruction of justice, a felony, which precludes Andersen from auditing public companies — effectively putting Andersen out of business.\(^{78}\) Most recently, Worldcom filed for bankruptcy protection, which will likely wipe out its shareholders' interests as well.\(^{79}\)

In addition to the general economic deterioration and loss of investor confidence that occurs, the individual losses from accounting irregularities and fraud can be tremendous. This is a frightening situation when one considers that the occurrence of financial restatements nearly doubled for all industries from 1997 to 2000.\(^{80}\)

While it is too early to draw any conclusions as to whether non-audit services impaired auditor independence in the Enron bankruptcy, Enron's financial reports stated that, in 2001, Andersen received $27 million in non-audit service fees and $25 million in audit fees from Enron.\(^{81}\) This translates into over $1 million a week in fees. This is by no means conclusive evidence, but once again a massive accounting irregularity and financial restatement were accompanied by the auditor


\(^{73}\) See Shore, supra note 3, at 398.


\(^{75}\) See Hilzenrath, supra note 68, at A1.

\(^{76}\) See WorldCom Comments, supra note 55.

\(^{77}\) See Hilzenrath, supra note 68, at A1.


\(^{80}\) Karl Schoenberger, When the Numbers Just Don't Add Up, N.Y. TIMES, Aug. 19, 2001, § 3, at 1.

receiving substantial non-audit fees. This note discusses the consequences of the Enron bankruptcy further in Part III.D.

III. The Commission Modernizes the Rules

A. The Debate Over Non-Audit Services Prior to Enron and the Sarbanes-Oxley Act

1. Supporters of an Exclusionary Ban

When the Commission decided to modernize the independence requirements, it encountered two basic ideologies regarding the correct path concerning non-audit services. One school supports an exclusionary ban, with certain carved-out exceptions, that bars the auditor from providing non-audit services to audit clients.82 The other school, which includes the AICPA, supports the specifically prohibited exclusions on non-audit services of the then-current law with the possibility of including others after more research and debate.83 The Panel Report, which was divided on which school of thought was more prudent, thoroughly explored these two schools.84

Panel members who supported an exclusionary ban argued that when an auditor provides non-audit services to an audit client, the audit firm is really serving two masters.85 First, the auditor is serving management by providing non-audit management consulting services.86 Second, the auditor is serving shareholders and the investing public by providing the audit.87 These supporters believe that providing both audit and non-audit services places a duty of loyalty on the auditing firm to both groups of clients.88 By serving both groups, the supporters noted that "the firm is subject to conflicts of interest that tear at the fragile fabric of loyalty owed to one client or the other."89 These Panel members believe that "the existence of dual loyalties creates a serious appearance problem," independent of whether, in a particular case, there was impaired independence in fact.90

Those Panel members supporting an exclusionary ban also believe that providing non-audit services gives the audit firm prospective revenues that create financial stakes in the audit client, which produce conflicts of interest "capable of impairing independence."91 They contended that this is especially true as long as accounting firms expect and reward the marketing of non-audit services by auditors to their

83. PANEL REPORT, supra note 38, ¶ 5.52, at 130.
84. See generally id. at ch. 5.
85. Id. ¶ 5.39(1), at 119.
86. Id.
87. Id.
88. Id.
89. Id.
90. Id.
91. Id. ¶ 5.39(6), at 121.
audit clients.\textsuperscript{92} These Panel members argued that an exclusionary ban on non-audit services to audit clients is the only way to achieve the goal of protecting auditor independence and investor confidence because it would avoid all potential conflicts of interest that may arise.\textsuperscript{93}

2. Opponents of an Exclusionary Ban

Panel members that oppose the exclusionary ban believe that audit firms can provide both audit and non-audit services to the same client and maintain independence and objectivity.\textsuperscript{94} These Panel members believe that many non-audit services are in the public interest and beneficial to audit effectiveness.\textsuperscript{95} As an example, a company may receive assistance from its auditor in correcting control weaknesses discovered during the audit. The public interest is served due to strengthened controls within the company, and audit effectiveness is improved because of the auditor's increased knowledge of the company's systems.\textsuperscript{96}

These members argued that limiting the non-audit services that auditors provide may disservce the public interest because the company may not improve its controls due to the "potential added costs and efforts" of hiring a firm, other than the auditor, who already has knowledge of the problem.\textsuperscript{97} The auditing company has an excellent and cost-effective ability to uncover the audit client's opportunities and risks and to address them efficiently because these auditors have a privileged and legally required opportunity to access and attest client records.\textsuperscript{98} Furthermore, not providing non-audit services would limit the amount of knowledge in the accounting firm about the client, thereby diminishing audit effectiveness.\textsuperscript{99}

Opponents to an exclusionary ban also asserted that there is a "lack of any specific link between audit failures and the rendering of non-audit services" to audit clients.\textsuperscript{100} For example, the Panel Report reviewed thirty-seven audit engagements involving non-audit services to audit clients and did not find any instance where the "non-audit services had a negative [impact] on audit effectiveness."\textsuperscript{101} In fact, the Panel found that some services actually had a positive impact on the audit.\textsuperscript{102}

In addition to the lack of a link between audit failures and non-audit services, there is a question as to whether providing non-audit services affects investor confidence.\textsuperscript{103} Phase I of the Earnscliffe Report to the United States Indepen-

\textsuperscript{92} Id. \textsuperscript{93} Id. \textsuperscript{94} Id. \textsuperscript{95} Id. \textsuperscript{96} Id. \textsuperscript{97} Id. \textsuperscript{98} Id. \textsuperscript{99} Id. \textsuperscript{100} Id. \textsuperscript{101} Id. \textsuperscript{102} Id. \textsuperscript{103} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008, 76,019 (Dec. 5, 2000) (to be codified at 17 C.F.R. pts. 210, 240).
dence Board stated: "The vast majority of respondents believe that auditors are currently performing audits, which meet a high standard of objectivity and independence."104 In Phase II, Earnsliffe reports that of those surveyed, "[m]ost had a high degree of confidence in the quality and reliability of the information that was available for them to use in making investment decisions."105 Thus, evidence exists that the public views auditors as appearing independent and that they have confidence in the information available to them. Those opposing an exclusionary ban are "reluctant to change the rules [without] any compelling evidence of a problem."106

3. The Commission Decides to Act

While no conclusive evidence existed at the time of the passing of the Final Rule that non-audit services were negatively affecting audit effectiveness, some evidence showed that these non-audit services were affecting investor confidence in the independence of auditors. "In a June 2000 study, Brand Finance surveyed analysts and representatives of companies listed on the London Stock Exchange."107 In the survey, 94% of analysts and 76% of companies "stating an opinion believe[d] that significant non-audit fees are likely to compromise audit independence."108

Phase II of the Earnsliffe study noted that "[m]ost [interviewees] felt that risks of unfavorable perceptions of auditor independence are growing, due largely to the provision of non-audit services to auditees."109 In addition, the Panel Report found that "[a]lmost two-thirds of the respondents to the Panel's survey from outside the [accounting] profession" expressed concern over non-audit services.110 Although no conclusive evidence exists that non-audit services are affecting investor confidence in audited financial information, the Commission stated that it could not "take lightly suggestions that even a minority portion of the population" is concerned over the appearance of impaired independence "or that their confidence is being undermined."111


106. PANEL REPORT, supra note 38, ¶ 5.43, at 127; see also Melancon, supra note 82, at 26 (stating that the "scope-of-services rule is a solution in search of a problem").


108. Id.

109. Id. at 76,017 (alterations in original) (quoting EARNSLIFFE II, supra note 105, at 5).

110. See PANEL REPORT, supra note 38, ¶ 5.20, at 113.

Addressing the issue of the lack of evidence linking non-audit services to audit failures, the Commission stated that searching for conclusive evidence "misses the point." Indeed, the Commission is not only concerned with audit failures, but also audit errors that may result in the "gray area" due to subtle pressures to bend to the client's interests to preserve non-audit fees. In addition, the Commission asserts that unless the auditor participates in fraud or admits to being biased, it "cannot know with absolute certainty whether an auditor's mind is, or at the time of the audit was, 'objective.'" Thus, the Commission believes that the "resolution of this issue must rest on our informed judgment rather than mathematical certainty."

B. The Commission Adopts a Two-Pronged Approach

The Commission recognized that a flat prohibition of all non-audit services would provide the "greatest assurance of auditor independence" because this would remove the economic incentives for auditors as well as any conflicts of interest that may arise. In adopting the Final Rule, the Commission believed that the best approach was "to draw a series of lines," based on "informed judgment," that identify "dangerous circumstances" or relationships that auditors must avoid. The Commission stated that this approach restricts "non-audit services only to the extent necessary to protect the integrity and independence of the audit function." As a result of limiting, rather than banning, non-audit services, the

112. Id. at 76,020.
113. Id. A recent statistical study supports this concern. The study, conducted by the Massachusetts Institute of Technology, Michigan State University, and Stanford University, examined whether non-audit services provided by auditors are negatively correlated with firm value and the quality of earnings. Richard M. Frankel et al., The Relation Between Auditor’s Fees for Non-Audit Services and Earnings Quality (Jan. 2002) (Stanford University Graduate School of Business, Research Paper No. 1696R), at http://gobi.stanford.edu/ResearchPapers/Library/RP1696R.pdf (last visited Sept. 12, 2002). The study used data collected from over 3000 proxy statements filed with the Commission between February 5, 2001 (the effective date of the Final Rule), and June 15, 2001. Id. at 1. The study found a significant negative stock price response for firms that disclosed the highest unexpected non-audit fees. Id. at 26. A drop in stock price due to unexpected non-audit fees provides some evidence that investors are concerned with the amount of non-audit services an auditor provides an audit client.

The study also found that firms with a high ratio of non-audit fees to total fees were more likely to just meet or barely exceed analysts' forecasts. Id. at Abstract. The results of the study "indicate that firms purchasing more non-audit services manage earnings to a greater extent than other firms." Id. at 2. This evidence suggests that large non-audit fees do affect auditor decisions in the gray area because auditors are more likely to make decisions that support the client's best interest when they receive high non-audit fees than compared to auditors that do not receive large non-audit fees. Although some have criticized this study, see Sergio G. Non, Consultants Might Make Friendlier Auditors, CNET NEWS.COM., at http://news.cnet.com/news/0-1007-200-6996743.html?tag=bplst (Aug. 29, 2001), it provides some evidence that non-audit services affect audit quality, earnings management, and decisions in the "gray area," and that the marketplace agrees with this contention.
115. Id.
116. Id. at 76,022.
117. Id.
118. Id.
Commission adopted a two-pronged approach in the Final Rule. First, the Final Rule identifies particular circumstances that are incompatible with independence.\textsuperscript{119} Second, the Commission requires disclosure (the Disclosure Rule) of the audit and non-audit fees billed by the auditor to the audit client.\textsuperscript{120} As discussed below, the Sarbanes-Oxley Act has modified both prongs of the Final Rule.\textsuperscript{121}

Under the Disclosure Rule, the audit client's financial statements must include the aggregate fees billed for: (1) professional services rendered for the audit for the most recent fiscal year; (2) financial information systems design and implementation services for the most recent fiscal year; and (3) all other services provided by the auditor.\textsuperscript{122} The Commission believes that the Disclosure Rule will enable investors to "evaluate for themselves whether the proportion of" non-audit fees to audit fees raises concerns of independence.\textsuperscript{123} Importantly, the Sarbanes-Oxley Act modified the Disclosure Rule by completely prohibiting auditors from providing financial information systems design and implementation services to audit clients.\textsuperscript{124}

\section{C. The Final Rule}

\subsection{1. Creating a Framework}

Prior to the Final Rule, the auditor independence requirements were found in various Commission rules and interpretations and various ethical rules and standards of the accounting profession.\textsuperscript{125} Thus, one goal of the Final Rule is to "consolidate and make more accessible the standards for auditor independence under the federal securities laws, . . . and [to] provide [an analytical] framework for evaluating auditor independence."\textsuperscript{126}

The Final Rule is not meant to be an exhaustive list of "all circumstances that raise independence concerns."\textsuperscript{127} While the Final Rule does set forth certain "restrictions on financial, employment, and business relationships"\textsuperscript{128} between

\begin{itemize}
  \item \textsuperscript{119} See generally Qualifications of Accountants, 17 C.F.R. § 210.2-01(c)(4) (2001).
  \item \textsuperscript{120} See generally Schedule 14A, Item 9, 17 C.F.R. § 240.14a-101 (2001).
  \item \textsuperscript{122} Item 9(e)(1)-(3), 17 C.F.R. § 240.14a-101 (2001).
  \item \textsuperscript{123} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,022.
  \item \textsuperscript{127} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,030.
  \item \textsuperscript{128} Qualifications of Accountants, Preliminary Note (1), 17 C.F.R. § 210.2-01 (2001).
\end{itemize}
auditors and their clients, it also provides a general "framework for analyzing auditor independence issues" that are not specifically addressed in the Rule.

When the Commission evaluates whether an auditor is independent, the Commission considers whether a relationship or a provision of service:

[1] creates a mutual or conflicting interest between the accountant and the audit client; [2] places the accountant in the position of auditing his or her own work; [3] results in the accountant acting as management or an employee of the audit client; or [4] places the accountant in a position of being an advocate for the audit client.

These four factors create a body of ethical principles that "play a role [similar] to . . . the Ethical Considerations in the American Bar Association's Model Code of Professional Responsibility." This is the general framework to which accountants and auditors can look for guidance when a service raises an independence issue that the Final Rule does not specifically address, and when determining whether the Commission would find the service to impair independence.

2. The General Standard

Situations and relationships specifically set forth in the Final Rule follow a bright line test: "[A]n auditor is not independent if he or she maintains the relationships, acquires the interests or engages in the transactions specified in the rule." The Commission measures situations or circumstances not addressed in the Final Rule by the general standard set forth in 17 C.F.R. § 210.2-01(b). Under this standard:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

The general standard recognizes that an auditor must be independent in fact and appearance by incorporating an objective test for independence that is measured by reference to the reasonable investor with knowledge of all relevant facts and circumstances. The Commission believes that this objective standard is necessary

132. Id.
to ensure consistent and uniform application of the law based on observable circumstances, rather than a subjective inquiry into the accountant's actual state of mind.\textsuperscript{134}

3. Application of the General Standard

\textit{a) Non-Audit Services}

Section 210.2-01(c) applies the general standard of § 210.2-01(b) to specific instances. These specific instances set forth a nonexclusive set of circumstances that the rule deems as inconsistent with the general standard.\textsuperscript{135} The rule divides these situations into five broad categories: (1) financial relationships, (2) employment relationships, (3) business relationships, (4) non-audit services, and (5) contingent fees.\textsuperscript{136} This note focuses on the provision relating to non-audit services.

Prior to the Sarbanes-Oxley Act, § 210.2-01(c)(4) provided a nonexclusive list of services that an auditor could not provide to an audit client during the professional engagement period.\textsuperscript{137} Subject to numerous exceptions, the auditor could not provide the following non-audit services for its audit clients: bookkeeping services;\textsuperscript{138} operating or supervising the design and implementation of an audit client's financial information system;\textsuperscript{139} appraisal or valuation or fairness opinions;\textsuperscript{140} actuarial services provided to insurance companies;\textsuperscript{141} internal audit

\textsuperscript{134} Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,031.
\textsuperscript{135} Id. at 76,032.
\textsuperscript{136} Id.
\textsuperscript{137} Id. at 76,043. The "audit and professional engagement period" includes both the period covered by the audited financial statements and the engagement period that begins when the accountant either signs an initial engagement letter or begins an audit or review, whichever is earlier. The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer a audit client. See Qualifications of Accountants, 17 C.F.R. § 210.2-01(f)(5)(i-iii) (2001).
\textsuperscript{138} Qualifications of Accountants, 17 C.F.R. § 210.2-01(c)(4)(i) (2001). "Bookkeeping services" include maintaining or preparing the audit client's accounting records; preparing the audit client's financial statements that are filed with the Commission; or preparing the originating source data underlying the audit client's financial statement. See id. § 210.2-01(c)(4)(i)(1-3). The rule contained certain exceptions for emergency or unusual situations and for foreign divisions or subsidiaries of audit clients. See id. § 210.2-01(c)(4)(i)(B)(1-2).
\textsuperscript{139} Id. § 210.2-01(c)(4)(ii). One of the most significant areas of debate over the Final Rule concerned the financial information system design and implementation provision. The rule stated that an accountant was not independent if the accountant designed or implemented a hardware or software system that was or would be used to generate information that was significant to the audit client's financial statements taken as a whole. However, the provision contained numerous exceptions. For example, an auditor could design and implement a system that aggregated the source data underlying the financial statements of the audit client, provided that the audit client's management acknowledged primary responsibility for the results, and made all management decisions. See Id. § 210.2-01(c)(4)(ii)(B)(1)-4.
\textsuperscript{140} Id. § 210.2-01(c)(4)(iii). The rule prohibited appraisal or fairness opinions where it was reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the accountant would audit the results of these services during an audit. Id. § 210.2-01(c)(4)(iii)(A). There were exceptions to this rule for opinions given in connection with tax services or if the valuation did not affect the financial statements, among others. See id. § 210.2-
services in an amount greater than 40% of the total hours expended on the audit client's internal audit activities in any one fiscal year;\textsuperscript{142} management functions;\textsuperscript{143} human resources;\textsuperscript{144} broker-dealer services;\textsuperscript{145} and legal services.\textsuperscript{146}

Section 201 of the Sarbanes-Oxley Act amended section 10A of the Securities Exchange Act of 1934 (amended section 10A) by enumerating services that auditors may not provide to public audit clients.\textsuperscript{147} Amended section 10A lists the same prohibited services that the Final Rule prohibited; however, the amendment adopts a flat prohibition against providing these services by removing the numerous exceptions contained in § 210.2-1(c)(4).\textsuperscript{148} Additionally, the amendment provides that auditors may only provide non-audit services to an audit client if the client's audit committee approves the activity in advance.\textsuperscript{149} The commission must adopt regulations consistent with amended section 10A by February 2003 (the amended Final Rule).\textsuperscript{150}

The amended Final Rule provides a bright-line test and notice to auditors of the services that they cannot perform. The Commission evaluates those services not listed by the four general ethical guidelines of the Final Rule — whether providing the service creates either mutual or conflicting interests, places the accountant in

\textsuperscript{01(c)(4)(iii)(B)(1)-(4).}

\textsuperscript{141. Id. § 210.2-01(c)(4)(iv). The rule incorporated three conditions that, if satisfied, would allow the auditor to perform limited actuarial services to the insurance company. See id. § 210.2-01(c)(4)(iv)(A)(1)-(3).}

\textsuperscript{142. Id. § 210.2-01(c)(4)(v)(A). The rule contained an exception for audit clients with less than $200 million in total assets. Id. The Final Rule also provided an exception for internal audit services that were unrelated to the internal accounting controls, financial systems, or financial statements of an audit client if certain conditions were met, such as designating a competent employee to be responsible for the audit and evaluating the results of the audit. See id. § 210.2-01(c)(4)(v)(B)(1)-(6).}

\textsuperscript{143. Id. § 210.2-01(c)(4)(vi). "Management functions" include acting temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. Id.}

\textsuperscript{144. Id. § 210.2-01(c)(4)(vii). "Human resources" includes searching for prospective candidates for managerial, executive, or director positions; engaging in psychological testing; or undertaking reference checks. See id. § 210.2-01(c)(4)(vii)(A)-(D). The rule included an exception for advising clients on a candidate's competency for financial accounting, administrative, or control positions. See id. § 210.2-01(c)(4)(vii)(E).}

\textsuperscript{145. Id. § 210.2-01(c)(4)(viii). "Broker-dealer services" include acting as a broker-dealer, promoter, or underwriter on behalf of an audit client, making investment decisions, executing buy or sell transactions, or having custody of assets of the audit client. Id.}

\textsuperscript{146. Id. § 210.2-01(c)(4)(ix). "Legal services" includes providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction. Id.}


a position of auditing his or her own work, or results in the auditor acting as management, an employee of the client, or as an advocate for the client.\textsuperscript{151}

\textbf{D. Changes Since the Enron Bankruptcy}

Since the Enron Bankruptcy, several major changes have occurred concerning the question of auditor independence and providing non-audit services. First, all of the then-big five accounting firms have spun off portions of their consulting services in an attempt to maintain the appearance of independence.\textsuperscript{152} However, accounting firms continue to advise clients on such things as management process, tax minimization, and corporate finance, obtaining more than an estimated 50% of revenues from non-audit sources.\textsuperscript{153} Second, in February 2002, the AICPA and the then-big five accounting firms announced that they would not oppose an exclusionary ban on providing information technology consulting services and internal audit services to audit clients.\textsuperscript{154} It appears that the Enron scandal may be serving as the "smoking gun" link between providing non-audit services to audit clients and impaired auditor independence. This seems especially true given Andersen's conviction for obstruction of justice based on the shredding of documents in an attempt to destroy evidence of the auditor's relationship with its audit client, Enron.

Finally, a wave of changes has occurred in the law concerning non-audit services. The desire for new "regulation and legislation is based upon the assumption that Enron is not unique — and indeed, that its sins are pervasive — which leads to the conclusion that our financial reporting and disclosure system is flawed or even broken."\textsuperscript{155}

On July 30, 2002, the Sarbanes-Oxley Act became law.\textsuperscript{156} In addition to the provision for amended section 10A prohibiting auditors from providing certain non-audit services, the Sarbanes-Oxley Act also creates the Public Company Accounting Oversight Board (the Board) "to oversee the audit of public companies that are subject to the securities laws."\textsuperscript{157} One of the Board's duties is to "establish or adopt, or both, by rule, auditing quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers."\textsuperscript{158} The Commission has oversight and enforcement authority over the Board and no rule of the Board will become effective without prior approval of the Commission.\textsuperscript{159}

\textsuperscript{151} See Qualifications of Accountants, Preliminary Note (2), 17 C.F.R. § 210.2-01 (2001).
\textsuperscript{152} Cassell Bryan-Low, Accounting Firms are Still Consulting, WALL ST. J., Sept. 23, 2002, at Cl.
\textsuperscript{153} Id.
\textsuperscript{155} Huber & Kim, supra note 154, at 5.
\textsuperscript{157} Id. § 101(a).
\textsuperscript{158} Id. § 101(c)(2).
\textsuperscript{159} Id. § 101(a), (b)(2).
The Commission may recognize, as generally accepted for purposes of the securities laws, any accounting principle established by standard setting bodies, such as the AICPA, that meet certain criteria.\(^{160}\) Now the accounting industry and the Board will work together in setting auditing standards under the oversight of the Commission.

The Sarbanes-Oxley Act also provides that it shall be unlawful to perform auditing services to an issuer "if a chief executive officer, controller, [or] chief financial officer . . . was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."\(^{161}\) This addresses some of the problems that occurred in the Waste Management case.

Another interesting provision of the Sarbanes-Oxley Act calls for mandatory audit partner rotation if the audit partner "has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."\(^{162}\) Lastly, the Sarbanes-Oxley Act significantly increases the fines and terms of imprisonment for securities fraud, tampering with official proceedings, and violations of the Exchange Act of 1934.\(^{163}\)

\textit{E. Analysis}

The amendments made by the Commission to the auditor independence requirements in the Final Rule were a good first step in an attempt to maintain independence during the audit by limiting the scope of non-audit services that auditors may provide. The Commission determined that the best approach to limiting the types of services an auditor may provide to an audit client was to draw lines based on "informed judgment" rather than to adopt a flat prohibition.\(^{164}\) Unfortunately, narrowly defined rules with numerous exceptions usually produce "finely tuned evasion," always blurring the line of what is, and what is not, legal.\(^{165}\) Congress has addressed these "finely tuned" evasions by placing a flat prohibition on auditors providing the enumerated services in section 201 of the Sarbanes-Oxley Act, rather than having the numerous exceptions included in the Final Rule. However, by not adopting a flat ban on all non-audit services, Congress has placed a duty on the Commission and the Board to ensure that the prohibited services and rules remain relevant and effective for protecting our financial markets. This duty requires active monitoring of the practices in the industry to ensure that the rules are still relevant given the inevitable industry changes. By actively monitoring the industry, the Commission can identify other services, such as tax consulting, that the Commission may need to address in the future.

\(^{160}\) \textit{Id.} § 108(a).

\(^{161}\) \textit{Id.} § 206.

\(^{162}\) \textit{Id.} § 203.

\(^{163}\) \textit{See generally, id.} §§ 807, 1102, 1106.


\(^{165}\) \textit{See PANEL REPORT, supra} note 38, ¶ 5.39(9), at 122.
The duty that Congress has placed on the Commission and the Board also requires diligent enforcement of the amended Final Rule to ensure that it is effective in preserving auditor independence. By meticulously enforcing the amended Final Rule, the Commission and the Board can help ensure compliance and determine whether the rules effectively protect the securities markets when they are followed.

Finally, by not adopting a flat prohibition on non-audit services, Congress has placed a duty on the accounting profession to ensure that its auditors are independent. The firm providing the audit must refocus its attention on performing the "public watchdog" function of protecting our markets rather than on acquiring non-audit fees. There must be a shift in the mindset of the accounting industry. Guides on how to be a business consultant, treating audits as commodities and loss leaders, or substantially tying an audit engagement partner's salary to the amount of audit and non-audit services they sell are practices that are no longer acceptable. The auditor needs to return his focus to providing the most accurate and reliable financial information to investors that he can without considering the amount of additional fees that may be jeopardized if he questions the client's books. Any hesitation on questioning a client's books resulting from fear of jeopardizing other fees is completely unacceptable given the tremendous cost to society that the aggregation of these slight hesitations can cause when they culminate in a massive audit failure. There is no argument for cost efficiencies or synergies resulting from providing non-audit services to audit clients that can overcome the possibly devastating effects of even one audit failure.

Unfortunately, remaining completely independent while providing substantial non-audit services may not be a workable premise. Telling the accounting firm to just think about what its left hand is doing and to forget about its right may be too daunting of a task. Active monitoring and diligent enforcement is therefore vital in determining whether the amended Final Rule is working effectively to protect our markets or whether more restrictive rules are necessary. Eventually, a flat ban on non-audit services may prove to be the only effective method of protecting auditor independence.

IV. Conclusion

The amended Final Rule is a major step in restricting the scope of non-audit services that auditors may provide to publicly traded audit clients. Now, the Commission and Board must proactively monitor the effects of the amended Final Rule to determine its impact on audit effectiveness and auditor behavior and to determine whether the law is actually protecting the independence of auditors or whether more restrictive rules are needed. In light of the potentially devastating consequences to the economy and society caused by a loss of auditor independence, the Commission and the Board must err on the side of caution and prohibition if there is any question whatsoever of whether a service impairs auditor independence.

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