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USE OF AUDIT FIRM FOR NON-AUDIT SERVICES: IS INDEPENDENCE IMPAIRED?

By

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and

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ABSTRACT

Public accounting firms have increased their scope of services during the final two decades of the 20th century. The Securities and Exchange Commission's proposed July 2000 Revision of the Commissions' Auditor Independence Requirements included scope of services as related to non-audit services provided to audit clients. This is the subject which is the focus of this paper.

A survey to secure opinions related to the non-audit services identified in Revision of Independence Requirements and to company policies was designed. A letter, memorandum, and questionnaire were mailed personally to the CEOs of 470 of the Fortune 500 companies. Usable responses were received from 89 companies (19.7 percent response of 451 assumed to have reached recipients.)

The responses revealed considerable range in policies and opinions. Companies appear concerned about the independence of their audit firms and the topic was discussed with their audit committees. There were five of the 10 services identified for which more than 50 percent of the respondents indicated that independence would be impaired if the audit firm provided the service. These were: bookkeeping and related services; appraisal or valuation services; management functions; broker-dealer, investment adviser, or investment banking; and legal services. The other five services listed, for which more than 50 percent of the respondents checked that independence would not be impaired, were: financial information systems design implementation; actuarial services; internal audit outsourcing; human resources; and expert services.

The final rules were issued in late 2000. The judgments of the SEC and of the respondents in this survey, which was completed prior to the final rules, were similar in relation to a number of the services. A brief postscript discusses the similarities.

INTRODUCTION

Public accounting firms have increased their scope of services during the final two decades of the 20th century. The Securities and Exchange Commission's proposed July 2000 Revision of the Commission's Auditor Independence Requirements [hereafter referred to as Revision of Independence Requirements] includes consideration of scope of services as related to non-audit services provided to audit clients, as well as other aspects of independence. However, attention in this paper is focused on non-audit services to audit clients only.

The sections that follow include: (1) developments that motivated the SEC's proposed rules re non-audit services; (2) the overall nature of the proposed rules re non-audit services; (3) the objective and design of a survey of Fortune 500 companies; (4) policies and extent of use of audit firm for non-audit services; (5) opinions re services identified in SEC proposal; (6) comparisons of findings with other surveys; (7) conclusions and comments (as of October 2000); and (8) postscript (as of August 2001).

1. EXTENT OF NON-AUDIT SERVICES TO AUDIT CLIENTS

From the early days of accounting in the United States, public accountants began providing professional advice to clients and serving as consultants. However, for many years, the extent of such services to audit clients was not perceived to be significant. Furthermore, prior to the 1970s, there was a perception that public accountants were not driven by competitive forces to increase revenues. Professionalism was perceived to be an overriding attitude that was assumed to sustain independence in the performance of audits.

The SEC's Revision of Independence Requirements highlighted the contemporary concern:

> The percent of Big 5 audit clients that paid MAS fees in excess of audit fees did not exceed 1.5 percent until 1997. In 1999, 4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees, an increase of over 200 percent in two years. For the five largest public accounting firms, MAS fees received from audit clients amounted to ten percent of all revenues in 1999. Almost three-fourths of audit clients purchased no MAS from their auditors in 1999. This means that purchases of MAS service by one fourth of firms' audit clients account for ten percent of all firm revenues (SEC, Revision of...9).

The questions related to the nature and extent of non-audit services that should be permitted continue. To date the issue is unresolved. In the following paragraphs are brief discussions of key comments during the final three decades of the twentieth century. This listing is representative, in a general sense, of the type of thinking about this matter. (See discussion in *The Panel on Audit Effectiveness: Report and Recommendations:* Appendix D).

The Accounting Establishment: A Staff Study: In the study of the accounting profession undertaken by a Senate subcommittee, information was provided by the Big Eight public accounting firms about the approximate percentage of revenues from services, such as management advisory and actuarial. There was no indication of the extent of such services for audit clients, however. Table 1 provides an excerpt from Table 1 in the study (Subcommittee, 30).

Table 1: Big Eight Public Accounting Firms' Revenues from Management Advisory Services*

7. Please indicate the approximate percentage of total revenues for services performed by your firm in the following categories:								
A. Auditing and accounting ……..……..66	69	69	73	74	68	76	62
B. Tax services ……..……18	17	19	17	15	21	16	24
C. Management advisory services including executive recruitment product analysis, marketing analysis, and plant layout …..16	14	10	9	5	11	6	14
D. Actual services……		2			1		14
E. Services Performed for Federal, State or local governments……..3	5-10	2	1	<5	4	2	15
F. Other				6			
8. Please state if your firm renders management or other advisory services in the following categories:							
A. Executive recruitment ……..…….No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
B. Marketing analysis……..……No	(17)	Yes	Yes	No	Yes	No	Yes
C. Plant layout……...No	(17)	Yes	Yes	No	Yes	No	Yes
D. Product analysis……No	(17)	No	Yes	No	Yes	No	Yes
E. Actuarial services …… No	(17)	Yes	No	No	Yes	No	20
F. Federal advisory committees ……..…. (10)	(17)	Yes	No	No	Yes	No	21

*An excerpt from Table 1. Summary of Certain Information contained in Responses of the "Big Eight" Accounting Firms to the December 19, 1974 Questionnaire. (Subcommittee, 30)

As noted in the excerpt, the percentages ranged from 5 to 16 percent with four of the eight attributing no more than 10 percent of their revenues to management advisory service, with executive recruiting the only service provided by more than half of the Big Eight firms. The conclusion of the study was that even a 5 percent contribution to revenue was *substantial.* The conclusion provided was:

> The rapid growth of management advisory services as a source of revenues for "Big Eight" firms has impaired their ability to act as independent auditors for publicly-owned corporations. The "Big Eight" firms are involved in providing management advisory services to varying degrees, but all of the firms derive substantial revenues from performing such service (Subcommittee, 35).

SEC Staff Study: In a 1994 SEC staff study, the conclusion was that much of the growth in non-audit services was for non-audit clients. In the meantime the requirement, promulgated in 1978, for disclosure in proxy statements of non-audit services performed by companies' external auditors and the relationship of fees from such services to fees for audit services, was dropped in 1982. In a 1994 review of the situation, the SEC concluded that no change in the rules was necessary, but that the staff should continue to be aware of the development of problems of independence that might be caused by non-audit services (SEC Revision, 7).

Improving Business Reporting -- A Customer Focus. Also, in 1994, the Special Committee on Financial Reporting (commonly called the Jenkins Commission) noted:

> Users are concerned about current pressures on auditor independence. They also are concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship (Special Committee, 104).

The Accounting Profession: Major Issues: Progress and Concerns: This report provides the status of recommendations made to the accounting profession over the period from 1972 through 1995. In the chapter on audit independence, scope of services is discussed. While the report identifies the concern with the expanding scope of professional services provided by public accounting firms to their audit clients, the report also presents support for both the appropriateness and inappropriateness of providing non-audit services to audit clients. Several studies discussed provided no conclusive evidence of diminished audit quality or harm to the public interest, or an actual impairment of auditor independence, as a consequence of public accounting firms providing non-audit services to audit clients. The report includes an acknowledgement, however, that some management advisory services to audit clients do lead to the perception by some that independence could be impaired (U. S. General Accounting Office, 41-42).

Independence Standards Board. In a study of perceptions of different audiences, the key findings related to non-audit services sold to auditees that trigger greater concerns where fees greatly or routinely exceed audit fees, where contracts are assigned rather than bid competitively,

where assignment is of a nature to become potential audit subject, and where assignment is a key to a firm, partner, or office's future strategy (Independence Standards Board, 7).

The Panel on Audit Effectiveness. The Panel on Audit Effectiveness devoted attention to non-audit services. (As noted earlier, Appendix D contains a brief chronicle and summary description of studies related to non-audit services to audit clients for a period of approximately 40 years.)

The panel reported that there was much discussion, including debate about recommending a ban on some or all non-audit services to public audit clients. The panel noted that public accounting firms were splitting off some or all of their consulting practices and that the SEC was soon to issue a proposed change in rules related to independence. This group, therefore, presented some general recommendations to the Independence Standards Board, the audit committee, and the Securities and Exchange Commission. The report also included the position of some members of the panel who believe that there should be an exclusionary ban on non-audit services, with some limited exceptions (Panel, 116-126).

2. PROPOSED RULES RELATED TO NON-AUDIT SERVICES

The SEC's Revision of Independence Requirements includes four guiding principles for determining when an auditor is not independent. They are when the auditor: 1) has a mutual or conflicting interest with the audit client; 2) audits the accountant's own work; 3) functions as management or an employee of the audit client; or 4) acts as an advocate for the audit client (SEC Revision, 15).

Under the current Rule 2-01, independence requirements apply to "any professional employee involved in providing [on behalf of an accounting firm] any professional service" to an audit client. The current rule further states that in making independence determinations..."all relevant circumstances, including evidence bearing on all relationships between the account and the client" will be considered.

The proposed rules apply only to non-audit services when provided to audit clients. They do not govern non-audit services when provided to organizations other than audit clients.

The proposed rule does not provide an all-inclusive list of the services incompatible with proposed rule 2-01 (b). The provision of a non-audit service not specified in the proposed rule is to be measured against the four general principles earlier identified.

There are detailed specific non-audit services that impair independence. For each there is a brief discussion.

1. Bookkeeping or other services related to the audit client's accounting records or financial statements.

> Currently, an auditor's independence is impaired if the auditor provides bookkeeping services for an audit client. Current proposal continues that position.

2. Financial information systems design and implementation.

> The proposal states that the accountant is not independent if the accountant designs or implements a. ...system that is or will be used to generate information that is significant to the audit client's financial statements taken as a whole.

3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.

> The impairment of independence is when such services lead to the reasonable likelihood that the results will be audited by the auditor.

4. Actuarial services.

> Proposal states that independence re such services is impaired, unless the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

5. Internal audit outsourcing.

> The proposed rule provides that an auditor is not independent when the auditor performs certain internal audit services for an audit client or an affiliate. However, nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function or operational internal audits unrelated to internal accounting controls, financial systems, or financial statements are not included as the limitations related to this item.

6. Management functions.

> The current rule that prohibits serving temporarily or permanently as a director, officer, or employee of the audit client or an affiliate or performing any decision-making, supervisory, or ongoing monitory functions is essentially continued in what is here proposed.

7. Human resources.

The proposed rule extends the provision of the current rule which provides that independence is impaired with respect to an audit client when the auditor recruits, hires, or designs compensation packages for officers, directors, or managers of the audit client or its affiliate. The proposed rule adds that independence is impaired when the auditor advises an audit client about its or its affiliate's management or organizational structure, when the auditor develops employee evaluation programs, or when the auditor conducts psychological or other formal testing of employees.

8. Broker-dealer, investment adviser or investment banking services.

The proposed rule provides that an accountant is not independent if the accountant acts as a securities professional for an audit client or an affiliate of the audit client.

9. Legal services.

The proposed rule is consistent with current regulations, under which legal services are deemed to be incompatible with auditor independence.

10. Expert services

The proposed rule states that an accountant's independence is impaired as to an audit client if the accountant renders or supports expert opinions for the audit client or an affiliate of the audit client in legal, administrative, or regulatory filings or proceedings.

11. Tax services

The proposed rule would not affect tax-related services provided by auditors to their audit clients.

3. THE PURPOSE AND DESIGN OF A SURVEY OF FORTUNE 500 EXECUTIVES

There is a lack of empirical evidence about companies and their use of their audit firms for non-audit consulting services. The chairman of the House Committee on Commerce, Thomas J. Bliley, sent a letter of inquiry to the SEC in April 2000. In that letter there were several questions, one of which was:

> What empirical evidence, studies, or economic analysis does the SEC possess that demonstrates accounting firms having consulting relationships with audit clients are less independent than those firms that do not have such relationships?

The response was surprisingly lacking in empirical evidence about companies and their use of their audit firms for non-audit consulting services. Since the time of Bliley's inquiry, there have been two surveys related to the topic. In May 2000 the Financial Executives Institute surveyed its members. The Association for Investment Management and Research also survey its members on the business services they would consider to be a conflict of interest for audit firms to provide their audit clients. This survey was conducted in the late summer of 2000.

Purpose of Survey

The purpose of the Fortune 500 survey reported in this paper was to learn of the general policies related to the use of a company's audit firm for non-audit services. Furthermore, there was an interest in knowing how the companies dealt with the independence question. Finally, opinions were sought related to 10 of the 11 services listed as non-audit services provided to audit clients in the Revision of Independence Requirements. The service omitted was tax services, which is a commonly provided service for audit clients.

Design of Survey

The design of the survey was influenced by the assumption that the largest U. S. companies were likely to be initially most responsive to recommendations to enhance the quality of financial reporting in their organizations as presented in Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon, 10-16). There was widespread discussion of the recommendations in the business press and at conferences. Recommendation No. 7 relates to the subject of this survey. It states:

> The Committee recommends that the listing rules for both the NYSE and the NASDAQ require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor, and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor (Blue Ribbon, 30).

The Sample. The original mailing was sent to 470 of the Fortune 500 companies. Letters were individually addressed to the chief executive officer in each company. The letter asked that an enclosed memorandum and a four-page questionnaire be forwarded to the individual in the organization who was in the best position to respond to the inquiries. The letter assured anonymity. If there was an interest in the results, the respondent was directed to send an email to one of the investigators.

The Response. Letters from 14 companies stated that they did not respond to survey questionnaires. An additional 3 were returned unopened with the notation that the chief executive officer was no longer with the company; one company's response indicated that it had merged with another of the Fortune 500 companies, so only one return was completed. One chief

executive wrote that his written statement reflected the position of his firm, which was that there should be no non-audit services provided to audit clients. There were 89 completed questionnaires for analysis, which is based on a total number of 451, or a 19.7 percent return based on usable returns.

The chief executive officer was directed to forward the memorandum and questionnaire to the person who could best respond. As noted in Table 2, respondents varied, with six chief executive officers themselves responding. In many instances, titles included more than one designation, such as Vice President and Controller or Vice President and Head, Internal Audit. Positions were categorized, however, by key function as related to financial reporting. As might be expected, in the majority of instances, individuals related to the financial reporting function were selected to respond to the questionnaire.

4. POLICIES AND EXTENT OF USE OF AUDIT FIRM FOR NON-AUDIT SERVICES

There is variation in relation to every aspect of the topic reflected in responses. However, there are several instances where one response was the choice of a majority of respondents.

Table 2
Position of Respondents

Position	**Number**	**Percentage**
Chief Executive Officer …….…….…….6		6.7
Senior Vice President (with no other specification)…….4		4.5
Chief Financial Officer ……..19		21.4
Controllers …….25		28.1
Internal Audit Heads ……..35		39.3
Total	**89**	**100.0**

Policy Re Use of Audit Firm

The initial question asked respondents to choose the statement that best characterized their current policy related to the use of their audit firm for non-audit consulting engagements. The statements provided were:

1. Our policy is **never** to consider our audit firm for non-audit services of any kind.
2. Our policy is to use our audit firm for clearly specified types of non-audit consulting services which are: (Respondents were directed to briefly describe such services).
3. Our policy is to use the consulting division of our audit firm for all types of non-audit consulting engagements.

4. We have **no** policy as relates to the use of our audit firm for non-audit consulting services, but make decisions based on our judgment of who can provide the most effective services.

As presented in Table 3, the "no policy" alternative was identified most frequently (65.1 percent). There appear to be, however, policies related to review of anticipated consulting engagements, with many noting that their audit committees were involved in making decisions to use their audit firms where the amount involved was more than a specified amount, such as $50,000 or $100,000. Thus, "our judgment" appears to have been interpreted as including some level of *policy* related to the extent to which audit firms are to be used.

More than a fourth of the respondents (28.1 percent) reported that it was their policy to use the audit firm for clearly specified types of non-audit services. Comments that illustrate types of services noted by respondents were:

"tax planning"
"internal audit assistance"
"Y2K internal audit assistance"
"Our external audit firm is used for specified types of non-audit services, excluding those prohibited by SEC guidelines. As a control, authority levels have been established. ..so that projected spending for each category will not exceed the total of the previous year's fee for audit services..."

Table 3
Current Policy Related to Use of Audit Firm for Non-Audit Services

Statement (abbreviated)	**Number**	**Percentage**
We have no policy --make decisions on basis of best service	58	65.1
We use our audit firm for clearly Specified services	25	28.1
We use our audit firm for **all** types of services	3	3.4
We **never** use our audit firm for such services	3	3.4
Total	**89**	**100.0**

Audit Committee Review

In responding to the question about policy, many made reference to their response to the question which asked the extent to which their audit committee of the board of directors discussed and made judgments about the independence of the audit firm. Table 4 shows the range of response, with the majority stating that independence is discussed. Many added comments about the extent to which the audit committee considered proposed engagements for

no-audit services by their auditors. A number noted that they were implementing Blue Ribbon Committee Recommendations.

Table 4
Extent of Discussion of Independence by the Audit Committee of the Board

Statement	Number	Percentage
Independence discussed each year at time of appointment of external auditor	78	87.6
Independence not discussed	2	2.3
Do not know if topic is discussed	1	1.1
Other: Comments included: when specific engagements are being considered; there are informal guidelines used for reviewing certain types of engagements	8	9.0
Total	**89**	**100.0**

Extent of Fees Paid to Audit Firm for Non-Audit Services

An open-ended question was asked about fees paid for non-audit services: *For your last fiscal year, indicate total of non-audit services fees as a percentage of your audit fees.* (An example was provided: *if non-audit fees were $10M and audit fees were $15M, non-audit fees would be recorded here as* 66.7%) The responses are shown in Table 5. Slightly over 49 percent of the respondents indicated that non-audit fees paid to their audit firms were no more than 100 percent of the audit fees. However, of the 74 who provided figures, there were 59.5 whose fees were no more than 100 percent of audit fees. Fifteen respondents indicated non-audit fees of 201 percent or more of audit fees. A number of respondents indicated that their fees for the last fiscal year were higher than normal because of Y2K-related services. In some instances, respondents separated out the fees for Y2K-related services. The figures summarized in Table 5, combined all payments, however, since respondents were not asked to consider Y2K-related payments as a separate item. The interpretation of these figures is not clear, since many indicated that the level of payments is not typical for their company.

Table 5
Non-Audit Services' Fees as a Percentage of Audit Fees for Last Fiscal Year

	Number	Percentage
No more than 20%	15	16.8 21%
21%-50%	13	14.6
51% -100%	16	18.0
101% -200%	15	16.9
201% -500%	10	11.2
Over 500% *	5	5.6
Did not provide a figure	15	16.9
Total	**89**	**100.0**

*This category includes one of 770%; one of 1200%; and one of 2400%

5. OPINIONS RE NON-AUDIT SERVICES IDENTIFIED IN SEC LISTING

The survey instrument listed only the identification of the non-audit service for which the SEC sought opinions. The Revision of Independence Requirements, however, included with each of the services some discussion of the issues and questions for consideration in preparing a response. The respondents in the survey here reported did not have a questionnaire with the additional information to aid them in selecting one of three options: 1. agree that such services impair auditor independence; (2) do not agree that such services impair auditor independence; (3) do not have an opinion at this point. (Respondents were not asked if they had read Revision of Independence Requirements. A question about this matter would have been appropriate. Several respondents called to discuss the questionnaire; those discussions, in some instances, did reflect a review of the SEC's proposal for change.)

Extent of Opinions

Table 6 shows the range of opinion for each the 10 services identified. The services for which more than 50 percent of the respondents agreed that independence would be impaired were bookkeeping or other related services; appraisal or valuation services; management functions; broker-dealer, investment adviser, or investment banking services; and legal services. For the other five services, more than 50 percent of the respondents believed that auditor independence would not be impaired. These services were: financial information system implementation; actuarial services, internal audit outsourcing; human resources; and expert services.

Approximately 25 percent of respondents qualified their opinions. Some typical qualifications are:

"...we said we did not agree that providing internal audit services impaired independence; however, we would never consider outsourcing the entire function to our external auditor."

"…do not feel that non-audit work interferes or impairs the annual audit because it is almost always performed by different employees, usually in different departments."

Of the 89 respondents, there were three who agreed that all 10 services impaired independence. Two of these respondents were internal audit directors (there were 35 such respondents) and one was a CEO (there were six such respondents). There were 16 respondents who identified seven or more services as impairing independence; 10 of these were internal auditors. There was a single respondent, a controller, who checked that none of the 10 services impaired auditor independence. There were 17 who believed that seven or more of the services did not impaired auditor independence.

There were variations in the extent of "no opinion." Twelve percent or more of the respondents indicated this alternative for four services: actuarial, human resources, broker-dealer, and legal.

Table 6
Opinions of Respondents of Impact of Non-Audit Services on Independence

Service	Impairs independence (percentage)	Does not impair independence (percentage)	No opinion (percentage)
1. Bookkeeping or other services related to the audit client's accounting records or financial statements. * (2 nonrespondents)	**68.5**	24.7	4.5
2. Financial information systems design implementation. *(1 nonrespondent)	25.8	**70.8**	2.3
3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports where there is a reasonable likelihood that the accountant will audit the results.	**65.2**	25.8	9.0
4. Actuarial services	29.2	**53.9**	16.9
5. Internal audit outsourcing	35.9	**56.2**	7.9
6. Management functions. ...an accountant acts, temporarily or permanently, as a director, officer, or employee.	**88.8**	9.0	2.2
7. Human resources. ...Recruiting, advising clients about organizational structure, developing employee evaluation programs, or conducting testing of employees. ..	15.7	**69.7**	14.6
8. Broker-dealer, investment adviser, or investment banking services.	**62.9**	24.7	12.4
9. Legal services.* (1 nonrespondent)	**52.8**	28.1	18.0
10. Expert services. ..renders or supports expert opinions in legal, administrative, or regulatory filings or proceedings	14.6	**76.4**	7.9 *

*(1 nonrespondent)

Percentages over 50 are in bold

(N = 89; an * indicates 1 or 2 nonrespondents, with the line less than 100%, therefore)

Opinions Related to Two General Positions

The positions toward the two ends of a continuum from "no non-audit services" to "essentially full non-audit services" are represented by two recent publicly reported positions. Barry C. Melancon, President and CEO of the AICPA, stated: “We believe that, with the appropriate safeguards in place, the provision of many non-audit services may enhance the audit by broadening the firm's understanding of a company's business, operating environment, and other factors that lead to a more effective audit. ...” Melancon's position isn't as extreme as it could be, since there could be an absolute statement that any non-audit service should be allowed. While that is theoretically a position, the reality of the contemporary environment in which auditors function would not support consideration of such a position (Melancon, 3).

The position at the other end of the continuum is represented by a statement by John H. Biggs, Chairman of TIM-CREF, in which he stated: "Independent public accounting firms should not be auditing any company for which they simultaneously provide other services" (Biggs, A26).

As noted in Table 7, there was more disagreement with Bigg's statement than there was agreement with Melacon's statement. Some added a comment that Bigg's statement was too inflexible; others noted that safeguards were critical in their support of Melancon's position.

Table 7
Opinions of Two Opposite Positions

	Agree	**Disagree**	**No opinion**
Melancon's position: allow --with safeguards	**74.2%**	19.1%	6.7%
Bigg's position: should not be auditing any company for which they provide any other services	11.2%	**82.0%**	6.8%

Comments Beyond the Specific Questions

Respondents were asked to add any other comments about the topic of auditor independence and the provision of non-audit services to audit clients. A number did add such comments. Illustrative of some are the following:

Decision can be handled by management and audit committee:

"Management, audit committee, and auditor are in the best position to identify potential independence issues. "

"Any future rules on auditor independence should give management enough flexibility to make the best choice for shareholders."

Extent of Non-Audit Service -- Reservations:

"Total outsource of an internal audit function impairs independence. Use of our external auditor to provide minor supplements on a contract basis do not."

"Non-audit services are useful to clients...but where practical, they should be performed by a firm other than the audit firm. Independence encompasses both in-fact and appearance situations. We have imposed a limitation on our external auditors. Non-audit service fees cannot exceed 50 *percent of the total fees paid to the external audit firm.* "

"As in most things, good judgment by both parties is the key to avoiding problems. "

"I think many of the questions (related to services) are too broad. For example, we said we did not agree that providing internal audit services impaired independence; however, would never consider outsourcing the entire function to our external auditor. Many of the other items are of a similar nature. ... okay on a limited basis, but on a large scale would not be acceptable. "

"The two positions stated in items 4.1 *and* 4.2 *represent two extremes of the argument. We do not agree with either position. We would, however, more readily agree with the reverse of the statement in Item* 4.1 *-i. e. with appropriate safeguards in place, the external audit firm providing statutory audit services has a broader understanding of the client's business, operating environment, and other factors that may lead to broader understanding of the client's business.* "

" *While it is true that a company's external auditor develops an understanding of their client's business that may enhance the value-added and efficiency of work performed, it is critical that safeguards be put in place to protect against undue influence on the external auditor's statutory audit work in favor of more lucrative 'consulting-type' (non-audit services) contracts.* "

"Total outsourcing of an internal audit function impairs independence. Use of our external auditor to provide minor supplements on a contract basis do not."

"Non-audit services are useful to clients...but where practical, they should be performed by a firm other than the audit firm. Independence encompasses both in-fact and appearance situations. We have imposed a limitation on our external auditors. Non-audit service fees cannot exceed 50 percent of the total fees paid to the external audit firm."

A Complex Issue

The identification of two positions as presented in Question 4 and consideration of responses, including the added comments, highlight the complexity of the issue of non-audit services provided by public accounting firms for their audit clients. A resolution that optimizes the credibility of publicly-issued financial statements is required.

The role of the profession is critical if self-regulation is to be maintained. Louis W. Matusiak's assessment of the self-regulatory program's prospects after about three years of the peer review program had begun may be relevant at this point. Matusiak stated:

> In each of its three special reports to Congress [1979-1981] on the oversight of the accounting profession, the SEC has stated that it is committed to a policy of self-regulation by the profession. The self-regulatory program has weathered the three difficult formative years only because of the strong will and dedication of the leaders of the profession to have the program succeed. Such will and dedication in the coming years are equally important to the program's continued existence (Matusiak, 30).

6. COMPARISON WITH OTHER SURVEYS

The regulations governing the scope of services cannot be determined by one or more opinion surveys of constituencies that have knowledge and credibility. Such surveys, however, provide insight into the thinking of interested parties and the public. Such knowledge can be useful in understanding how rules ought to be operationally specified after the profession's leaders and/or policy regulators have determined what is needed.

During public hearings related to the Revision of Independence Requirements, there were presentations from two associations who had done recent surveys of their memberships. Survey instruments differed from the one developed for the Fortune 500 companies, but since the general content was similar, the results are of interest.

Financial Executives Institute Survey (FEI)

In the words of its leadership, FEI..."is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the United States and Canada." Its membership was asked to identify services that, as a matter of policy, they do not allow their auditors to provide to them. The services listed included:

Maintaining accounting records, preparing financial statements, generating disclosure data.
Appraisal or valuation services, fairness opinions, contribution-in-kind reports.
Actuarial services.
Management services of a decision-making or supervisory nature.
Broker-dealer, investment advisor, or investment banking services.
Legal services (other than tax counsel/advice and tax opinions.)

The 500 Fortune companies' survey asked for opinion; not current practice, which was the inquiry of the FEI survey. All the above listed services, which the membership stated they did not allow; except for one: "actuarial services," were the services that 50 percent or more of the respondents to the Fortune 500 survey identified as impairing independence. This is an interesting comparison, even though its value is not easily determined.

In the public testimony before the SEC, Ameen, the chairman of the Corporate Reporting Committee of FEI, noted that "companies prefer to have all options open to them, to have freedom of choice in selecting consultants. ...However, companies time and again emphasized in written comments in the survey of this paper that they are very selective about the nature of consulting work they assign to their audit firm and that the company's audit committee is actively informed and consulted before entering these engagements" (Ameen, 3).

Association for Investment Management and Research (AIMR)

There are 43,000 members in 95 countries in this global, non-profit association of financial analysts, portfolio managers, and other investment professionals that "promote high standards of professional practice and full and fair disclosure of financial information to investments and those involved in investment decision-making" (Kohn, 1).

In the survey discussed in the SEC public hearings by Kohn, a member of the AIMR U. S. Advocacy Committee which is charged with reviewing and responding to major regulatory, legislative, and other developments in the United States, members were asked whether certain non-audit services would impair auditor independence if audit firms provided them to audit clients. Out of 970 respondents (2.2 percent of the membership), the percentages who said each service would compromise independence and objectivity were:

Asset valuation and appraisal	65 percent
Outsourcing of accounting and payroll	62 percent
Legal services	62 percent
Executive compensation consulting	61 percent
Treasury management	60 percent
Risk management	59 percent
Other management consulting	53 percent
Actuarial valuations	47 percent
Tax planning	42 percent
Management training	41 percent
Tax compliance	37 percent
Information systems design and implementation	37 percent

Kohn summarized AIMR's position stating: "We believe that auditors should be held to a higher standard than those providing other services" (Kohn, 4).

The categories used in the AIMR survey differed from those identified in the Revision of Independence Requirements, which were the categories used in the Fortune 500 survey reported herein. There appears to be some agreement about services that impair independence. Of the seven services with more than 50 percent of the respondents indicating that independence and objectivity would be comprised, five sound similar to the categories used in the Fortune 500 survey. In the AIMR, outsourcing is related to accounting and payroll, not specifically identified is internal auditing. Whether or not "internal auditing" is considered in the AIMR category is not determinable.

Sensitivity to Variations in Impairment

The three surveys, although different in design, populations sampled, and conclusions, do provide a rather important observation: Respondents differentiate among services as they consider impairment of independence. Persons who are knowledgeable about the role of the external auditor and the types of consulting services provided by public accounting firms are indicating that the matter of impairment is not universally related to all services or none.

7. CONCLUSIONS AND COMMENTS

Conclusions must be considered within the framework of the inherent limitations of the survey strategy for gaining information. Those limitations relate to the silence of the nonrespondents, the representativeness of the response for the entity in which the respondent works, the interpretation of what is said, and the inability to probe with a question that asks: "What do you mean. ...?"

The request for either "agreement" or "disagreement" with a particular service could not capture the qualifications related to “agreeing” or “disagreeing.” There was a request for additional comments, which provided, to a limited extent, the sense that there may be considerable variation in either an "agreement" or a "disagreement." The answer, given a specific service in a particular environment, at a particular level of billable hours, may shift from "agree" to "disagree."

Understanding of the Problem Reflected

The responses of the participants in the survey reported here reflect an understanding of the independence problem. They discriminated among the services and a significant number qualified their opinion because they realized that extent of a service, its relationship to the basic audit, and the nature of oversight provided by their own companies were all factors that deserved consideration.

In general, the opinions of this group of respondents is not unlike that of others who have undertaken surveys or presented testimony at public hearings. This group, too, presents the range of response elicited by the SEC's proposed changes.

There is support for Levitt's comment that Revision of Independence Requirements has raised the level and extent of discussion of the topic of auditor independence as evidenced by thoughtful comments and telephone conversations with prospective respondents, as well as the extent of requests for the findings. (See SEC, Public Hearings, September 26).

Involvement of Audit Committee

Furthermore, there appears to be a higher level of audit committee involvement in relation to independence than was perceived to be present when the Blue Ribbon Committee was established. This comment is derived from what was stated in relation to involvement of the audit committee. No question in the questionnaire dealt directly with the implementation of the Blue Ribbon recommendation re independence.

Extent of Non-Audit Services Differs from SEC Figures

As noted (page 1 of this paper), in Revision of Independence Requirements, there was a note that "4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees to their auditors. Almost three-fourths of audit clients purchased no MAS from their auditors in 1999. This means...services by one-fourth of firm's audit clients account for ten percent of all firm revenues. …"

The findings from the Fortune 500 survey herein discussed do not provide a basis for comparison with the figure presented by the SEC. While there is no basis for generalizations on the basis of the findings of this survey, a question can be raised: What is the reality re extent of provision for non-audit services? Given the intense interest of public accounting firms in the Revision of Independent Requirements, it is easy to challenge why dire predictions re economic consequences would ensue if only, for example, 4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees to audit firms? *(Underway is an effort to get the source of the figures provided by the SEC.)*

Tentative Observations

When the survey is viewed in relation to statements made by the SEC commissioners in public hearings, by various interested groups, academics, and others there are some tentative observations that raise questions:

1. What is the relationship of those who provide audit services to those who provide non-audit services in public accounting firms?

For example, it is not clear how non-audit services enhance the performance of an audit, as was stated by representatives of groups in the profession. Why have public accounting firms for several decades claimed that firewalls separated their auditing function from their consulting

services. How impervious has that firewall been? Does the current concern challenge the separation of consulting from auditing?

2. Will the leadership of the profession be effective in resolving independence issues, especially those related to non-audit services provided to audit clients?

At pubic hearings in Washington, DC, on September 20, two heads of Big-S firms provided testimony. Philip A. Laskawy, Chairman of Ernst & Young, and James J. Schiro, Chief Executive Officer of PricewaterhouseCoopers, offered what was perceived to be a form of compromise in relation to proceeding toward a reasonable decision (Norris, C12).

In his testimony, Laskawy noted: "It is unfortunate that the Commission's attempt to promulgate an independence rule has actually led to less civility and has increased the tension between the profession and the Commission. .." (Laskawy, 2).

Schiro, also in public hearings, revealed that "my firm has been engaging the Commission's staff and we've found them open to our ideas and interested in discussing the future of the profession...(Schiro, 2).

3. What will be the response of the Senate Committee on Securities Committee on Banking, Housing and Urban Affairs to the subject of auditor independence?

In testimony before the Senate Subcommittee on Securities Committee on Banking, Housing, and Urban Affairs, Arthur Levitt on September 28 summarized the hearings related to the Revision of Independence Requirements, noting that non-audit services provided to audit clients had "attracted the most attention and generated the most debate. He noted that although some had called for the SEC to look to the Independence Standards Board to address the questions, four public members of the ISB have asked the Commission to address these issues with a rulemaking." Allen, Chairman of the ISB, testified that making a rule on this subject -- non-audit services -- is not well-suited for a board of the character of the ISB. Levitt also quoted the former chairman and CEO of Deloitte & Touche, J. Michael Cook who stated: "Some action by the SEC, is probably the only practical and feasible way to deal with the issue."

Levitt discussed some of the key criticisms, including the lack of empirical evidence that non-audit services tainted an auditor's work, that non-audit services enhance an auditor's ability to do an effective audit, and that prohibiting non-audit services will lead to difficulty in recruiting new entrants because the career in auditing would be perceived as limiting (Levitt, Testimony, 6-9). He concluded by saying:

> The concept of the "independent auditor" has been a critical source of investor confidence. I hope and believe that it will continue to foster that confidence. But for that to happen, investors must be able to know that an audit is not an accountant's means to some other goal, and is not subordinate to some other relationship, but is an end in itself a service provided by a disinterested professional for the benefit of the public(13,14).

Then, on October 16, Levitt forwarded a letter to numerous Members of Congress asking that they not intervene in the Commission's auditor independence rulemaking process. (Levitt, Letter, 1)

At an AICPA meeting on October 24, Levitt stated:

> ...And in recent weeks, I've sensed a new willingness by those in the profession who have expressed serious concern about the Commission" rulemaking [related to the Revision of Independence Requirements] to come to the table and share with us the detail and depth of their concerns. ...I am optimistic that if we can continue to stay at the table, we will not only make progress towards long-overdue modernization, we will take the first steps towards mending and renewing the relationship between the Commission, the AICPA, and the profession (Levitt, The Public, 4).

A day later, October 25, *The Wall Street Journal* reported that,

> The SEC has indicated in negotiations with three big accounting firms that it may be willing to allow auditors to continue providing computer-systems consulting services to audit clients…. Negotiations over the new standards could still break down over final wording of many complex provisions... (Schroeder, SEC, C1).

4. How quickly will there be resolution of the deep differences of opinion between the SEC and some segments of the profession?

8. POSTSCRIPT

The Securities and Exchange Commission issued their final rules in late 2000 to become effective as of February 5, 2001. In relation to the provision of non-audit services to audit clients, they noted the difference between the proposed rule and the final ruling:

> The final amendments identify nine non-audit services that, when provided by the auditor to an audit client, impair the auditor's independence. In the proposed rule, we identified ten such services. In response to these [services] we made several modifications to the rules including eliminating altogether one service that had been identified.

Parallels Between Respondents in the Survey and the SEC Final Ruling

There is considerable agreement between the respondents to the survey, which was completed before the final rules were issued, and the final ruling related to non-audit services provided audit

clients. Both the respondents, in a majority of instances, and the SEC's new rulings identify the following as impairing independence:

a. bookkeeping or other services related to the accounting system

b. appraisal or valuation services, and similar services

c. management functions

d. broker-dealer, investment adviser, or investment banking services

e. legal services

There are some exceptions and qualifications noted for the above services, but the general rule is that independence would be impaired. For the additional four services, there are exceptions that allow for the provision of the service.

Over 70 percent of the respondents of the survey believed that there was no impairment of independence if services related to financial information systems design implementation were completed. As the SEC noted: "The final rule reflects a pragmatic approach to a difficult issue." The rule does not ban such services; there has been an amendment to the proxy disclosure rules that will require public companies to make specific disclosure of fees paid to their auditors for information technology services. As stated in the ruling: "In addition, public companies must disclose that their audit committees considered whether the provision of the information technology services, as well as other non-audit services, is compatible with maintaining the auditor's independence.

A majority of respondents (53.9 percent) in the survey believed that actuarial services did not impair independence. The SEC ruling related to this service concluded that if certain conditions were met, there were four types of actuarial services that can be provided to insurance companies without impairment of independence.

Over 56 percent of the respondents in the survey believed that performing internal audit outsourcing services did not impair independence. The final ruling allows for some internal audit services by the external auditor for audit clients.

Approximately 70 percent of the respondents in the survey believed that human resources services impaired independence. The SEC modified their proposed rule and the final rule closely parallels the current guidance related to this matter.

Expert services were eliminated. Over 76 percent of the respondents in the survey indicated that such services do not impair independence.

The End of the Independence Standards Board

The Independence Standards Board, which began operations in June 1997 and spent considerable effort in developing a conceptual framework for independence, ceased functioning as of July 31 2001. Comment letters had been received to an exposure draft of a conceptual framework. The task of developing the framework was not complete at the time the Board was abolished. The conceptual framework proposal was issued as a staff report on July 30. That report does not reflect consideration of comments received in 27 letters.

It is not clear what is likely to be proposed. There has been and continues to be much discontent with the "rules" approach to independence. Whether there will be further assessment and revision of the staff report of the ISB or whether a new group -- committee, board, panel -- will undertake to begin anew to determine the best way to enhance objectivity in the external audit is a matter to be resolved in the future.

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