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An Analysis of the Securities and Exchange Commission's Implementation of Key Audit Reform Provisions of Recently Enacted Corporate Reform Legislation

A central goal of the corporate reform legislation enacted in the last Congress was to raise the quality of audits of public companies, which had to an alarming degree ceased to fulfill their most basic public watchdog function -- ensuring that investors get accurate information about the companies in which they invest. The legislation entrusted the Securities and Exchange Commission with two key responsibilities in achieving that goal: appointing a private, independent regulatory board to oversee the auditors and enacting rules to enhance auditor independence and audit committee management of the audit. The Commission has now largely fulfilled its implementation responsibilities. In doing so, it has bowed to industry pressure, seriously undermining key reforms enacted by Congress and failing to adopt much needed strengthening amendments.

I. Commission Undermined Strong Auditor Oversight Legislation

In the first instance, Congress enacted strong investor protections which gave the board broad authority to raise standards, conduct thorough inspections to ensure those standards are being met, investigate suspected wrong-doing, and impose tough sanctions for violations. Appointing the five-person board was the first significant test of the Commission's commitment to reform. It is a test the Commission failed, and failed miserably. Instead of appointing a strong, reform-minded board, the Commission selected two board members, including the original chairman, with no identifiable expertise whatsoever in the issues to be addressed by the board. Only one board member had any public record of advocating reform. Furthermore, in making its selections, the Commission passed over innumerable highly qualified candidates with well documented records of support for creating the strongest possible oversight board.

Because of this and SEC Chairman Pitt's withdrawal of support from a highly qualified candidate when faced with strong accounting industry opposition, the overwhelming impression left on investors was that the regulated industry had been given veto power over the selection of its regulators. Given its disastrous start, and its continued lack of a permanent chairman, it remains unclear whether the board will emerge as the strong independent regulator the legislation anticipated. What is clear, however, is that in its bungled implementation of the law, the Commission seriously undermined the board's credibility with the investing public.

II. Commission Fails to Strengthen, and in Some Areas Weakens, Modest Auditor Independence Legislation

In the area of auditor independence, the accounting profession was far more successful in limiting the scope of congressionally mandated reforms. Having accomplished much of what they sought to achieve in Congress, the major firms had far less need to undermine the rules adopted by the SEC to implement those reforms. As a result, their primary goal in the rulemaking process appears to have been to ensure that the legislation was interpreted in the narrowest way possible and to prevent any significant new investor protections from being added that were not explicitly mandated by Congress.

In lobbying on the rules, the firms focused the greatest attention on three issues:

- eliminating any suggestion in the rule release that certain tax services may impair independence in ways that should preclude their approval by audit committees and, with it, any suggestion that audit committees have a responsibility to evaluate non-audit services for compliance with basic independence principles;

- dramatically narrowing the partner rotation requirement to leave most members of the audit engagement team outside its scope; and

- continuing to permit indirect compensation of audit partners for the sale of non-audit services.

In addition, each pushed a number of other weakening amendments and wording changes designed to scale back the reach of the rules.

This put them in direct conflict with investor advocates,[1] who argued that key provisions of the proposed rules should be strengthened, both to complete the work left unfinished by Congress and to fix aspects of the rule that either conflicted with legislative intent or undermined existing protections. Investor advocates focused their efforts on:

- codifying the principles for determining auditor independence that are the basis for the legislation's prohibited non-audit services in order both to make them enforceable and to clarify that audit committees should not approve any non-audit services that violate the principles, regardless of whether the service in question is specifically prohibited by the legislation;

- removing the provision of the rule that, totally without justification, undermines the legislation's requirement for express audit committee review and pre-approval of non-audit services by allowing pre-approval through policies and procedures;

- restoring clear distinctions in mandatory fee disclosures between audit and non-audit services; and

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[1] In addition to changes pushed by CFA, we have analyzed the comments of the AFL-CIO, the Council of Institutional Investors, Calpers, and former SEC Chief Accountant Lynn Turner, who has been an outspoken advocate of tough reforms since he helped author the auditor independence rules adopted by the SEC in 2000.

- opposing broad new exemptions from the rules for small and foreign public companies and their auditors.

Other priorities identified by investor advocates included eliminating language in several of the definitions of prohibited services that require subjective judgments about what is "reasonably likely" to be subject to audit procedures, restricting the scope of permitted tax services, and lengthening the "cooling off" period.

Unfortunately for investors, the major accounting firms were far more successful in achieving their central goals than investors advocates were in winning strengthening amendments.

- **Tax services and the relevance of auditor independence principles to decisions on pre-approval of non-audit services**

Despite having made a strong case in the proposing release that tax advisory services related to tax shelters and tax advocacy inevitably require the auditor to audit its own work, act as an advocate for the audit client, or both, the Commission backed away from these statements. Instead, in the final release, the Commission "reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence." Its far narrower guidance warns audit committees only of the potential independence violations related to tax-related legal advocacy and to retaining the accountant to devise possibly illegal tax shelters.

As requested by the accounting firms, the final rule release also removes any suggestion that audit committees should carefully evaluate these services in light of established independence principles. In short, far from codifying the independence principles or scaling back the types of tax services that auditors would be permitted to perform for audit clients, as investor advocates had sought, the Commission gave its tacit approval to a range of tax advisory services that the staff had identified in the proposing release as potentially violating the basic principles for determining auditor independence. That action affected more than just tax services. It also sent the message that audit committees should not feel constrained from hiring their auditors to perform services that violate the Commission's previously identified principles for determining auditor independence, as long as those services are not specifically prohibited by rule. As such, the rules contribute to the ridiculous notion pushed by the accounting firms that Congress intended to prohibit certain services because they violate those principles but allow others that pose the identical conflicts.

Furthermore, the rules seriously undermine the legislation's attempt to supplement its limited ban on non-audit services with a requirement that audit committees protect the independence of the audit through the pre-approval of non-audit services. For this requirement to be meaningful, it must include a presumption that audit committees will refrain from approving non-audit services that impair independence. In the Alice in Wonderland world created by the SEC's rule release, however, services that violate independence principles do not necessarily impair independence. Thus, this pre-approval requirement is rendered all but meaningless, a key goal of the accounting firms throughout the legislative process (as described in further detail below).

P Pre-approval of non-audit services through policies and procedures

From the outset of the legislative debate, the accounting firms had sought to eliminate or weaken the provision requiring audit committee pre-approval of non-audit services. From the earliest days of Senate drafting to final conference committee negotiations, the accounting firms aggressively pushed a series of weakening amendments. Their fear, articulated again in their comments on the rule proposal, was clearly that audit committees that are forced into direct accountability for maintaining the independence of the audit will be reluctant to hire the auditor to perform services that could compromise its independence, even where those services are not specifically prohibited by law. Since that was precisely the intent of those who drafted the legislation, their efforts to amend the bill were soundly rejected by Congress.

The accountants had far better luck with the SEC, which included a provision allowing pre-approval through policies and procedures as part of its rule proposal. The SEC offered no justification for this concession, which clearly conflicted with report language that unequivocally demonstrated Congress's intent that each non-audit service be subject to specific review and express approval, in the form of an audit committee vote, unless one of the bill's other exemptions was relied on. Furthermore, nowhere in its final rule release does the SEC acknowledge that commenters raised concerns that this provision was in conflict with the Act. The Commission's failure to answer these criticisms or to show why such arguments are mistaken implies, to us at least, that it cannot offer an adequate answer and has therefore chosen to ignore the issue.

Ignoring concerns expressed by investor advocates, then, the Commission retained this provision in the final rule. Worse, the final rule release affirms, as the accounting firms had requested, that "explicit approval and approval based on policies and procedures are equally acceptable." As the release itself notes, any suggestion that one approval method is preferable to another has been removed. The Commission's only "concession" to investor advocates was to specify that policies must be detailed as to the particular service and must not consist of delegation of this authority to management. While this is better than allowing pre-approval through general, boilerplate policies that totally abrogate the committee's responsibility to review and approve non-audit services, as the rule proposal would have allowed,[2] it is still a clear violation of congressional intent. No guidance is offered on what constitutes a policy that is "detailed as to the particular service." Under one possible interpretation, it might, for example, allow an audit committee to adopt a policy pre-approving the retention of the auditor to perform all tax advisory services for the audit client.

This is not an abstract problem. Audit committees have time and again demonstrated

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[2] It is interesting to note that, in the final rule release, the Commission feels the need to rewrite the record, by implying that its rule proposal would have required "detailed" pre-approval policies and procedures. While this was implied in the release text, no such requirement was included in the proposed rule language itself.

their reluctance to accept responsibility for protecting the independence of the audit. The legislation attempted to put them on the record by requiring express pre-approval of all non-audit services. By eliminating any suggestion that audit committees should evaluate non-audit services based on independence principles and by allowing pre-approval through policies and procedures, the Commission has seriously undermined legislative efforts to force audit committees to take their responsibilities for maintaining the independence of the audit seriously. In doing so, it has dismantled one of the key auditor independence provisions of the Act.

P **Disclosure of fees for audit and non-audit services**

When the Commission adopted auditor independence rules in 2000, it included a requirement that companies disclose in their proxy statements what they were paying their auditor for the audit and what they were paying for other services, including financial information system design and implementation (which had to be broken out separately). In contrast to previous industry practice, the disclosures then adopted required a clear separation between those fees charged specifically for the public disclosure function and all other fees. This enabled investors to easily determine the extent of any conflict of interest, evidence that provided crucial support to legislative efforts to limit certain types of non-audit services.

In a rule proposal that is supposed to enhance investor protections, and in an act not mandated by the legislation, the Commission bowed to industry pressure to change these disclosure requirements. According to the *Wall Street Journal*, which provided an illuminating account of the SEC's media briefing on the rules, an agency official claimed that the disclosure rules were being revised in response to "public comment." When challenged to name anyone outside the accounting profession who had called for the change, however, the official reportedly suggested it was time to move on to other issues. Small wonder, since, contrary to agency claims that the disclosures provide more detail, they in fact muddy the distinction between audit and non-audit fees and mask the extent of any conflict of interest. They do this both by allowing fees not strictly related to the audit to be classed as audit fees and by creating a new category of fees for other accounting and attest services misleadingly labeled as audit-related fees. Despite investor advocate opposition to the proposed changes, they were retained in the final rules.

P **Partner rotation**

In developing its rules, the Commission proposed to provide real heft to an otherwise largely meaningless legislative requirement shortening the time period for rotation of top partners off a particular audit assignment. The Commission proposed to do this by adding a "cooling off" period before the audit team members could rotate back on to the audit and by expanding the reach of the requirement to all professional members of the engagement team. As noted above, this was one of the provisions of the rules singled out for particular opposition by the major audit firms. The industry trade association, the American Institute of Certified Public Accountants, also argued for an exemption for small public companies and the firms that audit them. The rotation provision was supported in its proposed form by investor advocates.

Once again, the accounting industry largely prevailed when the final rules were adopted. The five-year rotation requirement, with a five-year cooling off period was retained only for the lead and concurring partner. A more limited number of other audit partners will be subject to a seven-year rotation requirement, with a two-year cooling off period. Small audit firms are exempt. While this is still stronger in some respects than the legislation, which required no cooling off period but provided no small firm exemption, it nonetheless represents a significant reversal by the Commission in the face of intense industry lobbying.

- **Compensation for the sale of non-audit services**

While it might seem obvious to the average investors that independent auditors should not be financially dependent on their ability to sell non-audit services to their audit clients, this principle seems to have been lost on the accounting firms. In a pro-investor move not required by the legislation, the SEC added a provision to its rule proposal to prohibit key members of the audit engagement team from being compensated based on the sale of non-audit services. Investor advocates generally urged that this ban be extended to all members of the engagement team, and that other practices designed to reward the sale of non-audit services also be prohibited. The accounting firms sought to scale the restriction back. In particular, they sought to preserve their ability to compensate partners indirectly for their sale of non-audit services. Because the final rule appears to do nothing to ensure that auditors are not evaluated on the basis of the profitability of the engagement, including non-audit services, or compensated based on the overall profits from the engagement, including those from non-audit services, the accounting firms are likely to have little difficulty in evading its strictures.

- **Vague language in definitions of prohibited non-audit services**

Investor advocates expressed concern that several of the definitions of non-audit services included language that put auditors and audit committees in the position of making subjective judgments about whether the service in question was likely to be subject to audit procedures. They sought to have the "reasonably likely" language removed from the definitions, on the grounds that it was unnecessarily confusing and would invite challenge. Clearly, even if the agency receives the long-delayed infusion of funding promised by the Act, the SEC will not have the resources to waste disputing, and possibly having to litigate, whether the product of a particular service was reasonably likely to be a subject to the audit. In fact, it is the auditor's responsibility to opine on the entire financial statements. Notwithstanding that fact, the final rule allows the auditor to reasonably conclude that they do not have to aduit numbers they have consulted on.

Ignoring those concerns, the SEC retained the offensive language, with a slight change in wording, in the definitions of bookkeeping services, actuarial services, and appraisal and valuation services. It also added the new "reasonable to conclude" language to its definitions of financial information system design and implementation and internal audit services. Thus, the final rule opens up additional loopholes in the ban on these two services, services that were the focus of so much concern in the wake of Enron and other recent accounting scandals.

- **Exemptions for small companies, foreign issuers and affiliates, and their auditors**

A variety of parties that failed to win broad exemptions for small companies and foreign issuers and their auditors from Congress renewed their lobbying before the SEC. In several areas, the rule proposal seemed to explicitly invite suggestions to provide such exemptions, creating the impression that the SEC was prepared to grant leniency to small and foreign audit firms and public companies that Congress was not. In the end, however, the final rules do not offer the broad exemptions for these groups that they seemed to anticipate. However, notwithstanding the fact that the vast majority of SEC enforcement actions ahve been taken against small accounting firms, they do provide at least one more targeted exemption, as noted above, letting small audit firms out from under the audit partner rotation requirement. This had been identified as a priority by the AICPA.

III. Conclusion

In contrast to its blatant bungling of the auditor oversight board appointment process, and with a few glaring exceptions, the Commission appears to have generally conformed to the modest auditor independence reforms adopted by Congress in adopting its implementing rules. To the degree that the Commission sought to expand on those reforms in even modest ways -- by suggesting, for example, that audit committees should determine whether tax services violate the independence principles before approving them -- the accounting firms were almost entirely successful in beating them back. They also succeeded in getting anti-investor provisions included on several key issues, including audit committee pre-approval of non-audit services and fee disclosure. Investor advocates' efforts to strengthen the rules, on the other hand, went entirely ignored. In the end, investors are left with the same disturbing impression created by the bungled appointment of the accounting oversight board -- that, despite its badly tarnished reputation, the accounting industry continues to exercise enormous influence over Commission decisions and uses that power to undermine investor protections.