MEMORANDUM

TO: Chairman Ruder

From: Ed Coulson, Chief Accountant EC
Office of the Chief Accountant

Date: February 23,1988

Subject: Meeting scheduled for 3:00 on February 25, 1988 with public accounting firm representatives.

The above-referenced meeting has been scheduled to discuss the views of three "Big Eight" accounting firms regarding one of the Commission's interpretations of the rules governing auditors' independence. The accounting firms will be represented by: Robert Mednick, Partner, of Arthur Andersen & Co.; Robert Eliott, Partner, of Peat Marwick Main & Co.; and Richard Bertholdt, Partner, of Price Waterhouse. The matter at hand is the Commission's position regarding the acceptability of auditors entering into prime/subcontractor relationships with clients in order to provide non-audit services to third parties.

Summary

On December 9, 1987, Robert Mednick of Arthur Andersen & Co. met with the staff of this office. At that meeting he advised us that his firm and the two others mentioned above intended to file a petition under Rule 4(a) of the Commission's Rules of Practice requesting that the Commission review one of its positions regarding auditor independence. That position is expressed in Section 602.02.g of the Financial Reporting Codification (the "Section"). The Section contains the Commission's interpretations of Rule 2-01 of Regulation S-X with respect to the effect of business relationships with audit clients on an auditor's independence.

Mr. Mednick subsequently met with Dan Goelzer. Mr. Mednick was advised that a petition under Rule 4(a) would not be the appropriate way to proceed with this matter because the topic being discussed is a Commission interpretation or statement of Commission policy rather than a legislative rule. As a result of that advice, Mr. Mednick requested the upcoming meeting.

In the upcoming meeting:

1) The three firms' representatives are expected to express their belief that auditors should be permitted to enter into prime/subcontractor relationships with audit clients in order to provide computer systems services to third parties. The staff has taken the position that such relationships are precluded by

the Section. The staff issued an interpretive letter which expressed that view on May 18, 1981.

Due to the increasing complexity of computer systems services, the large firms find it desirable to subcontract portions of some systems engagements to others having special expertise. Alternatively, a firm may be requested to serve as a subcontractor for the same reason. The firms named above believe that they are being placed at a disadvantage by being precluded from engaging audit clients as subcontractors and from participating as subcontractors in systems projects for which an audit client is the prime contractor. Mr. Mednick has informed us that in some cases a firm may believe that one of its clients is the sole reliable source for a certain product or service. They also believe that the purchaser of such services is disadvantaged since the best combination of vendors may be unavailable because of the staff's interpretation.

2) The firms are expected to argue that the interpretation cited does not apply. The staff believes that the background of the interpretation shows that the Commission intended to prohibit all but the most innocuous business relationships between auditors and their audit clients.

3) The firms are expected to argue that if the Commission's interpretation is found to apply to those types of relationships, then it should not apply. The firms believe that their quality control procedures will prevent any actual impairment of independence because they have separate divisions providing MAS, tax and audit services. The staff believes that permitting auditors to engage their audit clients as subcontractors or vice versa creates an obvious mutuality of interest, destroys the appearance of independence and should be prohibited.

4) The firms may propose a materiality standard for determining whether such relationships impair the appearance of a firm's independence, as an alternative to a total prohibition. In the earlier meeting with the staff of this office, Mr. Mednick suggested that independence should not be considered to be impaired so long as the fees derived from such an arrangement were not material relative to the total revenues of the auditor on a firm-wide basis and the fees to the client were not material in the aggregate to the client. In the earlier meeting Mr. Mednick advised the staff that some projects are so large that the fees would be material to the total revenues of even the largest firms. Mr. Mednick was not specific as to what he considered to constitute a material relationship, however, the largest firms have annual revenues which range from $1 billion to in excess of $2 billion.

The staff is not convinced that it is appropriate to apply a materiality standard to a direct business relationship with a client. The wording of the interpretation indicates that the Commission intended only to consider materiality where indirect relationships are involved. The problems that may arise from these types of business relationships are numerous and the potential impact on the public's perception of the credibility of audited financial statements would appear to be substantial. Among these problems might be customer dissatisfaction over the services provided by either the client or the auditor, which leads to litigation, and the auditor's dependence on the client as a result of their contractual arrangement.

For example, an auditor may be dependent upon a client to complete a sensitive portion of a large systems project. The auditor, as the prime contractor may be subject to substantial penalties, damages or litigation for failure to complete the project on a timely basis. The client is dependent upon lending institutions for the operating funds needed to perform under the subcontract. At the time of the annual audit the client is about to commence or has recently commenced its portion of the project. The client is found to have serious financial problems indicating that it may not be able to continue as a going concern. If those difficulties are disclosed the client's source of funds would be eliminated, which would prevent it from completing the job. It may appear to the casual observer that the auditor's objectivity might be tainted by concerns arising from the non-audit relationship.

If a materiality standard were to be applied to such relationships then the staff believes that the total firm revenue concept is inappropriate. It appears that the test proposed by Mr. Mednick would be almost meaningless to the large, international accounting firms. It would only be applicable in circumstances involving extremely large projects, and where the audit client is not itself a large company such as EDS or IBM. It is the opinion of the staff that a situation where the total fees derived from such relationships with a client are material relative to the audit fee may raise serious questions in the minds of financial statement users as to where the auditor's priorities lie. Since not only the fact of independence but also the appearance of independence must be considered, the staff believes that those situations should be prohibited to avoid impairment of the credibility of audited financial statements due to those questions and the resultant perceptions.

<u>Commission Rules on Independence</u>

The Federal securities laws require, or authorize the Commission to require, registrants subject to their provisions to file financial statements with the Commission that have been "certified by an independent public or certified public accountant"[1]. Furthermore, the Commission has the authority to define accounting terms[2], such as "independence". Rule 2-01 of Regulation S-X <17 CFR 210.2-01> covers the "Qualifications of Accountants" and states that under certain conditions the Commission may not recognize an accountant to be independent. That rule includes some examples of such conditions.

In Section 600 of the Financial Reporting Codification the Commission has included additional discussions of the topic of independence and examples of situations when an accountant's independence may or may not be deemed to be impaired. Among the situations cited in which an auditor's independence may be questioned are: when the auditor provides bookkeeping services to the client; when the auditor has a close family relationship with a shareholder, officer or employee of the client; when a former partner of the auditor accepts a position with the client; and when the auditor and client have business relationships not related to the audit. Section 601.01 specifically states that:

> "The Commission views both the fact and appearance of independence as essential in order that the public may justifiably view the audit process as a wholly unbiased review of management's presentation of the corporate financial picture."

The Role of the Staff

Section 602.02.a. recognizes that not every situation where the appearance of an auditor's independence may be subject to question can be anticipated and addressed by the Commission's rules. That section states that when unusual circumstances arise:

> "the Commission urges the parties concerned to bring the problem to the attention of the Commission's staff so that a timely and informed decision on the matter may be made."

1/ Items 25 and 26 of Schedule A of the Securities Act, 15 U.S.C. 77aa, and 17(e) of the Exchange Act, 15 U.S.C. 78q expressly require that the financial statements be audited. Sections 12(b)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m authorize the Commission to require the filing of financial statements that have been audited by independent accountants.

2/ Section 19(a) of the Securities Act, 15 U.S.C. 77s; Section 3(b) of the Exchange Act, 15 U.S.C. 78c(b).

The staff of this office routinely responds to questions on the subject of independence raised by registrants and their auditors. The Commission's rules have traditionally been strictly applied when responding to inquiries involving matters of independence. The interpretive letters issued in connection with such inquiries are available to the public through the Office of Public Affairs. Several reporting services, including Commerce Clearing House, have obtained those letters and published those that they believe to be of general interest.

A copy of each interpretive letter is also sent by this office directly to the Ethics Division of the AICPA, thirty days after its issuance in order to keep that body apprised of the staff's activities in this area. Similarly, the staff of this office meets on a quarterly basis with representatives of the AICPA Ethics Committee to discuss areas of mutual interest. This is particularly important since in many cases the Commission's interpretations are more stringent than the AICPA's ethics rulings. For example, the AICPA would permit certain types of bookkeeping services to be rendered to an audit client, which the Commission does not allow, and certain family relationships between the auditor and client employees are permitted by the AICPA but prohibited by the Commission.

<u>The Interpretation</u>

Section 602.02.g of the Financial Reporting Codification (the "Section") contains the Commission's views regarding the effect of "direct or material indirect business relationships, other than as a consumer in the normal course of business, with a client or with persons associated with the client in a decision-making capacity" on an auditor's independence with respect to the audit of that client. The Commission states in the Section that such a relationship "will adversely affect the accountant's independence". Included among the examples of such relationships is a joint business venture. The full text of the Section is included in Attachment A.

The staff of this office has interpreted the Section to mean that an auditor and its client are precluded from entering into any arrangement to jointly provide services to a third party. Such arrangements include a prime/subcontractor relationship between the auditor and the client. As stated in the Section, this position is based on the belief that the "mutuality or identity of interests with the client would cause the accountant to lose the appearance of objectivity and impartiality in the performance of his audit because the advancement of his interests would, to some extent, be dependent on the client". That position was expressed in an interpretive letter issued by the staff in 1981. I expect that the firms' representatives will argue that the Section was not meant to apply to these prime/subcontractor situations and, alternatively, that if it does then it should not.

Background of the Interpretation

The question of whether these types of business relationships with clients are permissible was first raised by Lybrand, Ross Bros. & Montgomery ("Lybrand"), then the U.S. affiliate of Coopers & Lybrand, in June 1971. At that time the staff was asked whether an auditor could contract or join with a client to provide systems design and similar services to third parties without affecting independence. Representatives of the accounting firm agreed that joining with the client in a joint venture or partnership would be improper. However, no decision on the question of whether a contractual relationship between the auditor and the client would be allowed was made at that time. Andrew Barr, then Chief Accountant in this office, suggested that the issue be raised with the Ethics Committee of the AICPA prior to his taking a position. A copy of the memorandum documenting that conference is included at Attachment B.

On July 5, 1972 the Commission issued Accounting Series Release No. 126 "Independence of Accountants - Guidelines and Examples of Situations Involving the Independence of Accountants", Release No. 33-5270 ("ASR 126"). ASR 126 was issued to clarify the intent of Rule 2-01 of Regulation S-X, which sets forth the "Qualifications of Accountants" required for the accountant to be considered independent. That release included the language quoted above regarding business relationships with clients. A copy of ASR 126 is included at Attachment C. That language was carried over to the Section through the issuance on April 15, 1982 of Financial Reporting Release No. 1 "Codification of Financial Reporting Policies", Release No. 33-6395, which codified the then relevant portions of previously issued Accounting Series Releases.

ASR 126 was given limited exposure to the Division of Professional Ethics of the AICPA prior to its issuance. In a letter dated March 31, 1972, Donald Schneeman, then Director of the Division of Professional Ethics transmitted a memorandum of a meeting held by the committee on independence at which the proposed ASR 126 was discussed. Copies of that letter and the referenced memorandum are included at Attachment D. Page 8 of the memorandum discusses the introduction to the "Business Relationships" section of ASR 126, which, as eventually issued, contained the language currently being considered. The committee believed that:

> "The introduction seems to state that an auditor cannot have any business relationships with clients. The following substitute first sentence is suggested:

> 'Material business relationships <u>other than in the normal course of business</u> [emphasis added] with a client..."

In a subsequent letter dated May 18, 1972, Mr. Schneeman notes the Ethics Division's concern that "It would appear that the SEC leans in the direction of considering any significant business transaction with a client to be a 'direct financial interest' and one which should be avoided lest the auditor lose his independence." He proposes that the rules provide for the accountant acting as a "consumer", which is similar to the "normal course of business" notion, which had been proposed earlier. A copy of that letter is included at Attachment E. It therefore appears that the Commission's intent to adopt a broad prohibition against business relationships with clients was understood by the AICPA .

In a memorandum to the Commission dated June 22, 1972, then Chief Accountant John Burton discussed a proposed modification to the "Business Relationships" section of ASR 126. He stated that:

> "The first sentence to the introduction of the section (p. 10) did not, as originally drafted, make explicit allowance for ordinary consumer transactions as an exception to the prohibition against direct...business relationships with a client.' In other words, technically speaking, if the auditor for A&P bought a loaf of bread from that company, he would have been in violation of the letter of this rule. The addition of the phrase 'other than as a consumer in the normal course of business' is intended to clarify our position with respect to such transactions."

A copy of that memorandum is included at Attachment F. The release as issued included that revision.

On May 18, 1981 the staff issued an interpretive letter to A. Clayton Ostlund of Touche Ross & Co. which stated that:

> "Since a subcontractor relationship between the client and accountant is a direct business relationship, other than as a consumer in the ordinary course of business, the staff believes such a relationship would impair the accountant's independence regardless of the materiality of the contract."

A copy of that letter is included at Attachment G.

<u>Management Advisory Services</u>

Accounting firms have provided management advisory, consulting and systems services ("MAS") for approximately thirty years. Over that time span the large public accounting firms have derived an increasing portion of their revenues from the provision of those services. For example, Arthur Andersen, which has the largest consulting practice among the "Big Eight", earned approximately 30% of their 1986 revenues (based on information obtained from the SEC Practice Section of the AICPA's Division for Firms) of approximately $1.5 billion dollars from MAS. Arthur Andersen derived approximately 27% of their 1984 revenues from MAS. The percentage of MAS fees to total revenues at the other "Big Eight" firms ranged from 12% to 21% during 1986 and from 11% to 17% during 1984. This is due to the expansion of the market for and scope of such services and the lack of growth in the market for core audit services.

The provision of MAS services to clients has been a complex and controversial issue. Arguments have been made that such services impair independence because of the relative fees collected from an individual client for audit services and MAS. Arguments have also been made that an auditor may not be independent when examining the product of a system that it designed and implemented.

During the period 1977-1978, the subject of auditor independence was addressed by several bodies.

In 1974 the AICPA established the Commission on Auditors' Responsibilities (the "Cohen Commission") to develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. The Cohen Commission was intended to be independent of its sponsor. In March 1977, a "Report of Tentative Conclusions" was issued. A final "Reports, Conclusions and Recommendations" was issued in 1978, after a series of public meetings and the consideration of comments. Although no empirical evidence was found to substantiate concerns that the provision of MAS services may impair an auditor's independence, both the preliminary and final reports stated that:

> "The persistence of the belief held by a large minority of financial statement users and other observers that management services may or do impair the auditor's independence remains and should be addressed by the public accounting profession."

The report also states that user concerns appear to diminish as they become more familiar with the actual services being provided and diminish substantially when the MAS function is separate from the audit function within the accounting firm. The report concluded that: 1) certain services such as executive search and placement should be prohibited; 2) an educational effort directed toward users should be undertaken by the profession; 3) the board of directors should be involved when management intends to engage the auditor to provide MAS services; and 4) corporations should publicly disclose the non-audit services provided by their auditors.

During April - June 1977, the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (the "Senate Subcommittee") held hearings (the "Metcalf Hearings"). The Metcalf Hearings were based on the issues raised in a study prepared by the Senate Subcommittee staff entitled "The Accounting Establishment", which was issued in January 1977, approximately two months prior to the release of the Cohen Commission's tentative conclusions. The Senate Subcommittee's report on those hearings, entitled "Improving the Accountability of Publicly Owned Corporations and Their Auditors" was issued in November 1977. General independence and the provision of MAS by auditors are among the topics addressed in that report (pages 16 and 17). With respect to independence the report states that:

> "the accounting profession must improve its procedures for assuring independence in view of the publics needs and expectations. Several activities of independent auditors have raised questions. Among them are ... maintaining relationships which detract from the appearance of arm's-length dealings with clients. Such activities are not appropriate."

With respect to MAS services the report states that the issue was not adequately addressed by the tentative findings of the Cohen Commission and notes that:

> "Testimony by several witnesses indicated that significant problems have arisen from the expansion of many accounting firms into providing management advisory services to their audit clients and others. The witnesses from the accounting profession saw the performance of nonaccounting management services by independent auditors as reflecting adversely on the stated ideals of professionalism and independence."

It goes on to conclude that:

> "The best policy in this area - and the policy which is presently followed by most accounting firms - is to require that independent auditors of publicly owned corporations perform only services directly related to accounting."

The report specifies that:

> "Management services related to accounting are confined to the limited area of providing certain computer and systems analyses that are necessary for improving internal control procedures of corporations."

On June 29, 1978, the Commission issued ASR 250, which included requirements for the disclosure of the relationship between the fees for audit and non-audit services paid to a registrant's auditor. ASR 250 was withdrawn in ASR 304 on January 28, 1982 because the Commission found that the disclosure required was not of sufficient utility to investors to justify continuation of the disclosure requirements.

On June 14, 1979, the Commission issued ASR 264, which discussed factors which the Commission identified as relevant to determining whether the performance of specific non-audit services would impair an auditor's independence, either in appearance or in fact. Included among those factors were: the dependence of the auditor on MAS fees including their relationship to the audit fee; avoidance of supplanting the role of management as the result of an MAS engagement; and avoidance of self-review by the auditor including the effect on objectivity of auditing the product of systems designed by the auditor. ASR 264 was withdrawn in ASR 296 on August 20, 1981. The Commission found that it might be confusing because some registrants were evaluating the propriety of non-audit services solely in view of the relationship between audit and non-audit fees. The Commission reaffirmed the views expressed in ASR 264, however, and stated that its principal objective had been accomplished since the profession and financial statement preparers were made aware of those views.

The SEC Practice Section of the AICPA's Division for firms currently requires its members to report annually the MAS, audit and tax fees as a percentage of total fees from each client. Those members consist of firms auditing approximately 89% of the publicly traded companies listed in "Who Audits America" per the 1986 - 1987 report of the Public Oversight Board. That information is available to the public.

Rep. Dingell has occasionally expressed his interest in the non-audit services provided by auditors to their clients. However, the hearings conducted by his Subcommittee have so far not concentrated on that issue.

cc: Linda Fienberg
Dan Goelzer
Linda Quinn
Howard Hodges