1999

# Report to the United States Independence Standards Board: Research into perceptions of auditor independence and objectivity, November 1999

Earnscliffe Research & Communications

Independence Standards Board

EARNSCLIFFE
RESEARCH &
COMMUNICATIONS

# REPORT TO THE UNITED STATES INDEPENDENCE STANDARDS BOARD

## Research into Perceptions of Auditor Independence and Objectivity

November 1999

EARNSCLIFFE RESEARCH & COMMUNICATIONS

# TABLE OF CONTENTS

## A. INTRODUCTION

Earnscliffe Research and Communications is pleased to present this report to the Independence Standards Board (ISB). It is based on a total of 131 one on one interviews conducted over a four-month period. The interviewees were selected, in roughly equal measure from the following segments:

| | |
|---|---|
| CEO's of SEC registrant companies | 16 |
| CFO's of SEC registrants | 24 |
| Chairs of Audit committees of such companies | 18 |
| Buy side investment analysts | 18 |
| Sell side investment analysts | 17 |
| Audit partners | 19 |
| Regulators | 19 |

The sample was distributed roughly equally across these groups, as indicated below. Interviews were done in person or on the phone, based on the preference of the interviewee. A complete listing of those who were interviewed is attached to this report as Appendix A.

The objective of this research undertaking was to assess the perceptions of different audiences around the question of auditor independence and objectivity. As part of the enquiry, interviewees were asked to consider whether they thought a problem currently did exist, what the ideal mix of safeguards would be, and which priorities they would set for the future in this area.

The interviews followed a semi-structured agenda, ensuring that each interview captured a certain amount of essential information, but also allowing the interviewee latitude to take the interview in a direction that reflected their personal experiences and perspectives. The interview guide used is attached to this report as Appendix B.

Bruce Anderson, Principal and one of the founding partners of the Earnscliffe Strategy Group, Canada's best respected public affairs firm, designed the research program, conducted more than 60% of the interviews, and authored this report. Questions and comments are welcomed and may be addressed to him directly, at 613-233-8080, or by email at anderson@earnscliffe.ca

We would like to acknowledge the helpful guidance of the ISB Board, and the considerable assistance of the ISB staff, led by Art Siegel, in the development and execution of this project. The project has been a highly interesting and challenging assignment and our work with the ISB has been most enjoyable.

## B. THE OVERALL HEALTH OF FINANCIAL REPORTING

Each of the interviews began with a discussion of the participant's view of the quality and reliability of the financial reporting system in the US. The results of this probing are very helpful in setting the context for the findings around auditor independence issues, and can be summarized as follows:

- **With very few exceptions, interviewees felt that the standard of financial reporting in the US was excellent.** They indicated that they felt it was the highest standard that existed in the world today, had been for a long time, and would continue to be in the future.

- **While the vast majority felt that restatements of earnings and stories of misrepresentation of financial results *seemed* more prominent, relatively few were convinced that misbehavior was really rising.** More often, interviewees felt that the combination of a bull market with broad (and anxious) participation, coupled with a huge increase in media coverage of markets and investments was giving an impression of a rise in problems.

- **The general consensus seemed to be that there might be a *slight* deterioration of integrity over time, but no more significant in the financial and business sector than in society as a whole.** Many people voiced the opinion that the more fast-paced, highly competitive global economy meant that individual executives felt more at risk and therefore possibly tempted to be more aggressive than they might have been in the past. They were also saying that while more people might feel more tempted to act inappropriately, the number who acted on that temptation might not be much different than in the past.

- **A fair sized minority (probably 40% of the total sample) took the view that while the standard of financial reporting in the US was excellent, reporting requirements were becoming unreasonably complex.** They argued that the average investor (meaning even the average institutional investor) could not really digest some of the material that was now being required, by changes in accounting standards. It should be noted that a fair number of analysts agreed with this point of view. Others argued the opposite case, and said that even more reform was needed to accounting standards in order to ensure that today's newer, more complex business transactions did not allow room to mislead investors.

- **Several of the regulators interviewed worried that their organizations were finding it difficult to keep pace with the changes in the increasingly global and complex transactions which companies were entering into.** This contributed to a sense that investors might be at greater, and less apparent, risk than they had been in years past.

- Despite the concerns just listed, the overall sentiment about financial reporting was positive, and respondents attributed this to several factors:

  i. **The fact that most people involved in the process had integrity and cared about doing a proper job. This benefit of the doubt was conferred equally on CEO's, CFO's and auditors.** As such, participants signaled a view which was an important underpinning of their attitudes around a number of issues probed subsequently: auditors are not seen as any more or less likely to act with integrity than are their clients. While everyone acknowledged that one of the auditors' functions is to protect investors against malfeasance, the assumption was that this service was not frequently called upon.

  ii. **The fact that litigation pressures served as a deterrent for those who might be inclined otherwise.** Some offered this point of view with a sense of dismay, lamenting that "too often we teach by lawsuit", others simply saw it as a fact of business life.

  iii. **The fact that rules and regulations existed, along with oversight, as a way of further deterring, finding and penalizing inappropriate action.** For the most part, respondents felt that the fewer, and more simple the rules, the better from the standpoint of both investor protection and the cost of doing business. At the same time, there was a widespread acknowledgement that a considerable amount of rules and oversight was needed, given the size and complexity of the financial markets.

iv. **The fact that most companies of any size cared greatly about having a pristine reputation in order to have low cost access to capital.** Many CEO's and CFO's indicated that a problem that required earnings restatement was a major problem for them, something they very much wanted to avoid. In this sense, they looked upon auditors as an additional check to ensure that their companies were reporting appropriately, to save embarrassment down the road.

| KEY FINDING |
| --- |
| FINANCIAL REPORTING GENERALLY WELL REGARDED |
| Reasons:<br>➢ Integrity of participants, including auditors<br>➢ Litigation pressures<br>➢ Rules, regulations, standards<br>➢ Desire for access to capital |

- **The annual audited financial statement is seen as an important part of financial reporting, however, its' role has become more secondary over time.** Most participants noted that investment decisions are increasingly made on the basis of more time sensitive, than that which is contained in the annual report. While asserting that audited financials were a basic requirement, their role in investment decisions was seen as providing confirmation and reassurance about information that was already in the public domain.

  A number of participants, most notably among the analyst community, also said that the data that affects investment decisions is increasingly somewhat different than the more standard categories included in the annual report.

- **The mood among most respondents, with the exception of regulators, was that caution was necessary when raising the level of public debate about financial reporting and its reliability.** Everyone acknowledged they had a stake in maintaining a high level of public and investor confidence in the underpinnings of the market. Since the market had been performing well for most, there was a disinclination to do anything that might disturb things. Regulators took the view that the

*"It's the auditor's job to say when the rules are being bent to breaking"* CEO

*"A sledge hammer can't settle everything"* Auditor

debate about how best to sustain confidence in the markets was a critical one to have now and better to have it now than in the wake of some debilitating future correction. They felt that strong language was occasionally necessary to catalyze a debate that others might be reluctant to engage in.

In summary, most of those interviewed were quite satisfied with the overall quality and reliability of the information which companies were making available to investors. They felt it was the best in the world and had been improving over time. Most doubted that there was a significantly greater effort to misrepresent performance than there had been in the past, and cited a number of factors, which they felt were useful checks against inappropriate behavior.

The role of the external audit and the auditor were seen as important checks, but not the only or necessarily predominant ones. They expected that annual audits would help deter or expose earnings reporting problems, but they also assumed that the more frequent disclosures from companies to markets represented an area of increasing risk.

While expressing broad satisfaction, there was a sense that markets were becoming more complex, competitive and aggressive all the time, and that scrutiny was on the rise as well. This led most to conclude that a debate about standards for auditor independence and objectivity was legitimate. At the same time, many (a majority among auditors, and probably 30% of other non-regulatory segments) worried that the profile, tone and the tenor of the debate might serve to frighten more than enlighten investors.

## C. THE BROAD VIEW OF AUDITOR INDEPENDENCE

In order to fully understand what people think should be done to assure auditor independence in the future, it is useful to begin with an understanding of to what degree there is a perceived need for change.

During the course of the interviews, it became clear that most of the audience segment were in general agreement around this question. Their opinions can be summarized as follows:

- **In general, respondents had a positive view of auditors and the way in which they performed their jobs.** Underneath this generally positive view, emerged a number of interesting and occasionally conflicting findings.

    i. Some chafed at the fees charged by audit firms, while others talked about the depth and competence that their auditors offered. Often people did both.

    ii. Some lamented that auditors seemed not as respected as they had been in the past. Others offered the view that the work of the auditor was mundane, not all that interesting or challenging. A surprising number expressed both views, despite the irony.

    iii. Some felt that the profession had not done a very good job of protecting its reputation over time, while others noted that auditors deserved greater respect for integrity than investment bankers and lawyers.

    Overall, however, there was a feeling that auditors were professional, competent, and played an important role in the functioning of financial markets, even if the prominence or luster of that role was in relative decline.

- **The vast majority of respondents believe that auditors are currently performing audits, which meet a high standard of objectivity and independence.** They believe that audit firms take their responsibilities seriously in this regard. They also maintain that clients who attempt to compromise the auditor's independence are few and far between. They expect that several

***"The auditors don't want to be some grunts grinding out dull but necessary work."*** **Analyst**

factors are helping ensure that auditors take their responsibilities seriously:

i. their training in the unique responsibilities of public accountants

ii. their firms' concerns about reputation (based on the reliability of financial statements it attested to) and its importance to future success

iii. their firms' concern about legal liability

iv. the personal integrity of the auditor

v. the auditor's desire to protect his or her reputation and career

| **KEY FINDING** |
|---|
| AUDITORS CURRENTLY MEET HIGH STANDARD OF INDEPENDENCE |
| Reasons:<br>➢ Training in Public Responsibility<br>➢ Personal integrity<br>➢ Desire to protect reputation and career<br>➢ Firms' concern for reputation<br>➢ Concerns about legal liability |

- **Most interviewees (auditors generally excepted) believe that the pressures on objectivity and independence are growing over time, and are becoming somewhat worrisome.** The main driver of this change, according to our interviewees, is the evolution of accounting firms into global, highly competitive, multi-disciplinary consulting enterprises. There is a *perception* that this evolution has led to the following:

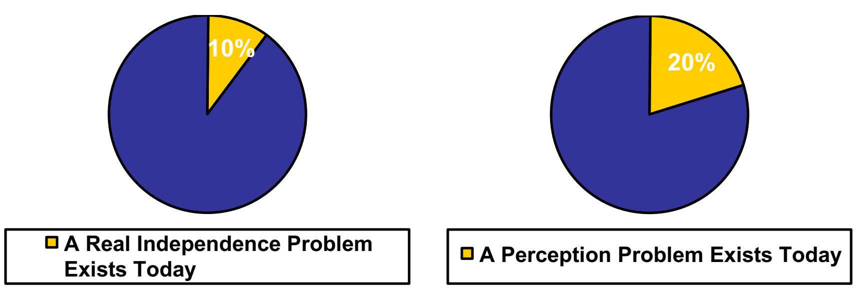
  i. Fees are cut, and margins shaved, in order to win an assignment, with the hope or expectation that more lucrative consulting arrangements will be available with the client in the future. This implies auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders.

***"The economics of accounting firms is driving growth and taking away from the professionalism of the audit."*** **CFO**

ii. Audit firms have created not necessarily deliberately, an internal culture whereby the role of the auditor is often seen as inferior to the role of the consultant. This has made it more difficult to attract and retain quality professionals to work on audit assignments, and has created adverse economic and peer pressures on auditors. When auditors are put into the role of relationship managers, it is made clear to them that an important element of their job is to help broaden the array of services the firm provides to the client, and improve profitability as well.

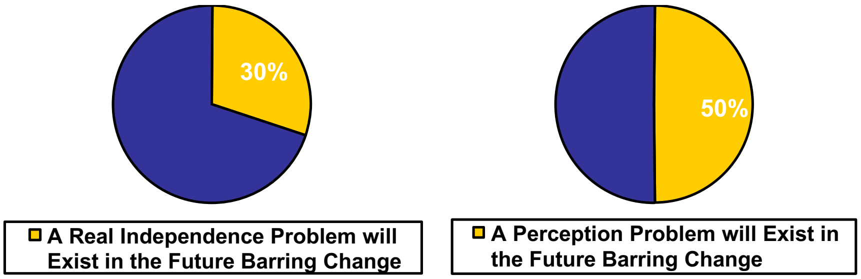
- **Most believe that the future will present even greater challenges, if steps are not taken to contain these issues today.** There is a feeling that current safeguards may have been effective in the past, but the pace of change has been so dramatic that a new set of approaches may be needed. Again, auditors as a group stand outside this general consensus, indicating a much lower degree of concern.

- **The principal consideration behind a demand for new approaches has to do with perception, more than real loss of objectivity.** Most people interviewed held that the volatility and visibility of financial markets, meant that the stakes associated with failures of objectivity and independence were growing rapidly. There was a general consensus that cases of failure were more widely reported, and with the huge increase in market participation by retail or individual investors, the political pressures to protect the consumer were growing. Barring a vigorous private sector response, regulatory initiatives, which most would rather avoid, were seen as inevitable.




*"The Big 5 have had a major cultural change – that's the real source of risk"* **Analyst**

*"Perception is non-measurable and perception is the problem here"* **CEO**




In reporting the general consensus just described, it is important to note that two of the segments stood out somewhat from the rest. Auditors, while not unanimous, were more likely to make the case that the current safeguards, with some modest updating, would be adequate to deal with future pressures. **They maintained that audit functions and consulting services can co-exist indefinitely, perhaps inelegantly, but without causing an erosion, or perceived erosion, of objectivity and independence.**

Regulators, for their part, were at the opposite end of a spectrum. They generally maintained that the problem was a fundamental one, and that the issues of perception were only going to grow in time. A good number pointed to an eventual downturn in the economy, or a major, prolonged market correction as being trigger events for a rapid increase in political pressure, and they felt that the backlash caused by disappointed investors would be severe. **Their view was that solutions were needed, sooner rather than later, and more sweeping than modest.**

| **KEY FINDING** |
| --- |
| PRESSURES ON INDEPENDENCE GROWING |
| Reasons:<br>➢ The more aggressive culture of the financial marketplace today<br>➢ Multi-disciplinary service offerings by audit firms<br>➢ Audits as loss leader<br>➢ Change in audit firm culture<br>➢ Scrutiny on the rise |

In a nutshell, the general conclusion was that audits are not significantly compromised today, and may be only slightly more compromised in the future, if the current audit firm business model continues unchanged. However, more concern is attached to the question of maintaining confidence in the soundness of financial reporting, and a significant number feel that the current model is like "a perception accident waiting to happen".

This in itself is problematic, as the following chapters will describe. In essence, this point of view argues for a very fundamental set of changes in the current marketplace, to prevent something from happening in the future, not something real, but something perceived. Not surprisingly, it was hard for people to find common ground on how much prevention, at whose cost, was appropriate.

Furthermore, most participants, with the notable exception of regulators, felt their interests would be poorly served by a high profile, high-tension debate about these issues. While on the one hand, they might see the need for change and communication about change in order to ward off perception problems, on the other they didn't want to increase the perception problem by increasing the reach and volume of the debate.

***"The real issue is eliminating the perception of conflict. There is a perception problem and that's a problem for the whole system"*** **Analyst**

## D. PRESSURES ON AUDITOR INDEPENDENCE

Having established the broad dimensions of concerns about auditor independence, it is useful to dig deeper into the roots of these concerns. During the course of the interviews, a good deal of probing was done on the nature and extent of the pressures affecting auditor independence, either in fact or in perception.

The main findings are as follows:

- **Virtually everyone agreed that when accounting firms *only* did audit work, there was some risk of impairment, but that the level of risk was acceptable.** The inherent risk cited was that the audit firm is paid by management, while performing a function on behalf of shareholders, and that the interests of management and shareholders do not always coincide perfectly.

  There was a belief that in this environment, the risk was minimized because audit firms had to care very deeply about their reputation among shareholders for doing quality, reliable work, since the audit was their bread and butter. Also, the sense was that the independent directors could add more support to the audit firm as needed, and that the audit firm would be more willing to call on that support than might be the case if they had no other assignments from management.

*"Integrity is the commodity they're selling"* **CEO**

- **As audit firms developed new lines of business, their preoccupation with audits was seen to be gradually in decline.** As people offered this point of view, they did not do so in a critical way, but stated it as a matter of fact. They understood why a professional services firm would want to expand and grow, and that the existence of competition actually demanded that they do so, to some degree.

  There was an implicit understanding that asking firms to perform a public interest function (audits) while operating in a free enterprise economy, is something of a recipe for some problems. No one offered a better solution (some discussed, but then rejected the bank examiners model as too radical and costly), but all sensed that there was a certain degree of tension which markets could not naturally resolve, since the public interest function was not market based.

*"No one wants to pay for the audit service. It's losing its value"* **Analyst**

- **The large majority of interviewees in each segment (including auditors) have sensed that in recent years accounting firms have lost their preoccupation with audits, and become much more preoccupied with growing new areas of consulting revenue.** Many felt that within firms, the psychic and financial rewards were tilted heavily towards the consulting side, and that auditors who wanted to be well compensated and respected by peers, needed to support the growth of the non-audit functions. This perception was even shared by a fair number of auditors, who in some cases lamented the new preoccupation.

  As people offered this perception, it was clear that some were of the view that these pressures could lead to compromises of objectivity, for example, where the size or profitability of a non-audit relationship dwarfed that of the audit. The reasoning was that the individual auditor, if not the firm or the office, would feel at risk if they were to cause a breach in such a relationship over an audit item.

  However, even those who refused to believe that such a compromise could occur, were generally concerned about the appearance of such a situation. Typically, these views were voiced as "If a problem ever occurred, such as a fraud or a major restatement, this relationship would look bad, even if it had nothing to do with the substance of the problem".

***"The power structure at audit firms has shifted dramatically"*** **Analyst**

- Audit clients are also seen to have had a considerable role to play in the increased pressures. This manifested itself in a number of ways:

  i. **The drive by all corporations to cut costs has led to considerable pressures to cut audit fees.** A fair number of the CEO's and CFO's in our sample noted that they felt that audit costs were high, and growing over time, especially for those companies which had become more global in their reach. They felt that while audits were necessary to sustaining market approval, their relative value was declining as other, more time sensitive forms of financial reporting took precedence in the minds of shareholders and investors.

  ii. **There was no evidence that this drive to reduce audit costs was motivated by a desire to see a more lax audit.**

***"The audit's a loss leader now"*** **CFO**

CEO's and CFO's were actually at pains to indicate that they valued the input of their outside auditors in terms of understanding what was working well or poorly within their companies. So while they wanted fees trimmed, they also wanted a rigorous, top quality job done. Worth noting is that they perceived that audit firms were willing to meet these demands.

iii. **Roughly half of the CEO's and CFO's interviewed said that they liked to use their audit firms for non-audit assignments, because they felt that it was likely to result in better consulting at a more reasonable cost.** They reasoned that their auditors were better able to understand their needs, that they had a relationship that worked, and that the audit firm would be motivated to do a good job and charge reasonable fees, knowing the client was a long term, important relationship.

However, the other half of CEO's and CFO's took a different view. While they didn't dispute the cost-effectiveness question, they said that they generally preferred to avoid a situation where outsiders might raise questions about the relationship between client and auditor. Generally, they would give only limited assignments to their audit firm, or allow them to bid on tenders, but require that they be demonstrably better than other bidders in order to get the work.

***"When their economic interests are too great, you run into problems"***
**Audit Chair**

| KEY FINDING |
| --- |
| PERCEPTION RISKS RISING DUE TO SEVERAL FACTORS |
| ➢ Firms are increasingly reliant on consulting<br>➢ Client pressures to cut audit fees, demand for consulting support<br>➢ Psychic and financial pressures on audit partners<br>➢ Ability to meet appearance test of angry shareholders |

- Interestingly, most of those interviewed agreed on the question of "earnings management" and its role in the auditor independence equation. The commonly held view can be summarized as follows:

i. **Earnings management is not a new phenomenon, although it is garnering more attention of late, because of the long running bull market, the instant and dramatic reaction to earnings reports which are outside the norms, and the proliferation of media reporting on financial affairs.**

ii. **While roughly one in three interviewees (across most segments, much higher among regulators) feel that earnings management efforts have become more aggressive, a roughly equal number dispute that assertion.** Those who dispute the assertion offer that emerging growth areas of the economy, such as technology, entertainment, information, are exposing weaknesses in accounting rules, either requiring more or allowing more "judgement calls", than would be possible in more traditional areas of the economy. This point of view holds that if judgement calls are possible, management will always tend to err on the side of massaging reports for advantage.

iii. **Most importantly, few feel that earnings management as practiced today involves any meaningful participation by auditors.** Earnings management was characterized as highly time sensitive, involving decisions made within a company, and communications made directly with financial markets. The audit firm is seen by most analysts, CEO's, and CFO's as more or less irrelevant to this communication, except at the end of a year, and in serving as a deterrent to fraud or gross misrepresentation. While most interviewees accept the idea of auditors *reviewing* quarterly earnings reports, not as many felt that they should issue opinions on same. In fact, the majority thought that this would be both costly and likely counterproductive, in the sense that it might give the markets a false sense of security about the reliability of numbers which had only been reviewed, rather than audited.

iv. Consistent with this view, most felt that the demands of analysts had little to do with the role of auditors. Some Buy-side analysts said that they viewed the audit firm-client relationship with suspicion, but tended to rely on their own sources of information to base their investment decisions on. They saw the audit as an essential part of good governance, and felt that changes were needed for the future, but did not

***"The focus on near-term earnings has put real pressures on management. That puts real pressures on auditors. I don't like it"*** **CFO**

***"Nothing is that precise in terms of accounting"*** **CFO**

***"The problem is managing expectations, not earnings"*** **CFO**

feel that their performance as analysts was being affected by auditor independence issues today.

- In discussing the question of earnings management, there were three factors which people thought might represent exceptions to their general views:

  i. **Many felt that there was a greater potential for a large corporation to put more pressure on a smaller audit firm, or for a smaller auditor to avoid a dispute with a larger client.** While people said that they doubted that mismatches like this occurred very often, some buy side analysts said they would see it as a warning sign if the audit firm and client seemed mismatched by size.

  ii. **There was a broad, but somewhat vague consensus, that new sectors of the economy represented a greater challenge to the auditor client relationship.** Some felt that audit firms were especially anxious to establish strong relationships in areas of new growth. Also, there was a feeling that accounting rules had been designed to apply to companies which manufactured, shipped and sold traditional services and goods, and that knowledge based product sales offered more room for judgements to be exercised, because rules were not so firmly established or understood. In this circumstance, the reasoning went, there was more potential for auditors to accept aggressive accounting practices, and for appearance problems to develop.

  iii. **Finally, there was a general view that the largest and most stable companies, especially those whose equities were not seen as growth investments, were less likely than other companies to be drawn into aggressive earnings management.** As a consequence, people were saying that growth oriented stocks and mid cap companies might represent a bigger area of challenge to the independence of auditors.

In summary, a combination of economic pressures and opportunities has contributed to the growth in potential for perception problems around auditor independence. Within audit firms, there has been pressure to expand non-audit revenues. This has resulted in a changed internal dynamic, where psychic and financial rewards are skewed somewhat, reducing the prestige of audit work.

From the client side, auditors feel pressure to cut audit costs, and receive somewhat mixed signals about the potential to broaden and deepen the relationship with non-audit assignments. Consequently, while the relationship can sometimes seem to carry great potential, it is somewhat inherently insecure. If this sense of insecurity does not lead to real erosion of independence, it can clearly add weight to a potential perception problem going forward.

## E. CURRENT SAFEGUARDS FOR AUDITOR INDEPENDENCE

A good deal of time was spent exploring perceptions of current safeguards and their ability to help protect against real or perceived problems of auditor independence. This was another area where certain segments stood out from one another.

**In general,**

- **Auditors were much more likely to say that the current safeguards were adequate or needed only a slight amount of fine-tuning.**
- **Regulators, on the other hand, were much more of the view that the current accounting firm model seemed fundamentally unworkable, or if not, then major initiatives would be needed to strengthen safeguards and protect investor confidence in the markets.**
- Audit committee chairs tended to see independence safeguards as a work in progress, requiring constant attention, and continuous improvement.
- CEO's and CFO's said that they assumed that current safeguards were probably appropriate, but the more they discussed the questions around non-audit services the more they indicated a feeling that there might be room for too much discretion.
- Analysts felt that the combination of safeguards, laws, regulations, and litigation pressures were all necessary, but they also believed that human temptation was always going to exist, and no system could be perfect.

To the extent that some findings can be generalized, they can be summarized as follows:

- **Most people felt that as long as audit firms did non-audit work for their audit clients, there would need to be a certain number of safeguards, and that these would have to be updated from time to time.**
- **Outside those who were or had been auditors, very few people had any significant knowledge about the safeguards that exist within the audit firm.** There was a general

understanding that firms tried to erect some sort of “walls” that there were periodic rotations and reviews of partner work, and that in-house training programs existed to help assert the importance of independence. Most people said that they thought these were all useful ideas, and were probably working as well as they could.

- **However, the majority of respondents felt that if the perception challenge was growing, these devices might ultimately be insufficient to sustain confidence in the independence of auditors.** They felt that the judgement of observers would turn on how the financial incentives and penalties were organized: if it appeared that a firm had more upside in bending to a client’s pressures, then internal processes would only be of limited value. Not everyone felt that this was the perception today, rather they were offering the view that internal firm safeguards had limited prophylactic value if the scrutiny were to become more punishing.

***“I’d hire honest policemen and then spy on them”* Audit Chair**

- **Most had a sense that there were laws and regulations governing the question of independence, but few had a clear picture of what they were, who mandated them, and how rigorously they were applied.** Participants saw a clear link between the work of organizations like the SEC, the AICPA, FASB, and NASBA. They felt that the work of these various bodies had to be linked together, and given consideration in the development of standards by the ISB.

  FASB was seen as a necessary linkage because of the perception that there were accounting judgement calls that needed to be cleared up, especially in areas touching on one-time charges, and affecting mergers and takeover activity. The SEC was seen as a crucial link because most felt that “a regulatory fix”, while distasteful, was inevitable if measures to limit the potential problem were not taken voluntarily. The AICPA was looked upon as an organization that needed to take a leadership role in advancing the perception of the public interest role function of auditing, even if this proved to be at odds with the business model of major multi-disciplinary firms. State Boards were seen as a vital part of the mix, as they have licensing leverage, and because of the need to avoid a patchwork approach.

***“As long as the (independence) rules aren’t clear, you’re begging for problems”* CFO**

- **Most people had little knowledge of the ISB to date, and while judging that its work would be important, hoped that it would take a somewhat higher profile in the future.** At the same time, not everyone agreed what the purpose and tone of this profile should be. Some (analysts in particular) wanted the ISB to be a voice somewhat independent both of the regulator and the profession. Others (auditors most notably) wanted the ISB to bring some balance to a debate they felt was imbalanced by the public statements of the regulator. Still others (regulators especially) wanted the ISB to represent the perspective of the shareholder and investor community, including the retail or individual investor, and move swiftly and visibly to remedy problems and create a more sound framework for the future.

- There was a widely held view that some existing rules may need to be reviewed and replaced or updated in order to help build credibility for the future. Many voiced the view that members of audit firms might be unduly restricted in the financial transactions they were permitted, and that rules regarding family relationships might need to be modernized as well. Those who advocated such changes were not looking for greater laxity, but were saying that a new set of standards, in order to have credibility, should logically strive to be as contemporary as possible.

- **Respondents were generally aware and mostly supportive of the work of the Blue Ribbon Panel.** There was a broad conviction that Audit Committees could serve a more important role in dealing with both substantive and perception issues around auditor independence. While endorsing the direction, many were at pains to point out a view that the quality of audit committees varied widely (and likely always would), something which would limit the effectiveness of this approach to managing future problems. Also, a fair number of people offered the view that the Panel took perhaps too narrow a view of the kind of qualifications which might enable an Audit Committee member to do an effective job.

***"Someone has to hold up the shining light of standards"*** **Analyst**

***"You can't micro-manage judgement"*** **CFO**

***"There's nothing like plenty of daylight to keep people honest"*** **CEO**

| KEY FINDING |
| --- |
| LOW AWARENESS OF CURRENT SAFEGUARDS |
| ➢ Apart from auditors, few know much about in-firm safeguards<br>➢ More awareness would help reduce apprehensions<br>➢ But rising scrutiny may mean external pressures also needed<br>➢ Desire for ISB to work in concert with others, add careful profile to debate |

In summary, the majority view was that current safeguards needed to be reviewed and updated. While most people who lacked first hand experience weren't really familiar with the current rules and firm-specific safeguards, they felt that if the perception challenge were to grow, then the current self-regulatory approach would be insufficient to meet the test of public confidence. Alternately, many offered the view that the self-regulatory model would be sufficient if audit firms only did auditing, or did only auditing for their audit clients.

## F. NON AUDIT SERVICES IN FOCUS

While the non audit services offered by accounting firms was easily the most perplexing issue surrounding auditor independence in the minds of our interviewees, it is instructive to break this category of findings down in more detail.

For one thing, not all non-audit services conjured up equal levels of disquiet, and some produced great consensus while others great division. The findings can be summarized this way:

- **The situations which were more likely to raise concerns about the prospect of a real or perceived problem of auditor independence** include the following:

  i. **Situations where the size of consulting fees greatly exceed the size of audit fees.** Most said that this should be looked at as a general principle, rather than a hard rule, since some consulting arrangements were more costly by nature. However, they felt that the perception test would be harder to meet after a problem, if there were an imbalance of this sort.

  ii. **Situations where consulting revenues *routinely* exceeded audit revenues.** In such a circumstance, many felt that the potential for a perception problem to develop was greater. Some argued that such a situation should not be allowed to occur, others argued that companies must take greater precautions, (e.g. through Audit Committees and disclosure to shareholders) if they were likely to find themselves going in this direction.

  iii. **Situations where bookkeeping type services were being provided to clients.** Some clients seemed to feel that they should be permitted to buy these services from their auditors, especially in foreign or distant markets, provided that accounting judgements were not being made by employees of the audit firm. However, many auditors seemed to feel that this was an area of potential reputation risk, and that the line between judgement and non-judgement services was harder to draw in today's economy.

iv. **Situations where consulting contracts were awarded to the auditor without competitive bidding.** Roughly half of the companies interviewed indicated that they avoided such a practice, while others said that they used discretion, but occasionally did so. Auditors generally were silent on this question. Analysts, regulators, and audit committee chairs were more likely to say that in a world where everyone had a stake in preventing perception problems, this practice should be avoided.

v. **Situations where consulting assignments were so large, or of a particular nature, so as to be logically touched on by a subsequent audit.** Some felt that installing computer systems was not a problem, as long as the firm had a demonstrated expertise, others argued that if the computer system had anything to do with the financial reporting systems, or if a major problem with the project would normally be reported to shareholders, then the auditor would be in serious conflict.

***"Auditors should not be allowed to sit in judgement of themselves"*** **CEO/Audit Chair**

vi. **Situations where the importance of the consulting assignment was unusually important to the audit firm,** such as a contract in an area where the firm was trying to develop a marketable expertise and the contract represented an anchor for business development.

vii. **Situations where the importance of a single client to an individual partner, or to a particular office was unusually high.** While most said that the test which people talked about was "whether the firm could afford to walk away from the client", they felt that the more appropriate test was "what would the consequences be to the partner or the office that walked away from a major client" over an audit dispute.

***"You can't trust anyone, if there's too much temptation"*** **Audit Chair**

- There were some areas where opinions were clearly in stress, meaning that **people felt pulled both ways,** and considered the matters to be important. These included:

i. **Situations where the audit firm was providing business strategy advice to the client.** Most people felt that with the appropriate firewalls in place within the audit firm, this might not cause a problem, but others felt that if the client followed the advice and the strategy failed, the auditors had a reputation risk, which might impair their objectivity.

ii. **Situations where tax advice turned into tax representation or advocacy.** While most said that this had traditionally been a role which auditors had played, and that it had not caused problems of independence in the past, there was a worry that as perception questions became more prominent, this was a more challenging situation. In particular, those concerned talked about the prospect of audit firms becoming seen as advocates for accounting rules which might be seen to work against the interests of shareholder transparency.

iii. **Situations where internal audit functions were outsourced to the independent auditor.** While most felt that this was in no way problematic, a notable minority took the position that this might lead to a lower standard of protection for the investor.

| **KEY FINDING** |
|---|
| CERTAIN NON-AUDIT SERVICES TRIGGER GREATER CONCERNS |
| ➢ Where consulting fees exceed, especially if routinely, audit fees<br>➢ Where bookkeeping services are provided<br>➢ Where consulting assignments were so large or of a nature to be potential audit items<br>➢ Where assignment is key to a growth strategy of a consulting division<br>➢ Where a client was disproportionately important to an individual auditor or office |

In summary, respondents generally held the view that the evolution of audit firms into the consulting fields was logical. They felt that if audits were not going to be performed by the public sector (as with bank examiners) then the private sector providers must be afforded a certain degree of latitude in terms of growing their businesses, especially in a competitive sector. Many also felt that the provision of most consulting services was not likely to create a real problem of audit independence, but almost everyone agreed that the potential for appearance problems to be created was quite significant.

## G. TESTING SPECIFIC SCENARIOS

In the course of conducting these interviews, a number of scenarios were developed for use in focussing attention on the kinds of practical situations in which an independence issue might or might not arise. These scenarios, and the responses which they generated, are summarized here.

### SCENARIO I

**ABC audit firm's consulting division takes a two year contract to develop and install a new SAP computer system for their client, ACME Manufacturing. ABC earns $10 million for the computer system work, and $1 million per year for their audit of ACME. The consulting contract equals about 1% of ABC's annual revenues.**

**ABC has recognized expertise in computer consulting, won the contract in competitive bidding, and the question of whether such a contract would impact the independence was raised with ACME's audit committee, which decided that there was no impairment. ACME management has the necessary expertise to monitor the consulting work, and make the necessary decisions around it.**

- The vast majority of interviewees did not perceive a real loss of independence in this situation. However, a notable minority, probably around 30% felt that there was a significant risk of impairment, if things turned out badly around this particular assignment.
- Even more respondents worried that the perception of such a large assignment could be troublesome, again if all did not go smoothly.
- Respondents indicated that a number of factors would determine the degree of risk involved.

  i. First off, the sheer size of the contract was seen as a potential perception challenge. Even though $10 million might be good value for the client, and only a tiny fraction of the audit firms business, there was a sense that observers would doubt that the firm would be willing to walk away from such a relationship, if that were necessary to protect the independence of the audit. Auditors typically felt differently on this issue, putting forward the case that the separation of audit and consulting practices within the firm, together with the auditor's and firm's commitment to audit integrity would be adequate to satisfy any doubts.

ii. The size of the consulting contract relative to the audit fee was also seen as an important factor.

iii. The proportion of firm revenues represented by the total billings to any single client were seen to have a significant effect on auditor independence. In general, "one off" consulting assignments were seen as less troubling than a steady flow of consulting revenue.

iv. Finally, the role of the audit partner was deemed important. Respondents were aware that the lead engagement partner can and often does become an advocate for a broader relationship with a client, but most respondents felt that the auditor's participation should stop at introduction.

- Everyone felt that a contract of that size needed to be submitted to tender, and that the Audit Committee had to be involved in the process of awarding the contract. Some felt that to be awarded such a contract, the audit firm should have to beat other bids by a considerable margin.

- Interviewees generally felt that investor confidence would not be shaken by this scenario. However when asked to consider the same scenario where the consulting contract equaled 20%, rather than 1%, of the audit firm's revenues (or the consulting arm's revenues), most agreed that there would be both a significant degree of real and perceived risk.

- Interviewees' assessment of risk was linked to their levels of confidence in the current safeguards. Auditors were confident that internal safeguards such as 'Chinese walls', or firewalls were sufficient. Management and audit committee members felt that as long as companies appropriate disclosure of such assignments, they could mitigate risks, although they tended not to want to do this very often. (As well, there was a separate question about disclosure requirements. Some felt that disclosure to a broader audience of investors would help deter real objectivity problems, and mitigate perception problems: others felt that doing so would only serve to fuel suspicions that inappropriate behavior was rising.)

***"Independence is a state of mind"*** **Auditor**

- The analyst and regulatory communities shared concerns about the size and nature of the assignment, and felt current safeguards offer little or no guarantee of independence. They were more likely to feel that nothing short of a strict separation of the audit and consulting services would really mitigate the risk in such a situation. They differed in how plausible or important they thought this to be.

## SCENARIO II

**John Doe, an auditor with the accounting firm BBB, has just completed his annual audit of Kate Inc. Kate Inc, then offers Doe the position of CFO, with a rich compensation package.**

**Doe immediately stops doing any work for Kate Inc, and notifies the management of BBB about the offer. After a short period of reflection, he takes the job, and ends all financial ties to BBB. BBB immediately conducts a thorough review of the most recent audit of Kate, makes sure it selects a senior partner to work on Kate's audit in the future, to ensure proper skepticism, and schedules QA and Peer Review inspections for next year.**

- An overwhelming majority of respondents saw neither a real loss of independence nor an unacceptable risk that auditor independence could be impaired in the future.

- Most also agreed that the perception of reasonable investors would not be negatively affected in this situation. Many noted that this type of situation is highly common, and quite productive from the standpoint of both the audit firm and the client. They reasoned that the audit firm could not attract good people, if those people had to foreclose the option of moving to the client side at some time. They also felt that clients should have the opportunity to recruit people who understood their business well and had established good working relationships within their organization.

- Beyond feeling comfortable because this situation arose so often without creating problems, respondents were also satisfied that the procedures taken by the individual and the audit firm were effective and important.

- The only areas of concern that appeared to have any resonance had to do with timing questions. Most took considerable comfort from the fact that the offer was not made until the opinion was signed for the year, however a few noted that audits were increasingly a year round process. Similarly, there was some debate about whether current guidelines were clear enough on the question of what type of discussion qualified as a reportable matter, or a step towards an offer.

- While some were concerned that there seemed to be a correlation between incidents of earnings misrepresentation and the recruitment of auditors into CFO positions, most seemed to feel that this was not causal, but coincidental.

## SCENARIO III

**Ace Accounting does the audit work for Moll Computers, based in New York. Ace's Vancouver office does some routine bookkeeping work for Moll's Portland subsidiary, MCP.**

**MCP accounts for no more than 4% of Moll Computer's revenues, and would not normally be visited by an audit team, because of its size. The bookkeeping work is done by an "accounting assistance" department of the Ace Portland office, which is separate from the audit department. The work includes processing company-supplied data, which is then reviewed and approved by MCP officials, before being forwarded to Moll's headquarters in New York. Ace personnel do not prepare any source documents, sign checks, have custody of assets or make significant judgements.**

- There was a clear lack of consensus about this scenario. Most did agree that it probably did not pose a significant real problem of independence, but many worried that the question of bookkeeping assistance can be a difficult one.

- There was a feeling that even if the work did not involve "significant" judgements, outside observers might doubt the auditor's independence, if the firm's staff was *implementing* accounting treatments which were likely to be a subject of dispute with the auditor down the road.

- A number of auditors said that their firms prefer not to do any of this type of work because of concerns about how it might be perceived. They felt that even if they could make the case about the routine and non-judgmental nature of the work, that participating in any aspect of internal accounting was better avoided.

- While several CEO's and CFO's said that this was a type of assistance, which they liked to be able to draw upon, they acknowledged that it could fall under unfavorable scrutiny.
- When asked how they would feel if the number of markets being served were to grow over time, many began to feel uncomfortable. Even if the dollar values were not material, they simply felt that it implied too close a relationship, and too stable a flow of revenues to the non-audit service side of the firm.
- There was a general feeling that the distance between the New York headquarters and a Portland subsidiary office provided some, but limited comfort.

## SCENARIO IV

**Jane Smith works as a senior audit partner with Tendy Accounting's Boston office. She has two relatives who happen to work for two different Tendy clients.**

**Jane's husband works for Able Inc. as a software developer. He has $8000 in Able's stock option plan. Jane and her husband earn a combined income of more than $200,000 per year. Able's audit is done by Tendy.**

**Jane's brother is the CFO of Simple Internet Services, a small, but rapidly growing company in Portland Maine. Portland is 120 miles from Boston, and all services for Simple are provided by Tendy's Portland office. Jane has no involvement in either client's account. She sees her brother socially about once a year.**

- There was a remarkably vigorous discussion about this scenario. It was a subject of careful consideration and seen as very topical.
- Interviewees overwhelmingly sensed that no real impairment of independence had occurred with respect to either the brother or the husband. This was largely because Jane was seen to have no material ability to affect the audit of either company. Many felt that the relationship and distance rules should have significance only if Jane was involved in the audit itself.
- But at the same time, respondents acknowledged that the perception issues were real, critical to Jane's reputation, the reputation of her firm, the perceived integrity of the audits, and the reputation of the clients involved.

- There was a widespread feeling that the rise of dual income families, the increased entry of women into the workplace and the increasingly global reach of audit firms has rendered relationship and distance rules somewhat archaic. Most felt that the current rules governing personal relationships are quite strict and created an impediment to attracting and retaining new entrants to the profession. Others argued that it was only appropriate that auditors be held to a higher standard than other participants in the financial community are, given the attestation function they perform. They felt that any relaxation of rules, even admittedly archaic ones, might be perceived as a weakening of the commitment to independence.

- The majority felt that application of sound personal judgement by the auditor was the best assurance of a high degree of independence when it came to personal relationships. Most people were of the view that there was no substitute for general principles of conduct applied with personal judgement.

- As well, many interviewees looked to the internal culture of audit firms as vital. They talked about the importance of "tone at the top" and in some cases, wondered aloud if it was as clear and firm as it had been in the past. Some auditors acknowledged some concerns of this sort as well.

- Most people felt that the perception question surrounding Jane's husband was less significant than those involving her brother. They reasoned that the amount of money involved was immaterial, and that the husband's role in the company was not at a senior enough level to cause concern.

  With respect to Jane's brother, there was more concern, particularly because of his role as CFO and the fact that his firm was rapidly growing. There was a feeling that his company might, over time become a more important client of the firm. Ultimately people were reassured by the fact that Jane and her brother lived in different cities, and rarely had contact with each other. When asked how they would feel if "Jane's brother regularly contacted her for advice on investments" most felt more uncomfortable with such a situation.

- Full disclosure of these situations was viewed as critical to maintaining the reality and perception of independence. Most people felt the auditor had a strong obligation to disclose any potential (real or perceived) conflict arising from personal relationships not just to their own firm but to their clients as well. Audit committees were cited as an important line of defense for management and shareholders. The overriding assumption is that once disclosed, these relationship issues could be assessed on a case by case basis to determine whether they offended either the shareholders or management sense of propriety.

- In an age of jet travel and instant Internet access, many interviewees signaled that the comfort provided by geographic separation was diminishing over time.

In summary, four scenarios were tested which explored a number of contemporary dimensions of the question of auditor independence. In all but one case, there were mixed opinions, and a lack of consistency in how participants felt current guidelines could or would normally be applied. This underscored a call for greater clarification and a hope for greater consistency over time, in how auditors and their clients set and meet the tests of independence. This degree of uncertainty was highest when significant consulting relationships were at stake, and when family relationships were involved.

## H. POTENTIAL IMPROVEMENTS

During the course of the interviews, a fair bit of probing was done to determine what respondents felt should be priorities for change. Accepting as a starting point that not all audiences were equally convinced that change was needed, or that much change was needed, the main points findings can be summarized as follows:

- **The broad majority of respondents felt that there are too many "gray" areas where the role of auditor as consultant to their audit clients is concerned.** In some cases, this feeling had to do with the fact that people are unfamiliar with the regulations and policies that currently exist, in others it was based on a feeling that as things have developed, new, clearer standards are needed.

- **A fair number of people advocated a requirement of full disclosure as a way to both deter an unhealthy relationship between auditor and client, and to inform investors of any risks related thereto.** However others, CFO's most notably, did not like this idea, as they felt that disclosure generally is associated with the idea of having done something inappropriate.

- **Almost everyone interviewed felt that the challenges of auditor independence would not be solved by writing new "bright line" type policies.** They reasoned that these would act not as a deterrent, but an opportunity for those who wanted to act inappropriately to understand how to structure such actions successfully.

- **Most preferred the idea of setting forth broad principles, which should underpin the relationship between auditor and client. Alongside these broad principles, many endorsed the idea of developing a series of "best practices" advisories.** These would set out common situations, and indicate what the best practice would be for auditors and clients to follow in order to protect against real and perceived independence problems. Some went further and suggested that those companies which chose not to follow these best practices should be required to disclose this fact, and their reasons for deciding not to. However, many preferred not to go this far, arguing that this step would convey too great a degree of suspicion where none might be warranted.

- **There was a wide consensus that any changes to strengthen standards should be accompanied by a review of existing rules, and the termination of those that are archaic.** These might include certain aspects of the restrictions on financial dealings by employees of audit firms, and more contemporary perspectives on the issues of spousal relationships.

- **Most interviewees felt that an essential or important part of any effort to strengthen independence and the perception of independence, had to have a strong communications component.** They reasoned that to affect perception, those whose perceptions mattered had to be aware of both the existing safeguards as well as any new increments that might be added to the mix. While some segments felt that the audiences in question were institutional and corporate exclusively, others (especially, but not exclusively the regulatory segment) felt strongly that the individual investor was a key audience, perhaps more important than any other.

| KEY FINDING |
| --- |
| A VARIETY OF POTENTIAL IMPROVEMENTS |
| ➢ Fewer gray areas, more clarification, better communication |
| ➢ Broad principles and best practices, not bright lines |
| ➢ Greater disclosure, stronger audit committees |
| ➢ Review existing rules, add and subtract as necessary |
| ➢ Review audit firm internal practices |

- **While a fair number of interviewees felt that the best ultimate solution to the independence question would be for consulting and audit practices to separate, few anticipated that this would happen in the short term, if at all.** There was also an acknowledgement that even if this did occur, the residual issue of a service provided to shareholders, but contracted for with management, would still offer the potential for perception problems. As a result, people generally expected that the best approach would involve a number of components:

1. **A review of audit firm internal practices, to ensure that standards are as high as they should be, and as consistently applied as possible.** While many felt that independence

procedures might be areas of competitive advantage, there was also a feeling that the reputation of the profession as a whole rose or fell on the performance of the weakest performer. As such, some argued that a more standardized approach might be more advisable.

2. **A gathering and communication of the variety of component safeguards affecting independence.** Both those working within the audit firms and those outside, felt there would be value in drawing together, in one source, the major component elements, whether they emanate from FASB, SEC, ISB, AICPA, State Licensing Boards, etc.

3. **Greater precision about the acceptable and unacceptable practices in seeking or accepting consulting assignments from audit clients.** Many people, including a fair number of auditors, said that they were unsure about certain practices and felt that more precision, or at least a clear restatement of how current guidelines should best be applied, would be helpful. This could include several components:

   i. **The nature of marketing activities for non-audit assignments with audit clients.** Who should be involved, linkages to the audit assignment, competitive bidding, are all subjects which could potentially be treated under this heading.

   ii. **The nature of non-audit services which have greater potential to create the risk of perception problems.** At the present time, many felt that they had a great deal of discretion in this area, perhaps more discretion than was advisable, if the perception risk was to be reduced.

   iii. **The size or relative thresholds of audit versus non-audit assignments.** While people said that a simple numerical formula probably wouldn't make sense, in the context of "best practices" they felt some guidance would be appropriate.

   iv. **The appropriate role of senior audit engagement partners in managing a broader relationship with the client.** During the course of the interviews it was clear that different audit firms had different practices, and that clients were occasionally uncomfortable with some current approaches. Some auditors and clients feel that they can best assure independence if the auditor is the point person for the whole relationship, others feel that this represents a significant risk, at least from a perception standpoint.

v. **This was particularly sensitive when it came to the question of compensation procedures for audit partners, who were acting as relationship managers.** Different policies exist in different firms. While some clients are comfortable with the fact that firms reward auditors for relationship growth (as one component of performance, with only a modest impact on overall compensation), others feel that any linkage between the compensation of the auditor and the growth of the non-audit relationship is entirely inappropriate.

| **KEY FINDING** |
|---|
| GREATER PRECISION SOUGHT AROUND NON-AUDIT WORK |
| ➢ Nature of marketing and selling activities |
| ➢ Nature of services which should not be offered to audit clients |
| ➢ Size or thresholds for audit vs. non-audit fees |
| ➢ Appropriate role of audit partners |
| ➢ Compensation for audit partners |

# I. SUMMARY OF KEY SEGMENT DIFFERENCES

As the various sections of this report have indicated, the audience segments for this study had different perspectives on a number of matters. This section of the report will attempt to summarize in one place the nature and importance of these differences.

## CEO's

There was a mixture of opinions registered by the CEO's in this study: this was not a particularly homogeneous group. Generally speaking, they were more concerned about good corporate governance, and wanted to be able to rely on their auditors to keep their companies from reporting anything which might later be a cause of embarrassment. Many indicated a strong feeling that the quality and reliability of financial statements issued by their company was a matter which touched very directly on their personal reputations.

Most of the CEO's felt that there was not a real problem of auditor independence, but that there was a slight, but growing perception issue which should be addressed. They saw their auditors more as suppliers than business partners, and had few strong feelings one way or another about using them for non-audit services.

***"Everyone has to recognize ethical standards are more important than everything else"*** **Audit Chair/CEO**

While they liked the idea of having the flexibility to do so if it was the most cost-effective solution for a particular consulting assignment, they understood the arguments against having too significant a relationship with the audit firm, and were prepared to accept a world where this flexibility might be reduced or even eliminated.

To some degree, the more they thought that scrutiny of non-audit assigments to their audit firm would rise in the future, the less they wanted to be placed in a position of influencing or even supporting such a decision personally.

CEO's generally felt that the pressures to manage earnings were not all that new, although the pace and severity of market reactions was increasing over time. They felt that there had always been and always would be important judgement calls to be made about accounting treatments and thought that a professional, cordial and respectful relationship with their auditors was a useful element of helping arrive at sound decisions.

While the majority voiced some frustration at the profile and tone taken by the SEC in raising issues of earnings management and audit independence, most accepted that politcal stakeholders felt apprehensive about the breadth of participation in stock markets, and wanted to err on the side of caution. Some argued that it was necessary to use language which would create an impact, since the debate might not take place otherwise.

Ultimately CEO's felt that a combination of measures would be necessary to ease the potential of perception problems: more clarity around current regulations and safeguards, better education of investors about the safeguards which exist (in order to reduce the pressures on political and regulatory bodies) as well as the kinds of ideas favored by the Blue Ribbon Panel.

## CFO's

This group was fairly homogeneous on some issues, and showed clear divergence on others. The main points of agreement began with the fact that they were, next to auditors, the segment which was least convinced that independence (real or perceived) was under significant pressure.

***"You can never get to zero risk"*** **CFO**

CFO's generally saw their auditors as key suppliers, partners in business to a limited degree, and they very much liked to have a direct relationship with the most senior engagement personnel.

They felt that their audits were conducted with a high degree of independence and objectivity and felt that whatever pressures were inherent in the auditor-client relationship were being successfully managed by themselves. While they acknowledged the role of the audit committee, they saw it as being a "failsafe" in the event that they failed to do their jobs properly. As such, they were somewhat less enthusiastic about the Blue Ribbon recommendations, although not opposed in principle.

Some CFO's took quite a firm and restrictive view of the idea of hiring their auditors to do non-audit work. A few said that they almost never would consider it, a few others said that audit firms could bid on assignments, but had to be considerably superior to other bids in order to win the assignments. Another number said that they liked the idea of using their auditors for many assignments and that as long as they submitted a competitive bid they would get the assignment.

***"Essentially all auditors are honest people with very few exceptions but the lines are getting fuzzy now"*** **CFO**

Finally a few felt that they were comfortable making some assigments to their auditors directly, without a competitive process, and were ready to defend those decisions as legitimate management prerogative.

Almost all of the CFO's were wary of the idea of new regulation around financial reporting, claiming that current rules were already so complex that even the best honest effort could still run afoul of some rules inadvertently. They argued that the largest clients and the largest auditors generally operated in a fully appropriate fashion and that they should not be saddled with additional costs and complexity because of the misbehaviour of a small minority. They urged that solutions to any perception problems show restraint around the instinct to regulate, establish best practices rather than bright lines, educate investors, and target offenders as much as possible.

## Auditors

As a group auditors were more homogeneous than any other except perhaps regulators. There were some important generational gaps, noted below, but otherwise auditors had a fairly common view of the world.

The general sentiment was that the quality of audits was improving over time, as audit firms became more expert, and more able to bring a broader set of skills to bear on behalf of a particular client. Auditors were also insistent that there were no greater issues of independence today than there had been in the past, and they recognized that the unique role and structure of the relationship presented natural challenges.

***"There's no substitute for an honest client"***
**Auditor**

Auditors felt that as a group they had been rigorously trained, and within firms, constantly coached, to maintain the state of mind required to provide proper attest services. They felt that the issues of independence and audit failures had been exaggerated by media coverage, and that there were far more significant problems of real or perceived conflict in the role played by securities firms and investment bankers.

Auditors accepted the potential for perception problems to occur, and recognized that these questions were becoming more prominent. At the same time, they bridled at the notion that they might have to consider altering their business model, simply to avoid a perception problem, when the reality was that there was no impairment.

Notwithstanding their sense of frustration with the issue and the debate, there was a view that some remedies would be helpful in defusing the tensions. Their preferred actions included education of investors about current safeguards, clarification and modernization of some of the rules, publication of best practices, and an expanded role for Audit Committees. They were inclined to reject the idea of bright lines as ineffective.

While the views described above were generally held, a handful of those auditors who had the longest experience took a somewhat different view on the impact of the multi-disciplinary evolution of their firms. They felt that over time, despite safeguards and best efforts within firms, auditors couldn't help but notice a certain difference in the environment surrounding client relationships.

They felt that auditing was portrayed within firms as less profitable than consulting work, and increasingly important only as a way of generating consulting opportunities. They felt that the compensation structure was creating a disincentive for good people to stay in auditing, and for clients to respect the auditors who served them. While they did not conclude that this had impaired objectivity and independence to date, some wondered whether the management structure and business strategies of their firm could or would continue to take appropriate account of the unique role of the independent auditor.

***"Audit Partners are being made to feel like sales people"*** **Auditor**

## Audit Committee Chairs

This segment was fairly homogeneous, and enthusiastic about participating in the study. Without exception, they all felt that the work of the Audit Committee was of great importance, and increasing in importance over time.

Also without exception was the view that the companies they served took the role of the audit committee very seriously (which could be to some degree a self-selection bias). They saw themselves as serving the interests of shareholders and the rest of the Board, rather than management. They felt that company management supported their efforts to inquire into important issues, have a private relationship with the audit firm, and to offer dissenting opinions as appropriate.

***"You really need to put it through the wringer and be absolutely sure"*** **Audit Chair**

They felt that the number of problems in financial reporting were probably not increasing in number, but were certainly increasing in profile. They sensed that the pace of change and competition, as well as the heightened scrutiny, meant that regardless of whether there were real problems of independence, a greater degree of caution needed to be exercised.

All felt that one of the more important matters for them to be involved in reviewing was the awarding of non-audit assignments to the audit firm. As a group, they tended to feel that the less of this that went on, the better, and several said that they supported a policy of no additional work for the audit firm.

They did not quarrel with the instinct on the part of audit firms to expand into other areas, and were reluctant to support solutions that restricted their access to new lines of business. At the same time, they had a keen sense of the need to meet their own obligations to shareholders. Insofar as remedies were concerned, they favored greater clarification of current guidelines, the publication of best practices to help provide guidance in new areas, and a general principles rather than bright lines approach.

**KEY FINDING**

CONCERNS ABOUT INDEPENDENCE VARY BY TIME, SEGMENT

| | Real problem today | Perception problem today | Real problem tomorrow | Perception problem tomorrow |
|---|---|---|---|---|
| **Auditors** | None | Slight | None | Slight |
| **CEO's** | None | Slight | None | Moderate |
| **CFO's** | None | Slight | Slight | Moderate |
| **Buy-side** | Slight | Moderate | Slight | More serious |
| **Sell-side** | None | Slight | Slight | Slight |
| **Audit Committee** | Slight | Slight | Moderate | More serious |
| **Regulators** | Moderate | Moderate | Serious | Serious |

## Regulators

Regulators were a unique audience in this study, and were fairly homogeneous in their views. They regard the issues as more serious and more pressing than the other segments, and are impatient to see solutions coming out of the private sector stakeholders.

While some took the view that there were few real issues of independence today, the view of SEC interviewees was that there were immediate problems of fact today. All felt that perception problems were growing, and that they needed to be dealt with sooner rather than later.

In particular, there was concern that a downturn in the economy and/or a major market correction might cause a number of problems in past reporting to become evident. That coupled with the prospect of a significant deterioration in the paper wealth of millions of consumers meant that pressure for a political intervention into the marketplace was highly likely, if protective measures were not taken in advance.

There was a sense that the pace of change in the economy, means that accounting rules have trouble keeping up, and this leads to a greater degree of discretion in reporting than existed in the past. Together with the fact that so many investment decisions are being made on the basis of non-audited information, regulators would rather strengthen the role of the independent auditor, or at least not see it weakened in any way. With only one or two exceptions, those regulators included in this sample felt that the business model of the largest accounting firms was putting pressure on independence and on the appearance of independence.

The ideal world for most regulators would likely be one in which audit firms did only audit work. Failing that, they would prefer that audit firms did their consulting work only for non-audit clients. Failing that, they want to see a significant ramping up of effort to safeguard independence and to ensure that individual investors have the protection of independent audits and as importantly, *feel* as though they have that protection. In offering this latter point of view, it was clear that regulators felt that this study should take into account the views of individual, and not just institutional investors.

While regulators value the kind of safeguards which firms impose internally, they signaled that they didn't feel that these would be adequate over the long term. They worried that the profession had been moving too slowly to deal with the issues around non-audit assignments and were looking for the ISB to improve the pace of activity in this area.

They strongly felt that efforts should be stepped up to educate investors about the roles and responsibilities of various stakeholders and the steps that are taken to assure reliable information, along with the limitations therein. This, they felt, would help reduce the risk of a severe political backlash in the future.

(A methodological point: while virtually all other interviews were done on a one to one basis, several of the SEC participants preferred to be interviewed as a group, a desire that was accommodated)

### Buy Side Analysts

Buy side analysts were fairly homogeneous, with the exception of a few who had previously worked as auditors and whose perceptions were influenced by that experience. Overall, they tended to be sanguine and skeptical about the question of auditor independence at one and the same time.

They were generally of the view that financial reporting and the audited financial statements could be trusted, while asserting that the audited statements were of minimal importance compared to other sources of data. They felt that the relationship between auditors and clients was becoming an unhealthy one, and that something probably ought to be done about it.

While offering this latter opinion, they also indicated that they personally, as well as their firms, were careful not to become victimized by financial reporting which misrepresented the performance of companies. In effect, they were saying that they would rather see steps taken to remedy the situation than not, but that they were taking their own protective measures in any event.

Their view that the relationship between auditors and clients was becoming unhealthy was partly based on a belief that the incidents of abuse were increasing in number over time. Some felt that there had been an embarrassing and costly increase in such incidents.

But mostly it was based on a view that the financial dynamics of the evolving relationship were unavoidably dangerous, and a desire to insure against a more significant increase in problems in the future. They saw the inclination to cut prices on audits in order to win more lucrative consulting assignments as the kind of circumstance which would have the potential to corrupt even the least corruptible individuals.

As such, they were not impugning the integrity of the auditors, nor even saying that it had been all that damaged to date. However, they had a strong sense that virtually anyone's motivations can be altered if the economic penalties and incentives are substantial enough.

Finally, buy side analysts felt the issue of reliability of financial reporting would only become more prominent as the hunt for value in a highly priced stock or rapidly correcting market became more intense.

They recognized the impact that they as a group had on earnings management, and lamented that markets seemed to be overreacting to short term considerations, and that they were contributing to that effect. At the same time, they argued that it was up to companies to issue financial statements, and up to the market to react as it chose to. They would not take responsibility for efforts by companies to manage earnings, did not think it was a new phenomenon, and considered it to be more or less manageable, from their standpoint.

### Sell Side Analysts

Sell side analysts were also quite homogeneous in their views. As a group, they have concerns about the pressures on financial reporting and auditor independence, but they feel that they can live with the status quo.

There is concern about the prospect that a downturn might expose more problems than people imagine, but sell side analysts indicate a clear stake in market momentum and worry about the prospects of a high profile debate undermining confidence in the markets.

They see the annual audit as a "table stakes" part of financial disclosure, perhaps losing importance over time, but always something that will be necessary and useful. They are quite confident that the largest companies and the largest auditors generally do a good job and resist pressures to manage earnings too aggressively. They assume that there is a fair amount of give and take in the normal auditor-client relationship and that earnings management is not a new phenomenon.

As a group, they are highly resistant to the idea of greater regulation of any sort, preferring to believe in the ability of the market to correct, over time, any excesses. While offering their views, several in this segment acknowledged that their views tended to fluctuate, and that their perceptions were highly influenced by what appeared in the media.

They had generally a low level of detailed understanding of the current safeguards around auditor independence, and had not done a great deal of thinking about the issues of how to set standards for the future. For the most part, there was some skepticism about the potential for Audit Committees to do much to alter the current situation.

## J. CONCLUSION

This study examined a complex web of issues among a set of audiences, which often had different points of view. As such, the idea of drawing conclusions has some inherent hazards.

Nonetheless, we believe it is both necessary and possible to draw some conclusions based on these findings, and would focus attention on the following:

1. Most of those interviewed felt that the quality, depth and reliability of financial reporting in the United States is better than that found anywhere else.

2. Most felt that auditors of public companies perform a valuable function and do so in a way which reflects a high degree of integrity, competence, and independence.

3. Most felt that the evolution of accounting firms to multi-disciplinary business service consultancies represents a challenge to the ability of auditors to maintain the reality and the perception of independence.

4. The challenge is most apparent in two circumstances:

   i. When auditors pursue or accept consulting assignments with their audit clients.

   ii. Because of the increasingly intense media and investor scrutiny which exists today.

5. While some believe that perceptions of the independence of auditors is already suffering some corrosion, more people take the view that damage is inevitable in the future if greater precautions are not taken to protect the perception of independence.

6. Auditors stand at one end of the spectrum of views on these issues, tending to feel that they are managing the pressures effectively, and that few further precautions are required. At the other end of the spectrum are regulators, who feel that the profession needs to move more aggressively and rapidly to strengthen safeguards on a voluntary basis, or have a more stringent regime imposed. The rest of those segments included in

this sample fall somewhere in between these poles, closer to the auditors' view on the question of problems to date, and closer to the regulators on the need for further action going forward.

7. No one believes that these challenges can be solved easily, or by one set of measures. Instead, there is a tendency to favor a combination of efforts, involving a variety of different stakeholders:

   i. The ISB should set out very clear standards regarding non-audit assignments for audit firms with their audit clients. These should ideally be accompanied by a set of "best practices" which can be added to and amended as necessary over time, (these might more appropriately be issued by another organization, such as the SEC Practice Section).

      These standards might usefully address the following subjects:

      - Those consulting services which are more or less appropriate for audit firms to supply to their audit clients.

      - The ideal and acceptable practices for selling and bidding on consulting assignments.

      - A view on the relevance of the size of the consulting arrangements, in absolute terms, relative to audit fees, and whether on a one-off or sustained basis.

      - The ideal and acceptable roles for the audit engagement partner to play in securing and helping manage non-audit work. Compensation should be addressed as well.

   ii. An effort should be made to regroup in one source all the measures in place presently to safeguard auditor independence and objectivity. This would include government and professional regulations and codes of conduct, audit firm and client practices which are common, (if not codified) and should incorporate a discussion of the importance of scrutiny by buyers/investors.

   iii. A careful review of existing rules, regulations and standards with a view to making them as clear and contemporary as possible. Where necessary to enhance credibility, some rules could be abandoned, and some penalties or sanctions could be strengthened.

iv. An initiative to raise the level of investor familiarity with the safeguards which are in place and the care they should take as investors in consuming the financial reports of companies they might invest in.

We look forward to discussing this draft report with the ISB prior to issuing a next draft in advance of the upcoming Board meeting.

# APPENDIX A – INTERVIEWEES BY GROUP

| CEO'S OF SEC REGISTRANT COMPANIES | |
|---|---|
| ABN-AMRO | Bill Thiel |
| Airtouch | Sam Ginn |
| BF Goodrich | David Burner |
| BP Amoco | Lawrence Fuller |
| Brunswick Corporation | Peter Larson |
| Cendant | Henry Silverman |
| Chase Manhattan | Walter Shipley |
| Guardian Life Insurance | Joseph Sargent |
| IMC Global | Robert Fowler Jr. |
| Knight-Ridder | Tony Ridder |
| Nipsco Industries | Gary Neale |
| Nucor | David Aycock |
| Ryder System, Inc. | Tony Burns |
| TIAA-CREF | John Biggs |
| United Stationers | Randall Larrimore |
| York International | Robert Pokelwaldt |
| **Total** | **16** |

| CFO'S AND CONTROLLERS OF SEC REGISTRANT COMPANIES | |
|---|---|
| Abbott Laboratories | Dave Diamond |
| Allstate | John Carl |
| Amerada Hess | John Schreyer |
| American International | Howard Smith |
| Avon Products | Robert Corti |
| Chase Manhattan | Joseph Sclaffani |
| CISCO Systems | Dennis Powell |
| Colgate-Palmolive | Steve Patrick |
| CostCo | Richard Galanti |
| Hewlett Packard | Robert Wayman |
| Interpublic Group | Thomas Volpe |
| Lexmark | David Goodknight |
| McDonald's | Mike Conley |
| McGraw-Hill | Robert Bahash |
| Newell-Rubbermaid | Donald Krause |
| Pfizer | David Shedlarz |
| Republic National Bank of New York | Stan Martin |
| RJR Nabisco | Dave Rickard |
| Unicom | Robert Berdell |
| United Airlines | Nancy Tauber |
| USG Corporation | Richard Flemming |
| Washington Mutual | William Longbrake |

| | |
|---|---|
| Wells Fargo | Tom Emerson |
| Wells Fargo | Jim Thvedt |
| **Total** | **24** |
| **AUDITORS** | |
| Arthur Andersen | Jack Benedik |
| Arthur Andersen | Patrick Condon |
| Arthur Andersen | Michael Underwood |
| BDO Seidman | Al Ferrara |
| BDO Seidman | Steve Ferrara |
| Deloitte & Touche | Robert Giordano |
| Deloitte & Touche | Ralph Siegel |
| Deloitte & Touche | Tom Hoover |
| Ernst & Young | Lou Kramer |
| Ernst & Young | Tom Vogelsinger |
| Ernst & Young | Steve Almassy |
| Grant Thornton | Kunio Yoshioka |
| KPMG | Paul Wirth |
| KPMG | Dan Schmitt |
| KPMG | Steve Marsh |
| Pricewaterhouse Coopers | Tom Colligan |
| Pricewaterhouse Coopers | John Baily |
| Pricewaterhouse Coopers | Keith Klaver |
| Pricewaterhouse Coopers | George Kennedy |
| **Total** | **19** |
| **BUY-SIDE ANALYSTS** | |
| Aeltus Investments | Scott Fox |
| American Express Asset Management | Bill Miller |
| Dresdner RCM Global | William Price |
| Equitable Life Insurance | Peter Noris |
| Federal Home Loan Bank of Seattle | Judy Daily |
| GATX Capital Corporation | Ken Foster |
| Hartford Steam Boiler Inspection | James Rowan |
| Janney Montgomery Scott | Jerry Lombard |
| Mutual of Omaha | John Maginn |
| Nationwide Insurance | Dave Diamond |
| Pilgram & Baxter | Gary Pilgram |
| Security Benefit Life Insurance | John Cleland |
| Selective Life Insurance | Robert Rank |
| The Chubb Corporation | Michael O'Reilly |
| TIAA-CREF | Martin Leibowitz |
| Transamerica | Gary Rolle |
| Voyageur Asset Management | James King |
| Wanger Asset Management | Harold Litchenstein |

| | |
|---|---|
| **Total** | **18** |

| **SELL-SIDE ANALYSTS** | |
|---|---|
| BancBoston Robertson Stephens | Brian Bean |
| Bear Stearns | Patricia McConnell |
| First Chicago Capital | Gerald Byrne |
| Goldman Sachs | Ester Mills |
| Goldman Sachs | Sarah Smith |
| Goldman Sachs | Gabrielle Napolitano |
| HSBC Securities | Jeffrey Haroldson |
| Janney Montgomery Scott | James Myer |
| JC Bradford | Emily Evans |
| Keefe, Bruette & Woods | David Berry |
| Lehman Brothers | Bob Williams |
| McFarland Dewey | Alan McFarland |
| Morgan Keegan | Minor Perkins |
| Morgan Stanley Dean Witter | Joanne Pace |
| Nomura Securities | Mike Lowry |
| Prudential Securities | Paul Scura |
| The John Nuveen Company | George Adams |
| **Total** | **17** |

| **AUDIT COMMITTEE CHAIRS AND MEMBERS** | |
|---|---|
| Amerada Hess Corporation | Robert Wilson |
| Amerada Hess Corporation | Bill Spencer |
| Anixter | John Petty |
| Brunswick | Michael Callahan |
| Brunswick | Jeffrey Bleustein |
| Citigroup | Dudley Meecum |
| Citigroup | Alan Belda |
| Consolidated Edison | James O'Brien |
| IMC Global | Harold MacKay |
| Interpublic Group of Companies | Frank Borelli |
| Lehman Brothers | Michael Ainslie |
| Merrill Lynch | John Phelan |
| Motorola | Anne Jones |
| Pfizer | Don Cornwell |
| Tribune | Arnold Weber |
| Unicom | James Compton |
| Unicom | Bruce DeMars |
| Walgreen | Jim Schwemm |
| **Total** | **18** |

| REGULATORS | |
|---|---|
| American Stock Exchange | Sal Sodano |
| FDIC | Robert Storch |
| NASDAQ | Pat Campbell |
| National State Boards of Accountancy | Dennis Spackman |
| National State Boards of Accountancy | Robert Gray |
| National State Boards of Accountancy | David Costello |
| New York Stock Exchange | James Cochrane |
| Office of Comptroller of the Currency | Zane Blackburn |
| Office of Thrift Supervision | Timothy Stier |
| SEC | Arthur Levitt |
| SEC | Norman Johnson |
| SEC | Isaac Hunt |
| SEC | Brian Lane |
| SEC | Robert Bayless |
| SEC | Walter Schuetze |
| SEC | Robert Walker |
| SEC | Lynn Turner |
| SEC | Harvey Goldschmid |
| US General Accounting Office | David Walker |
| **Total** | **19** |

# APPENDIX B – THE INTERVIEW GUIDE

## A. CONTEXT

1. In general terms, how would you characterize the effort/quality/reliability of information sharing by public companies with the investing public? How has it changed?

2. How would you characterize the relationship between most public companies and their auditors? What about your approach?

## B. AUDITOR INDEPENDENCE

1. Have you personally observed situations where the objectivity or independence of an auditor of a public company was impaired, or was in serious risk of impairment?

2. What factors are most likely to contribute to impairment of independence? What about to the perception of a loss of independence?

3. Is impairment of independence becoming more common or more rare? What impact, if any are these factors having? (Probes: financial markets changing, technology, consolidation, rules, regulations, safeguards, earnings management, analysts estimates, etc.)

4. In your opinion, is there an *issue* of auditor independence?

   i. Whenever circumstances are such that the *potential* for impairment exists.

   ii. Whenever the circumstances are such that the risk of impairment occurring is greater than what might be considered normal.

   iii. Only when circumstances *actually result* in an action which demonstrates a lack of independence.

5. As far as you are concerned, is there an *issue* of auditor independence:

   i. Whenever a reasonable person might *perceive* a loss of independence, regardless of whether there has been any material impact, because it undermines confidence in the financial markets.

   ii. When a loss of independence has actually occurred.

iii. When a loss of independence has occurred that has resulted in negative impact on investors.

## C. THE NECESSARY ELEMENTS

1. Based on what you know, are current *prohibitions* governing the relationship between audit firms and their clients appropriate?

2. Over and above the prohibitions, are there adequate *safeguards* to help prevent impairment?

3. Here are some examples of safeguards, which are or can be taken to mitigate against a real or perceived loss of independence. Would you comment on the usefulness of each.

   i. Chinese walls /physical separation/internal governance/tone at the top

   ii. Stepped up role for Audit Committee

   iii. Disclosure to the public of independence safeguards and procedures

4. From your perspective, what do you think the main priorities of the ISB should be? What sort of effort do you think that the ISB should make to communicate with different audiences over the next few years?

   i. Perception/reality:

   ii. Prevention/remedial:

   iii. Bright lines/best practices/clear rules:

## SCENARIO A

ABC audit firm's consulting division takes a two year contract to develop and install a new SAP computer system for their client, ACME Manufacturing. ABC earns $10 million for the computer system work, and $1 million per year for their audit of ACME. The consulting contract equals about 1% of ABC's annual revenues.

ABC has recognized expertise in computer consulting, won the contract in competitive bidding, and the question of whether such a contract would impact the independence was raised with ACME's audit committee, which decided that there was no impairment. ACME management has the necessary expertise to monitor the consulting work, and make the necessary decisions around it.

1. In this example, has there been a real loss of independence?

2. If not, ask, is there an unacceptable risk that independence could be impaired?

3. Is it likely that reasonable investors might, upon learning of these facts, mistrust the financial reporting of ACME? Of the reliability of audited statements more generally?

4. Would your views change if the consulting contract equaled about 20% instead of 1% of ABC's revenues? Why/Why not?

5. Would your views change if the audit partner helped win this consulting contract, and as a result, is it likely to have a positive impact on the audit partner's compensation by ABC?

## SCENARIO B

John Doe, an auditor with the accounting firm BBB, has just completed his annual audit of Kate Inc. Kate Inc, then offers Doe the position of CFO, with a rich compensation package.

Doe immediately stops doing any work for Kate Inc, and notifies the management of BBB about the offer. After a short period of reflection, he takes the job, and ends all financial ties to BBB.

BBB immediately conducts a thorough review of the most recent audit of Kate, makes sure it selects a senior partner to work on Kate's audit in the future, to ensure proper skepticism, and schedules QA and Peer Review inspections for next year.

1. In this example, has there been a real loss of independence?

2. If not, ask, is there an unacceptable risk that independence could be impaired?

3. Is it likely that reasonable investors might, upon learning of these facts, mistrust the financial reporting of Kate Inc.? Of the reliability of audited statements more generally?

4. Would your views change if John Doe turned down the job, and continued working on Kate's audits?

## SCENARIO C

Ace Accounting does the audit work for Moll Computers, based in New York. Ace's Vancouver office does some routine bookkeeping work for Moll's Portland subsidiary, MCP.

MCP accounts for no more than 4% of Moll Computer's revenues, and would not normally be visited by an audit team, because of its size.

The bookkeeping work is done by an "accounting assistance" department of the Ace Portland office, which is separate from the audit department. The work includes processing company-supplied data, which is then reviewed and approved by MCP officials, before being forwarded to Moll's headquarters in New York. Ace personnel do not prepare any source documents, sign checks, have custody of assets or make significant judgements.

1. In this example, has there been a real loss of independence?
2. If not, ask, is there an unacceptable risk that independence could be impaired?
3. Is it likely that reasonable investors might, upon learning of these facts, mistrust the financial reporting of Moll Computers? Of the reliability of audited statements more generally?
4. Would your views change if MPC accounted for about 20% instead of 4% of Moll's revenues? Why/Why not?
5. Would your views change if the accounting assistance was provided to five of Moll's subsidiaries, instead of one?

## SCENARIO D

Jane Smith works as a senior audit partner with Tendy Accounting's Boston office. She has two relatives who happen to work for two different Tendy clients.

Jane's husband works for Able Inc. as a software developer. He has $8000 in Able's stock option plan. Jane and her husband earn a combined income of more than $200,000 per year. Able's audit is done by Tendy.

Jane's brother is the CFO of Simple Internet Services, a small, but rapidly growing company in Portland Maine. Portland is 120 miles from Boston, and all services for Simple are provided by Tendy's Portland office.

EARNSCLIFFE RESEARCH & COMMUNICATIONS

Jane has no involvement in either client's account. She sees her brother socially about once a year.

1. In this example, has there been a real loss of independence?

2. If not, ask, is there an unacceptable risk that independence could be impaired?

3. Is it likely that reasonable investors might, upon learning of these facts, mistrust the financial reporting of either Able or Simple? Of the reliability of audited statements more generally?

4. Would your views change if Jane's brother called her regularly for advice about investments and personal money management?

5. Would your views change if Jane Smith provided some consulting work, but no auditing services to Able?

ISB

**Independence Standards Board**



July 13, 1999

Dear ______:

I am writing to ask you to contribute half an hour of your time to an important research effort.

The Independence Standards Board (ISB) was established by the Securities and Exchange Commission to provide and maintain independence standards for auditors of public companies. As part of its mandate, the ISB has commissioned Earnscliffe Research and Communications to conduct a small number of interviews among the most senior executives in a variety of business fields. Earnscliffe is a firm highly experienced at conducting this type of research.

Attached please find a letter of request from Earnscliffe for an interview. The subject of the interview will be your views on how well auditor independence is maintained today, and how best to ensure auditor independence in the future. The views of those who agree to participate will be reported without attribution. The findings will be used to help shape the agenda for the ISB in the years to come.

These interviews are ideally conducted in person, however if an in person interview is impossible, a telephone interview can also be arranged. Every effort will be made to do the interview at a time and in a location convenient for you.

We very much appreciate the challenge of finding a half an hour to spare, and hope that you will give this request favorable consideration. If you would like to know more about the research or have any other questions, please do not hesitate to contact Art Siegel, Executive Director of the ISB at (212) 596-6141.

Sincerely,

William T. Allen

Chairman

EARNSCLIFFE RESEARCH & COMMUNICATIONS

July 13, 1999

Dear _______:

Earnscliffe Research and Communications has been retained by the Independence Standards Board (ISB) to conduct a number of research interviews with a sample of very senior people in various business fields.

Further to the letter from the Chairman of the ISB, we are writing to ask if it would be possible to arrange an interview. Roughly one half hour of your time would be required. The subject would be your views on how well auditor independence is maintained today, and how best to ensure auditor independence in the future.

As is customary with this type of research, the views of those who agree to participate will be reported without attribution. The findings will be used to help shape the agenda for the ISB in the years to come.

Elizabeth Nickolas of my office will be in touch to follow up on this letter in the next day or two. We very much hope you will be able to find the time to share your views, and every effort will be made to conduct the interview at a time and a location convenient to you. If you would like more information before considering this request, please do not hesitate to contact me at (613) 233-8080 or Art Siegel, Executive Director of the ISB at (212) 596-6141.

Sincerely,

Bruce A. Anderson