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Independence Standards Board

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Discussion Memorandum

Legal Services

December 1999



**Independence
Standards
Board**



Independence
Standards
Board

Discussion Memorandum
(DM 99-4)

Legal Services

December 1999

Comments should be received by February 29, 2000, and may be sent via:

1. Mail: Independence Standards Board
6th Floor
1211 Avenue of the Americas
New York, NY 10036-8775
2. Fax (212) 596-6137
3. e-mail isb@cpaindependence.org

Please reference DM 99-4 in your correspondence.



**Independence
Standards
Board**

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Assistant Technical Director

Date: December 1999

To: Interested Parties

From: William T. Allen, Chairman

The mission of the Independence Standards Board (ISB or Board) is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets. Two of the founding precepts of the ISB are that (1) while many factors may affect the functioning of the capital markets, these markets will not function effectively unless investors have confidence in the information they use to make investment decisions, and (2) an independent audit is essential to providing that sense of confidence. If knowledgeable and reasonable investors believed that the independent auditor placed the interests of the accounting firm, the audit client, or any other person, over the interests of investors, then the value of the audit function would be impaired.

It is with this mission in mind, and while working concurrently on its project to establish a conceptual framework for auditor independence to serve as the foundation for principles-based independence standards, that the Board is studying the independence concerns related to audit firms providing legal services for SEC audit clients. As such, the Board seeks comment on the issues described in this Discussion Memorandum (DM).

The operating policies of the ISB are designed to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue.

The ISB is seeking specific input on the questions posed at the end of this DM. In addition, we welcome comments and suggestions on any other aspect of the auditor independence issue related to the provision of legal services for SEC audit clients. The Board appreciates the time that respondents are taking to study this DM, and recognizes that the document is lengthy and the issues complex. It is not necessary for each respondent to respond to every question raised, although we certainly encourage that.

Any individual or organization may obtain one copy of this Discussion Memorandum (DM 99-4), without charge, by contacting the ISB. The ED is also available on the ISB website at www.cpaindependence.org.

Your responses, which must be received by February 29, 2000, may be sent via:

1. mail: Independence Standards Board
6th Floor
1211 Avenue of the Americas
New York, NY 10036-8775
2. fax: (212) 596-6137
3. e-mail isb@cpaindependence.org

Please reference DM 99-4 in your correspondence.

All responses will be available for public inspection and copying for one year at the offices of the Independence Standards Board and also at the library of the American Institute of Certified Public Accountants (AICPA), Harborside Financial Center, 201 Plaza Three, Jersey City, NJ, telephone (201) 938-3000.

ISB Discussion Memoranda explore auditor independence issues in an effort to solicit debate and public comment. They do not in any way modify existing auditor independence requirements.

Discussion Memorandum

Legal Services

December 1999

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Legal Services

Background and Executive Summary

Scope

1. This project poses the question, “under what circumstances, if any, can an audit firm or its affiliates provide *legal services* for SEC audit clients without impairing independence?” Situations involving attorneys providing legal advice directly to audit engagement teams (as governed by Statement of Auditing Standards (SAS) No. 73, “Using the Work of a Specialist”) are not covered by this project.
2. “*Legal services*,” for the purposes of this Discussion Memorandum (DM), are defined as “those services that can only be provided by someone licensed to practice law.” (There are, of course, many services provided by licensed lawyers that are also routinely provided by audit firms and other non-lawyers, including tax advisory services. Such services are expressly excluded from the definition of “legal services” used in this DM.) The Board acknowledges that, because legal licensing requirements vary by jurisdiction, this definition will relate to different services in different jurisdictions. However, the Board does not believe such variations should significantly detract from the development of an appropriate independence standard.
3. While a list of individual services comprising those possible as “legal services” under this DM likely is too long and subjective to be practical for inclusion here, such services sometimes are grouped in three categories that may be helpful in focusing this document:
 - a. Representing clients before courts and other adjudicatory bodies;
 - b. Preparing legal documents such as contracts, wills, and trust instruments; and
 - c. Providing legal advice to clients on the application of laws and regulations to particular facts.

Current Environment

4. Lawyers cannot currently practice law in partnership or share fees with audit firms (or other non-lawyers) in the United States because of various state laws and Bar Association rules. In many other countries, however, the rules are different. International audit firms have been rapidly developing large networks of affiliated law firms in Europe, South America, Australia and other parts of the world. In response, in August 1998 the American Bar

Association (ABA) appointed a Commission on Multidisciplinary Practice (CMDP) to assess the implications of these and related developments and to evaluate whether the current ABA *Model Code* ban on fee sharing between lawyers and non-lawyers should be retained. In June 1999, this Commission recommended that lawyers should be permitted to share legal fees with a non-lawyer, and deliver legal services through a multidisciplinary practice.¹ However, at its annual meeting in August 1999, the ABA House of Delegates approved a resolution barring such affiliations unless further study shows they can be accomplished without harming clients or compromising lawyers' independence.

5. There are currently restrictions on audit firms performing legal services for SEC audit clients. These restrictions are based on the belief that acting as auditor and attorney for the client are incompatible because the auditor's primary responsibility is to the investing public, which requires independence (in fact and appearance), while the lawyer's primary responsibility is to the client as a loyal advocate and zealous defender. There are also AICPA restrictions based on the belief that a lawyer's advocacy may lead to a commonality of interests with the client, which, in turn, could result in a loss of objectivity and thus impair an auditor's independence.
6. The Board understands that starting around 1993, certain audit firms began providing legal services to foreign subsidiaries of SEC audit clients and foreign SEC audit clients, based on a set of broad principles (which are described in paragraph 15).

Potential Threats to Independence

7. Potential threats to independence due to the provision of legal services generally focus on the following somewhat overlapping general categories: (1) a lawyer's client advocacy role is incompatible with an auditor's independence role; (2) attorney-client privilege is contrasted with the auditor's focus on the protection of investors through proper public disclosure; and (3) persons providing legal services either fulfill a management role and participate in management decisions or their advice becomes the basis for reliance that could place the audit firm in the position of reviewing its own work.

Safeguards for Independence

8. Firms have represented that they have developed or are developing quality controls (or safeguards) to ensure the firm's independence when a member of the firm provides legal services to an audit client. Some believe

¹ "Recommendation." American Bar Association. Commission on Multidisciplinary Practice. Chicago, IL. June, 1999, page 1.

these safeguards adequately address the additional conflicts and pressures on independence that are created when an audit firm provides legal services to its audit clients. Others believe that, in part because of the strength of the incentives to provide legal services, the firms' safeguards do not adequately address those additional conflicts and pressures.

Range of Possible Independence Requirements

9. This DM discusses five possible approaches to establishing independence requirements in this area. The requirements cover a wide range, and include variations based upon degrees of advocacy, materiality and safeguards.

Legal Services

Discussion of Issues

Introduction

10. In a January 1999 letter to the Chairman of the ISB, one of the issues the Chief Accountant of the SEC requested the Board to place on its agenda was “Legal Advisory Services.” The letter stated, with respect to this topic:

“Press reports have cited the expansion of independent auditors into legal services. These services may involve representing clients before the Internal Revenue Service, providing advice on structuring corporate transactions and benefit plans, providing expert witness testimony on behalf of clients, etc. Providing legal services appears to be more predominant in foreign countries, but at least one recent press report cited one of the international firms as considering the acquisition of a New York law firm in the future. The Big Five accounting firms could provide the ISB with more accurate information as to the exact nature and types of services being provided.

“The Commission has held in the Codification of Financial Reporting Policies, Section 602.02e.ii, that an accountant-attorney relationship with a client is inconsistent with the appearance of independence. This is due in part to the primary concerns attorneys have with the personal rights and interests of their clients and the advocacy role they are expected to undertake.

“You may wish to consult with the American Bar Association Commission on Multidisciplinary Practice, which also is studying this issue.”²

11. While the question “Under what circumstances, if any, can an audit firm or its affiliates provide legal services for SEC audit clients without impairing independence?” may appear straightforward, it raises a number of issues, including:
- a. Why is the question so relevant and important now?
 - b. What is the current regulatory environment?
 - c. What are the arguments for audit firms providing legal services?

² Letter. Lynn E. Turner, Chief Accountant, SEC to William T. Allen, Chairman, ISB. January 7, 1999, page 3.

- d. What are the arguments against audit firms providing legal services, particularly with respect to threats to auditors' independence?
- e. What range of possible independence requirements should be considered?
- f. Transition issues (whether or not legal services are permitted prospectively) and other matters.

Each of these items will be discussed in the following paragraphs.

Relevance and Importance of the Question

12. As indicated in the SEC Chief Accountant's letter, audit firms, partly in response to client expectations and partly because of what they view as a natural extension of their other service lines, have begun offering legal services to their clients, including foreign units of SEC audit clients.³ This development has not occurred in the United States because of regulatory constraints, but it has caused the U.S. legal profession to consider a response. For example, in August 1998, the American Bar Association (ABA) appointed a Commission on Multidisciplinary Practice (CMDP) to assess the implications of these and related developments and to evaluate whether the current ABA *Model Code* ban on fee sharing between lawyers and non-lawyers should be retained. In June 1999, this Commission unanimously recommended that lawyers should be permitted to share legal fees with a non-lawyer, and deliver legal services through a multidisciplinary practice.⁴ However, at its annual meeting in August 1999, the ABA House of Delegates approved a resolution barring such affiliations unless further study shows they can be accomplished without harming clients or compromising lawyers' independence. It should be noted that even if the ABA ultimately endorses multidisciplinary practices, state rules, and, in some cases, laws, would have to be changed to permit such practices.

Current Regulatory Environment

13. Throughout this section on the "Current Regulatory Environment," the distinction between the primary responsibilities of auditors and lawyers is evaluated. That is, the auditor's primary responsibility is to the public through independence in both fact and appearance, resulting in an objective audit. On the other hand, the lawyer's primary responsibility is to

³ The firms have adopted no single model for delivering legal services. Instead, their approach depends upon the rules of the relevant country. In some countries, they have developed affiliations with independent law firms. In other countries, legal services may be offered by the accounting firm or by a separate law firm in partnership with the accounting firm.

⁴ "Recommendation." American Bar Association. Commission on Multidisciplinary Practice. *Op. Cit.*

the client as adviser and advocate. While the duties of lawyers and auditors are not identical, some argue there are many similarities. They point out that both auditors and lawyers do not, in most cases, voluntarily reveal client confidences without client consent; that neither can continue to advise a client who knowingly makes false statements to third parties, including corporate shareholders, the investing public, tribunals, the SEC and the Internal Revenue Service (IRS); and that, under the federal securities laws, both are obligated not to make misrepresentations or omissions about material matters and must take certain actions to prevent their clients from doing so. Others conclude that the primary roles of auditors and lawyers are different, and an auditor's independence responsibilities and obligations to disclose information to the public are incompatible with an attorney's advocacy responsibilities and attorney-client privilege.

14. The views of the Office of the Chief Accountant (OCA) of the SEC are contained in a letter to the Chair of the ABA's CMDP. This letter, excerpts of which are contained in the Appendix, cites both a United States Supreme Court decision and SEC regulations. These positions are also outlined in a letter to the ABA dated July 12, 1999 from the SEC's General Counsel, Chief Accountant and Director of Enforcement. That letter states in part:

“...while the SEC has taken no position on multidisciplinary practice *per se*, the SEC has long made clear that its independence rules prohibit an auditor from certifying the financial statements of a client with which his firm also has an attorney-client relationship. Indeed, just several weeks ago, the SEC issued an order formally disciplining an attorney-accountant who gave legal advice to an audit client of another partner in his accounting firm. In its order, the SEC reiterated its long-held position that the attorney-client relationship is inconsistent with the independence required of accountants in reporting to investors. *Matter of Charles E. Falk*, Exch. Act Rel. No. 41426, AAE Rel. No. 1136, 1999 SEC LEXIS 1013, 1999 WL 311802 (SEC) (May 19, 1999).

“...all involved should realize that the SEC will continue vigorous enforcement of its rules on auditor independence and that, unless and until those rules are modified, those rules prohibit an auditor from certifying the financial statements of a client with which his firm also has an attorney-client relationship.”⁵

⁵ Letter. Harvey J. Goldschmid, Chief Counsel, SEC, Lynn E. Turner, Chief Accountant, SEC, and Richard H. Walker, Director of Enforcement, SEC to Philip S. Anderson, Esq., President, ABA. July 12, 1999.

15. The Board understands that starting around 1993 certain audit firms began providing legal services to foreign subsidiaries of SEC audit clients and foreign SEC audit clients, based on a set of broad principles described below:
- a. The subject matter is not material to the financial statements on which the firm is reporting;
 - b. The service is permitted by the laws of the relevant country;
 - c. The legal services provided do not involve acting as general counsel or management; and
 - d. The matter involved and the legal relationship with the client are unlikely to be highly visible.
16. In addition to the SEC regulations just cited, the AICPA's *Code of Professional Conduct* (the *Code*) emphasizes the need for a member in public practice to be independent in fact and appearance when providing audit services. It is important to note that all auditors must comply with the independence requirements of the AICPA. (Auditors of public companies must also comply with ISB/SEC rules where these are more restrictive.) The *Code* states, in pertinent part:

“Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.

“...For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interests.”⁶

The *Code* further recognizes that accounting firms sometimes provide professional services that involve client advocacy, and that advocacy on

⁶AICPA Professional Standards: *Code of Professional Conduct*. AICPA, New York. June 1, 1998, ET§55.03, p. 4321.

behalf of a client does not necessarily compromise the firm's independence with respect to the client. The *Code*⁷ provides:

“Professional services involving client advocacy. A member or a member's firm may be requested by a client—

“1. to perform tax or consulting services engagements that involve acting as an advocate for the client.

“2. to act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

“Services provided or actions taken pursuant to such types of client requests are professional services [ET section 92.100] governed by the *Code of Professional Conduct* and...in the performance of any professional service, a member shall comply with Rule 102 [ET section 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with rule 101 [ET Section 101.01] of the *Code of Professional Conduct*.

“Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.”⁸

17. On the other hand, the ABA's *Model Rules of Professional Conduct (Model Rules)* stress more the lawyer's responsibility to the client. For example, the preamble to the ABA *Model Rules* states:

“As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the advocacy system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others. As intermediary between clients, a lawyer seeks to reconcile their divergent interests as an advisor and, to a limited extent, as a spokesperson for each client. A lawyer acts as evaluator by

⁷*Op. Cit.* ET§102.07 (Interpretation 102-6), p. 4443.

⁸*Ibid.*

examining a client's legal affairs and reporting about them to the client or to others."⁹

Potential Threats to Independence

18. Potential threats to the independence of an audit firm from the firm providing legal services to an SEC audit client generally fall into five somewhat overlapping categories:
 - a. A lawyer's duty to advance the client's position may involve a degree of advocacy (potentially creating a commonality of interest and the related loss of objectivity) that is incompatible with auditor independence;
 - b. Acting in a management role, for example, functioning as general counsel when it involves making or participating in management decisions, is also incompatible with auditor independence;
 - c. Providing corporate secretarial services, such as maintenance of stock records or preparing minutes of meetings, may be equivalent to maintaining client accounting records (i.e., "bookkeeping") and therefore could involve the firm auditing its own work;
 - d. Auditors rely upon representations from counsel about the likely outcome of material litigation or the definition or enforceability of, or compliance requirements concerning contracts, and, if the lawyer were with an affiliated firm, it could also be perceived as the equivalent of auditing the firm's own work; and
 - d. The general need for a lawyer to maintain client confidentiality may reduce the flow of information within the accounting firm that is required to ensure proper client disclosure to the public.

Safeguards for Independence

19. Certain safeguards have been suggested to mitigate any potential threats to independence raised in a particular situation, such as:
 - a. Include the individuals performing legal services in an affiliated but separate entity from that performing the audit services. The objective would be to separate the management of those services so as to reduce the possible and perceived commonality of interest of the different service providers.

⁹ *ABA Compendium of Professional Responsibility Rules and Standards, 1999 Edition.* ABA, Chicago, IL, 1999. Page 13.

- b. Discuss the legal services provided, or to be provided, with the audit committee or board of directors of the client to enable it to make an informed decision regarding the impact performing such services has on the accounting firm's independence.
 - c. Require additional internal quality assurance or external peer review of the audits for clients for whom legal services were also provided, to mitigate the self-review concern.
 - d. Prohibit legal services which involve matters that, in the aggregate, would reasonably be expected to have a material impact on the client's financial statements.
 - e. Use a different firm to audit a client subsidiary for which the client's primary auditor provided (significant) legal services, to avoid potential self-review problems that might result if a firm audited such a client subsidiary.
 - f. Obtain a waiver from the client to permit lawyers of the accounting firm to discuss with auditors of that same firm otherwise confidential audit-related information coming to their attention, to comply with auditing requirements, facilitate client disclosure to the public, and eliminate any perceived threat to the flow of information with the firm.
20. Others, however, are generally skeptical about the effectiveness of safeguards to protect auditor independence when conflicts arise between (a) the attorney-client privilege and the attorney's responsibilities to be a zealous advocate for the client and (b) the auditor's responsibilities to protect the public investor and maintain professional skepticism and independence in fact and appearance.

Arguments for Audit Firms Providing Legal Services

21. Some proponents of audit firms being permitted to provide legal services to their SEC audit clients suggest there are two principal reasons for doing so. First, auditor independence would not be impaired since auditors, like all professional service providers, are advocates to some degree, and there is little difference between many legal services and the other non-audit services the firm may provide, and, second, the proponents believe it is in the public interest to provide such legal services.

Some supporters assert that many legal services are similar to other advisory services (e.g., accounting advice) provided only for the benefit of the client, and not in an adversarial position against any third party. Therefore, since an audit firm can properly perform these other advisory services for clients that it audits, supporters suggest the firm should also be allowed to perform similar legal services.

Their rationale with respect to auditor independence not being impaired centers on the concepts that independence cannot be measured by an absolute “bright line” based on whether the service involves advocacy because all professional service providers, including auditors, are advocates of their clients’ positions to some extent. Instead, supporters suggest a safeguards approach based on relevant facts and circumstances.

On this graduated scale, there may be some legal services that are of such a public “adversarial” nature and that differ sufficiently from other services provided by auditors to warrant either special safeguards or outright prohibition. For example, representing an audit client in a court proceeding might be considered sufficiently adversarial to be proscribed if the matter involves material amounts. On the other hand, preparing legal documents and/or advising audit clients on the application of laws might be limited enough in terms of their adversarial nature to be acceptable. Some supporters suggest that legal services could be provided by an audit firm to an audit client if the services were carefully limited to be of low degrees of both advocacy and materiality, and if appropriate safeguards were used.

Others believe that legal services should be permitted to be offered by an independent, but affiliated, law firm of the audit firm. They suggest that where legal services are offered by individuals who are not in partnership with the auditors, any threats, whether in fact or in appearance, are dramatically reduced, and therefore the range of legal services that could be offered by the affiliated law firm should not be limited.

22. In their second principal argument, supporters contend that the rules should permit audit firms to provide legal services for an audit client because they believe it is also in the public interest, since the client could be better served in one or more specific ways. For example, the client:
 - a. May realize a more effective and efficient audit from a firm that is able to take advantage of its shared common body of knowledge concerning the business, accounting and legal aspects of the corporation;
 - b. Will have a wider choice of lawyers, by not being precluded from using lawyers affiliated with the audit firm;
 - c. May be better able to satisfy the need for comprehensive and global solutions to complex problems which also include legal, financial and business dimensions, due to the world-wide perspective and diverse expertise of the audit firm;
 - d. Would potentially have easier and more rapid access to a legal services provider of known standards in a domestic or overseas location with which the client is unfamiliar;

- e. May receive less conflicting advice from a coordinated provider of both auditing and legal services; and
- f. Could achieve a reduction in total audit and legal fees because of the more current and in-depth knowledge of the corporation by the combined auditing/legal firm, as well as other efficiencies such a multidisciplinary firm will be able to share with clients.

In sum, the items noted above may provide the potential for improved auditing, plus efficiencies to the corporation, which could ultimately flow to the public through higher profits or lower prices.

23. Supporters also respond to some of the arguments against permitting legal services as follows:
- a. With regard to the argument that legal services should be prohibited, they assert that the SEC does not apply such a “bright line” rule to other similar advisory services, and that a “bright line” ban is not necessary to serve the public interest.
 - b. With regard to the argument that attorney/client privilege creates a special relationship with a lawyer which is inconsistent with the role of an auditor, they respond that audit firms also have a privilege governing some aspects of their practice—i.e., the federal tax practitioner privilege, and accountant/client privilege statutes in some states—and that the ethical rules governing CPAs require confidentiality of client information.¹⁰ They also point out that a client who receives legal services from an unrelated law firm cannot permissibly shield from public disclosure material information simply by communicating that information to its lawyer.
 - c. With regard to any appearance problem that might exist, they believe that investors and capital markets would not be any better off if lawyers and auditors were in separate firms and that, in fact, failure of lawyers to disclose information to auditors may be more likely to happen when that is the case.

¹⁰ The Supreme Court has stated that “no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases.” *Couch v. United States*, 409 U.S. 322, 335 (1973). The Supreme Court further stated, “Endowing the workpapers of an independent auditor with a work-product immunity would destroy the appearance of auditor’s independence by creating the impression that the auditor is an advocate of the client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.” *Arthur Young v. United States*, 465 U.S. 819-20 (1984). This precedent is unchanged by the federal tax practitioner privilege.

Arguments Against Audit Firms Providing Legal Services

24. Those opposed to audit firms providing legal services for their audit clients point out that the purpose of an audit by an independent auditor is to enhance investor confidence in the financial statements of those audit clients. They believe that the broad public interest arguments set forth by the proponents are secondary to maintaining the confidence of the investor. Moreover, in response to paragraphs 22-23 above, they would note that:
- a. The attorney is generally bound by the attorney-client privilege and thus prevented from sharing knowledge concerning the business, accounting and legal aspects of the corporation, while disclosure to the auditor would generally nullify the assertion of the attorney-client privilege against all others and might possibly result in a matter being disclosed to the public.
 - b. Some believe that lawyers have no expertise in auditing so that there is no added knowledge or efficiency in the audit by permitting the audit firm to offer legal services to the client. Others believe that permitting an audit firm to provide legal services to an audit client will increase an audit firm's liability since the audit firm will be held to have corporate knowledge of sensitive client matters.
 - c. Those that argue against the audit firm providing legal services to its audit clients note that there are bright line rules to certain other services to enhance investor confidence in audited financial statements (e.g., a complete proscription against acting as a broker-dealer for an audit client, or as an actuary determining policy reserves for an insurance company audit client).
25. Those who oppose audit firms providing legal services to their audit clients believe the advocacy/independence distinction discussed earlier is pervasive, critical and irreconcilable. That is, a lawyer's responsibility to the client of advocacy, loyalty and a zealous defense of the client's position is a totally different role that cannot be reconciled with the auditor's responsibility to the public of independence and objectivity. Also, "auditors are the only professionals that an entity must engage before it may sell securities in the United States, and the only professionals charged by law to act independently from management."¹¹ (Emphasis in original.)
- More specifically, those against audit firms providing legal services to their audit clients include the following among their arguments:
- a. Independence should be measured on a "bright line" basis. That is, an auditor either is or is not independent—it is not a question of

¹¹ Letter. Lynn E. Turner, Chief Accountant, SEC to Sherwin P. Simmons, Chair, CMDP, *Op. Cit.*, page 1.

“degree” or “relative” independence--and providing legal services of any kind impairs independence and should thus be proscribed.

- b. A clear and sharp distinction must be made between the auditor’s role requiring independence and objectivity and the lawyer’s primary role of advocacy, and that any degree of client advocacy is unacceptable for an auditor, given the auditor’s responsibility to the public.
- c. Legal services are qualitatively different from other non-audit services in view of the attributes of client advocacy and loyalty, and attorney-client privilege.
- d. At least an appearance problem would exist (i.e., investors and the capital markets would be concerned) if a lawyer employed by the audit firm knew of a major problem and failed to disclose it to the auditors, even if such non-disclosure was technically appropriate.
- e. Maintaining investor confidence in the financial statements of the audit client is the purpose of independent audits and far outweighs the positive “public interest” arguments in favor of legal services that are said by some to emphasize, generally, the benefits of increased client knowledge, “one-stop shopping,” and cost savings. It is also argued that these benefits are somewhat nebulous. They suggest a more valid “public interest” benefit would be for auditors to assist investors by doing nothing which might impair their independence.

Range of Possible Independence Requirements

26. The following table sets forth some alternative approaches to establishing independence standards in this area, and they are discussed in the paragraphs which follow.

27. TABLE

LEGAL SERVICES
RANGE OF POSSIBLE INDEPENDENCE REQUIREMENTS

I Legal Services Are Not Permitted	II Degrees of Advocacy	III Magnitude	IV Safeguards	V Legal Services Are Permitted
<p>No legal services should be performed for an audit client. This is because, at least from an appearance viewpoint, such services involve advocacy for the client, therefore creating a commonality of interest, which leads to a perceived loss of objectivity that is incompatible with independence.</p>	<p>Legal services could be segregated by their varying degrees of advocacy. Those with a low enough advocacy level could be considered acceptable, while those with a higher level could be proscribed.</p>	<p>Legal services could be considered acceptable only if they are below some "magnitude" test. For example, services could be considered acceptable if the financial impact on the client could not be material.</p>	<p>Safeguards could be established, such as "firewalls," affiliated but separate audit and law firms; or client "waivers" may be obtained to permit lawyer-auditor communication. Other safeguards also are possible, such as having a different auditor for a subsidiary where significant legal services were provided by the primary auditor.</p>	<p>There should be no restrictions on performance based upon the services being "legal services." However, other restrictions would apply, so that any such services should not, in the aggregate, result in the auditor becoming a de facto employee or officer of the client.</p>

NOTES

1. Regulatory/legal restrictions affecting the performance of legal services are not considered here as they are beyond the scope of this project.
2. While the above five alternatives may overlap to some degree, their details might further be combined to produce still different approaches.

28. Alternative I—Legal Services Are Not Permitted. Supporters of the position that no legal services should be performed for audit clients by the auditor strongly endorse the “bright line” hypothesis that advocacy for the client is incompatible with auditor independence because of the risk of a loss of objectivity and the related threats of commonality of interests and self-review. In addition, they argue that legal services are qualitatively different enough from other professional services (e.g., in terms of their advocacy, client loyalty and attorney-client privilege considerations), to render them contrary to the auditor’s first duty to the public and thus warrant prohibition. This requirement is supported by certain existing legal decisions and regulations, and is clear, concise and understandable. However, it could be considered by some to be unnecessarily restrictive.
29. Alternative II—Degree of Advocacy. A less restrictive approach would be one based on the degree of advocacy. This could be important to those who believe that some level of advocacy is a factor in the services of all professional service providers and that the degree of independence may be measured on other than a “bright line” basis. Some also express the view that the important criterion is independence in fact, which they believe would be retained in these circumstances, rather than independence in appearance.
- Hence, supporters of this view would suggest that providing legal services with a high degree of advocacy (for example, representing clients in court) should be proscribed, but providing services with a lesser degree of advocacy (such as preparation of legal documents or advising on the application of laws in routine and minor situations) should be considered acceptable in view of these services being relatively low in advocacy. They also note it would raise fewer concerns about independence in appearance.
- Supporters of this view believe that at some point advocacy creates a commonality of interest which dilutes the degree of healthy skepticism and objectivity required of an auditor, and thus may lead to an impairment of independence. Some would consider these restrictions to be a logical and understandable response to the advocacy issue and the related commonality of interest threats raised to the auditor’s objectivity and independence, as well as the appearance issue. Others may believe they are either too restrictive or not sufficiently restrictive.
30. Alternative III—Magnitude. Instead of focusing on advocacy, a different approach could consider legal services acceptable only if they fell below some magnitude limitation. For example, legal services handled by the firm could be considered acceptable if they relate to a legal matter¹² for which the financial impact on the client would be immaterial. Those legal services that would have a material effect on the client would be prohibited. This restriction attempts to correlate and assign restrictions explicitly based on the degree of materiality, and, therefore, presumably also on the related degree of threat. Critics contend that this approach would be too subjective.

¹² (and all legal matters in the aggregate)

31. Alternative IV—Safeguards. Another approach would involve the use of safeguards, which some would view as sufficiently mitigating the threats to permit the performance of a least some legal services. For example, the firm’s organization can be changed (e.g., separate but affiliated firms¹³ or operations) to emphasize differing reporting and management channels for the legal and audit services, or “firewalls” could be constructed (although present Generally Accepted Auditing Standards (GAAS)—which require communication within the firm of all audit-related matters—would currently not permit them). Alternatively, client waivers (if permitted in the jurisdiction) could be obtained to allow intra-firm communication of otherwise confidential audit-related information.¹⁴ New firm policies could also provide safeguards. For example, policies might include special in-depth pre-report-issuance partner reviews and post-issuance quality assurance and peer reviews. Another safeguard could be that if significant legal services are performed for a subsidiary of the audit client, a different audit firm must audit that entity to provide an intermediate level of review. While an approach using safeguards could reduce the threat to auditor independence, it might be complex in implementation and unsatisfactory to some because they would not consider the threats to be sufficiently mitigated.
32. Alternative V—Legal Services Are Permitted. Finally, there could be no specific restrictions on performance based upon the services being “legal services.” However, general restrictions would apply, so that any such services should not result in the auditor becoming a de facto employee or officer of the client, or in the auditor otherwise performing a management role, or auditing its own work.

Transition Issues and Other Matters

33. It should be noted that not all legal services eventually viewed in an audit context would have been performed initially for an audit client. For example, when an audit firm gains a new client (including by merger either of the corporation or the audit firm) legal services which are not permitted for an audit client might have been performed for the previous non-audit client company. While such “transition” issues do not involve performing services for a client, they may result in a subsequent audit reviewing work the firm performed in a prior legal services role. An additional transition concern could be a situation in which an audit firm performed legal services that were not proscribed when performed, but are not permitted under new regulations (e.g., a final standard resulting from this project).

¹³ The Board also has a separate project underway on “Evolving Forms of Firm Structure and Organization.”

¹⁴ The use of waivers might also cause certain legal difficulties for clients, and this possibility should be considered and evaluated on a case-by-case basis, although it is beyond the scope of this paper.

34. Among the possible solutions to the transition issues noted above are the following:
- a. Considering independence to be impaired if a now-proscribed legal service still has a significant and on-going effect on the financial statements of the client;
 - b. "Grandfathering" certain previously performed but now proscribed services, but disallowing the performance of any new such services;
 - c. Requiring the current audit of that business segment of the client which received the now-proscribed legal service to be performed by a different audit firm than the principal auditor; or
 - d. Handling transition issues on a case-by-case basis.

Questions for Respondents

- Q1.** The Discussion Memorandum, in paragraph 2, defines “legal services” as “those services that can only be provided by someone licensed to practice law.” Do you believe that definition is appropriate for this analysis, or that it needs to be expanded or reduced, and, if so, how and why?
- Q2.** Should the Board consider cost/benefit factors, and, if so, what are these factors, and how would they be measured?
- Q3. A.** This DM describes a number of potential threats and other factors to be considered in determining the independence implications of an audit firm providing legal services to audit clients. It also describes arguments as to why the threats are not substantial, or how they can be cured with safeguards. Are there additional threats which you believe should be addressed? Also, are there other safeguards that should be considered? If so, please describe each of them and their importance.
- B.** Would you be concerned, and why, if you became aware that a lawyer employed by the audit firm and performing legal services for the audit client, knew of a major client problem and failed to disclose it fully to the auditors because the information was protected by the attorney-client privilege? Do you expect the risk of such occurrences to increase or decrease if the lawyer and auditor are in the same firm, and, if so, why?
- C.** This DM discusses potential benefits to the client and to the public from the provision of legal services by an audit firm. Do you agree or disagree with these potential benefits, and why?
- Q4.** Do you believe that the safeguards described in the DM would mitigate any potential threats to an auditor’s independence when legal services are performed? Why, and if yes, which safeguards are important to you?
- Q5.** The DM discusses whether or not to prohibit legal services by an audit firm to an audit client, and describes several categories of legal services that could be permitted, based on their degree of advocacy and materiality. Do you believe that those factors should be considered in determining the acceptability of legal services? Or, should other factors be considered, and, if so, which ones and why? Please identify those specific categories of legal services which could be offered by an audit firm to an audit client and indicate which you believe should be permitted and/or prohibited, and why.
- Q6.** This DM also describes, as a possible safeguard, provision of legal services by an associated, but separate, law firm. Do you believe that the scope of permitted legal services should change if those services were to be offered by a separate, but affiliated law firm, rather than by the audit firm itself? If so, what factors in the relationship between the law firm and the audit firm influence your opinion? How important are such factors as the

degree of association, profit/cost sharing, cross-referring of work, management structure, use of a common name, etc.?

- Q7.** One transition issue, described in paragraph 33, involves the situation in which a firm acquires, as an audit client, a company for which it had previously provided legal services proscribed for audit clients. How should this situation be resolved—by any of the approaches offered in paragraph 34, or by some other method?
- Q8.** The Board’s mandate includes the use of both original and archival research to facilitate the development of principles-based independence standards. Is there any existing research, or research that the Board could commission, which would be beneficial to this project? Please provide any specific suggestions for new research, as well as your knowledge of the availability of any existing research.

Appendix

The views of the Office of the Chief Accountant (OCA) of the SEC are outlined in a letter to the chair of the ABA's *CMDP*. This letter cites both a United States Supreme Court decision and SEC regulations, and states, in part:

(The Supreme Court Decision)

“The United States Supreme Court, in *United States v. Arthur Young*, 465 US 805 (1984), indicated that the purpose of independent audits under the federal securities laws is to enhance the credibility of financial information and, in turn, the securities markets. To accomplish this purpose successfully, investors must be confident that auditors will place investors’ interests above all else, including the interests of the client and the accounting firm. In explaining the need for auditors to place investors’ interests over those of the client, the Court noted, ‘If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.’

“In contrasting the role of the attorney with that of the independent accountant, the US Supreme Court stated, ‘...the private attorney’s role [is] the client’s confidential adviser and advocate, a loyal representative whose duty it is to present the client’s case in the most favorable light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.’” (Emphasis in original.)

(The SEC Regulations)

“The Commission’s auditor independence regulations specifically state that the roles of auditors and attorneys under the federal securities laws are incompatible. Rule 2-01(c) of Regulation S-X, 17 CFR 210.2-01(c), states that in determining whether an accountant is independent of a particular person, the Commission ‘will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.’ The Commission further stated in an interpretive release, which has been incorporated into its codification of Financial Reporting Policies

(“Codification”), that one of the relationships that must be considered in making independence determinations is the relationship created by rendering legal services. The Commission stated,

“ ‘Certain concurrent occupations of accountants engaged in the practice of public accounting involve relationships with clients that may jeopardize the accountant’s objectivity and, therefore, his independence. In general, this situation arises because the relationships and activities customarily associated with this occupation are not compatible with the auditor’s appearance of complete objectivity or because the primary objectives of such occupations are fundamentally different from those of a public accountant...

“ ‘A legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interests of such client. An independent accountant is precluded from such a relationship under the Securities Acts because the role is inconsistent with the appearance of independence required of accountants in reporting to public investors.’ (Emphasis added in OCA letter).

“Accordingly, OCA would consider a firm’s independence from an SEC registrant to be impaired if that firm also provides legal advice to the registrant or its affiliates...”¹⁵

¹⁵Letter. Lynn E. Turner, Chief Accountant, SEC to Sherwin P. Simmons, Chair, CMDP, ABA. January 22, 1999.



**Independence
Standards
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