American Accounting Association's Financial Accounting Standards Committee Comments on the SEC's Proposed Rule S7-13-00: Revision of the Commission's Auditor Independence Requirements

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The Financial Accounting Standards Committee of the American Accounting Association (hereinafter the Committee) is charged with responding to requests for input on issues related to financial reporting. The Committee is pleased to respond to the SEC's invitation to comment on the SEC's *Proposed Rule: Revision of the Commission's Auditor Independence Requirements* (hereinafter the Proposed Rule). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

Our response to the Proposed Rule is presented in four sections. The first section describes the Committee's assumptions about auditors, the audit environment and the purpose of independence rules. The second section summarizes the Committee's general views on the Proposed Rule. These views are based on assumptions laid out in the first section, previously expressed views of the Committee, and empirical academic research that is pertinent to a consideration of auditor independence rules. The third section reviews the empirical academic literature related to auditor independence. The fourth section provides further discussion of the Committee's general views based on the related academic research.

Conceptual basis for auditor independence rules

1. Auditor independence is desirable because it is an input to reliable financial statements. That is, auditor independence increases the quality of the audit which in turn increases the reliability of the financial statements. Auditor independence is not, however, an objective in and of itself.

2. Good quality audits require both competence (expertise) and independence. These two qualities have direct effects on actual audit quality, as well as potential interactive effects. In addition, financial statement users' perceptions of audit quality are a function of their perceptions of both auditor independence and expertise.

3. The auditor is an expert and a professional. Because auditors are trained professionals, arguments from the research literature about their states of mind or their susceptibility to cognitive bias must be based on research which actually uses

auditors doing realistic tasks that are taken from, modeled on or adapted from their work environment.[1]

4. Both independence and self-interest reside in persons. The intent of independence rules directed at individual persons is to affect the behavior of persons (auditors) making individual and team judgments and decisions within an organization (the audit firm). Independence rules should distinguish the auditor from his/her firm and should acknowledge that the individual auditor faces incentives and penalties that differ from those facing the audit firm as a whole.

5. The intent of independence rules directed at auditing firms is to affect the contracting opportunities available to audit firms acting as legal entities. Audit firms are made up primarily of human capital, knowledge capital and financial capital. Physical capital plays a relatively small role. Therefore, the object of independence regulations as they pertain to audit firms as a whole is the placing of limitations on contracts for obtaining human capital, knowledge capital and financial capital.

6. The entity whose financial reports are the subject of the audit should not be viewed as if it were a natural person (i.e., the client) with a unique state of mind. Rather, the committee adopts a stakeholder or contracting view, in which a corporation is composed of multiple groups with potentially different interests. The auditor has relations and interactions with some of the stakeholder groups (or contracting parties) who comprise the entity whose financial reports are being audited. For example, an auditor might interact with members of management and the audit committee of the board of directors. Since the latter have an oversight function with respect to the former, the interests of the two (management and audit committee) cannot be assumed to be identical.

Summary of general views of the Committee

The Committee's general views are organized according to five areas covered by the Proposed Rules: (1) governing principles for determining when an auditor is not independent, (2) financial relations with an audit client, (3) employment relations with an audit client, (4) provision of non-audit services for or in alliance with an audit client, (5) disclosure of fees for non-audit services. The general views are based on assumptions laid out in the first section and results of empirical academic research, which relates primarily to the fourth category. Additionally, three views previously expressed by the Committee guide the general views on the Proposed Rules. The first view is that concepts based standards are preferred.[2] The second view is that, where possible, standard setting should be the responsibility of independent private sector standard setters who are chosen for

[1] For a discussion, see J. Smith and T. Kida, "Heuristics and Biases: Expertise and Task Realism in Auditing," *Psychological Bulletin* 109:3, 1991, pp. 472-489.
[2] For some history and a discussion of why conceptual frameworks are the best if not the only basis for setting financial reporting standards, see R. Storey and S. Storey, *The Framework of Financial Accounting Standards and Methods*. Norwalk CT: Financial Accounting Standards Board, 1998.

their technical expertise.[3] The third view is that the goal of rule-making and standard setting should be the development of clear and operational guidelines that apply as broadly as possible across jurisdictions.[4]

1. *Governing Principles*

In the Committee's opinion, the governing principles do not constitute a conceptual framework for auditor independence. Rather, these governing principles resemble rules that might be derived from a framework of auditor independence. The rules also do not incorporate the view that audit clients are composed of various stakeholder groups with different interests. Given the Committee's preferences for concepts-based standards promulgated by private sector standard setters, the Committee believes the SEC should consider the Conceptual Framework under development by the Independence Standards Board as a possible framework for its own rulemaking.

2. *Financial Relationships*

The Committee generally agrees with the Proposed Rules on financial relationships since they are consistent with the Committee's belief that independence and self-interest reside in persons, not audit firms. Therefore, only audit personnel directly or indirectly associated with an audit engagement are at risk for having their independence impaired with respect to a particular client.

3. *Employment Relationships*

Given the Committee's preferences for concepts-based standards promulgated by private sector standard setters, the Committee believes the SEC should consider adopting Independence Standard 3, *Employment with Audit Clients.*

4. *Non-audit Services*

The Committee has concerns about several of the assumptions and implications of the Proposed Rules related to non-audit services. First, the Committee believes the rules reflect an assumption that auditor independence is impaired primarily by across-services' incentives, i.e., the desire to enter into an audit relationship with a client in order to obtain consulting services. Research does not support this assumption, but does demonstrate the importance of incentives for auditors to continue an audit relationship across time. The Committee believes that independence rules directed at individual auditor behavior should take explicit account of over-time incentives within the audit function to compromise independence (most importantly, the desire to retain an audit client for

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[3] The Committee has previously discussed its views on the importance of private sector standard setting by independent experts in a discussion of proposed restructuring of the International Accounting Standards Committee. See "AAA's Financial Accounting Standards Committee Response to IASC Discussion Paper, Shaping IASC for the Future," *Accounting Horizons* 13:4, 1999, pp. 443-452.

[4] The Committee advocated global auditing standards, comparably implemented across jurisdictions, and global harmonization of regulation and enforcement in its comment letter on the SEC's Concept Release, *International Accounting Standards* (File No. S7-04-00).

personal career-related reasons, whether or not the client ever purchases any consulting services from the audit firm and regardless of any financial relationships and employment relationships).

The Committee believes that the Proposed Rules do not give sufficient weight to incentives and institutions that mitigate the effects of incentives faced by auditors to compromise or impair their independence. These counterbalancing factors include environmental forces such as reputation loss and the threat of litigation or other similar sanctions. Mitigating factors within audit firms include peer review and compensation plans that emphasize firm, rather than local-office, profitability. Finally, corporate audit committees can weigh potential independence impairments when approving contracts for auditors to provide non-audit services. Research indicates that these incentives and institutions are effective in mitigating effects of incentives for auditors to impair independence in order to retain clients.

Because audit quality is a joint product of auditor independence and auditor expertise, the Committee believes implications of the Proposed Rules for either enhancing or impairing auditor expertise should be considered. Research indicates that both auditors' innate problem-solving ability and task-specific knowledge are crucial to high-quality audits. The Committee believes that the Proposed Rules may impair audit firms' ability to hire high quality professional employees, i.e., to acquire human capital. This belief is based on a recent study by Albrecht and Sack (2000), who report that the recent decline in students majoring in accounting is attributed by both accounting faculty members and accounting practitioners both to relatively lower starting salaries and to students' perceptions that auditing provides a less rewarding and challenging career than other careers such as consulting. The Proposed Rules also impair audit firms' ability to acquire task-specific knowledge capital via consulting experience and alliances with other business.

The Committee interprets the Proposed Rule as concerned, at least in part, with independence in appearance, which involves perceptions not facts. In general, research indicates that financial statement users perceive that non-audit services do not have significant effects on auditor independence as long as the fees for such services are not material to the office providing the service and separate staffs perform the audit and non-audit services. Research also shows that users perceive that relatively small amounts of non-audit services improve auditors' competence and enhance financial statement reliability. The Committee also recognizes that the extant research generally speaks to fairly generic non-audit services and may not focus specifically on the type of consulting that is viewed as most problematic in the Proposed Rule.

The Committee also considered the relation between independence-in-fact and independence-in-appearance. The Committee believes that in order for an independent-in-fact auditor to be perceived as not independent, one or both of two conditions is needed. The first is significant information asymmetry (the observer's perceptions are not fully informed). The second is cognitive bias (the observer has all the necessary information but does not process it rationally). The Committee suggests the possibility that the group most likely to avoid both conditions is the audit committee, because of

their expertise and access to information. The Committee therefore suggests that the audit committee can reasonably be expected to make the judgment that a given business relationship (e.g., a consulting relationship) or other circumstance will or will not impair the auditor's independence. If this possibility is accepted, then one possible outcome is a rule which gives the audit committee the authority and responsibility to decide if an audit firm is independent.

5. *Disclosure of Fees for Non-audit Services*

Overall, the Committee supports the Proposed Rules to require disclosure of non-audit services. Research does not speak directly to appropriate disclosure thresholds in this context, so there is no basis from academic research for judging whether the materiality levels in the Proposed Rules for non-disclosure of fees are appropriate.

Review and discussion of empirical research

The empirical academic research has focused on issues related to impairment of independence due to incentives to retain engagements for audit and non-audit services. Thus, this research relates primarily to the fourth category of the Committee's general views, issues related to providing non-audit services for or in conjunction with audit clients. The discussion of academic research is organized into four sections: (1) over-time versus across-services incentives to compromise independence, (2) existing incentives and institutions that ameliorate impairments of auditor independence, (3) auditor competence and audit quality, and (4) users' perceptions of auditor independence.[5]

1. Over-time versus across-services incentives for client retention

Research indicates auditors' judgments and decisions are influenced by incentives to retain audit engagements. These over-time incentives exist separate from the existence of across-services incentives for obtaining or retaining consulting engagements for audit clients. Research also suggests that auditors do not systematically low-ball audit fees in order to obtain engagements for non-audit services from audit clients.

Farmer et al. (1987) show that an auditor is more likely to agree with managers' financial-reporting preferences when the risk of losing the engagement is high versus low. Trompeter (1994) finds that auditors who are compensated based on local-office profitability are more likely to agree with clients' preferences as GAAP becomes more subjective. Overall, this research suggests that auditors' judgments can be influenced by incentives to retain audit clients.

Two papers specifically examine the effects of non-audit services on auditors' judgments and relations with clients. Emby and Davidson (1998) show that auditors are less influenced by client managers' preferences for financial reporting when non-audit

[5] We do not review the literature on causes of audit failures, because such a review is found in Professor Zoe-Vonna Palmrose's comment letter.

engagements involve specialized, as opposed to general, services. This result suggests that auditors are less susceptible to manager pressures when they possess greater economic power in their consulting arrangements with these clients. Beck et al. (1988) find that the incremental effects of consulting service on auditor tenure with a client are small in relation to the base tenure level associated with audit services. Thus, consulting services appear to have little effect on auditor and client ties beyond those that already exist as a result of the auditing relation.

Finally, a body of literature examines the relation between audit and non-audit fees. Simunic (1980), Palmrose (1986), and Davis et al. (1993) document a positive relation between audit fees and fees for non-audit services. Although empirical research suggests that auditors low-ball initial audit fees (Simon and Francis 1988), the positive relation between audit fees and non-audit fees is inconsistent with the idea that auditors use audit fees as a loss leader in order to earn higher fees on non-audit services. The low-balling results are more consistent with a lack of independence through time within the audit services practices than across the audit and non-audit services. Although the positive relation between audit and non-audit fees could indicate positive synergies between the provision of audit and non-audit services (Simunic 1980), research sheds doubt on this idea. Specifically, Palmrose (1986) finds the positive relation holds for both incumbent and non-incumbent auditors and Davis et al. (1993) document that the positive relation is due to auditors expending more effort to audit clients to whom they provide more non-audit services.

2. Incentives and institutions that ameliorate impairments of auditor independence

There are several countervailing forces that mitigate effects of incentives for client retention. These include environmental forces, such as litigation and reputation loss. These also encompass institutions within audit firms, including peer review and compensation arrangements. Finally, stakeholder groups at audit clients, such as audit committees, provide counterbalancing forces.

Several environmental forces mitigate the effects of incentives faced by auditors to compromise or impair their independence. These forces include strong self-regulatory mechanisms such as the Public Oversight Board (including peer reviews and other quality assurance reviews), the Independence Standards Board and the Auditing Standards Board; the possibility of reputation loss; and the threat of litigation or other similar sanctions. Individual auditors who face significant penalties if they are caught having performed a defective audit have strong incentives to avoid defective audits. Regulatory elements that increase independence as an element of a good audit include a high probability of being caught and a big penalty.[6] Research indicates that the risk of litigation reduces the influence of manager preferences on auditors' decisions and deters

[6] The argument that the Private Securities Litigation Reform Act (PSLRA) of 1995 reduced the penalties for bad audits depends on whether the pre-PSLRA environment was one of merit-based litigation or one of random losses imposed by a legal system where merit did not determine outcomes. Random "enforcement" of rules would not be expected to induce compliance since the penalties are decided on bases other than breaking or adhering to the rules.

unethical behavior on the part of auditors (Farmer et al. 1987; Trompeter 1994; Shafer et al. 1999). Wilson and Grimlund (1990) also document that audit firms whose reputations have been impaired due to a SEC disciplinary action suffer losses in terms of market share and client retention.

There also are institutional arrangements within audit firms that provide mitigating forces. Shafer et al. (1999) show that peer review deters unethical behavior on the part of auditors. Certain types of compensation arrangements also appear to mitigate the effect of incentives for client retention. Trompeter (1994) finds auditors do not use the flexibility in GAAP to justify clients' preferences when firm wide, as opposed to local office, profitability is emphasized in compensation arrangements (large-pool compensation). Carcello et al. (2000) indicate that the type of compensation plan (small- versus large-pool) also interacts with client size in determining the likelihood that an auditor issues a going concern opinion. These results suggest that audit firms' compensation plans play a significant role in whether auditors compromise their professional judgment in light of pressure from corporate managers.

Certain stakeholder groups at audit clients also appear to provide counterbalancing forces towards auditor independence. Parkash and Venable (1993) find that the amount of recurring non-audit services purchased by audit clients varies with proxies for the level of agency costs between client managers and shareholders. Specifically, they find that corporations purchase fewer non-audit services from their auditors when share ownership is dispersed and management owns a relatively lower percentage of stock. Firth (1997) documents a positive relation between the purchase of non-audit services from the auditor and ownership concentration (measured as director shareholdings and the percentage shareholding of the largest owner), implying that lower ownership concentrations--a proxy for agency costs--are associated with larger purchases of non-audit services from auditors. These results suggest that either corporate managers or audit committees (or both) are sensitive to issues related to auditor independence when purchasing non-audit services from their auditors.

McMullen (1996) documents that the presence of an audit committee is positively associated with more reliable financial reporting, as measured by lower shareholder litigation alleging management fraud, fewer earnings restatements, fewer SEC actions, fewer illegal acts, and lower auditor turnover involving an accounting disagreement. Other studies suggest that the benefits of an audit committee depend on the characteristics of its members. For example, Beasley (1996) finds that "no-fraud" firms have a significantly higher percentage of outside directors on the audit committee than do "fraud" firms. Additionally, Carcello and Neal (1997) show that auditors are more likely to issue a going-concern opinion when there is a lower percentage of insider or "gray" directors on the audit committee. Overall, these findings highlight the importance of an audit committee composed of outside directors to both financial statement reliability and auditors' ability to withstand pressure from client management. Thus, the recommendation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) for audit committees to be composed of independent directors is likely to have significant positive effects on auditor independence.

3. Auditor competence and audit quality

Research highlights the importance of general problem solving ability and task-specific knowledge to auditors' expertise and resulting audit quality. Recent survey evidence documents a decline in students majoring in accounting and attributes this decline to both lower relative salaries in accounting and students' perceptions that auditing provides a less-rewarding and challenging career than other careers such as consulting.

Bonner and Lewis (1990) document that auditors' performance in various audit tasks is related to task-specific training and experience and innate problem solving ability. In contrast, general audit experience explains very little of the variation in task performance. Overall, research on the quality of audit judgments consistently has emphasized the importance of task-specific knowledge (Libby 1995). This research suggests that independence rules that inhibit audit firms' acquisition of task-specific knowledge capital are likely to impair auditor competence and audit quality.

A recent study published by the AAA suggests that the accounting profession already faces problems acquiring high quality professional employees.[7] This study indicates that yearly accounting graduates have decreased approximately 25% from 1995-96 to 1998-99. Additionally, 80% of educators and 46% of practitioners believe that accounting students are less qualified than those in the past. Educators and practitioners attribute this decline primarily to two factors: (1) the relatively lower starting salaries in accounting compared to other business disciplines such as information systems and finance and (2) students' perceptions that accounting is less challenging and rewarding than other fields of study. Approximately 90% of the practitioners and accounting educators surveyed in the study strongly agree that consulting work in CPA firms is viewed as challenging and rewarding careers; however, only about 60% of these two groups strongly agree that audit services in a CPA firm are challenging and rewarding. Thus, students' interest in employment at CPA firms may decline further if the Proposed Rules reduce the ability of firms to provide non-audit services.

4. Users' perceptions of auditor independence

In general, financial statements users express greater concerns about independence than do auditors. Research suggests that these differences are related in part to experience and knowledge differences between users and auditors. Results on the effect of consulting services on users' perceptions of independence are mixed, but generally suggest that financial statement users believe relatively small amounts of consulting services have little effect on auditor independence and increase auditor competence. Separation of the audit staff from the staff performing consulting services also increases the perceived independence of auditors. Some evidence suggests that users believe large amounts of consulting services impair auditor independence.

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[7] See W. S. Albrecht and R. J. Sack, *Accounting Education: Charting the Course Through a Perilous Future*, Sarasota, FL: American Accounting Association, 2000.

Several studies show that financial statement users express greater concern than do auditors that factors such as competition, the provision of non-audit services, and incentives to retain clients negatively affect auditor independence (Shockley 1981; Reckers and Stagliano 1981; Firth 1980). This result may be due in part to users' lower levels of experience and knowledge. For example, Reckers and Stagliano (1981) find that a larger percentage of MBA students express concerns about auditor independence than do financial analysts. Farmer et al. (1987) note that accounting students, staff accountants, and senior accountants place more importance than managers and partners on the effect of financial incentives on auditor independence. Finally, analysis in Shockley (1981) indicates that partners in Big Eight CPA firms have more complex mental models for evaluating auditor independence than the mental models of commercial loan officers and financial analysts. These results for financial statement users are consistent with research on the psychology of attitude formation. Psychology research finds that peoples' beliefs about groups to which they do not belong (e.g., college students' beliefs about senior citizens) are less complex than their beliefs about groups to which they do belong (e.g., college students beliefs' about other college students). These simpler belief structures lead to more extreme beliefs for out-groups than in-groups (Eagly and Chaiken 1993, 120; Linville 1982). Thus, financial statement users' concerns about auditor independence may reflect a lack of understanding of the checks and balances in the audit environment, regardless of whether the issue is over-time or cross-sectional threats to independence.

Results on users' perceptions of the effect of consulting services on auditor independence are mixed, in part due to the use of different research designs (Pany and Reckers 1987). In general, however, studies show that users do not believe auditors' independence is impaired for low levels of consulting services. For example, Lowe and Pany (1995; 1996) find that loan officers and financial analysts perceive little impairment in auditor independence when consulting work performed via an alliance with an audit client is less than 1% of office revenue. In these two studies, however, users did perceive greater independence problems when fees from this type of consulting arrangement were 12% of office revenues. Other studies provide evidence that users believe that financial statements are more reliable when auditors perform some consulting services for a client. McKinley et al. (1985) document that loan officers perceived less likelihood of fraud when auditors perform consulting services than when they do not perform such services. Additionally, Pany and Reckers (1988) find that loan officers have higher rates of loan approval when consulting fees are 25% of audit fees than when auditors perform no consulting services for an audit client. Overall, these results are consistent with the idea that users believe that there are positive synergies between auditing and consulting. Users perceive the benefits of these positive synergies to exceed negative effects on independence as long as the consulting fees are not material to an individual office. There is some research evidence that large levels of consulting concern investors; however, research is mixed as to what constitutes "large" levels of consulting.

Lowe, Geiger and Pany (1999) find that loan officers perceive auditor independence to be impaired when the external auditors perform internal audit functions for a client if

the same personnel are used for both the internal and external audit. In contrast, if different audit firm personnel perform these two functions, loan officers perceive independence to be as great as when client personnel perform the internal audit function. Lowe and Pany (1995) show that loan officers have fewer concerns about auditor independence and financial statement reliability when separate divisions of the firm perform consulting services than when auditors perform both the consulting and audit services. Loan officers' perceptions of independence do not increase, however, when consulting services are organized as a separate firm. These results suggest that the current trend of audit firms spinning-off consulting practices will not significantly improve users' perceptions of independence relative to the prior practice of firms having separate audit and consulting divisions.

Discussion of the Committee's general views

The following discussion provides further detail on the Committee's general views on the Proposed Rules and integrates results of empirical academic research upon which these views are based.

1. *The Proposed Rule identifies four governing principles for when an auditor is not independent. They are when an auditor: (1) has a mutual or conflicting interests with the audit client; (2) audits the accountant's own work; (3) functions as management or an employee of the audit client; or (4) acts as an advocate for the audit client.*

   Regardless of the merits of the individual principles, in the Committee's opinion the governing principles do not constitute a framework for auditor independence. Given the Committee's general views that concepts-based standards are preferred and that standard setting should be the responsibility of the private sector, the Committee believes the SEC should consider the Conceptual Framework under development by the ISB as a possible framework for its own rulemaking.

   With respect to the individual principles, the Committee has concerns about the first and fourth principles. As indicated in the prior section on the conceptual basis for auditor independence, the Committee believes that audit clients are best viewed as groups of stakeholders rather than a single entity. Auditors interact with these different stakeholder groups, which may have different interests and objectives. The auditor may have mutual interests with certain stakeholder groups, e.g., the audit committee, and conflicting interests with other stakeholder groups, e.g., management. The Committee recommends that the governing principles recognize this approach and incorporate the auditors' relationships with the different stakeholder groups.

2. *The Proposed Rules expand the number of audit firm personnel who may have financial relationships with an audit client without impairing independence.*

   To the Committee's knowledge, the empirical academic literature has not addressed directly the question of whether auditors' financial relationships with a client affect actual or perceived auditor independence. The Proposed Rules related to

financial relationships with a client, however, are consistent with the Committee's belief that independence and self-interest reside in persons, not audit firms. Therefore, only audit personnel directly or indirectly associated with an audit engagement are at risk for having their independence impaired with respect to a particular client. The Committee generally agrees with the Proposed Rules on financial relationships.

3. *The Proposed Rules expand the number of former auditors and family members of current auditors who may be employed by an audit client without impairing independence.*

To the Committee's knowledge, there has been little empirical research on the effects of employment relationships with a client on auditor independence.[8] As indicated in the General Views, the Committee believes standard setting should be the responsibility of private standard setters and, accordingly suggests that the SEC adopt Independence Standard 3, *Employment with Clients*.

4. *The Proposed Rules restrict both auditors' business relationships with audit clients and the provision of certain non-audit services to audit clients.*

The Committee has several concerns about both the assumptions underlying the Proposed Rules and the implications of the rules. The areas underlying these concerns include: (1) over-time versus across-services incentives to compromise independence, (2) existing incentives and institutions that ameliorate impairments of auditor independence, (3) effects of the Proposed Rules on auditor competence and audit quality, and (4) users' perceptions of implications of non-audit services for auditor independence.

Over-time versus across-services incentives: The Committee believes the Proposed Rules reflect an assumption that auditor independence is impaired significantly by across-services' incentives, i.e., the desire to enter into an audit relationship with a client in order to obtain consulting services. Research does not support this assumption. Empirical research is not consistent with the belief that auditors use auditing engagements as a loss leader for consulting services; rather, there is a positive relation between audit and consulting fees. Additionally, research indicates that client-retention incentives that could impair independence exist in the absence of consulting services. Auditors have monetary and non-monetary incentives to continue an audit relationship with a client over-time; the addition of consulting activities may not significantly increase these incentives. Thus, eliminating certain consulting services to audit clients may not alter auditors' overall incentives to retain

[8] One study has examined users' independence perceptions when an audit client employs a former auditor. The study found that users perceive greater impairment of independence when the former auditor was in a supervisory role at the audit firm compared to a non-supervisory role. The passage of time, however, reduced users concerns about independence; the vast majority of users in the study were not concerned about independence issues after 18 months had passed since the auditor was employed by the audit firm. See E. Imhoff, Jr., "Employment Effects on Auditor Independence," *The Accounting Review* 53:4, 1978, pp. 869-881.

a client. The Committee believes the Proposed Rules should be reconsidered in light of implications of the relative importance of over-time versus across-services incentives.

Existing incentives and institutions that ameliorate impairments of auditor independence: The Committee believes that the Proposed Rules do not give sufficient weight to incentives and institutions that temper incentives faced by auditors to impair or compromise their independence. Research indicates that the risks associated with litigation and loss of reputation have serious economic consequences and affect auditors' judgments. Additionally, studies indicate that incentives for client retention are created in part by the type of compensation plan used by certain audit firms. Compensation plans that emphasize large-pool (firm wide) versus small-pool (office level) profitability appear to negate incentives toward client retention that impair independence. Finally, institutional structures such as peer review under the auspices of the Public Oversight Board and independent audit committees provide counterbalancing forces that help auditors maintain their independence. Research documents that audit committees currently are sensitive to auditor independence issues when approving non-audit services.[9] In light of recent recommendations for improved independence and financial literacy of audit committee members, the Committee believes that this institution will provide an even stronger force in the future toward auditor independence.

Effects of the Proposed Rules on auditor competence and audit quality: Research indicates that auditors' performance is related strongly to their innate problem solving ability and task-specific experience and knowledge. Thus, audit quality could be harmed if the Proposed Rules impair auditing firms' ability either to obtain high quality in their professional employees or task-specific knowledge via consulting engagements and business alliances. The recent study by the AAA suggests restrictions on CPA firms providing consulting services may further impair firms' ability to obtain high-quality human capital. In addition to these concerns about hiring qualified professional staff, the Proposed Rules restrict auditing firms' ability to acquire task-specific knowledge via alliances with other companies. Overall, the Committee believes the Proposed Rules are likely to have significant negative effects on the competence of auditors and resulting audit quality.

Users' perceptions of implications of non-audit services for auditor independence: The Committee believes research on financial statement users' perceptions of auditor independence have several implications for the Proposed Rules. First, financial statement users appear to have the general faith in auditor independence needed for proper functioning of capital markets.[10] Second, institutional arrangements currently exist within CPA firms that alleviate users'

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[9] The July 26, 2000 testimony of John H. Biggs, Chairman and CEO of TIAA-CREF on the Proposed Rule supports these research findings. Specifically, TIAA-CREF has a strict rule against hiring their external auditors for non-audit services.

[10] The research supporting this conclusion reflects perceptions and beliefs at the time the research was done. The Committee notes that much (but by no means all) of this research predates the recent expansion of non-audit services by Big 5 and other firms.

concerns about auditor independence, including the separation of audit and non-audit staff. The positive effects of separate staff have been found even for the provision of internal audit services by CPA firms, one of the two services for which the Proposed Rules would significantly change current practice. Overall, research results suggest that splitting CPA firms in two separate auditing and consulting firms is unlikely to result in significant increases in users' perceptions of auditor independence. Third, although financial statement users' general confidence in auditor independence is important, users may not be the appropriate group to use a "reasonable man" benchmark to evaluate whether particular activities impair independence. The Committee believes that the audit committee is the group best able to make these decisions since audit committee members are most likely to have full information and process this information in a rational manner.

5. *The Proposed Rules require companies to disclose in their proxy statement all non-audit services provided by their auditors, the percentage of the fee for each non-audit service compared to total audit fees, and a statement whether each non-audit service was considered by the audit committee of the board of directors or by the board itself. Fees that are less than the smaller of $50,000 or 10% of the audit fee need not be disclosed.*

   Academic research on the effects of non-audit fee disclosures for US corporations is limited.[11] Research does not speak to the appropriate disclosure threshold in the specific context described in the Proposed Rules. Additionally, due to differences in research designs, extant research does not provide a clear indication of the exact threshold at which financial statement users are likely to perceive significant problems with non-audit services impairing independence. Overall, the Committee supports the Proposed Rules to require disclosure of non-audit services, but makes no conclusion as to the appropriateness of the materiality levels for disclosure contained in the Proposed Rules.

[11] One study has examined the effect of non-audit fee disclosures under ASR No. 250. This study found that shareholder approval rates for auditors did not change due to disclosure of non-audit fees, suggesting that shareholders did not perceive the amount of fees as material. See G. W. Glezen and J. A. Millar, "An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No. 250," Journal of Accounting Research 23:2, 1985, pp. 859-870.

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