



U.S. Securities and Exchange Commission

Speech by SEC Staff: Remarks Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

by

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Introduction

Good afternoon. My primary area of responsibility is auditor independence. I started with the Commission in June 2003 shortly after the introduction of the revised auditor independence rules that were a result of the enactment of the 2002 Sarbanes-Oxley Act ("Act"). I have had the opportunity to work on numerous issues associated with the auditor independence rules, and acquired an appreciation for the challenges audit firms and registrants encounter to comply with all provisions of the rules. I believe that despite these challenges, compliance with the independence rules is crucial to ensuring investors are confident that audited financial statements are free from bias.

I also would like to mention that the staff's experience with the rules since they were last updated in January 2003 provides an opportunity to consider revisions that might make the rules more compliance friendly, while not jeopardizing a "reasonable investors" view of an independent audit or deviating from any legislatively mandated provisions contained in the Act.

Given the limited time available, my comments will focus on just a few areas of auditor independence that I believe will be of interest to most of you.

- Smaller Audit Firms and Smaller Companies
- Independence Guidance
- Independence Discussions with Audit Committees

Smaller Audit Firms and Smaller Companies

The prohibitions on bookkeeping and performing management functions have been part of the Commission's independence rules since 2001, but the staff occasionally receives inquiries from smaller companies or smaller audit firms concerning the circumstances under which those services are prohibited. Several of those questions have focused on assisting audit clients with implementation, or on-going compliance, with recently issued accounting standards. Smaller companies may not typically have the technical resources that are available to larger companies to tackle complex accounting matters. The dilemma facing issuers and their auditors is to ascertain the point where advice ends and managerial responsibility begins. The Codification of Financial Reporting Policies provides some guidance in this regard.¹ In determining whether the auditor is too closely identified with the audit client, the basic consideration is whether, to a third party, the client appears to be (i) substantially dependent upon the accountant's skill and judgment in its financial operations, or (ii) reliant only to the extent of the customary type of consultation or advice. It is the Commission's position that an accounting firm cannot be deemed independent with regard to auditing financial statements of a client if it has participated closely in maintenance of basic accounting records and preparation of financial statements, or if the firm performs other accounting services through which it participates with management in operational decisions. The following are a few factors that registrants and auditors should consider in determining whether the auditor is performing services that impair his or her independence:

- Is the level of management's knowledge sufficient enough to maintain materially accurate books and records, without de facto delegation of the financial reporting process to the auditor?
- Is the auditor providing the audit client with technical guidance, research materials, advice, comments, or editorial suggestions regarding presentation of the footnotes or basic financial statements as opposed to making significant adjustments to the financials or rewriting the footnotes?
- Is management's financial expertise commensurate with the complexity of the business and the relevant accounting standards?
- Has management performed the necessary work in taking full responsibility for the judgments applied in preparing the financial statements or has undue reliance been placed on the auditor's judgment?
- Would a reasonable investor be concerned about the number and significance of adjustments proposed by the auditor?

The prohibitions on bookkeeping and management functions are not intended to discourage two-way communication between the audit firm and its audit client. The Commission addressed this issue from an internal control perspective in its May 2005 statement on implementation of Section 404 of

the Act.² The May 2005 guidance encourages frequent and frank dialogue between management, auditors and audit committees. As long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, we do not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of the Commission's independence rules.

Public companies, small and large, have a responsibility to ensure that they have competent accounting staff in place, given the complexity of the business, to prepare accurate books and records. However, management should not be dissuaded from seeking the auditor's guidance about complex matters, provided management is capable and does make its own judgments.

Independence Guidance

The staff is considering additional guidance concerning the application of the auditor independence rules, including certain types of financial interests, application of the "not subject to audit" provision applicable to certain types of non-audit services, employee benefit plans, and FIN 46R. To the extent staff guidance concerning the independence rules has been issued, it can be accessed on the Commission's website under information for accountants.³

I have a few comments concerning three matters, for which additional guidance is being considered. First, five of the prohibited services delineated in Rule 2-01(c)(4) (bookkeeping, financial information system design and implementation, appraisal or valuation services, actuarial services, and internal audit outsourcing services) have an exception condition, "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements", also known as the "not subject to audit" provision⁴. The staff's position is that a successor auditor's independence would not be impaired if the successor auditor provided prohibited non-audit services in the current audit period and these services (i) relate solely to the prior period which is audited by a predecessor auditor, (ii) will not be subject to audit procedures by the successor auditor, and (iii) are not management functions.

The second matter pertains to employee benefit plans, where the entity sponsoring an employee benefit plan and the plan itself are generally considered "affiliates" in applying the Commission's auditor independence rules.⁵ The question posed to the Staff is whether the auditor of an employee benefit plan, Form 11-K filer, and who is not the auditor of the sponsor of the benefit plan, can provide certain non-audit services to the plan sponsor. The independence of the auditor of the 11-K filer would not be impaired if the auditor provides certain non-audit services to the sponsor, provided (i) the services are within the scope of the "not subject to audit" provision, and (ii) the auditor does not provide any service that would effect the benefit plan audit.

The third issue relates to FIN 46R and its application to the auditor independence rules. Generally, an entity that consolidates a variable interest

entity ("VIE") under FIN 46R implicitly chooses at the time of its investment to either define the activities in which the VIE is permitted or prohibited to engage. Or alternatively the enterprise may obtain the ability to make decisions that affect a VIE's activities through contracts or the entity's governing documents. Accordingly, an audit client generally has "control", as defined in Rule 1-02 of Regulation S-X⁶, over a VIE that it is required to consolidate. Thus, the auditor should be independent of all entities that are required to be consolidated under FIN 46R, even in circumstances where the VIE is not consolidated due to materiality or other considerations. Registrants should consider consulting with the staff in rare situations where an enterprise believes it does not "control" a VIE that it is required to consolidate.

Independence Discussions with Audit Committees

Rule 2-01 of Regulation S-X was revised in 2003 to reflect the new auditor independence requirements provided for in Title II of the Act. In particular, Section 202 of the Act requires the audit committee to pre-approve all audit and non-audit services provided by the company's principal auditor. While pre-approval of non-audit services is an important regulatory requirement that helps promote compliance with the independence rules, there are other types of prohibited relationships that could jeopardize the independence of the auditor. These include restrictions on financial interest, employment, partner rotation, and business relationships. The PCAOB's Interim Independence Standards require the auditor to at least annually disclose to the audit committee, in writing, all relationships between the auditor and the company that, in the auditor's judgment may reasonably be thought to bear on independence and to discuss the auditor's independence with the audit committee.⁷ These disclosures are not intended to only communicate all violations of the independence rules, but to also promote discussion of matters that from a reasonable investor's perspective might be thought to bear on the auditor's independence. Rule 2-01 of Regulation S-X requires the auditor to consider all circumstances that might raise independence concerns not just those relationships or non-audit services that are explicitly prohibited. In applying its professional judgment, the auditor should ask, in its informed good faith view, whether the members of the audit committee, who represent reasonable investors, would regard the fact in question as bearing upon the board's judgment of auditor independence.⁸

Auditors must be forthright in disclosing and discussing independence matters that might be thought to bear on their independence. Otherwise, the value of auditor and audit committee communications is greatly diminished.

Closure

Issuers and their auditors have strong incentives to comply with the Commission's auditor independence rules. It is the issuer's financial statements that an auditor examines. Issuers have the legal responsibility to file the financial information with the Commission, as a condition to accessing the public securities markets, and it is their filings that are legally deficient if

auditors who are not independent certify their financial statements. Similarly, the credibility of the audit profession has been questioned in recent years and resulted in more rigorous oversight when the Act created the Public Company Accounting Oversight Board. The auditing profession is a business and those that share in its financial benefits have every incentive to ensure that audits are performed in an objective and impartial manner.

At the end of the day, investors will not have confidence in the quality of the auditor's work if they have doubt about whether the auditor is independent of its audit client. The staff is committed to helping issuers and auditors properly apply the requirements and spirit of the Commission's independence rules.

Thank you.

Endnotes

¹See Codification of Financial Reporting Policies, 602.02(c)(i).

²See Commission Release No. 2005-74, May 2005.

³See www.sec.gov/info/accountants/ocafaqaudind121304.htm.

⁴See Rule 2-01(c)(4)(i)-(v) of Regulation S-X.

⁵See Rule 2-01(f)(4) of Regulation S-X.

⁶The term "control" as defined in Rule 1-02(g) of Regulation S-X means, "the possession, direct or indirect, of the power to direct or cause direction of the management of the policies of a person, whether through the ownership of voting shares, by contract, or otherwise."

⁷See PCAOB Interim Independence Standards, ISB No. 1, Independence Discussions with Audit Committees.

⁸See Commission Release No. 33-7919, November 2000.

<http://www.sec.gov/news/speech/2006/spch121106mwh.htm>