



## U.S. Securities and Exchange Commission

### **Speech by SEC Staff: Remarks Before the 2005 AICPA National Conference on Current SEC and PCAOB Developments**

*by*

**Edmund W. Bailey**

*Senior Associate Chief Accountant, Office of the Chief Accountant  
U.S. Securities and Exchange Commission*

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Good morning. My name is Ed Bailey and I am a Senior Associate Chief Accountant in the Professional Practice Group of the Office of the Chief Accountant. It is my duty to remind you that my comments do not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff. My primary area of responsibility is auditor independence and my talk today is a reflection of my experiences over the last three years on independence issues post Sarbanes-Oxley. Before I begin, I too would like to express my appreciation for Andy Bailey's, soon to be my former boss, contribution to the Commission and personally for his support and guidance over the past two years.

The notion of independence is at the foundation of the auditing profession and fundamental to its role as a gatekeeper. Under the securities laws, auditors are the only professionals that a corporate entity must engage in order to sell securities in the United States. It is the unique requirement of the audit franchise that the auditor be independent of the employing organization. Maintaining independence serves two goals. One goal is to promote investor confidence in the financial statements of public companies. The other goal is to foster high quality audits by minimizing potential conflicts of interest and maximizing in the minds of auditors and investors, the potential for objective and impartial judgments. Success in meeting this

second goal is the foundation on which public trust is built. Independence is the auditor's most valuable asset and there is no room to compromise this principle.

According to a recent poll conducted by the Wall Street Journal and Harris Interactive, "55 percent of U.S. investors believe that financial and accounting regulations governing publicly held companies are too lenient." This public concern encompasses the network of related standard setters, preparers and the auditor. The public lost much of its trust in the audit profession following the audit failures of 2001 and 2002. While the loss of trust was seemingly instantaneous, regaining the trust of the investors is a long and difficult process. Improvements have been made in the last couple of years, but we are still in a position where any improved image can be destroyed by the smallest negative event.

Insuring independence currently relies on a system that includes certain fundamental principles, but also to a great extent on rules. This system is overseen by various regulatory bodies, primarily the PCAOB and the SEC. The current arrangement, with its heavy reliance on rules was the result of many concerns, not all of which I have time to elaborate on today. However, it was fundamentally the belief that the profession was not adequately regulating itself through a profession or firm-based culture of independence that led to the rule-set promulgated in 2000, the passage of Title II of the Sarbanes-Oxley Act, and the additional rules adopted in 2003.

The rules have at least been successful insofar as they have resulted in accounting firms, audit committees and corporate managements being much more sensitive to the need for auditor independence than they have been in the past. This process, however, encounters some of the same issues of other rules-based systems. On occasion, auditing firms try to find ways to negotiate around specific rules. Often, both the Commission staff and the firms seem to spend a great deal of time dealing with inadvertent violations. As a result of these and other, perhaps unintended consequences of the rules, the staff in OCA has been considering whether the public interest can better be served by a system that relies on principles and objectives rather than specific proscriptions. Before we can start down that road, however, there would have to be not only attitude adjustments among practitioners and regulators, but real improvements in the firms' independence monitoring and tracking systems and public company oversight of the independence of their auditors. Thus, the "principles based" approach that I could envision and I would like to discuss here today would encompass a complete set of principles, as well as a set of constant, concise and coherent rules, and, importantly, some new safeguards.

I have often been asked whether a different approach to independence rules, one with less specific guidance, would work if a culture of independence was a core value of the public company and the audit firm. It seems unlikely principles alone would work within the complex and competitive environment that audit firms operate. Thus, we will continue to need at least some guidelines and rules. But it is not unreasonable to consider whether it is possible to maintain the public's trust in the audit process with an approach

that has less harsh lines and relies more on principles.

The rules that would be part of such a system would not be expected to cover all instances that could conceivably impair an auditor's independence but, in some cases, would require audit committees and firms to make independence related judgments in accordance with the principles set forth. As I mentioned, a new approach would require changes in attitudes of public companies and auditors. This approach would work only if independence judgments are made on principles and not on how close to a rule one can go without breaking the words of the rule. The profession should stop pushing the boundaries and saying: "there was no rule, so I could do it." We can not sustain a philosophy of "if its not prohibited it must be permitted."

The change in attitude must, however, also be accompanied by changes in the ways that companies and their auditors monitor and control performance of services and other factors relevant to independence. The current methods being used allow far too many "inadvertent" instances of prohibited services being provided, and do not inspire confidence that such situations can be stopped, or even comprehensively identified by issuers and their auditors. While one of the responsibilities for obtaining an independent audit remains with the issuer, it seems clear that development of strong systems is a cost that can best be borne by the audit firms who are also responsible for maintaining their independence.

Thus, prior to the staff ever considering recommending to the Commission a more "principles based approach", the audit firms must ensure that they have systems and processes in place regarding auditor independence that support their field auditors, capture internal consultations and resolutions and are accessible for inspection by the PCAOB. The PCAOB and the SEC would oversee the system with a "trust but verify" approach. These independence quality control systems have to include more than a checklist approach to maintaining independence. The systems and processes should involve monitoring the tone at the top of the firm to ensure it is clear that maintaining public trust and serving the investor's interest through independence is a firm-wide core mission. This will require a greater emphasis and a continuous focus of the firms on the independence processes. Developing internal monitoring and quality control systems is expensive, requires an on-going effort, requires flexibility in response to changing conditions and needs to be able to recognize international cross jurisdictional differences. The objective is competent and independent audits with an appropriate audit communication to the public.

The maintenance by the accounting firms of effective quality controls over independence would assist the individual auditor and the firm by minimizing inadvertent failures, providing a demonstration of the firm's intent to comply with the principles underlying auditor independence and demonstrating a commitment to achieving the public's trust. The systems and processes established at the audit firms and the firm's conclusions on independence issues should be available to the PCAOB for inspection and consideration. The transparency this affords may provide the basis and opportunity for a more complete dialogue and discussion between the PCAOB and the firms

regarding the independence issues and judgments arrived at by the firms each year. As result of this inspection process and dialogue, the PCAOB may oversee the firms' independence processes and ensure their continuous effort to maintain independence.

Such monitoring and recordkeeping systems, accessible to the PCAOB and the SEC would provide comfort to investors that independence issues are taken seriously, properly considered and carefully resolved. With such an oversight approach by the PCAOB and SEC, I believe the public could have not merely a continuing confidence, but an increased confidence, that the auditor is independent.

My discussion has primarily focused on the change needed from the independent audit firms. However, the responsibility for clear and accurate communication to the public, including the requirement for an independent audit, lies with the preparer. Sarbanes-Oxley substantially altered the relationship between the preparer and the auditor when it invested the Audit Committee of the Board with the power to hire, compensate, oversee and fire the auditor. The auditor now clearly works for the shareholders through the Audit Committee, not for management. My "new" vision of auditor independence and oversight is made possible, in part, by this altered relationship. However, in order for such a vision to become reality, we need Audit Committees and Boards to exercise effective oversight in meeting their Sarbanes-Oxley Act mandate.

If the changes in attitudes, as well as monitoring and documentation system described above are successfully implemented, the SEC staff will be in a position to consider a more principles based approach regarding auditor independence. Recall that I believe that principles-only are unlikely to be effective, but given the right environment, the SEC staff should be able to consider the creation of a simpler, more flexible rule-set. For example, while current independence rules do not take into consideration the magnitude of independence violations, a future "principles based approach", together with the monitoring and inspection process just outlined, might allow both the consideration of the significance of the violation and a related graded response on behalf of the SEC.

Today, many independence issues are an on/off switch; the auditor has either violated the independence rules or has not violated the rules. However, OCA does consider all relevant facts and circumstances once a violation has occurred when determining the regulatory response to a violation. For example, we consider all relationships between the auditor and the audit client and whether a reasonable investor with the knowledge of all relevant facts and circumstances would conclude that the auditor was not capable of exercising objective and impartial judgment on the issues encompassed within the accountant's engagement. When accounting firms seek out, self-report and rectify conduct that violates the rules, and otherwise cooperate with Commission staff, it may be possible to avoid large expenditures of shareholder resources that would result from a mandatory re-audit of the company's financial statements. The staff always considers how to best protect the investors, and depending on the nature and circumstances

of the violation investors may benefit when their company is not required to incur substantial costs because of some independence violations.

In making these assessments as to the impact of an independence rules violation, the staff considers the facts and circumstances on a case-by-case basis. While it is important to note that the staff's actions in a case-by-case consideration do not confer any "rights" on any persons or entities nor limit SEC staff discretion to evaluate every case individually, some of the questions we often ask include but are not limited to:

1. What was the nature of the misconduct involved? Did it result from inadvertence, honest mistake, simple negligence, reckless or deliberate indifference, willful misconduct, or unadorned venality?
2. How did the violation arise?
3. How high up in the chain of command in the firm and the issuer was knowledge of, or participation in, the violation of the independence rules?
4. How was the misconduct detected and who uncovered it?
5. How long after the discovery of the violation did it take to implement an effective response?
6. What processes did the firm and the issuer follow to resolve any identified issues and ferret out necessary information?
7. Did the company and audit firm commit to learn the truth, fully and expeditiously? Did they do a thorough review of the nature, extent, origins and consequences of the violation and related behavior?

While the staff considers these and other questions in its deliberations of independence issues today, these questions will continue to be important even if the Commission or the PCAOB ultimately decide to pursue a new approach like the one I discussed earlier.

It is our hope that with better quality control systems in place at accounting firms, auditors, audit committees and regulators can act jointly to avoid many of the violations that have been reported in the past, diminish the severity of the violations and therefore diminish the consequent penalties and, most importantly, contribute to the development and maintenance of an overall culture of independence.

Finally, in today's global economy none of us can ignore the global consequences of our actions. Today, a small number of large international accounting firms audit companies that have issued a significant portion of the world's publicly traded securities. When one jurisdiction takes an action to impose its views on how these firms should operate in its "local" jurisdictions, it reverberates through the global economy.

As a result, it is not surprising to find that many countries around the world are considering their auditor oversight rules and regulations. The International Organization of Securities Commissions (IOSCO) is currently working on compiling information about the regulation and oversight of non-audit services around the world. As the international community works towards convergence in international accounting and auditing standards, it is only reasonable to expect that auditor independence oversight structures and quality assurance processes would also be considered.

I will conclude with a remark made by Michel Prada, Chairman of Financial Markets Authority, the French securities regulator and newly named Chairman of the Technical Committee of IOSCO in his October address to The Global Public Policy Symposium in London, Mr. Prada said, "...please put an end to these everlasting and depressing discussions on authorized non-audit activities. Do not spend the best of your energy in developing your activities in the so called grey areas...stop trying to reconcile fire and water, audit and consulting or commercial services for the same client. I believe that the days of the pure audit specialist are ahead of us. Markets like pure players."

His call will not end the debate about his conclusion, but the sentiment is clear and consistent with independence as a core value in everything the auditor does for the audit client.

Thank you.

*<http://www.sec.gov/news/speech/spch120505ewb.htm>*