INTRODUCTION

In June 2000, the SEC issued Proposed Rule S7-13-00, Revision of the Commission's Auditor Independence Requirements (hereafter the Proposed Rule). The Proposed Rule primarily deals with five areas related to auditor independence:

- governing principles for determining when an auditor is not independent,
- financial relations with an audit client,
- employment relations with an audit client,
- provision of nonaudit services for or in alliance with an audit client, and
- disclosure of fees for nonaudit services.

The SEC cited recent developments in the business world and the auditing profession as the impetus for the Proposed Rule. These developments include increased business and financial relationships between auditors and their clients, the increase in dual-career families and mobility of accounting professionals, and changes in the magnitude and nature of nonaudit services (SEC 2000a, Section I).

A senior member of the SEC staff asked the Financial Accounting Standards Committee of the American Accounting Association (hereafter the Committee) to respond to the Proposed Rule. Given the importance of auditor independence to financial reporting and the Committee's charge to respond to requests for input on issues related to financial reporting, we agreed to this request. In preparation for writing the comment letter, the Committee read academic articles, financial press articles, documents prepared by the Independence Standards Board, the text of testimony given by individuals in SEC public hearings, and the text of speeches made by SEC officials, including former Chairman Arthur Levitt and Chief Accountant Lynn Turner. This article summarizes the content of the letter submitted by the Committee to the SEC in October 2000. The Committee's letter does not provide comments on two areas in the Proposed Rule: contingent fees and audit firm's quality controls. Additionally, the Committee's letter combines the discussion of business relationships/alliances between auditors and clients and the provision of nonaudit services to audit clients. These two areas are listed separately in the Proposed Rule. A copy of the Committee's complete letter is available at http://accounting.rutgers.edu/raw/aaa/about/committee/fasc/index.htm.
article first discusses foundations for the Committee's views. The Committee's views are presented next, organized according to five primary areas covered by the Proposed Rule. Within each area, we discuss the Proposed Rule, summarize any related research, and present the Committee's view on the Proposed Rule. The concluding section of this article briefly notes differences between the Proposed Rule and the final rules issued by the SEC in November 2000.

FOUNDATIONS FOR THE COMMITTEE'S VIEWS

The Committee's views are based on results of empirical academic research, views previously expressed by the Committee, and several assumptions about the persons and entities involved in or influenced by financial statement audits. The relevant empirical academic research is discussed below for each area of the Proposed Rule. Additionally, three views previously expressed by the Committee guide its general views on the Proposed Rule. The first view is that concepts based standards are preferred. The second view is that, where possible, standard setting should be the responsibility of independent private sector standard setters who are chosen for their technical expertise. The third view is that the goal of rulemaking and standard setting should be the development of clear and operational guidelines that apply as broadly as possible across jurisdictions. Finally, the Committee's views are based on the following assumptions.

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 that uses actual auditors doing realistic tasks that are taken from, modeled on, or adapted from their work environment.

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 the firm and should acknowledge that the individual auditor faces incentives and penalties that differ from those facing the audit firm as a whole.

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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 Storey and Storey (1998).

3 The Committee previously discussed its views on the importance of private sector standard setting by independent experts in a discussion of the proposed restructuring of the International Accounting Standards Committee. See AAA FASC (1999, 443-452).

4 The Committee advocates 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).

5 For a discussion, see Smith and Kida (1991, 472-489).
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 client entity whose financial reports are the subject of the audit should not be viewed as if it were a natural person 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/contracting parties who compose 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 management and the audit committee cannot be assumed to be identical.

GOVERNING PRINCIPLES

Overview of Proposed Rule

The Proposed Rule sets forth a general standard for the test of auditor independence, specifically that the SEC "will not recognize as independent an accountant who, with respect to an audit client, is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement" (SEC 2000a, Section IIIB). Additionally, the Proposed Rule identifies four governing principles for evaluating when an auditor is not independent; the intent of the principles is to provide a framework for analyzing auditor independence rules and to make the general standard more specific (SEC 2000a, Section IIIB). The four governing principles state that independence is impaired when an auditor: (1) has a mutual or conflicting interest with the audit client; (2) audits the auditor’s own work; (3) functions as management or an employee of the audit client; or (4) acts as an advocate for the audit client.

Committee’s Views

Regardless of the merits of the individual principles, in the Committee’s opinion the governing principles in the Proposed Rule 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. 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.6

With respect to the individual principles, the Committee has concerns about the first and fourth principles. As indicated in the prior section on foundations for the

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Committee's views, the Committee believes that audit clients are viewed best as groups of stakeholders rather than single entities. Auditors interact with these different stakeholder groups, which may have different interests and objectives. The auditor may have mutual interests with certain stakeholder groups, such as the audit committee, and conflicting interests with other stakeholder groups like management. The Committee recommends that the governing principles recognize this approach and incorporate the auditors' relationships with the different stakeholder groups, rather than treating these relationships as if they existed between the auditor and a single entity.

FINANCIAL RELATIONSHIPSHIPS

Overview of Proposed Rule

The Proposed Rule expands the number of audit firm personnel who may have financial relationships with an audit client without impairing independence. These financial relationships include investment in an audit client and other financial interests, such as loans, savings and checking accounts, and insurance products. The Proposed Rule limits restrictions on financial relationships primarily to individuals who work on the audit or can influence the audit.

Committee's Views

The Committee generally agrees with the Proposed Rule on financial relationships. 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 Rule related to financial relationships with a client, however, is 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.

EMPLOYMENT RELATIONSHIPS

Overview of Proposed Rule

The Proposed Rule expands the number of former auditors and family members of current auditors who may be employed by an audit client without impairing independence. Additionally, the Proposed Rule identifies positions at an audit client that impair an auditor's independence if held by a close family member, specifically, those positions in which the employee can influence the audit client's accounting records or financial statements. The Proposed Rule also delineates measures that should be taken to prevent impairment of independence when an audit client employs a former auditor.

Committee's Views

To the Committee's knowledge, there has been little empirical research on the effects of employment relationships with a client on auditor independence. Given the Committee's preferences for concepts-based standards promulgated by private sector

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7 One study examines users' independence perceptions when an audit client employs a former auditor. The study reports that users perceive greater impairment of independence when the former auditor was in a supervisory role at the audit firm compared to a nonsupervisory role. The passage of time, however, reduces users' concerns about independence; the vast majority of users in the study were not concerned about independence issues 18 months after the auditor was employed by the audit firm (see Imhoff 1978, 869–881).
standard setters, the Committee believes the SEC should consider adopting Independence Standard No. 3, Employment with Audit Clients (Independence Standards Board 2000). This standard establishes requirements for a program of safeguards to preserve independence when auditors engage in discussions about possible employment with an audit client and when audit clients employ former auditor employees of the audit firm.

**NONAUDIT SERVICES**

**Overview of Proposed Rule**

The Proposed Rule restricts both auditors' provision of nonaudit services in alliance with audit clients and the provision of certain nonaudit services to audit clients. Specifically, the Proposed Rule continues the existing rules that state an auditor's independence is impaired by direct or material indirect business relationships or alliances with an audit client, its affiliates, officers, directors, or significant shareholders. The Proposed Rule also lists several nonaudit services that the SEC considers as impairing independence under certain circumstances, including bookkeeping services, financial information systems design or implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, management functions, human resource services, investment advising or banking services, legal services, and services in which the auditor renders or supports experts' opinions (expert services).

**Review of Empirical Academic Research**

Considerable empirical academic research relates to implications of business relationships and nonaudit services for auditor independence. Our discussion of academic research is organized into four sections: (1) over-time vs. across-services incentives for client retention, (2) existing incentives and institutions that ameliorate impairments of auditor independence, (3) auditor competence and audit quality, and (4) users' perceptions of auditor independence.

1. **Over-Time vs. Across-Services Incentives for Client Retention**

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

Farmer et al. (1987) find that an auditor is more likely to agree with managers' financial-reporting preferences when the risk of losing the engagement is high. 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 nonaudit services on auditors' judgments and relations with clients. Emby and Davidson (1998) find that auditors are less influenced by client managers' preferences for financial reporting when nonaudit engagements involve specialized, as opposed to general, services. This result suggests

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8 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.
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, the provision of general consulting services appears 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 nonaudit fees. Simunic (1984), Palmrose (1986), and Davis et al. (1993) document a positive relation between audit fees and fees for nonaudit services. Although empirical research suggests that auditors low-ball initial audit fees (Simon and Francis 1988), the positive relation between audit fees and nonaudit fees is inconsistent with the idea that auditors use audit fees as a loss leader in order to earn higher fees on nonaudit services. The low-balling results are more consistent with a lack of independence through time within the audit services practice than across the audit and nonaudit services. Although the positive relation between audit and nonaudit fees could indicate positive synergies between the provision of audit and nonaudit services (Simunic 1984), other research offers alternative explanations. 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 for whom they provide more nonaudit 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 both environmental forces, such as litigation and reputation loss, and 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 promote independence as an element of a good audit include a high probability of being caught and a big penalty. Research indicates that the risk of litigation reduces the influence of managers' preferences on auditors' decisions and deters unethical behavior on the part of auditors (Farmer et al. 1987; Trompeter 1994; Shafer et al. 1999). Additionally, Wilson and Grimlund (1990) find that audit firms whose reputations have been impaired due to a SEC disciplinary action suffer losses of market share and client engagements.

There also are institutional arrangements within audit firms that provide mitigating forces. Shafer et al. (1999) report that peer review deters unethical behavior on the

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9 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 is not expected to induce compliance since the penalties are decided on bases other than breaking or adhering to the rules.
part of auditors. Certain types of compensation arrangements also appear to mitigate the effect of incentives for client retention. Trompeter (1994) finds that 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- vs. 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 clients' managers.

Certain stakeholder groups at audit clients also appear to provide counterbalancing forces toward auditor independence. Specifically, management and/or the audit committee appear to take independence issues into account when approving nonaudit services by the company's auditor. Parkash and Venable (1993) find that the amount of recurring nonaudit 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 nonaudit 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 nonaudit services from the auditor and ownership concentration, measured as director shareholdings and the percentage shareholding of the largest owner. This finding implies that lower ownership concentrations—a proxy for agency costs—are associated with larger purchases of nonaudit 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 nonaudit services from their auditors.

McMullen (1996) reports 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 following 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) report 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 stock exchanges' recent implementation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999) recommendation that audit committees be composed of independent directors is likely to have significant positive effects on auditor independence.

3. Auditor Competence and Audit Quality

Research links general problem-solving ability and task-specific knowledge to auditors' expertise and thus 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 do 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 emphasizes 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 indicates that the accounting profession already faces problems acquiring high-quality professional employees. This study reports that yearly accounting graduates have decreased approximately 25 percent from 1995-96 to 1998-99. Additionally, 80 percent of educators and 46 percent 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 percent of the practitioners and accounting educators surveyed in the study strongly agree that consulting work in CPA firms is viewed as challenging and rewarding; however, only about 60 percent 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 Rule reduces the ability of firms to provide nonaudit services.

4. Users' Perceptions of Auditor Independence

In general, financial statement 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 point toward financial statement users believing that relatively small amounts of consulting services have little effect on auditor independence and actually 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.

Several studies find that financial statement users express greater concern than auditors that factors such as competition, the provision of nonaudit services, and incentives to retain clients negatively affect auditor independence (Firth 1980; Reckers and Stagliano 1981; Shockley 1981). 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 M.B.A. 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 do managers and partners on the effect of financial incentives on auditor independence. Finally, analysis in Shockley (1981) suggests that partners in Big 8 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. According to psychology research, peoples' beliefs about groups to which they do not belong (out-groups), such as college students' beliefs about senior citizens, are less complex than their beliefs about groups to which

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10 See Albrecht and Sack (2000).
they do belong (in-groups), such as 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 overtime 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 find 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 percent of office revenue. In these two studies, however, users perceive greater independence problems when fees from this type of consulting arrangement are 12 percent 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) report that loan officers perceive 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 percent of audit fees than when auditors perform no consulting services for an audit client. Overall, these results are consistent with the notion 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 et al. (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, then loan officers perceive independence to be as great as when client personnel perform the internal audit function. Lowe and Pany (1995) report 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.

Committee's Views

The Committee has several concerns about both the assumptions underlying the Proposed Rule related to business relationships and nonaudit services and the implications of the rules. We organize these concerns according to the research categories previously discussed.
Over-Time vs. Across-Services Incentives

The Committee believes the Proposed Rule reflects an assumption that auditor independence is impaired primarily by across-services’ incentives, that is, by the desire to enter into an audit relationship with a client in order to obtain consulting services. Research does not support this assumption. Specifically, empirical research previously discussed 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 nonmonetary 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 a client. The Committee believes the Proposed Rule should be reconsidered in light of implications of the relative importance of over-time vs. across-services incentives. Most important is the desire to retain an audit client for 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.

Existing Incentives and Institutions that Ameliorate Impairments of Auditor Independence

The Committee believes that the Proposed Rule does 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) vs. 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 also notes that audit committees currently are sensitive to auditor independence issues when approving nonaudit services. In light of the stock exchanges’ recent implementation of rules for improved independence and financial literacy of audit committee members, the Committee believes that audit committees will provide an even stronger force toward auditor independence in the future.

Effects of the Proposed Rule on Auditor Competence and Audit Quality

Because audit quality is a joint product of auditor independence and auditor expertise, the Committee believes implications of the Proposed Rule for either enhancing or impairing auditor expertise should be considered. 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 Rule impairs auditing firms’ ability to obtain either high quality in their professional

\[1\] 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 nonaudit services.
employees or task-specific knowledge via consulting engagements and business alliances. Evidence in Albrecht and Sack (2000) also suggests that restrictions on CPA firms providing consulting services may impair further firms' ability to obtain high-quality human capital. In addition to raising these concerns about hiring qualified professional staff, the Proposed Rule restricts auditing firms' ability to acquire task-specific knowledge via alliances with other companies. Overall, the Committee believes the Proposed Rule is likely to have significant negative effects on the competence of auditors and on audit quality.

**Users' Perceptions of Implications of Nonaudit Services for Auditor Independence**

The Committee interprets the Proposed Rule as concerned, at least in part, with independence in appearance, which involves perceptions not facts. The Committee believes research on financial statement users' perceptions of auditor independence has several implications for the Proposed Rule.

First, financial statement users appear to have the general faith in auditor independence needed for proper functioning of capital markets. Second, institutional arrangements within CPA firms should alleviate users' concerns about auditor independence, including the separation of audit and nonaudit staff. The positive effects of separate staff occur when CPA firms provide internal audit services, one of the two services for which the Proposed Rule 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.

Finally, although financial statement users' general confidence in auditor independence is important, users may not be the appropriate group to use as a "reasonable man" benchmark to evaluate whether particular activities impair independence. In evaluating this issue, the Committee 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 that the group most likely to avoid both conditions is the audit committee, because of its expertise and access to information. The Committee therefore expects the audit committee to make the judgment that a given business relationship, such as a consulting engagement, will or will not impair the auditor's independence. If this possibility is accepted, then one outcome is a rule that gives the audit committee the authority and responsibility to decide if an audit firm is independent.

**PROXY STATEMENT DISCLOSURES**

**Overview of Proposed Rule**

The Proposed Rule requires companies to disclose in their proxy statements all nonaudit services provided by their auditors, the fee for each nonaudit service as a percentage of total audit fees, and a statement whether each nonaudit service was

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12 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 nonaudit services by Big 5 and other firms and thus recognizes that this research may not focus specifically on the type of consulting viewed as most problematic under the Proposed Rule.
considered and approved by the audit committee of the board of directors or by the board itself. Fees less than the smaller of $50,000 or 10 percent of the audit fee need not be disclosed. Finally, the Proposed Rule requires a company to disclose if its principal auditor leased or acquired from another entity the personnel needed to perform the majority of the audit.

Committee’s Views

Academic research on the effects of nonaudit fee disclosures for U.S. corporations is limited.\textsuperscript{13} Research does not speak to the appropriate disclosure threshold in the specific context described in the Proposed Rule. 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 nonaudit services impairing independence. Overall, the Committee supports the requirement in the Proposed Rule to disclose information related to nonaudit services, but does not conclude on the appropriateness of the materiality levels for disclosure contained in the Proposed Rule.

CHANGES IN FINAL RULES


The Final Rule differs from the Proposed Rule in the following respects. In the Final Rule, the four governing principles are included in a preliminary note, rather than in the general standard (SEC 2000b, Section IVA). The Final Rule contains relatively minor changes to the Proposed Rule in areas related to financial, employment, and business relationships. The Final Rule on nonaudit services generally is less restrictive than the Proposed Rule.\textsuperscript{14} Additionally, the Proposed Rule for restriction of expert services was not adopted in the Final Rule. With respect to proxy statement disclosures, companies do not have to describe each separate nonaudit service or disclose the fee for each service. Rather, the Final Rule requires companies to classify nonaudit services in two categories, those related to financial information systems design and implementation and those related to all other services, with aggregate fees disclosed for each category. The Final Rule also requires disclosure only of whether the audit committee considered the effect on auditor independence of the auditor providing nonaudit services in these two categories. Finally, the Final Rule modifies the disclosure for leased personnel by requiring companies to report the percentage of total audit hours performed by leased personnel only if greater than 50 percent.

\textsuperscript{13} One study examines the effect of nonaudit fee disclosures under ASR No. 250. This study finds that shareholder approval rates for auditors do not change due to disclosure of nonaudit fees, suggesting that shareholders do not perceive the amount of fees as material (see Glezen and Millar 1985, 859–870).

\textsuperscript{14} The specific proposed and final rules related to nonaudit services are very detailed. See the Proposed Rules (SEC 2000a, Section D) and the Final Rules (SEC 2000b, Section D4) for specifics of the rules.
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