Public Statement

Who Watches the Watchers?* Joint Statement on Auditor Independence Amendments

Commissioner Allison Herren Lee

Commissioner Caroline A. Crenshaw

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Auditors play a crucial role in promoting public trust in our markets by providing assurances about the reliability of financial disclosures. This role has been described as a "public watchdog" function that "demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[1] Those clients, however, hire and pay their own watchdogs, prompting the late, distinguished securities law professor Lynn Stout to observe "[w]hen the people being watched get to choose their watchdog, they're not going to choose the toughest animal around."[2] The import of this observation is not to impugn motives, but to point out that there is an obvious and inherent conflict of interest in the so-called "issuer pays" model used in public auditing.[3] This conflict would be significant even if auditing fees were its only source. But in recent years, audit fees at the Big Four accounting firms have been dwarfed by even more lucrative consulting, tax, and other non-audit services offered by large accounting firms, which now account for close to two-thirds of overall revenues.[4]

Auditor independence rules provide the central method for addressing and mitigating this conflict of interest. By reducing the potential for external influence, they promote two separate but related goals: fostering high quality audits and promoting investor confidence in audits.[5] In this way, auditor independence rules underpin public trust and confidence in our capital markets. But that trust must be carefully guarded and nurtured. As the Supreme Court has noted, "[i]t is [] not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional."[6] Yet, a recent analysis by an Oxford Professor of Business and Public Policy begins with this ominous warning: "Auditing today faces a crisis of trust, an especially perverse situation given the audit's central role in fostering trust in markets."[7] International regulators are taking note and moving to implement reforms.[8]

It is against this backdrop that the Commission relaxes auditor independence rules for the second time in as many years. Among other changes, today's rules replace a clear standard with one that provides auditors greater discretion when assessing their own independence and presents greater risk of mistaken or inconsistent application of that standard. What's more, under the final rules, there is no mechanism for ensuring that the SEC and the investing public have visibility into how effectively auditors are making these assessments. And, as has too often been the case in recent years, these changes are disfavored by investors – those who actually rely on auditor assurances.[9]

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The auditor independence rules identify certain relationships that impair the objectivity of auditors. These rules provide that an auditor is not independent if, for instance, it has certain lending relationships with, or if it provides certain non-audit services to, its audit client or the client's affiliates. It is important, therefore, for the rules to clearly define which entities are considered affiliates and thus within the definition of "audit client." These rules are most useful when they draw clear lines so that both auditors and investors know exactly what to expect when it comes to the critical issue of independence. Today, however, a majority of the Commission is continuing the trend of blurring these lines and introducing uncertainty into a calculus that benefits greatly from clarity.

Last year, the Commission agreed to narrow the definition of "audit client" to exclude certain affiliated entities under the loan provision of the rules.[10] Those amendments also replaced a bright line test with a more discretionary "significant influence" test for determining when a lender's ownership interest in an audit client impairs independence. Today's rules go in the same direction, giving auditors greater discretion in assessing their own independence. The amendments introduce a new materiality analysis into the common control prong of the definition of affiliate and permit auditors to carve out even more entities from the definition of audit client through that materiality analysis. Indeed the final rules go even further than the proposal in reliance on materiality, by introducing a so-called "dual-materiality" analysis into the rule, giving auditors two bites at a materiality analysis to exclude affiliates.[11] This is concerning in part because we know that auditors may be inconsistent and err in their application of the materiality standard.[12] Thus, whereas the current rule draws a clear line, the final rules introduce more opportunity for uncertainty and error.[13]

We understand that the introduction of the materiality standard into the rules, as well as the loosening of other standards, is based in part on the staff's experience in the consultation process.[14] That is, when auditors have violated independence rules in the past and come to the staff to make the case that their independence is not actually impaired despite a "technical" violation, auditors have relied in part on materiality assessments like those that will now be permitted by these amendments. We appreciate the staff's professional expertise and experience, and we believe that expertise is invaluable for assisting auditors in analyzing and making these judgments. By writing this broad standard into the rule, however, we place greater reliance on auditors to decide what is or is not "material." Thus, we rely on auditors to subjectively determine when their own independence is impaired, and we do so without providing specific guidance on materiality.[15] This despite the fact that people and organizations are so often inept at perceiving their own conflicts of interest and/or understanding if or how such conflicts may affect their own judgment.[16] What's more, the rule fails to provide visibility into how auditors apply this standard.

While it makes sense for us to assess how our rules are functioning from time to time and to recalibrate them as needed, we are concerned that the dial for auditor independence is turning in only one direction, and that is towards loosening standards and reducing transparency. We cannot support introducing greater opportunity for error and uncertainty into auditor independence standards while decreasing visibility into how auditors are actually making these judgments. We respectfully dissent.

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* "Who Watches the Watchers," *Star Trek: The Next Generation*, Season 3, Episode 4, CBS (Oct. 14, 1989).

[1] *United States v. Arthur Young & Co*., 465 U.S. 805, 817-18 (1984) ("By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this

special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.").

[2] *See* Michael Rapoport, *Role of Auditors in Crisis Gets Look*, Wall Street Journal (Dec. 23, 2010).

[3] The conflict inherent in this model is widely recognized. *See* Max H. Bazerman, George Loewenstein, and Don A. Moore, *Why Good Accountants Do Bad Audits*, Harvard Business Review (Nov. 2002) ("Auditors have strong business reasons to remain in clients' good graces and are thus highly motivated to approve their clients' accounts. Under the current system, auditors are hired and fired by the companies they audit, and it is well known that client companies fire accounting firms that deliver unfavorable audits. Even if an accounting firm is large enough to absorb the loss of one client, individual auditors' jobs and careers may depend on success with specific clients."); *see also* S. Rep. No. 111-176 (2010) ("Section 932 attempts to eliminate the effect of the inherent conflict of interest in the issuer-pays model of the credit rating industry. Under this model, issuers of debt have the incentive to use the rating agency that provides the highest rating. A conflict of interest thus arises because agencies want to provide the highest rating to keep the issuer's business and are less willing to publish a lower rating.); Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Rel. No. 34-61050 (Nov. 23, 2009) (adopting rules to address conflicts arising where a credit rating agency is paid by an arranger of a structured finance product to rate that product).

[4] *See* Statista, Revenue of the Big Four accounting/audit firms worldwide in 2019, by function, https://www.statista.com/statistics/250935/big-four-accounting-firms-breakdown-of-revenues/.

[5] *See* Revision of the Commission's Auditor Independence Requirements, Rel. No. 33-7919 (Nov. 21, 2000).

[6] *See Arthur Young*, supra note 1, at 819 n.15.

[7] *See* Karthik Ramanna, Building a Culture of Challenge in Audit Firms, A paper commissioned by PwC UK as part of the Future of Audit initiative (Sept. 2019), https://www.pwc.co.uk/who-we-are/future-of-audit/building-a-culture-of-challenge-in-audit-firms.pdf.

[8] *See, e.g.*, Aoife White and Hugo Miller, *Big Four Face Big Split in U.K. as Watchdog sets Separation Deadline*, Accounting Today (July 6, 2020) ("The U.K.'s dominant accounting firms must separate their audit units from other operations by June 2024 as the country's industry watchdog reacts to shortcomings that led to the collapse of several companies."); The Dutch Authority for the Financial Market, Vulnerabilities in the Structure of the Audit Sector (Nov. 2018) ("For some years in the Netherlands, there has been a mandatory separation between audit services and non-audit services: briefly, a multi-disciplinary service provider may not provide other services to P[ublic] I[nterest] E[ntities]s if it also performs a statutory audit engagement. The aim here is to reduce the mixing of auditing and advice and the related independence issues."); Olaf Storbeck and Guy Chazan, *Germany to Overhaul Accounting Regulation after Wirecard Collapse*, Financial Times (June 28, 2020).

[9] *See* Comment Letter from Council of Institutional Investors (Mar. 16, 2020) (opposing the introduction of a materiality qualifier into the definition of affiliation, but providing that, if "despite our concerns, the SEC adds the materiality requirement as proposed, we would support the proposed 'focus on the materiality of the sister entities to the controlling entity' rather than a double trigger threshold based on the AICPA affiliate definition that focuses 'on whether sister entities are material to the entity under audit, in addition to whether they are material to the controlling entity'"); Comment Letter from Consumer Federation of America (May 4, 2020) (arguing that the Commission "should withdraw its proposal to add a materiality qualifier to the definition of audit client, as it applies to common control, sister entities and in the context of portfolio companies in ICC or private equity structure" and focus on strengthening auditor independence standards).

[10] *See* Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships, Rel. No. 33-10648 (June 18, 2019).

[11] Where the current rules define all entities under common control as affiliates of the audit client, the changes proposed last December introduced a materiality qualifier that would have permitted an auditor to make a

judgment that a commonly-controlled entity is an affiliate, and therefore part of the audit client, only if that other entity is material to the parent, or controlling entity. The final rules double down on this reliance on materiality, permitting auditors to undertake a so-called "dual materiality" approach, whereby if either the entity under audit or the commonly-controlled entity is not, in the auditor's view, material to the controlling entity, the auditor may deem the other entity not an affiliate. *See* Qualifications of Accountants, Release No. 33-[], 16 (Oct. 16, 2020) (Adopting Release). In other words, even greater reliance on materiality judgments, and even greater room for uncertainty and error.

[12] *See* Preeti Choudhary, Kenneth Merkley, and Katherine Schipper, Auditors' Quantitative Materiality Judgments: Properties and Implications for Financial Reporting Reliability, (June 28, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958405 (finding substantial variation in materiality judgments made by auditors and linking looser materiality judgments with less reliable financial statements).

[13] The amendments loosen the standards in various other ways as well, including by shortening the lookback periods applicable to domestic initial public offerings. Under the current rules, auditors are not independent for purposes of signing off on financial statements if they have had any of the prohibited relationships for the entirety of the "audit and professional engagement period." Under the new rules, the audit and professional engagement period is reduced to one year prior to the IPO, even though financial statements may be required for up to three years. The stated reason for shortening the lookback period is to achieve parity between domestic and foreign first time filers. *See* Adopting Release at 50. However, no substantiated rationale is provided for why that parity is not better achieved by lengthening the look-back period for foreign first time filers, particularly given the importance of reliable financial statements for IPOs. *See* Renee M. Jones, The Unicorn Governance Trap, 66 U. Pa. L. Rev. Online 165 (2017) (highlighting the increase in so-called unicorns, large highly capitalized non-reporting companies, and discussing the governance challenges and lack of reliable financial information prior to registration for such companies); Jean Eaglesham, *Unicorns' Pre-IPO Profit Claims Get Scrutinized*, Wall Street Journal (Sept. 22, 2019) ("While they were private, these companies could easily paint rosy pictures of their finances. But going public means they have to report numbers based on standard accounting rules, which often reveal losses, sometimes huge ones.").

[14] *See* Amendments to Rule 2-01, Qualifications of Accountants, Rel. No. 33-10738, 12 (Dec. 30, 2019) ("Based on the SEC staff's consultation experience, audit firms providing services to or having relationships with sister entities not material to the controlling entity do not typically present issues with respect to the audit firm's objectivity or impartiality. As such, we believe it is appropriate to exclude sister entities that are not material to the controlling entity from being considered affiliates of the audit client because an auditor's relationships and services with such entities do not typically pose a threat to the auditor's objectivity and impartiality."); *SEC Proposes to Codify Certain Consultations and Modernize Auditor Independence Rules*, Press Rel. 2019-276 (Dec. 30, 2019).

[15] Adopting Release at 44 ("In response to commenters' request for guidance, consistent with the discussion in Section II.A.1.a.iii above, we remind auditors and their audit clients of their shared responsibility to monitor independence, including monitoring affiliates and obtaining information necessary to assess materiality. We are not providing any specific guidance on materiality at this time because we understand that auditors and their audit clients have developed approaches to determine materiality in compliance with current rules, and we expect those approaches would continue to be applicable under the final amendments.").

[16] *See* Antonia Argandoña, Conflicts of Interest: The Ethical Viewpoint, IESE Business School Working Paper No. 552 (Apr. 6, 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=683784 (For many reasons, including the way we view ourselves and process information, "agents, groups and organizations believe that they are capable of identifying and resisting the temptations arising from their own interests (or from their wish to promote the interests of others), when the evidence indicates that those capabilities are limited and tend to be unconsciously biased); *see also* Bazerman, et al., supra note 3 ("Psychological research shows that our desires powerfully influence the way we interpret information, even when we're trying to be objective and impartial. When we are motivated to reach a particular conclusion, we usually do. That's why most of us think we are better than average drivers, have smarter than average children, and choose stocks or funds that will outperform the market—

even if there's clear evidence to the contrary. Without knowing it, we tend to critically scrutinize and then discount facts that contradict the conclusions we want to reach, and we uncritically embrace evidence that supports our positions. Unaware of our skewed information processing, we erroneously conclude that our judgments are free of bias.").