Administrative and Judicial Approaches to Auditor Independence

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INTRODUCTION

The responsibility for establishing criteria to maintain and monitor an auditor's independence from his client has been a joint effort of accounting firms, the American Institute of Certified Public Accountants (AICPA), and state and federal regulatory authorities. In recent years, however, both the AICPA and the United States Securities and Exchange Commission (SEC or Commission) have expressed concern about the current system of monitoring auditor independence. The joint creation of the Independence Standards Board by the SEC and AICPA in May 1997 was an important step toward responding to concerns regarding auditor independence.

The creation of the ISB as a new policymaking body provides an opportunity for new and creative thinking in the area of auditor independence. In promulgating new standards for auditor independence, however, the ISB obviously will consider past regulations, rulings, decisions, and interpretations of such bodies as the SEC, AICPA, state licensing authorities, and the courts, as all have addressed auditor independence issues. This Article analyses the weaknesses and flaws of existing rulings, regulations, and decisions with respect to auditor independence. This Article also examines SEC disciplinary decisions and judicial rulings adverse to accountants

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who have violated independence standards during the period 1980 through September 1998. Such an examination provides insight into the possible direction that the ISB will take toward auditor independence policy.

I. BACKGROUND

Financial statements are prepared in accordance with generally accepted accounting principles[1] and reported in accordance with generally accepted auditing standards,[2] which require that "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."[3] An auditor's independence from his client is one of the hallmarks of the accounting profession.[4] Independence ensures that the auditor will be objective when obtaining, reviewing, and reporting client information. The United States Supreme Court summarized the importance of the independence requirement when the Court warned: "Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional . . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."[5]

Historically, accounting firms, the accounting profession as a whole (primarily through the AICPA), and state and federal regulatory authorities (primarily through the state licensing agencies and the SEC) jointly have taken responsibility for establishing criteria to maintain and monitor auditor independence.[6] In December 1998, the SEC questioned whether accountants were adequately policing themselves and requested the five largest accounting firms to

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[1] The generally accepted accounting principles represent the accepted protocol in financial accounting and reporting. *See* HANDBOOK OF ACCOUNTING AND AUDITING 5-7 (Robert S. Kay et al. eds., 2d ed. 1989). The Financial Accounting Standards Board is the independent organization responsible for promulgating these principles. *See id.*

[2] The American Institute of Certified Public Accountants (AICPA) is generally responsible for promulgating the generally accepted auditing standards. *See id.* at 50-54.

[3] CODIFICATION OF AUDITING STANDARDS AND PROCEDURES, Statements on Auditing Standards no. 1, § 150.02 (American Inst. of Certified Pub. Accountants 1972).

[4] *See id.*

[5] United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984).

[6] American Inst. of Certified Pub. Accountants (AICPA), *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* at 10, 15-25 (Oct. 20, 1997) [hereinafter *Serving the Public Interest*].

strengthen their internal controls due to concerns that some auditors may no longer be independent from their clients. The SEC also requested that the AICPA strengthen and accelerate its process for disciplining members who violate the profession's rules.[7]

II. THE ISB

Nineteen months earlier, in May 1997, the SEC and AICPA took a step toward responding to independence concerns when they jointly created the Independence Standards Board (ISB).[8] Although the SEC had the express authority to define and regulate independence,[9] it decided to delegate some of that authority to the private sector through the ISB. The desire to have the profession's experts actively involved in the standard-setting process coupled with limited SEC resources appears to have been a driving force behind this decision. The ISB's auditor-independence decisions apply to all accountants engaged in the audit of publicly held companies.[10]

The AICPA and the SEC's concerns about the current system of monitoring independence precipitated the creation of the ISB. Since the passage of the federal securities laws in the 1930s, the independence rules have developed in a piecemeal fashion and now encompass a large body of miscellaneous interpretations.[11] In addition, the AICPA and SEC have become concerned with the rapidly changing nature of the accounting profession: "Because auditors have entered new service areas, merged and restructured operations, and become involved in more complex business and

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[7] *See* Melody Petersen, *Regulators Express Concerns on Independence of Auditors*, N.Y. TIMES, Dec. 9, 1998, at C8; Michael Schroeder, *SEC Increases Accounting-Fraud Probes*, WALL ST. J., Dec. 9, 1998, at B8.

[8] *See SEC and AICPA Announce Members of New Independence Standards Board* (last modified June 16, 1997) <http://www.aicpa.org/news/P061697a.htm>.

[9] *See, e.g.*, Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a)(2) (1994) (requiring public companies to file annual reports "certified . . . by independent public accountants"). Under the Securities Act of 1933, registration statements must be accompanied by financial statements certified by an independent public accountant or certified accountant. *See* 15 U.S.C. § 77aa(25), (26) (1994). References to independent public accountants also are made in the other federal securities laws. *See, e.g.*, Trust Indenture Act of 1939 § 314, 15 U.S.C. § 77nnn (1994) (authorizing the SEC to require indenture obligors to file annual reports certified by independent public accountants); Securities Investor Protection Act of 1970 § 11, 15 U.S.C. § 78ggg(c)(2) (1994) (requiring the Securities Investor Protection Corporation to submit annual reports to the SEC containing financial statements examined by independent public accountants).

[10] *See ISB Objective and Mission* (visited Dec. 1, 1999) <http://www.cpaindependence.org/textview.php3?doc_id=mission>.

[11] *See* Serving the Public Interest, supra note 6, at 24-25.

professional relationships, a fresh approach to addressing auditor independence issues is needed."[12] Furthermore, the consolidation of the large accounting firms has caused the regulators to call for revision of the old rules.[13]

The ISB is composed of eight members: four public members, including the chairman, and four representatives of the AICPA's SEC Practice Section.[14] The ISB's current chairman, William Allen, formerly was the Chancellor of the Delaware Court of Chancery. Allen is renowned for having written some of the seminal corporate and securities law judicial opinions from the late 1980s to the mid-1990s.[15] The ISB's mandate is to develop new independence standards for auditors of public companies. Standard-setting meetings of the ISB are open to the public, and all new standards that the ISB proposes are exposed for public comment before they become final.[16]

In January 1999, the ISB issued its first new rule, which required auditors to disclose to their clients in writing any relationship that could weaken auditor independence.[17] That same month, the ISB proposed another rule that would prevent auditors from accepting employment from audit clients for a specified period of time.[18]

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[12] Douglas R. Carmichael, *A Conceptual Framework for Independence,* THE CPA J., Mar. 1998, at 16.

[13] *See* INDEPENDENCE ISSUES COMMITTEE, ISSUE SUMMARY NO. 99-2, MERGERS OF ACCOUNTING FIRMS, at 1 (last modified June 8, 1999) <http://www.cpaindependence.org /webview.php3?doc_id=ISSUM992>.

[14] In 1977, the AICPA established the SEC Practice Section (SECPS) as a voluntary membership organization within the AICPA, with the aim to improve the quality of practice before the SEC. *See infra* note 29 for SECPS-imposed firm requirements that most directly relate to independence; *see also* Exchange Act Release No. 6695, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,122, at 88,638 (Apr. 1, 1987) (citing SEC REPORT TO CONGRESS ON THE ACCOUNTING PROFESSION AND THE COMMISSION'S OVERSIGHT ROLE, 94th Cong., 2d Sess. (1978)). Since 1990, the AICPA has required that all of its member firms that audit public companies join the peer review program. The Public Oversight Board oversees the activities of the SECPS. *See Quality Control Inquiry Committee* (visited Dec. 1, 1999) <http://www.aicpa.org/members/div/secps/report/quality.htm>.

[15] *See, e.g., In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. 1996); Paramount Communications Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

[16] *See About the ISB* (visited Dec. 1, 1999) <http://www.cpaindependence.org/textview.php3?doc_id=whatdoes>; *ISB — 1998 Annual Report* (visited Dec. 1, 1999) <http://www.cpaindependence.org/textview.php3?_id=annual98>.

[17] *See Independence Standards Board Approves Final Ruling on Auditor Meetings with Audit Committees,* (last modified Jan. 8, 1999) <http://209.63.115.156/current/p010899.php3>; Melody Petersen, *Auditors Given New Rules to Prevent Bias,* N.Y. TIMES, Jan. 11, 1999, at C2 [hereinafter *New Rules to Prevent Bias*].

[18] *See Independence Standards Board Approves Final Ruling on Auditor Meetings with Audit Committees, supra* note 17; *see also New Rules to Prevent Bias, supra* note 17, at C2.

III. MAJOR SOURCES OF RESEARCH

As stated above, the ISB's status as a new policymaking body presents an opportunity for new and creative thinking about issues related to the regulation of auditor independence. An analysis of past coverage of this issue also provides valuable insight.

There are several resources with which to research auditor independence issues. Publicly accessible resources include (1) SEC administrative decisions disciplining accountants who practice before the agency; (2) federal and state judicial decisions; (3) SEC administrative rulings and interpretations, including No-Action Letters issued by the staff of the SEC; (4) AICPA rulings and interpretations; and (5) AICPA decisions disciplining member accountants. Closed-case Summaries issued by the Quality Control Inquiry Committee of the SEC Practice Section of the AICPA, decisions of state boards of accountancy disciplining their accountant members, in-house accounting firm policies, and in-house rulings on implementation of accounting firm policies also provide additional insight. Trends and systematic changes in the treatment of auditor independence are difficult to discern in these data because much of it has not been subjected to detailed analysis. Still, the ISB can benefit from a better understanding of how the SEC and the courts have handled the issue of auditor independence and from an analysis of the factors that these bodies found contribute to independence problems.

Research in the first category of publicly available resources, SEC administrative decisions disciplining accountants who practice before the agency, yielded a low number of SEC disciplinary decisions in which lack of auditor independence was a major issue. Those decisions found, however, contain many interesting dimensions. Despite the low number of disciplinary decisions released by the agency, the SEC is taking a more active policymaking role in this area. This role is evidenced by the SEC's recent requests for accounting firms to strengthen their internal controls and for the AICPA to accelerate its disciplinary process.[19] In addition, many of the SEC's No-Action Letters from the late 1980s and 1990s concern the more controversial and subtle policy issues in this area, such as the auditing firm's provision of nonauditing services to the client.[20]

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[19] *See id.*

[20] *See, e.g.*, Elms, Faris & Co., P.C., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 576 (June 7, 1996); Gordon, Hughes and Banks, LLC, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 278 (Feb. 20, 1996); Levitz, Zacks & Ciceric, SEC No-Action Letter, 1992 WL 390591 (S.E.C.) (Dec. 17, 1992); Chenkas, Kruger, Stein & Co., SEC

Even fewer state and federal judicial decisions exist in which an auditor's lack of independence was an important issue. Most of the decisions that do exist address pre-trial motions and are not final trial or appellate court decisions. Due to the low number of cases that address auditor independence, the courts have not had the opportunity to act as policymakers in this area. Without an increase in the number of justiciable disputes involving the issue of auditor independence, judges cannot make their mark.

SEC and AICPA rules, represented by categories three and four above, have been extensively interpreted by these bodies and, therefore, do not warrant a comprehensive analysis in this Article.[21] While the SEC has never defined the term "independence," in the mid-1930s the agency adopted Rule 2-01 of Regulation S-X, which provides that "[t]he Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent."[22] This independence-in-fact requirement is similar to the generally accepted auditing standards requirement that an auditor maintain his or her "independence in mental attitude."[23] Rule 2-01 identifies two situations in which the SEC will deem an accountant not independent-in-fact from a client: if the accountant (1) "has a direct financial interest or any material indirect financial interest" in the client or (2) acts "as a promoter, underwriter, voting trustee, director, officer, or employee" of the client.[24] Rule 2-01 also provides that "[i]n determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances."[25]

By the 1970s, the SEC had begun to focus on the "appearance" of independence in their releases.[26] Subsequently, the staff of the SEC began to issue detailed interpretations setting forth its views on the appearance-of-independence issue. The staff's published guidance now is voluminous.[27]

No-Action Letter, 1989 WL 246584 (S.E.C.) (Dec. 18, 1989).

[21] *See Serving the Public Interest, supra* note 6, at 10.

[22] 17 C.F.R. § 210.2-01(b) (1999).

[23] CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Statements on Auditing Standards No. 1, § 150.02 (American Inst. of Certified Pub. Accountants 1972).

[24] 17 C.F.R. § 210.2-01(b) (1999).

[25] *See id.* § 210.2-01(c).

[26] *See* Guidelines and Examples of Situations Involving the Independence of Accountants, Accounting Release No. 126, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,148, at 62,306 (July 5, 1972).

[27] The SEC has issued releases on the independence issue since 1937. In 1982,

Security and Exchange Commission No-Action Letters are not comprehensively analyzed in this Article because they do not reflect binding decisions by the SEC. Instead, the Letters merely reply to inquiries made to the SEC, often by accounting firms, asking whether the SEC will take action if proposed activities are undertaken. References to several recent No-Action Letters that deal with the issue of auditor independence, however, are made in this Article.

The AICPA's guidelines on auditor independence, the sources mentioned in categories four and five, exceed fifty pages of rules, interpretations, and ethics rulings.[28] Since 1990, AICPA member firms that audit public companies have been required to join the AICPA's SEC Practice Section. Membership in the SEC Practice Section imposes requirements that, among other things, protect independence.[29] As discussed later in this Article, because the views of both the SEC and the AICPA on auditor independence are rule oriented, these rules deal mainly with form rather than substance. The ISB may decide to take a different approach when drafting new standards for auditor independence.

IV. ANALYSIS OF PAST ADMINISTRATIVE AND JUDICIAL DECISIONS

A. SEC Disciplinary Decisions

The SEC maintains control over the competence and integrity of auditors who practice before it through the use of Rule 102(e), commonly referred to as "Rule 2(e)," of its Rules of Practice.[30] Rule 2(e) provides that the SEC may suspend from practice any accountant or accounting firm found to lack the qualifications to

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the SEC recodified many of the older releases into section 600 of a new Financial Reporting Release series. Section 600 provides background, interpretation, and guidance on SEC independence positions. *See* Section 600, Matters Relating to Independent Accountants, 7 Fed. Sec. L. Rep. (CCH) ¶ 73,251-73,323 at 62,881-62,930 (1997).

[28] *See generally* CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Statements on Auditing Standards No. 1 (American Inst. of Certified Pub. Accountants 1972). *See also Serving the Public Interest, supra* note 6, at 10.

[29] The requirements that most directly relate to independence are (1) periodic rotation of audit engagement partners; (2) concurrence by a partner, other than the audit partner in charge, that the audit report is acceptable; (3) minimization of the provision of certain management advisory services; and (4) communication (at least annually) to the audit committee or, if there is no audit committee, to the board of directors, of selected fee information related to management advisory services that have been performed. *See* VINCENT M. O'REILLY ET AL., MONTGOMERY'S AUDITING 329-30 (12th ed. 1998).

[30] *See* 17 C.F.R. § 201.102(e) (1999).

represent others, to have engaged in unethical or improper professional conduct, or to have willfully violated any of the federal securities laws. The SEC has used Rule 2(e) to discipline auditors for breach of independence.

On September 23, 1998, the SEC amended Rule 2(e) to clarify the meaning of "improper professional conduct" by an accountant.[31] The amendment specifies that an accountant can be held liable for "improper professional conduct" in situations in which the accountant has violated his own professional standards, including standards relating to auditor independence, either (1) through repeated negligence or (2) through a single instance of "highly unreasonable conduct" in circumstances in which the accountant should have known warranted "heightened scrutiny."[32]

By adopting this standard of "highly unreasonable conduct in circumstances requiring heightened scrutiny," the SEC made clear that auditor independence was an issue about which it had particular concerns. The SEC release containing the Rule 2(e) amendment states:

> Because of the importance of an accountant's independence to the integrity of the financial reporting system, the Commission has concluded that circumstances that raise questions about an accountant's independence always merit heightened scrutiny. Therefore, if an accountant acts highly unreasonably with respect to an independence issue, that accountant has engaged in "improper professional conduct."[33]

This release also states that the SEC will not limit its law-enforcement proceedings against accountants to cases involving "highly unreasonable conduct." Rather, when an accountant has engaged in even a single act of negligent conduct, the SEC may implement its cease-and-desist remedy, a separate type of proceeding explicitly provided for in section 21C of the Securities Exchange Act of 1934.[34]

Rule 2(e) proceedings are purely administrative. The disciplinary matter is handled completely within the SEC, although an accountant may appeal the SEC's decision to the Circuit Court of Appeals for the District of Columbia.[35] Potential sanctions for a Rule

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[31] *See* Securities Act Release No. 7593, 1991 SEC LEXIS 2256 (Oct. 19, 1998).

[32] *See* 17 C.F.R. § 201.102(e)(1)(iv)(B) (1999).

[33] Securities Act Release No. 7593, 1991 SEC LEXIS 2256 (Oct. 19, 1998).

[34] *See id.*

[35] The SEC may take court action against accountants, however, in the form of injunctive proceedings in order to enjoin or restrain them from violating the federal

2(e) violation include temporary and permanent suspension from practice. Accountants fear SEC discipline because of these severe sanctions and because of the negative publicity and possible litigation that may follow the publication of a Rule 2(e) decision. This is particularly true for accountants whose practice is dependent upon or highly concentrated within SEC-regulated companies.[36] This fear is one of the reasons why accountants seek No-Action Letters from the SEC's staff before engaging in transactions that may be perceived to lack independence.

The SEC publishes Rule 2(e) decisions in its releases, and the Rule 2(e) decisions discussed in this Article are based on the pre-amendment Rule. Between 1935 and September 1998, the SEC released a total of 347 decisions concerning accountants, not including decisions that address nonsubstantive administrative-type issues. Over one-half of these decisions concerning accountants were released during the 1990s.[37]

During the 1990s, the SEC released twenty-four disciplinary decisions that involved independence impairment.[38] During the

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securities laws.

[36] *See* Paul R. Brown & Jeanne A. Calderon, *Heightened SEC Disciplinary Activity in the 1990's*, THE CPA J., June 1996, at 57 [hereinafter *Heightened SEC Disciplinary Activity*]; Paul R. Brown & Jeanne A. Calderon, *An Analysis of SEC Disciplinary Proceedings*, THE CPA J., July 1993, at 54 [hereinafter *SEC Disciplinary Proceedings*].

[37] *See Heightened SEC Disciplinary Activity*, *supra* note 36, at 55.

[38] *See* Steven M. Scarano, 1998 WL 568771 (S.E.C.) (Sept. 9, 1998); Charles N. Lipton, 1998 WL 568775 (S.E.C.) (Sept. 9, 1998); Thomas D. Leaper, William T. Wall, III and Fred S. Flax, 1998 WL 315556 (S.E.C.) (June 17, 1998); George Christopher Bleier, Accounting and Auditing Enforcement Release No. 983, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,498 (Nov. 7, 1997); Dennis Klein, Accounting and Auditing Enforcement Release No. 937, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,452 (July 17, 1997); SEC v. Greenway Envtl. Serv. Inc., Accounting and Auditing Enforcement Release No. 914, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,429 (May 13, 1997); Philip Greifeld, Accounting and Auditing Enforcement Release No. 888, [1995-1998 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 74,403 (Feb. 20, 1997); Monte S. Colbert, Accounting and Auditing Enforcement Release No. 835, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,350 (Feb. 20, 1997); Michael Goodbread, Accounting and Auditing Enforcement Release No. 861, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,376 (Dec. 10, 1996); Russell Ponce, Accounting and Auditing Enforcement Release No. 759, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,274 (Dec. 4, 1996); Hein & Assoc. and Duane C. Knight, Accounting and Auditing Enforcement Release No. 798, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,313 (July 2, 1996); Bernard Levy, Accounting and Auditing Enforcement Release No. 770, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,285 (Mar. 29, 1996); SEC v. Jon P. Fries, Accounting and Auditing Enforcement Release No. 665, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,125 (Apr. 24, 1995); SEC v. Ernst & Young, Accounting and Auditing Enforcement Release No. 655, [1995-1998 Transfer

1980s, the SEC released seven such decisions.[39] The SEC released fifteen decisions in the 1970s and seven decisions prior to 1970 in which lack of independence constituted at least one basis for discipline.[40]

Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,115 (Mar. 15, 1995); Glenn N. Deans, Accounting and Auditing Enforcement Release No. 651, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,111 (Mar. 6, 1995); SEC v. PNF Indus. Inc., Accounting and Auditing Enforcement Release No. 602A, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,062 (Oct. 3, 1994); Martin Helpern, Accounting and Auditing Enforcement Release No. 601, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,061 (Sept. 27, 1994); Alan S. Goldstein, Accounting and Auditing Enforcement Release No. 587, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,047 (Sept. 6, 1994); Alan S. Goldstein, Accounting and Auditing Enforcement Release No. 586, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,046 (Sept. 6, 1994); John Rider, Accounting and Auditing Enforcement Release No. 555, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,105 (Apr. 29, 1994); Alan Kappel, Accounting and Auditing Enforcement Release No. 552, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,012 (Apr. 22, 1994); John J. Mohalley, Accounting and Auditing Enforcement Release No. 528, 1994 WL 55527 (S.E.C.) (Feb. 18, 1994); John J. Mohalley, Accounting and Auditing Enforcement Release No. 489 [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,948 (Sept. 30, 1993); Bernard Tarnowsky, Accounting and Auditing Enforcement Release No. 467, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,926 (July 15, 1993); Robert J. Iommazzo, Accounting and Auditing Enforcement Release No. 437, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,896 (Jan. 12, 1993); D. Spencer Nilson, Accounting and Auditing Enforcement Release No. 364, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,831 (Mar. 31, 1992); Terrence M. Wahl, Accounting and Auditing Enforcement Release No. 321, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,790 (Sept. 30, 1991); Samuel George Greenspan, Accounting and Auditing Enforcement Release No. 312, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,781 (Aug. 26, 1991); Michael Ford, Accounting and Auditing Enforcement Release No. 302, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,771 (June 17, 1991); SEC v. Ernst & Young, Accounting and Auditing Enforcement Release No. 301, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,770 (June 13, 1991).

[39] Noemi L. Rodriguez Santos, Accounting and Auditing Enforcement Release No. 246, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,715 (Sept. 1, 1989); Frederick D. Woodside, Accounting and Auditing Enforcement Release No. 244, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,713 (Aug. 21, 1989); Bill R. Thomas, Accounting and Auditing Enforcement Release No. 192, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,402 (May 27, 1988); Marvin D. Haney, Accounting and Auditing Enforcement Release No. 126, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,526 (Jan. 28, 1987); Carl E. Wright and Lewis P. Herman, Accounting and Auditing Enforcement Release No. 97, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,497 (Apr. 23, 1986); José L. Gomez, Accounting and Auditing Enforcement Release No. 68, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,468 (Aug. 6, 1985); Louis Pokat, Accounting and Auditing Enforcement Release No. 2, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,402 (Aug. 18, 1982).

[40] *See Heightened SEC Disciplinary Activity*, *supra* note 36, at 55; *SEC Disciplinary Proceedings*, *supra* note 36, at 54; Paul R. Brown & Jeanne A. Calderon, SEC's Rule 2(e) Disciplinary Actions Concerning Accountants: Compilation and Analysis 20, 40

From 1980 through September 1998, the SEC publicly released thirty-one decisions that address disputes generally involving obvious breaches of independence. These decisions, by and large, address situations that are covered by the detailed and specific SEC and AICPA rules on auditor independence. Approximately half of the decisions released during the 1990s[41] and 1980s[42] address situations in

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(May 1990) (unpublished working paper on file with authors at Leonard N. Stern School of Business, New York University). The SEC decisions released during and prior to the 1970s are not discussed in this Article.

[41] Thirteen of the twenty-four decisions released during the 1990s relate to situations in which an auditor had either a financial interest in, or financial dependence on, his client. *See* Steven M. Scarano, 1998 WL 568771 (S.E.C.) (Sept. 9, 1998); Charles N. Lipton, 1998 WL 568775 (S.E.C.) (Sept. 9, 1998); Thomas D. Leaper, William T. Wall, III and Fred S. Flax, 1998 WL 315556 (S.E.C.) (June 17, 1998); Michael Goodbread, Accounting and Auditing Enforcement Release No. 861, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,376 (Dec. 10, 1996); Russell Ponce, Accounting and Auditing Enforcement Release No. 759, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,274 (Dec. 4, 1996); SEC v. Jon P. Fries, Accounting and Auditing Enforcement Release No. 665, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,125 (Apr. 24, 1995); SEC v. Ernst & Young, Accounting and Auditing Enforcement Release No. 655, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,115 (Mar. 15, 1995); SEC v. PNF Indus. Inc., Accounting and Auditing Enforcement Release No. 602A, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,062 (Oct. 3, 1994); Martin Helpern, Accounting and Auditing Enforcement Release No. 601, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,061 (Sept. 27, 1994); Alan S. Goldstein, Accounting and Auditing Enforcement Release No. 587, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,047 (Sept. 6, 1994); Alan S. Goldstein, Accounting and Auditing Enforcement Release No. 586, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,046 (Sept. 6, 1994); John Rider, Accounting and Auditing Enforcement Release No. 555, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,105 (Apr. 29, 1994); John Mohalley, Accounting and Auditing Enforcement Release No. 528, 1994 WL 55527 (S.E.C.) (Feb. 18, 1994); John J. Mohalley, Accounting and Auditing Enforcement Release No. 489, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,948 (Sept. 30, 1993); Bernard Tarnowsky, Accounting and Auditing Enforcement Release No. 467, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,926 (July 15, 1993); Robert J. Iommazzo, Accounting and Auditing Enforcement Release No. 437, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,896 (Jan. 12, 1993); D. Spencer Nilson, Accounting and Auditing Enforcement Release No. 364, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,831 (Mar. 31, 1992); SEC v. Ernst & Young, Accounting and Auditing Enforcement Release No. 301, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,770 (June 13, 1991).

[42] Three of the seven decisions released during the 1980s relate to situations in which an auditor maintained a financial interest in, or a financial dependence on, his client. *See* Frederick D. Woodside, Accounting and Auditing Enforcement Release No. 244, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,713 (Aug. 21, 1989); Bill R. Thomas, Accounting and Auditing Enforcement Release No. 192, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,402 (May 27, 1988); José L. Gomez, Accounting and Auditing Enforcement Release No. 68, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,468 (Aug. 6, 1985).

which the auditor had either a financial interest in, or financial dependence on, the client. "Financial interest" refers to the auditor holding either equity or debt of the client, while "financial dependence" refers to the magnitude of the audit fees generated by one client relative to total revenues of the auditor. In nine of the decisions released during the 1990s[43] and five of the decisions from the 1980s,[44] the auditor performed managerial duties by helping to prepare or by actually preparing the financial statements under audit. In six of the decisions, the auditor was also an employee of the client.[45] Two of the decisions do not fit into any particular category.[46]

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[43] George Christopher Bleier, Accounting and Auditing Enforcement Release No. 983, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,498 (Nov. 7, 1997); Dennis Klein, Accounting and Auditing Enforcement Release No. 937, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,452 (July 17, 1997); SEC v. Greenway Envtl. Serv. Inc., Accounting and Auditing Enforcement Release No. 914, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,429 (May 13, 1997); Glenn N. Deans, Accounting and Auditing Enforcement Release No. 651, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,111 (Mar. 6, 1995); Alan Kappel, Accounting and Auditing Enforcement Release No. 552, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,012 (Apr. 22, 1994); John Mohalley, Accounting and Auditing Enforcement Release No. 528, 1994 WL 55527 (S.E.C.) (Feb. 18, 1994); John J. Mohalley, Accounting and Auditing Enforcement Release No. 489 [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,948 (Sept. 30, 1993); Bernard Tarnowsky, Accounting and Auditing Enforcement Release No. 467, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,926 (July 15, 1993); Terrance M. Wahl, Accounting and Auditing Enforcement Release No. 321, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,790 (Sept. 30, 1991); Michael Ford, Accounting and Auditing Enforcement Release No. 302, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,771 (June 17, 1991).

[44] Noemi L. Rodriguez Santos, Accounting and Auditing Enforcement Release No. 246, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,715 (Sept. 1, 1989); Frederick D. Woodside, Accounting and Auditing Enforcement Release No. 244, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,713 (Aug. 21, 1989); Marvin D. Haney, Accounting and Auditing Enforcement Release No. 126, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,526 (Jan. 28, 1987); Carl E. Wright and Lewis P. Herman, Accounting and Auditing Enforcement Release No. 97, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,497 (Apr. 23, 1986); Louis Pokat, Accounting and Auditing Enforcement Release No. 2, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,402 (Aug. 18, 1982).

[45] George Christopher Bleier, Accounting and Auditing Enforcement Release No. 983, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,498 (Nov. 7, 1997); Philip Greifeld, Accounting and Auditing Enforcement Release No. 888, [1995-1998 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 74,403 (Feb. 20, 1997), Monte S. Colbert, Accounting and Auditing Enforcement Release No. 835, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,350 (Feb. 20, 1997); Hein & Assocs. and Duane Knight, Accounting and Auditing Enforcement Release No. 798, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,313 (July 2, 1996); John J. Mohalley, Accounting and Auditing Enforcement Release No. 528, 1994 WL 55527 (S.E.C.) (Feb. 18, 1994); John J. Mohalley, Accounting and Auditing Enforcement Release No. 489, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,948

Research addressing the Rule 2(e) decisions against accountants yielded similar results.[47] For example, Marie Coppolino concluded that, of the seventy-five Rule 2(e) orders issued between October 1984 and September 1994 against accountants acting in their capacity as independent public accountants, only thirteen percent involve lack of independence.[48]

B. Federal and State Judicial Decisions

In contrast to the narrow focus of the SEC Rule 2(e) database, the judicial database is more diverse. The Rule 2(e) database only contains SEC decisions ruling on matters concerning auditors, while the decisions contained in the judicial database are made by different courts within the federal and state court systems. The auditors are often named along with other defendants, and the courts are simultaneously faced with many legal issues. Few judicial decisions exist that discuss auditor independence. Research uncovered eleven judicial decisions concerning auditor independence from the 1990s[49] and seven decisions from the 1980s.[50] All but five of the decisions

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(Sept. 30, 1993); Noemi L. Rodriguez Santos, Accounting and Auditing Enforcement Release No. 246, [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,715 (Sept. 1, 1989); Carl E. Wright and Lewis P. Herman, Accounting and Auditing Enforcement Release No. 97, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,497 (Apr. 23, 1986).

[46] Bernard Levy, Accounting and Auditing Enforcement Release No. 770, [1995-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,285 (Mar. 29, 1996); Marvin D. Haney, Accounting and Auditing Enforcement Release No. 126, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,526 (Jan. 28, 1987).

[47] *See* David R. Campbell & Larry M. Parker, *SEC Communications to the Independent Auditors: An Analysis of Enforcement Actions*, J. OF ACCT. AND PUB. POL'Y 297, 297 (1992); Eshan H. Feroz et al., *The Financial Effects of the SEC's Accounting and Auditing Enforcement Releases*, 29 J. ACCT. RES. 107, 114 (1991).

[48] *See* Marie L. Coppolino, Note, *Checkosky, Rule 2(e) and the Auditor: How Should the Securities and Exchange Commission Define Its Standard of Improper Professional Conduct?*, 63 FORDHAM L. REV. 2227, 2246 (1995).

[49] *See generally* Plummer v. American Inst. of Certified Pub. Accountants, 97 F.3d 220 (7th Cir. 1996); Lavin v. Kaufman, Greenhut, Lebowitz & Forman, 226 A.D.2d 107 (N.Y. 1996); Cohen v. Wolgin, CIV. No. 87-2007, 1995 WL 33095 (E.D. Pa. Jan. 24, 1995); Earles v. State Bd. of Certified Pub. Accountants, 665 So. 2d 1288 (La. Ct. App. 1995); Chambers Dev. Sec. Litig., 848 F.Supp. 602 (W.D. Pa. 1994); *In re* Colonial Ltd. Partnership Litig., 854 F. Supp. 64 (D. Conn. 1994); *In re* Checkers Sec. Litig., 858 F. Supp. 1168 (M.D. Fla. 1994); Bank of Tokyo Trust Co. v. Friedman, 197 A.D.2d 354 (N.Y. 1993); Lerch v. Citizens First Bancorp., Inc., 805 F. Supp. 1142 (D.N.J. 1992); Clare v. State Bd. of Accountancy, 12 Cal. Rptr. 2d 481 (1992); Lyne v. Arthur Andersen & Co., 772 F. Supp. 1064 (N.D. Ill. 1991).

[50] *See generally* Fidelity and Deposit Co. of Md. v. Arthur Andersen & Co., 131 A.D.2d 308 (N.Y. App. Div. 1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir. 1986); *In re* Jacob S. Eisenberg v. New York Educ. Dep't, 125 A.D.2d 837

found were disposed of on pre-trial motions, not by final trial or appellate-court judgments.[51] Most of these motions were made by defendants seeking dismissal of plaintiffs' complaints or summary judgments in defendants' favor. In the five cases in which the court rendered actual judgment, the courts determined that the auditor in question did lack independence.[52]

These eighteen judicial decisions deal specifically with suspect relationships between the auditor/firm and the client. For example, in *Cohen v. Wolgin*,[53] the defendant simultaneously served as the company's lawyer, accountant, and tax advisor, although not as its independent auditor. Seven decisions allege that the auditor maintained a financial interest in the client, such as ownership of a majority interest in the client at the time the audit was conducted or an outstanding debt for prior audit fees.[54]

(N.Y. 1986); *In re* Robert W. Preusch v. University of the State of N.Y., 112 A.D.2d 502 (N.Y. 1985); Bennett v. Berg, Nos. 80-0381-CV-W-O, 80-0459-CV-W-O, 1984 WL 2756 (W.D. Mo. June 21, 1984); Summer v. Land & Leisure, Inc., 571 F. Supp. 380 (S.D. Fla. 1983); Cocklereece v. Moran, 532 F. Supp. 519 (N.D. Ga. 1982).

[51] For the five decisions disposed of by final judgments of the court, see *Plummer*, 97 F.3d at 220; *Clare*, 12 Cal. Rptr. 2d at 481; *Earles*, 665 So. 2d at 1288; *In re Jacob S. Eisenberg*, 125 A.D.2d at 836; *In re Robert W. Preusch*, 112 A.D.2d at 502.

[52] *See Plummer*, 97 F.3d at 224 (upholding disciplinary action against accountant for performing an audit for a trust for which accountant was co-trustee); *Clare*, 12 Cal. Rptr. 2d at 499 (upholding suspension levied at accountant for failing to disclose to audit client's board of directors a secret savings account used by audit client's president and CEO); *Earles*, 665 So. 2d at 1289 (upholding disciplinary action against accountant for serving a client as both accountant and commissioned securities broker); *In re Jacob S. Eisenberg*, 125 A.D.2d at 838 (upholding revocation of accountant's license for issuing grossly inflated financial statements for a business in which accountant had personal interests); *In re Robert W. Preusch*, 112 A.D.2d at 503 (upholding revocation of accountant's license for inducing loans of client funds to businesses in which accountant had personal interests and which were known to be financially unsound).

Only decisions determining that an auditor lacked independence are included in this Article. Cases in which a plaintiff alleged a lack of independence and in which the court determined that such an allegation lacked merit do not add anything to the analysis of the independence issue.

[53] CIV. No. 87-2007, 1995 WL 33095 (E.D. Pa. Jan. 24, 1995).

[54] *See Lerch*, 805 F. Supp. at 1154 (auditor owed client outstanding debt, which allegedly fuelled fraudulent attempt to inflate stock prices); *Clare*, 12 Cal. Rptr. 2d at 484 (accountant maintained interest in secret savings account of audit client's president and CEO because betting losses owed to the auditor by the president were paid from this secret account); *Lyne*, 772 F. Supp. at 1066 (auditor not independent because $37,500 in fees were owed to auditor by audit client prior to auditor's providing accounting services); *Earles*, 665 So. 2d at 1290 (upheld disciplinary action for accountant who was acting for audit client as both accountant and commissioned securities broker); *In re Jacob S. Eisenberg*, 125 A.D.2d at 838 (auditor not independent because loans and participations existed between the auditor and the auditor's client); *Summer*, 571 F. Supp. at 386 (auditor alleged to have had interest in client

In *In re Chambers Development Securities Litigation*,[55] plaintiffs alleged that the client "cooked"[56] the books with the auditing firm's active participation and that the firm thus violated the independence requirement (among other professional accounting requirements).[57] The case was subsequently settled and the auditing firm, Grant Thornton, agreed to pay $8,800,000 to the plaintiffs.[58] By settling the case, the accounting firm did not admit liability.[59] Similarly, in *Fidelity and Deposit Co. of Maryland v. Arthur Andersen & Co.*,[60] the court found that a cause of action was stated in a complaint that alleged that the accounting firm bowed to client pressure to use an inappropriate accounting method and to devise a speculative method of income calculation.[61]

Rudolph v. Arthur Andersen & Co.[62] was the only case that raised the important, and currently hotly debated, issue of an auditor providing nonaudit services, e.g., consulting. The firm accused was Arthur Andersen, and the decision does not elaborate on the actions that constituted the specific nonaudit services in question. The court upheld the validity of the plaintiff's compliant, which alleged that the firm may have been involved in a client's fraud because the firm provided nonauditing services.[63] In *Bank of Tokyo Trust Co. v. Friedman*,[64] the accountants were deemed not independent because they acted as the client's internal accountants and bookkeepers while they audited its financial records.[65] Finally, in *In re Robert W. Preusch v. University of the State of New York*,[66] the court found that the accountant lacked independence because he served as the client's treasurer while his firm served as the client's auditor.[67]

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due to a pledge of receivables given to auditor partially to satisfy past-due accounting fees); *Cocklereece*, 532 F. Supp. at 523 (plaintiff contended that various members of accounting firm owned a majority interest in client).

[55] 848 F.Supp. 602 (W.D. Pa. 1994).

[56] "Cooked" books are books that are prepared through the use of accounting practices that are outside the acceptable norms of the accounting profession. *See id.* at 611.

[57] *See id.*

[58] *See In re* Chambers Dev. Sec. Litig., 912 F. Supp. 822, 828 (W.D. Pa. 1995).

[59] *See id.* at 847.

[60] 515 N.Y.S.2d 791 (1987).

[61] *See Fidelity and Deposit Co. of Md.*, 131 A.D.2d at 311.

[62] 800 F.2d 1040 (11th Cir. 1986).

[63] *See id.* at 1041.

[64] 197 A.D.2d 354 (N.Y. 1993).

[65] *See id.*

[66] 112 A.D.2d 502 (N.Y. 1985).

[67] *See id.* at 504.

In *Lincoln Savings and Loan Ass'n v. Wall*,[68] the accounting firm was not named as a party to the litigation, but the court nevertheless referred to the firm's lack of independence from Lincoln Savings, its audit client.[69] The final judgment was rendered against the plaintiff financial institution. The federal trial court held that the appointment of a receiver was justified because the institution had engaged in unsound banking practices and was insolvent.[70]

In a footnote, the court discussed the lack of independence by Arthur Young, the accounting firm, based on the appointment of one of its partners to a high-level and well-compensated position with Lincoln Savings.[71] The judge actually stated that "[t]his practice of 'changing sides' should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence."[72] The court suggested a "cooling off" period of one or two years before a senior official may be permitted to join an audit client.[73] Interestingly, the judge who presided over this case and wrote the court's decision was Stanley Sporkin, a former Director of the SEC's Enforcement Division.[74]

C. Analysis

The SEC disciplinary decisions and judicial decisions analyzed in this Article provide an important historical perspective. Overall, the most important finding is the relative scarcity of decisions involving auditor independence, both by the courts and the SEC. This is especially distressing because auditor independence is one of the cornerstones of the accounting profession and, therefore, is an issue that one would expect to be the subject of disputes in different forums. Given the thousands of judicial decisions involving securities fraud matters, one would anticipate a large number of judicial decisions and SEC disciplinary decisions.[75]

Procedural realities, such as the scarce number of litigants with

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[68] 743 F. Supp. 901 (D.D.C. 1990).

[69] *See id.* at 917 n.23.

[70] *See id.* at 905.

[71] *See id.* at 917 n.23.

[72] *Id.* at 917 n.23.

[73] *See id.*

[74] *See Lincoln Savings*, 743 F. Supp. at 902.

[75] *See generally* Zoe-Vonna Palmrose, *Who Got Sued?*, J. ACCT., Mar. 1997. This article discusses one thousand instances of litigation involving approximately twenty audit firms, yet relatively few decisions have been located involving the issue of auditor independence.

judicial standing regarding auditor independence and the high number of cases disposed of through pre-trial motions, leave the courts with little opportunity to act as policymakers in this area. Given that most state and federal judges are not experts on the issue of auditor independence, however, perhaps it is beneficial that they are being denied this opportunity.

The sparseness of documented independence problems should not automatically be construed to mean that independence problems are nonexistent. At least three scenarios may explain this sparseness: (1) it is difficult for plaintiffs or the SEC to link audit failure to lack of independence because the independence rules deal mainly with form, (e.g., an auditor may not own shares of the client's stock) rather than substance (e.g., the impact of the client's fee on the auditor's overall compensation); (2) independence issues could be embedded in the more common auditing problems that have been documented in the decisions of the courts and the SEC ; and (3) the outsourcing to the auditor of various client functions and the provision of certain types of consulting services by the auditing firm — potentially causing independence problems — are relatively new phenomena that have not yet reached the courts.

1. Current Independence Rules Deal Mainly with Form, Not Substance

The independence rules of the SEC, AICPA, and state licensing authorities deal only with the most obvious breaches of independence, such as an auditor having a financial interest in, or financial dependence on, the client, or the auditor performing managerial duties for the client that should have been performed by the client. These types of breaches are naturally rare and are commonly referred to as independence lacking in "form" because no rule interpretation is necessary once the facts become known.[76]

The more subtle and important independence issues, such as the type and magnitude of nonaudit services that may affect auditor independence are not dealt with in the regulations. Although the SEC's disciplinary decisions have involved obvious breaches of independence, inferences of less-than-obvious breaches can be made.

Consider the sixteen disciplinary decisions in which the lack of auditor independence was based on the auditor's financial interest

[76] *See generally* CODIFICATION OF AUDITING STANDARDS AND PROCEDURES, Statements on Auditing Standards No. 1, § 220.03 (American Inst. Certified Pub. Accountants 1972).

in, or dependence on, the client.[77] Although the SEC's disciplinary ruling against Bernard Tarnowsky[78] involved this sole practitioner's financial dependence on his audit client (approximately seventy-five percent of his total income), perhaps an analogy can be made to a large accounting firm's regional or local audit office being deemed financially dependent upon a particular audit client if its total income is significantly dependent on that particular client's business. By extension, consider an audit that contributes only marginally to the large accounting firm's overall fees, but contributes materially to the regional or local office's fees and particularly to the compensation of the partners working out of such office. If both audit and nonaudit fees are combined, the effect may be even greater. As former SEC Commissioner Steven M. H. Wallman writes:

> Neither the Commission's published independence requirements nor the AICPA's requirements address the . . . overwhelming . . . independence implications of having a firm's individual partner, office or other unit of an audit firm — as opposed to the firm itself (for which there is guidance) — receive a substantial portion of its revenues from a single audit client, or be dependent on that client for status within the firm.[79]

Thus, research on auditor compensation incentives and, more generally, on substantive independence issues rather than simple issues of form, would be useful for the development of new independence standards. In particular, a thorough review of the auditor work environment, addressing such issues as whether compensation of partners at international, national, or regional firms is based on local office performance, or the effect of pressure to bring new clients and retain existing ones, might yield insights as the ISB develops new independence guidelines.

2. Independence Issues Embedded in Other Auditing Procedural Problems

Inferences can also be made with respect to the fourteen decisions in which the SEC determined that the auditors had

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[77] *See id.* For a list of these sixteen decisions, see *supra* notes 41-42.

[78] *See* Bernard Tarnowsky, Accounting and Auditing Enforcement Release No. 467, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,926 (July 15, 1993).

[79] *See* Steven M. H. Wallman, *The Future of Accounting, Part III: Reliability and Auditor Independence*, 10 ACCT. HORIZONS 76, 85 (1996). *But see* Max H. Bazerman et al., *The Impossibility of Auditor Independence*, SLOAN MGMT. REV., June 22, 1997, at 89 (using psychological research to support the argument that auditors are biased in clients' favor, which causes independence problems and justifies the very restrictions on auditor activities that are argued against by Wallman).

breached their independence based on their performance of managerial duties.[80] For example, in the proceeding against Glenn Deans,[81] the disciplined auditor, in conjunction with an audit staff accountant, helped to prepare the client's financial statements and made decisions as to how to report and classify particular transactions. While the obvious breach of independence involved the auditor auditing his own work, a breach may not be so obvious in more complicated situations in which the client gives the auditor so much discretion that, in essence, the auditor is operating as a high-level manager making difficult reporting decisions on behalf of the client.

Such a situation allegedly occurred in *In re Chambers Development Securities Litigation*,[82] in which the plaintiffs alleged that the auditing firm actively participated with management to "cook the books,"[83] through the use of accounting practices that were well outside the professional norms.[84] In *In re Checkers Securities Litigation*,[85] although the obvious breach of independence was the appointment of a Peat Marwick partner as vice president and chief financial officer of the client, the plaintiffs also alleged that the firm acted in concert with the client to systematically overstate revenue and understate expenses.[86]

Finally, in *Lincoln Savings*,[87] the court criticized the auditing firm's blind application of accounting conventions because the firm reviewed transactions without determining whether they made any economic sense and without first finding that the transactions had economic substance that would justify booking them.[88] In addition, the court criticized the accounting firm because one of its partners was appointed to a high-level and well-compensated position with Lincoln Savings shortly after he concluded the Lincoln audit.[89]

In fact, all of the judicial decisions analyzed in this Article deal with a somewhat suspect relationship between the audit firm and

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[80] *See supra* notes 43-44 (citing the fourteen cases in which auditors breached their independence by performing managerial duties).

[81] *See* Glenn N. Deans, Accounting and Auditing Enforcement Release No. 651, [1991-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,111 (Mar. 6, 1995).

[82] 848 F. Supp. 602 (W.D. Pa. 1994).

[83] *See supra* note 56 for an explanation of this term.

[84] *See In re Chambers Security Litig.*, 848 F. Supp. at 611.

[85] 858 F. Supp. 1168 (M.D. Fla. 1994).

[86] *See id.* at 1174.

[87] 743 F. Supp. 901 (D.D.C. 1990).

[88] *See id.* at 921.

[89] *See id.* at 917 n.23.

client. One of the outstanding questions is at what point the relationship between the auditor and management becomes so close that their mutual interests impair independence. In essence, independence problems can be embedded in violations of generally accepted accounting principles. The independence issue must be taken out of the small box in which the SEC and AICPA rules have placed it.[90]

3. Outsourcing of Client Functions to Auditors

In several recent No-Action Letters, the SEC has addressed the issue of outsourcing services.[91] The SEC has indicated that in such circumstances the problem of perceived auditor-independence impairment cannot be ignored because of the more complex nature of these types of services. The No-Action Letters discuss auditing firms providing for their clients such services as financial forecasting, firm valuation, merger and acquisition evaluations, traditional internal audit function tasks (for example, receivable confirmations and bank reconciliations), and compilation and payroll work. In some cases, the SEC staff has ruled that independence would not be impaired.[92] In most cases, the SEC staff has taken the position that performance of operational services constitutes the assumption by the auditor of an employee or management function, and thus independence would be impaired.[93] However, the distinctions drawn

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[90] Thus, future research on judicial decisions in which there are findings (or at least allegations made) that the auditor aided and abetted, that the auditor acted grossly negligently or recklessly, or that the auditor's long-standing relationship with the client perhaps led the auditor to take on more of an advocacy position, would be useful. For example, consider three cases in which independence per se was not an issue and in which the term "independence" was not even used; nonetheless, the facts and the rulings in these cases are relevant to any future independence research. *See, e.g., In re* American Continental Corp./Lincoln Savings and Loan Sec. Litig., 794 F. Supp. 1424 (D. Ariz. 1992); *In re* Consolidated Capital Sec. Litig., No. C 85 7332 AJZ, 1990 WL 82383 (N.D. Cal. Feb. 26, 1990); *In re* AM Int'l Inc. Sec. Litig., 606 F. Supp. 600 (S.D.N.Y. 1985).

[91] *See, e.g.*, Elms, Faris & Co., P.C., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 576 (June 7, 1996); Gordon, Hughes & Banks, LLC, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 278 (Feb. 20, 1996); Lindgren, Callihan, Van Osdol & Co., Ltd., SEC No-Action Letter, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,026 at 79,033-34 (Jan. 6, 1995).

[92] *See* Elms, Faris & Co., P.C., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 576 (June 7, 1996); Adler Blanchard & Co., SEC No-Action Letter, 1991 WL 176820 (S.E.C.) (Feb. 20, 1991); Cherkas, Kruger, Stein & Co., SEC No-Action Letter, 1989 WL 246584 (S.E.C.) (Nov. 17, 1989).

[93] *See* Gordon, Hughes & Banks, LLC, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 278 (Feb. 20, 1996); Harvey Judkowitz, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 908 (July 27, 1995); Semple & Cooper, SEC No-Action Letter, 1995 SEC

among these outsourcing services are, at times, tenuous. Such fine distinctions suggest that more analysis and independent assessment of the specific situations pondered by the SEC staff would be beneficial before the ISB issues new independence standards, especially given the recent growth of these outsourcing services.

CONCLUSION

In its new standard-setting role, the ISB will generally benefit from a review of these past administrative and judicial decisions, although such decisions do not provide complete answers to the new and different questions that are facing regulators in this changing auditor service environment. The ISB, however, promulgated a new rule requiring auditors to disclose to their audit clients any relationships the auditors have had that could weaken their independence, and proposed a new rule that would prevent auditors from going to work for their audit clients for a set period of time.[94] Already the ISB is employing the standards that the SEC and courts have used in finding lack of auditor independence.

No-Act. LEXIS 506 (Feb. 3, 1995); Lindgren, Callihan, Van Osdol & Co., Ltd., SEC No-Action Letter, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,026 at 79,033-34 (Jan. 6, 1995).

[94] *See supra* notes 17-18 and accompanying text (discussing the new rules promulgated by the ISB).