

INFORMATIONAL

Auditor Independence

SEC Review of Auditor Independence Rules

SUGGESTED ROUTING

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- Executive Representatives
- Legal & Compliance
- Senior Management

KEY TOPICS

- Auditor Independence

Executive Summary

In November 2000, the Securities and Exchange Commission (SEC) completed a comprehensive review of outside services that auditors provide to their audit clients, and as a result, amended the auditor independence rules in Regulation S-X. In the final version of Release 33-7919 (the Release), published in February 2001, the SEC described the amendments as a "modernization" of its existing rules. The SEC's actions were prompted primarily by the increasing proportion of revenue that larger audit firms were generating from non-audit services, and the extent to which such services were being provided to their audit clients.

While the SEC's rules regarding auditor independence apply to all broker/dealers, the amendments are particularly relevant to NASD members as the SEC strictly limits the circumstances in which an auditor is permitted to provide accounting and bookkeeping services to an audit client without impairing his or her independence. Generally, the SEC prohibits an auditor from providing accounting and bookkeeping services to its audit client to avoid placing the auditor in the position of auditing his or her own work. The SEC permits an auditor to perform certain financial system services, only if the client has explicitly acknowledged its responsibility to actively maintain, monitor, and evaluate the financial information and reporting system.

During 2001, NASD Regulation conducted certain reviews that showed that an auditor's independence with respect to its broker/dealer client was impaired. The staff required broker/dealers to restrict the nature of the services obtained from their accountant or employ a different and

independent outside auditor. To provide background and guidance on auditor independence to our member firms, this *Notice* discusses the issues considered by the SEC and summarizes specific amendments we believe most relevant to NASD members. It also discusses the American Institute of Certified Public Accountants' (AICPA) current rules regarding certain auditor independence issues to highlight certain conclusions reached by the SEC. Finally, in this *Notice*, we focus on criteria that firms should consider in determining whether an auditor's independence may be impaired. The NASD Regulation staff will use the same criteria in determining whether an auditor's independence is impaired in any given situation.

We emphasize that with respect to broker/dealers, the SEC's rules regarding auditor independence take precedence over guidelines established by any other organization. Member firms are encouraged to read all or portions of the SEC's Release if they encounter complex circumstances or fact patterns regarding an auditor's involvement with the audit client.

Questions/Further Information

Members should direct any questions on the issues discussed in this *Notice* to Andrew Labadie at (202) 728-8397 or Susan DeMando at (202) 728-8411, Member Regulation, NASD Regulation.

Background

According to SEC Rule 17a-5(f)(3), an accountant must be independent to render an audit opinion on a broker/dealer's financial statements. The rule states that with regard to independence, the

auditor needs to comply with the provisions of Rules 2-01(b) and (c) of Regulation S-X. In February 2001, the SEC amended its rules regarding auditor independence. The amendments apply to any auditor whose client files audited financial statements with the SEC, and consequently are applicable to any accountant who provides audit services to a broker/dealer. Among other things, the SEC was concerned with situations where an auditor, based on the full scope of the business relationship with an audit client, would not be considered capable of issuing an independent audit opinion regarding the client's financial statements. In particular, the SEC emphasized that *an audit firm cannot be in a position in which it is, or appears to be, auditing its own work*. This circumstance could arise if an auditor were to perform accounting and bookkeeping services, or design and implement financial information systems to such an extent that it contributes substantively in the creation and maintenance of the audit client's books and records.¹

The AICPA has guidelines in its Code of Professional Conduct regarding an auditor's performance of non-audit services for an audit client. The guidelines emphasize that an auditor's independence could be impaired with respect to the audit client if the auditor was, or would appear to be, serving the audit client in a managerial capacity. The SEC took the AICPA's approach one step further, indicating that if an auditor is involved substantially in creating the audit client's books and records, he or she could be considered to effectively control or appear to control, the client's accounting process and preparation of the financial statements. The SEC believes that, "keeping the books is a management

function, the performance of which [by the auditor] leads to an inappropriate mutuality of interests between the auditor and the audit client." As a result of the SEC's amendments, the AICPA is planning to revise its guidelines, especially those sections pertaining to an auditor's performance of non-audit services for an audit client. A brief description of the SEC's amended rules and the AICPA's current guidelines in its Code of Professional Conduct is provided in the following section to assist NASD members in evaluating whether an auditor is independent.

Two Perspectives

In the section of the Release discussing "Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements," the SEC concluded that the auditor could only provide bookkeeping services on an exceptional basis for the audit client without impairing independence. Specifically, the auditor can provide such services, "...in emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions..." or for a foreign division or subsidiary of the audit client, where the services are limited and the foreign subsidiary or affiliate is small relative to the client's operations.²

With respect to an auditor's involvement in the design and implementation of financial information systems for an audit client, the SEC and the AICPA are, to a great extent, in accord. The SEC indicated that, "...an accountant is not independent of an audit client if the accountant is directly or indirectly operating, or supervising the operation of, the audit client's information system

or managing the audit client's local area network." Yet, the auditor is permitted to, "...design or implement a hardware or software system that *aggregates source data* underlying the financial statements or *generates information* that is significant to the audit client's financial statements, taken as a whole..." if the client's management maintains an effective internal control system and has personnel capable of managing the design and implementation of a financial information and reporting system. [Emphasis added.]

In the section on Independence, paragraph 101-3 of the Code of Professional Conduct, the AICPA indicates that "an accountant in public practice who performs for a client services requiring independence may also perform other financial services for that client. "...[Yet], care should be taken *not to perform management functions or make management decisions* for an audit client, *the responsibility for which remains with the client's board of directors and management.*" [Emphasis added.]

According to the AICPA, independence would *not be impaired* if the auditor were to perform the following bookkeeping services for an audit client:

- a. record transactions for which management has determined or approved the appropriate account classification, or post transactions, which have been classified by management, to the client's general ledger;
- b. prepare financial statements based on information in the trial balance;
- c. post client-approved entries to a client's trial balance; propose standard, adjusting,

or correcting journal entries or other changes affecting the financial statements of the client; and

- d. provide data processing services.

Yet, the AICPA would consider independence to *be impaired* if in performing the above services the accountant were to:

- a. determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval;
- b. authorize or approve transactions;
- c. prepare source documents or originate data; or
- d. make changes to source documents without client approval.

While the SEC considered the AICPA's guidelines appropriate, it believed that the existing rules – its own and those of the accounting profession – needed to better account for the structural changes in the provision of accounting services. We believe this is borne out by the comprehensive nature of its review.³ Citing examples where the amounts paid by a firm to its auditor for non-audit services dwarfed the costs of the audit, the SEC questioned, and continues to question, whether the quality of the audit and the objectivity of the auditor were and are being compromised by the accounting profession's emphasis in expanding consultative services with both audit and non-audit clients.

Guidelines

While the amendments were driven primarily by the

relationships between larger accounting firms and their clients with broad public ownership, they apply to all firms which file audited financial statements with the SEC. Thus broker/dealers regardless of size, and their respective auditors are affected by the new rules. Broker/dealers that either cannot afford or choose not to employ personnel to perform accounting functions, need to obtain book-keeping and accounting services from accountants who are not controlled by the broker/dealer's auditor. As a way to clarify the respective duties and responsibilities of the auditor and audit client, broker/dealers should obtain an engagement letter from their auditor that explicitly outlines the nature and scope of the auditor's or accountant's services, and states categorically that both parties recognize that the broker/dealer is responsible for maintaining the integrity of its accounting system and preparing and presenting its financial statements.

Based upon the preceding discussion, the following examples should aid NASD members in determining whether an auditor's independence might be impaired.

Indications that an auditor is *not* independent:

In addition to performing the audit, the auditor:

- 1. posts, classifies, or codes the original entry of client transactions;
- 2. reconciles subsidiary ledgers to records of original entry;
- 3. prepares periodic accruals and related adjustments on an on-going basis;
- 4. reconciles client records to bank statements;

- 5. resolves open fails;
- 6. monitors information flow leading to preparation of financial records;
- 7. prepares general ledger and/or financial statements; or
- 8. supervises such tasks.

Also, if the member firm does not engage an employee who is capable of actively managing the firm's accounting functions and preparing its financial statements, and the member uses its auditor to provide accounting and book-keeping services, the question arises as to whether the firm is reliant on its auditor for the maintenance and management of its financial records. If so, the auditor would *not* be independent of the firm.

In contrast, the following activities, in and of themselves, do not indicate that the auditor is **not** independent.

The auditor limits his or her activities to:

- 1. observing the member's business operations;
- 2. inquiring about the nature and extent of the member's accounting practices and procedures;
- 3. reviewing documents of original entry;
- 4. verifying completeness of subsidiary and general ledgers;
- 5. questioning reconciliation differences and open fails;
- 6. testing automated systems for completeness and reliability;
- 7. performing and documenting analytical review of firm's operations and financial condition; and

8. determining the representational faithfulness of the member firm's financial statements.

Annually, members are encouraged to review the services provided by their outside auditors to ensure that the auditor's independence is not impaired. We strongly recommend that the member obtain an engagement letter from the auditor outlining the services to be provided and the respective responsibilities of both parties. The engagement letter should also include a representation from the auditor that he or she is either a certified public accountant duly registered or a public accountant entitled to practice in good standing under the laws of his or her place of residence or principal office. While the person or group performing the audit may be independent, neither the NASD nor the SEC will accept audited financial statements prepared by someone who is not qualified in accordance with SEC's Rule 17a-5.

Endnotes

- 1 The SEC's amendments also addressed "...rules for determining whether an auditor is independent in light of investments by auditors or their family members in audit clients, and employment relationships between auditors or their family members and audit clients." The revisions, if anything, are less restrictive than the AICPA's guidelines in its Code of Professional Conduct, and thus are likely to be less of an issue with respect to evaluating an auditor's independence with respect to the broker/dealer. The SEC sought to modernize these particular rules by, "...significantly reducing the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor for purposes of determining the auditor's independence, and shrinking the circle of family and former firm personnel whose employment impairs an auditor's independence." The SEC's goal with respect to these situations was to focus solely on those parties who could realistically affect the outcome of the audit.

- 2 With respect to such services, the final amended Rule 2-01 of Regulation S-X states,

"... (4) Non-audit services. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides [any of] the following non-audit services to an audit client:

- (i) Bookkeeping or other services related to the audit client's accounting records or financial statements.

(A) Any service involving:

- (1) Maintaining or preparing the audit client's accounting records;
- (2) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or
- (3) Preparing or originating source data underlying the audit client's financial statements.

- (B) Notwithstanding paragraph (c)(4)(i)(A) [the above paragraph] of this section, the accountant's independence will not be impaired when the accountant provides these services:

- (1) In emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions; or
- (2) For foreign divisions or subsidiaries of an audit client, provided that:
 - (i) The services are limited, routine, or ministerial;
 - (ii) It is impractical for the foreign division or subsidiary to make other arrangements;
 - (iii) The foreign division or subsidiary is not material to the consolidated financial statements;
 - (iv) The foreign division or subsidiary does not have employees capable or competent to perform the services;
 - (v) The services performed are consistent with local professional ethics rules; and
- (vi) The fees for all such services collectively (for the entire group of companies) do not exceed the greater of 1% of the consolidated audit fee or \$10,000."

- 3 In the Executive Summary section of the Release, the Commission emphasized that, "...to promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society. There have been important developments in each of these areas since we last amended our auditor independence requirements in 1983.

"...the accounting industry has been transformed by significant changes in the structure of the largest firms. Accounting firms have woven an increasingly complex web of business and financial relationships with their audit clients. The nature of the non-

audit services that accounting firms provide to their audit clients has changed, and the revenues from these services have dramatically increased. In addition, there is more mobility of employees and an increase in dual-career families.

"...we are adopting rules, modified in response to almost 3,000 comment letters we received on our proposal, written and oral testimony from four days of public hearings (about 35 hours of testimony from almost 100 witnesses), academic studies, surveys and other professional literature."

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