

**Outline of Testimony of William T. Allen
Before
Securities and Exchange Commission
July 26, 2000**

RE: PROPOSED RULE MAKING RESPECTING AUDITOR INDEPENDENCE

1. Introduction

A. Chair of Independence Standards Board which was formed through the cooperative action of the SEC and the AICPA in 1997 and was authorized in February 1998 by SEC FRR 50 to establish standards that have prima facie validity. Other members of Board here with me - John Bogle, Robert Denham and Manuel Johnson. Each will briefly speak.

B. My background is as a judge (Chancellor, Delaware Court of Chancery 1985-97), Professor of Law and of Business (New York University 1997 - date) and as counsel or consultant to a law firm in New York (Wachtell, Lipton, Rosen & Katz).

C. Today I speak for myself and not the ISB institutionally..... Nor do I speak for any other institution with which I am proud to be affiliated professionally.

2. Importance of Auditor Independence

Auditor independence in fact and in appearance is a vital protection to capital market efficiency and thus to economic welfare in our capital market-centered brand of capitalism. On this I think there is universal agreement.

Evolution of the auditing profession into multi-service professional firms plainly gives rise to reasonable concerns that the integrity of financial data is being or may be adversely affected (or at the least markets may become suspicious of that fact and impose an additional discount for such risk).

3. Independence Standards Board

The ISB was established in 1997 by the SEC and the AICPA to create principle-based standards for the determination of auditor independence. The Board is comprised of people of integrity and experience. Pursuant to agreement between the SEC and the SECPS, the ISB has been afforded sufficient resources to accomplish this task. While getting the infrastructure of the Board in place was time consuming at the outset, the ISB is making good progress and indeed is close to completion on its 4th and 5th major Standards at this time.

A short summary of its standard setting work:

1). Preparation of a conceptual framework for establishing standards of auditor independence. We see this task as important to achievement of a long-term goal of a coherent and effective system of standards. We retained two academics to act as our reporters and impaneled a Task Force of experts from within and without the accounting profession. That Task Force under Board oversight has almost completed its project after about two years of steady work. This has been a very large and time consuming effort, and we are now within several months of a final statement.

2) Address a series of problematic questions that appear to have fewer system-wide (or market efficiency) side-effects.

- A. ISB Standard No. 1: Designed to encourage greater auditor – audit committee interaction with respect to independence.
- B. ISB Standard No. 2: Designed to address a specific appearance problem related to audits of mutual funds and affiliated entities.
- C. ISB Standard No. 3: Designed to modernize independence rules respecting employment of former audit firm partners or employees by audit clients.
- D. Project on Financial Interests of Audit Firm Personnel in Audit Clients: At Exposure Draft stage - thus currently close to completion, but recently deferred due to overlap with this proposed rule making.
- E. Project on Family Relations: At Exposure Draft stage - thus currently close to completion but recently deferred due to overlap with this proposed rule making.
- F. Project on Valuation and Appraisal Services: At Exposure Draft stage – also deferred due to overlap with this proposed rule making. The ISB has tentatively concluded that independence standards should preclude auditor provision of these services where the asset valued (or all such assets valued) have financial statement significance.
- G. Project on Future Firm Structures: This project, unlike the foregoing ones, represents an aspect of the larger question: what forms should firms that provide audit services to public companies be legally permitted to take. This project was deferred in January.

4. Summary of Testimony

- A. I warmly *support that aspect of the Proposed Rule making that would mandate public disclosure of facts respecting non-audit services provided to audit clients.* Since this change in policy requires amended issuer disclosure it is beyond the authority of the ISB to implement through standard setting. It is nevertheless the most significant single change that can be made in my opinion respecting auditor independence. The wisdom of the original decision to premise our capital markets regulation on disclosure and not government substantive economic judgments has been reaffirmed over the decades. There is no reason that information about non-audit services -- if in fact it is information that relates to the integrity of financial disclosure and thus to financial risk -- will not be priced.

An additional strong reason to support this change in disclosure policy is that the ability of markets to price the risk associated with this information will permit financial economists to conduct studies of the existence of any risk premium associated with this information. Such information would be extremely helpful; if an informed market does not care about this information, the case for regulating these relationships is reduced. On the other hand if the market does care (i.e., firms that have auditors who perform substantial non-audit services are penalized by a higher average cost of capital) then the activity will to some extent be self-correcting.

Thus, especially in the absence of good social scientific data respecting the costs and benefits of the provision of non-audit services, it is arguable (and I believe) that disclosure is the optimal social policy.

- B. Nevertheless, I *do not oppose the substantive provisions in the proposed rule dealing with scope of permissible services to audit clients.* Lack of good information respecting the existence of a correlation between an increase in the provision of non-audit services to audit clients and decrease in reliability of financial statements however prevents me at this time from endorsing the expanded prohibition that the rule includes. Others with more intimate knowledge of the practices followed in the world of auditing would have more dependable intuitions on this subject. In all events in this setting of highly imperfect information, the choice here represents a public policy estimate of where the balance of public interest lies. I know of no facts that make the proposals made unreasonable exercises of policy-making judgment.
- C. With respect to other aspects of the proposed rule, I do respectfully recommend *that the proposal's provisions relating to Employment with Audit Clients be modified to conform to Independence Standard Board Standard No. 3.*

That standard reflects the best judgment of a board comprising experienced individuals and a process that entailed wide public participation. This Commission authorized the ISB to undertake that work and I respectfully suggest that where the product of that process represents a reasonable and good faith balancing of appropriate factors in

standard setting, the Commission should limit its options to accepting or rejecting an ISB Standard *in toto*.

Of course the SEC can and should reject a standard that in its judgment is not consistent with the public interest. But I suggest that it ought not to "second guess" specific judgments that are built into an ISB Standard. The SEC should accept or reject a standard. It is not reasonable to expect that senior professional people will continue to dedicate their time to this form of public service if the end result of the lengthy public deliberation process is in effect a proposal to the SEC Staff for modification. Attached is a brief summary of differences between ISB No. 3 and the Proposed Rule's treatment of the employment with audit clients.

- D. I also respectfully recommend that the SEC *amend those aspects of the proposed rule dealing with Family Relations or Financial Interests to conform to the existing ISB Exposure Draft of Standards* which reflect the best judgment of the Board on those topics as of this time, *or alternatively defer acting on those aspects of the rule until the ISB has completed its Standard setting process on these subjects* and then adopt or reject those standards. Attached hereto is an appendix that briefly identifies the differences from the proposed ISB ED on these subjects and that of the proposed Rule.
- E. Finally I must *express concern that the adoption of this rule -- with its highly abbreviated and abstract conceptual underpinnings -- will unduly restrict the development of the ISB's Conceptual Framework Project*. That project has been in the works for almost two years and is close to fruition. It has involved a large Task Force of volunteer experts from the accounting and investment communities as well as academics and others. The existing product of the Conceptual Framework Task Force is sophisticated and deeply considered. We are now in the process of considering public comments on that document. It would not be good policy in my opinion to shortcut that process or to constrain its conclusions by the adoption of a brief statement of core threats to independence that is contained in the Proposed Rule.

The framework of the proposed rule is a first step at a conceptual framework, but it is just a first step. I agree that values or principles that form the premise for the proposed rule constitute significant threats to auditor independence. Advocacy, mutuality or conflict of interest, auditing one's own work and performing management functions for an audit client certainly are problematic for auditor independence. But these generalities need much more conceptual refinement before they can be useful guides to standard-setting independence determinations. What constitutes advocacy for example will often not be clear. Mutuality of interest too should be deemed a problem, but always? To the extent of every mutual interest? What about a passive investment in which an audit client also has a passive investment? Say limited partnership interests. This is a mutual interest, does it in all events prevent the auditor from being independent? What if these investments are material to both? Or financially material to neither? What are the factors that count in deciding when it might and when it doesn't? The framework won't help people know.

Thus I tend not to share the optimistic view of the proposal, that its adoption would helpfully clarify the work of the ISB or at least to do so in a way that is consistent with careful, highly textured standard setting.