Statement of David M. Becker

Concerning Auditor Independence

Before the

The Public Company Accounting Oversight Board

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I appreciate the kind invitation of the Public Company Accounting Oversight Board to participate in this roundtable. My statement begins with a summary of my background as it relates to issues of auditor independence. I discuss some principles that I think should govern consideration of auditor independence issues and apply them briefly to the question of audit firm rotation. Finally, I set forth some suggestions as to matters the Board and the Securities and Exchange Commission might pursue with respect to auditor independence.

My views on these matters are mine alone. They may or may not coincide with the views of others, but they are not intended to reflect the views of any persons with whom I am associated or have ever been associated or of any of my current or former clients.

Background

I have spent most of my career in private law practice. Some of my clients have been accounting firms. Some have been adverse to accounting firms. I have had occasion to observe the conduct of auditors with respect to a range of issues, including independence. I have investigated the conduct of audit firms in a variety of contexts, and I have represented audit firms whose conduct has been questioned. I also served on the Board's Standing Advisory Group.

I served as General Counsel of the SEC twice – between 2001 and 2002 and again between 2009 and 2011. I had significant responsibility for the Commission's 2000 auditor independence rulemaking and spent a great deal of time on it. That experience convinced me that it takes a significant commitment of limited resources of time, energy, personnel, and political capital to modify auditor independence rules.

Approaching Independence Issues

Issues of auditor independence are extraordinarily difficult from a policy perspective. Everyone acknowledges the importance of having auditors who are free from bias and who are capable of independent, objective analysis of audit issues. But beyond a few broad principles the consensus breaks down quickly.

The basic principle of the SEC's independence rule is that it will not recognize any auditor as "independent" if the auditor is not "capable of exercising objective and impartial judgment." SEC Regulation S-X, Rule 2-01(b). Auditor independence rules are concerned with the elimination of bias – including unconscious bias – in auditing. To be more precise, auditor independence is concerned with identifying and eliminating circumstances that breed bias that is strong enough to prevent the auditor from performing his duties in an objective fashion. Where bias exists, the auditor sees matters more than he should from the perspective of someone sympathetic or antagonistic to management, rather than from the perspective of a disinterested third party.

The absence of bias is distinct from the presence of other necessary attributes for professional competence, particularly professional skepticism.[1] Among the auditor's duties is the

[1] I fear footnote 2 of the Board's Concept Release incorrectly elides over the differences between skepticism, independence, and objectivity. Skepticism denotes a questioning mind; independence denotes a freedom from bias; and objectivity connotes a capacity to arrive at judgments within the range of those a reasonable auditor would hold.

requirement to act with professional skepticism. Bias in favor of (or against) client management, if it is significant enough, disables the auditor from acting with professional skepticism. It is not, of course, the only factor that may give rise to a lack of skepticism. Among other things, insufficient professional skepticism may arise from a lack of talent, a lack of training, a firm culture that discourages skepticism, laziness, an excessively trusting disposition, a predilection against taking measures that the client may be reluctant to pay for, or experience suggesting that management is truthful and competent.

Because a lack of professional skepticism can arise from many different causes, a lack of professional skepticism does not necessarily demonstrate a lack of independence. Similarly, the absence of bias hardly guarantees the presence of professional skepticism.

Bias, of course, is a state of mind, and states of mind are notoriously difficult to identify. There is no meter to measure the amount of bias lurking within the brain of an auditor, no light that stays green when attached to the unbiased mind but turns red in the presence of bias. There are few studies that identify circumstances in which auditors lose or retain their objectivity, nor should one expect that there would be, since auditors will invariably believe they are not biased.

There is not much data about the circumstances that give rise to a loss of professional skepticism, less about the circumstances that give rise to auditor bias in favor of management, and even less about the circumstances in which a loss of auditor skepticism arises from circumstances that give rise to bias in favor of management.

Accordingly, independence rules are mostly prophylactic. In addition to stating that an auditor must not be biased, the rules specify circumstances in which the regulator believes that there is a sufficient likelihood that an auditor will become biased, and they thus direct the auditor to avoid them. Here is where policy views diverge sharply, because there is often disagreement about which circumstances in fact pose a meaningful danger to objectivity.

As a legal matter, it is not clear, particularly in light of *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011), the extent to which the SEC (which ultimately must approve any rule adopted by the Board) is free to promulgate prophylactic rules in the absence of meaningful data about the benefits to be gained and the costs to be incurred. While one can make data-based cost estimates, benefits are extremely difficult to estimate. Quantifying potential benefits ultimately would have to be tied to some estimates of how many audits would be performed by unbiased auditors that would, in the absence of a rule, be performed by biased ones or – perhaps – how much investor confidence would be preserved that otherwise would be put at risk by engendering a (reasonable) belief that audits are performed by biased auditors.

My own view is that the SEC (and by extension, the Board) even in the absence of supporting studies should be free to promulgate prophylactic rules where its knowledge and experience support a reasoned exercise of judgment. That is, the Board should be free to act even without data (and in the absence of contradictory data) where it can articulate a logically coherent rationale under which it extrapolates from one what it knows to be the case to what it fears to be the case, so that it can conclude that it is reasonably likely that the identified

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One probably cannot be skeptical if one is biased in favor of management; but one can be independent and still be incapable of skepticism; and one can be skeptical and still be incapable of arriving at reasonable judgments.

circumstance will produce an unacceptable degree of auditor bias. It should be emphasized, though, that one easily could imagine that the courts will require a more rigorously data-driven showing.

How should policymakers determine where to draw the line? To begin with, there are some analytical traps that I believe it is important to avoid. First, the independence rules mandate only an absence of that degree of bias that is inconsistent with objectivity. "Independence" does not come in amounts; one either is independent or one is not. Similarly, one does not find in the law any notion of degrees of independence, meaning a notion that one can be either "more" or "less" independent. Again, one either is free from disqualifying bias or one is not. In the aggregate, it makes little sense to say auditors need to be "more" independent. It does make sense, though, to say that too many auditors are not independent and that particular rules would free more auditors from disqualifying bias.

Second, one cannot determine reliably where the lines should be drawn either as a matter of logical deduction from first principles or by simple analogy to other circumstances. The current independence rules make sense as an outgrowth of regulatory experience over time. But they do not cohere as a logical whole. For every written principle, there are long-recognized exceptions; and for every analogy to what is permitted, there is an equally apt analogy from to what is forbidden. My experience is that it is extremely difficult, in the absence of explicit rule language, to advise clients – be they government clients or private ones – as to whether a particular course of conduct is permitted or prohibited under the independence rules.

Policymakers should draw the lines where their experience tells them there are real dangers. They should be able to identify the facts that in their experience suggest the existence of dangers. They should be able to articulate how it is the line they would propose to draw would ameliorate the danger they see.

Rotation of Audit Firms

I have little to add to the many fine comments the Board has received on the suggestion that auditing firms rotate periodically, other than to point out how much of the analysis in the Concept Release is driven by its apparent assumption of the close association between a lack of professional skepticism and the presence of pro-management bias.

It may be that auditor bias would be reduced, and thus professional skepticism increased, by an audit firm rotation requirement, but the case has not yet been made. The Board's Concept Release – which is an admirably candid and balanced document – says that the Board's inspections "frequently" find deficiencies that "may be attributable to a failure to exercise the required professional skepticism and objectivity." (P. 7.) The Concept Release cites five examples, each of which says with little elaboration that the inspectors found instances of insufficient professional skepticism.

The Concept Release further states (at page 9) that the "specific reasons for findings like these are complex" but that the Board is concerned that they "*may* reflect instances in which the auditors involved failed to put the interests of investors before those of the client's management." (Emphasis added.) The Board states that it does not believe that auditors generally do this intentionally, but that they "sometimes fail to recognize and guard against their own unconscious biases." (Footnote omitted.)

If the Concept Release is modest about its suggestion that its inspections "may" have revealed an absence of professional skepticism, it is all the more so about suggesting that any lack of skepticism might have arisen from a bias to please management. There is simply nothing in the release that suggests that this is the case. This is not to criticize the Board; it is to be commended for not exaggerating the record before it.

Without some indication that the perceived (potential) lack of skepticism arises from pro-management bias, there is no basis to conjecture, much less conclude, that the lack of skepticism is not an artifact of a lack of analytical ability, laziness, a well-founded belief in the competence and integrity of management, or any of the other factors that may give rise to a lack of professional skepticism.

In addition, as the Concept Release notes, for decades the weight of opinion has been that audit firm rotation would not eliminate appreciable amounts of bias among auditors. I would hope that before proposing audit firm rotation the Board should be able to identify some new information that would suggest a different outcome this time around.

Independence aside, the Concept Release makes a strong case that in some cases there may be sound reasons to rotate auditors, to obtain the benefit of a "new set of eyes."[2] The release points out that anyone – auditors included – tend to do a better job when they know someone else will check their work and take note of any shortcomings. The release ably describes the potential benefits of analysis unencumbered by preconceived notions as well as the risks of an audit unencumbered by experience with a company and expertise about the potential pitfalls in its financial statements.

It strikes me that finding the appropriate balance is intensely situational. That is, factors such as the size of the issuer, the complexity of its financial statements, the necessity for specialized expertise to perform the audit, and the competence of the incumbent auditors would seem to counsel differing outcomes in a range of situations. Reaching the appropriate balance would appear to be the quintessential business decision, and audit committees should consider the issue at regular intervals.

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[2] I say "independence aside," because the proponents of rotation on this basis point to the likelihood that auditors will do a better job when they know that someone else will later be reviewing their work. I suspect that this is true, but it is not a matter of independence, except to the extent that one assumes at the outset that auditors are not doing their jobs well because of a lack of independence. By itself, the prospect of later review does not increase or decrease the existence of pro-management bias, particularly unconscious bias. Such a prospect, though, may well decrease the likelihood of reducing all shortcomings of which an incumbent auditor is aware.

What To Do

If there is a deficiency in professional skepticism, it is not at all clear to me that modifying the independence rules would eliminate it. But that does not mean that there is little to be done.

1. Perhaps the Board has already done this, but the Board could mine its inspection data in a more systematic way, analyze the circumstances that gave rise to a lack of professional skepticism, and publish its analysis. In particular, the Board could track factors such as the nature of the accounting issues involved, the significance of the issues to the audit client, the length of time the audit firm had been employed, the seniority of the individuals who failed to exercise professional skepticism, the training of the individuals involved, the stage in the audit in which the failure to exercise professional skepticism arose, the size of the audit client, the significance of the audit client to the firm, the significance of the audit client to the audit partner, the industry of the audit client, and various characteristics of the audit firm.

In this way, the Board might be able to draw correlations between some or all of these factors and the instances in which the Board's inspectors have found a failure to employ professional skepticism. If so, the Board might be in a better position to attack deficiencies of professional skepticism head on and determine the techniques that are most likely to have a direct impact on audit quality. For example, perhaps it turns out that a lack of professional skepticism arises most frequently when the audit partner is relatively junior and the audit client is her first major client. Or perhaps it turns out that a lack of auditor skepticism arises most frequently in particular industries. This would be useful information both for the firms and for the Board. It would tell them of circumstances of which they might not be currently aware and that counsel special vigilance.

2. If there is a problem of insufficient professional skepticism, I would suggest that the most effective way of dealing with it is to communicate to auditors, by deed rather than words alone, that their exercises of judgment could well be reviewed by the Board's inspectors in the not very distant future. The Concept Release suggests (at page 19) the possibility of enhanced inspections that focus particularly on professional skepticism. There could be great benefit to this, as there has been to the Board's inspection program generally. That communication could be useful to the audit profession to the extent the Board can report on the particular circumstances that, in its experience, are giving rise to questions about auditor skepticism.

3. The Board should encourage audit committees to consider at regular intervals whether they should rotate their auditors. As noted, I believe this is a matter that should be committed to the sound business judgment of audit committees and that it would be potentially quite useful to have the issue on the agenda. The Board does not have direct authority over audit committees, but should consider whether there are ways to encourage them to exercise their business judgments as to the retention of auditors more vigorously on a regular schedule.

4. The Board should, with the assistance of the SEC, correct a serious problem with the administration of the auditor independence rules. As the Board knows, various provisions of the securities laws require financial statements filed with the SEC to be certified by an "independent" auditor. SEC Regulation S-X, Rule 2-01(b) sets forth the general standard of

what makes an auditor independent, and Rule 2-01(c) sets forth a non-exclusive list of circumstances that the SEC deems to be inconsistent with the general standard set forth in Rule 2-01(b).

As a matter of law, if an auditor violates any[3] of the auditor independence rules, the financial statements signed by the auditor do not meet statutory requirements, and the audit clients may not file them. Absent some relief, issuers are legally required to replace their auditors, find new and independent ones, and subject their financial statements to a new audit.

In practice, this rarely happens. Generally, these issues seem to surface rather late within an engagement period, often shortly before deadlines for making public filings of periodic reports or offering documents, both of which require currently certified financial statements. When these matters arise, audit committees generally ask their auditors whether, in the auditors view, they are independent notwithstanding the violations of the independence rules.

Sometimes the auditors, audit committees, or both consult with the SEC's Office of the Chief Accountant (OCA), which in the large majority of cases tells audit committees that it will not seek to prevent the issuer from filing financial statements. When they do consult, sometimes OCA tells audit committees or auditors that the issuer should seek new auditors for future periods; sometimes it tells them that it needs to re-audit certain parts of their financial statements. Sometimes it tells them nothing. But in almost all events, the issuers end up making their required public filings, because if they do not, in the first instance the harm falls on shareholders or other investors who are in no way responsible for any wrongdoing by the auditors and who are powerless to prevent it.

As noted, all of this takes place against a legal backdrop in which the import of the SEC rules is that the auditor is not independent and that, as a result, the financial statements do not meet various legal requirements. In my experience, the SEC is extremely reluctant to separate the various prophylactic provisions of the independence rules from the general standard, for fear that auditors will feel freer to violate them if they know in advance that doing so will not cause them to lose their audit clients and thereby visit potential catastrophe on them.

All this also takes place with no legal standard to guide audit committees and auditors as to how they should act. It is far from clear how audit committees or auditors can conclude that auditors are "independent" if the rules say they are not. In practice, auditors sometimes advise their clients that they are "capable of exercising impartial and objective judgment," the words of the general independence standard in Rule 2-01(b). That may well be true, as far as the auditor knows, but the very premise of Rule 2-01(c) is that the prophylactic rules are necessary because in any given circumstance one cannot know whether the auditor is in fact biased and that much auditor bias may be unconscious.

A fair question is why any of this needs to change, inasmuch the regulators, audit committees, and auditors seem to have found a way to accommodate themselves to it. There are two answers, it seems to me. The first is that it may well undermine the seriousness with which

[3] Under certain circumstances, pursuant to Rule 2-01(d), the firm will not be deemed to have violated Rule 2-01(c), as long as the violation would involve a so-called "covered person" and the firm has an adequate system of quality controls.

all concerned treat the independence rules. Everyone agrees that independence is crucial, so crucial there can be no such thing as a trivial violation. And yet, when faced with the choice of taking that view to its analytically compelled but absurd conclusion – most everyone agrees most of the time that it would be highly unwise to do so. But in the absence of an articulated legal standard, there is very real risk that the actual administration of the independence rules – as opposed to what people say about them – will be regarded as arbitrary and unprincipled.

Second, it is not in the public interest for regulators, audit committees, and auditors to be forced to make extremely consequential decisions in a short timeframe with no legal guidance. While regulators may want to preserve maximum flexibility, the absence of any articulated legal standards does not promote sound and transparent decision making. For audit committees, issues as to what to do in the face of an auditor's violations of the independence rules usually occur literally once in a lifetime. They need guidance.

Conclusion

The Board deserves significant credit for conducting this open and deliberative process. I am confident that it will produce useful results. I thank the Board for the opportunity to participate.

David M. Becker