Mr. Chairman, Commissioners, I want to thank you for the opportunity to appear here today to comment on the SEC's proposed rule on auditor independence. I have spent over 20 years in and around the auditing profession, first as a partner with Arthur Andersen and the last 5 years as a partner with Andersen Consulting. As you know, last month by order of Dr. Guillermo Gamba, the arbitrator appointed by the International Chamber of Commerce, Andersen Consulting is no longer affiliated in any way with Arthur Andersen. Therefore, my interest in appearing today is to give you observations on the audit profession and the interaction between auditing and consulting based on my years of experience with both professions.

I want to state up front that Andersen Consulting supports the SEC's proposed rule. This rule is necessary to ensure the independence and quality of audits - and the confidence of investors in such audits - on which the integrity of our capital markets rely. No one, from the smallest individual investor to the largest institutional investor, should be left to wonder whether the financial statements guiding their investment decisions were audited by an independent, objective party.

The audit profession has been granted a unique franchise through the securities laws and auditors are entrusted to act as the “gatekeepers” for the securities markets. In this regard, the auditor holds a public trust. A trust that should not be compromised by the pursuit of unrelated consulting activities.

The Securities and Exchange Commission has a statutory responsibility to ensure the independence and soundness of audits. Therefore, the SEC is properly acting within its authority in promulgating this rule. It is also acting at the proper time. This issue is not new. The issue has been debated within the profession and by others for over 20 years. The only thing that has changed, in my opinion, is that the risks to the system have increased. The relative size of the non-audit activity in accounting firms has never been greater. The sophistication and complexity of business, systems and financial instruments today provide many incentives and many new avenues for financial fraud. With the many small, household investors entering the market for the first time, an audit failure today may have far larger ramifications than it may have had twenty years ago. That is why it is important that the SEC act this year to finalize the proposed rule.

Some of the accounting firms have a vision of becoming multi-disciplinary firms comprised of management consultants, investment bankers, lawyers and others, as well as accountants and auditors. While this may be a good strategy for increasing growth and profitability, it should not be allowed in a
profession that has been granted a unique franchise by the public. It fundamentally undermines the unique role of the auditors.

The SEC's proposed rule would prohibit an audit firm from providing certain non-audit services to its audit clients. The rule simply codifies common sense. Section 2-01(b) states that an accountant is not independent when the accountant:

- Has a mutual or conflicting interest with the audit client
- Audits his or her own work
- Functions as management or an employee of the audit client
- Acts as an advocate for the client

Specific services giving rise to independent concerns include bookkeeping, financial information system design and implementation, appraisal and actuarial services, and management and human resources functions, among others. The firms can still provide other non-audit services to audit clients if it doesn't give rise to independence concerns. And for non-audit clients, accounting firms can continue to provide the full range of consulting and other non-audit services.

This rule will help redirect the focus of the relationship between the accounting firm and audit client to the audit itself and away from the use of audits to develop other general consulting activities. These types of restrictions are commonly accepted by other professions to address real and perceived conflicts of interest. Practitioners in the medical and legal professions accept the principle that certain relationships, by their very nature, give rise to a lack of independence and objectivity. The applicable regulators have seen fit to include such restrictions in their rules rather than simply rely on the good will of the professionals. The public good is served by avoiding these relationships altogether rather than, as those opposing this rule would have it, waiting for the harmful consequences of a breach of independence before acting.

We believe that a strong case can be made for the adoption of the SEC's alternative proposal, the bright-line approach: that prohibiting audit firms from providing all unrelated consulting services is the only way to preserve the long-term health and professional nature of the accounting profession; I say "unrelated" because we accept that there is a narrow scope of services that are closely related and indeed support the audit - the rule does not prohibit those services. Later, I will discuss how we have come to this conclusion. However, we do applaud the initial step taken by the SEC to address the most egregious problems and recognize that it may not be possible to achieve the bright-line result.

Critics of the proposed rule are demanding that the SEC produce a smoking gun - an audit failure caused by lack of independence due to scope of services issues - to justify acting in this area. Focusing on this issue alone, however, obfuscates the real problem, which is the erosion of the professional nature of the accounting firms as they become more like a commercial business. This is the fundamental question raised by the proposed rule. Is the public interest served by accounting firms becoming "multi-disciplinary firms", comprised of many different professions and commercial businesses, offering a wide variety of services to their audit clients and entering new businesses solely for new sources of revenue and profitability? Or is the public interest served by firms focusing on the audit profession, as the franchise granted to them implies?

Over the past several years, we have witnessed first-hand the change in focus of the accounting firms from being anchored in the audit profession to a commercial business offering a wide range of
services, which should lead any disinterested observer to conclude that independence is in jeopardy. Just take a look at some of the accounting firms’ websites. The characterization of the firm’s relationship to its audit clients would lead you to believe that they are in business together.

Now I would like to turn to what we believe have been the factors that have led to the erosion of the focus of the auditing profession. The competitive pressure for growth is fierce. The focus on long-term relationships and “one-stop shopping” is driving the accounting firms. The pressure to cross-sell other lines of business is intense. It is common knowledge that accounting firms for years have “low-balled” audit proposals in anticipation of a long term relationship and receiving lucrative consulting assignments. Treating the audit as a “loss leader” to attract other commercial business is problematic on many levels. Since the audit must be performed at a bargain basement price, there is pressure to “cut corners,” placing pressure on the scope of the audit itself. The firm may seek to limit its loss on performing the audit and the result is that audit quality can be compromised. The audit partner has become the “client service partner”, incented and evaluated based on sales of all services to the client. In all of this, the common denominator is the commercial interests of the accounting firm, rather than what will sustain the confidence of investors in the integrity of the auditors’ report.

An auditor is judged, in terms of compensation and opportunity to advance within the firm, by his or her ability to attract non-audit business to the firm. This subtle pressure in criteria for advancement raises the obvious question of whether those with highly-developed marketing skills are promoted over those with the best technical auditing skills. Many former colleagues in the audit profession will say they would prefer to return to the days when they could focus on auditing, because the constant pursuit of commercial business has led to the denigration of their profession. Some of these people go so far as to say that the accounting firms have “lost their souls”.

Finally, in cases where the audit firm provides both auditing and consulting services for (or has an alliance or other relationship with) a particular client there can be a strong economic incentive to retain the more lucrative consulting contract (or other business relationship). This can lead to a willingness to compromise audits in order to keep the client happy. Simply put, if the non-audit services provided to, or relationship with, the client are disproportionate to the audit services, the objectivity of the audit is undermined. An objective observer can certainly have a good faith concern to this effect. There are numerous situations where audit firms have dropped an audit client where another relationship is more lucrative. What does this say about the value of the audit?

These are all situations in which independence may be compromised by the audit firm seeking or performing non-audit business for an audit client. But as I stated earlier, the very fact that the audit firm performs these services for any clients has led to an erosion of focus on the audit function within the firm. This is the result of audit firms focusing on management consulting and other high-growth service lines to the detriment of the audit function. Consulting and other non-audit services are growing at a much faster rate, and are regarded as more profitable, than auditing, thus investment dollars tend to flow to the non-audit services. This, at a time when the need for investment in both audit-related skills and in reinvention of the audit in the new economy is critical.

A few of the audit firms have voiced strong opposition to the proposed rule. I would like to take a few minutes to discuss some of the arguments they are using to justify their opposition.

The primary argument in opposition is that no evidence exists linking an audit failure to a lack of independence due to consulting services. This argument is simply a red herring designed to deflect
real examination away from the gradual erosion of accounting firms' emphasis on the audit profession and the redirecting of their focus on commercial interests, such as consulting, investment banking and legal work.

In most cases it is virtually impossible to put oneself in the mind of the auditor and ascertain the true cause of audit failure. I believe that the diversion of resources from the audit function manifests itself in audit failures that continue to be uncovered. Moreover, we believe it is simply too much to ask for the same partners to have the professional skepticism required of an auditor at the same time as they focus on very commercial relationships with their client or the advocacy relationship required of a lawyer, for example. In any event, the concern of investors and business executives in this regard is real, has not dissipated and cannot be ignored.

Some of the accounting firms also argue that a prohibition on providing consulting services will actually impede their ability to conduct quality audits for two reasons. First, they argue that redirecting the focus of accounting firms back to auditing will result in an inability to recruit the best and the brightest to join accounting firms. Their second argument is that accounting firms develop in-depth knowledge about a company in the course of providing non-audit services, which aids them in performing high-quality audits.

I believe both of these arguments are faulty and I will discuss them both in turn. First, will the proposed rule harm the accounting firms' ability to recruit highly skilled auditors and related skills? The rule would prohibit accounting firms from providing traditional consulting services such as financial information system design and implementation, as well as management, human resources and legal services to audit clients. It is difficult to conclude that this prohibition will harm the recruitment of auditors, since in our experience there is no meaningful cross-over of personnel between the audit divisions and these other business consulting functions. The skills necessary to perform high-quality audits are vastly different from those needed to perform consulting services of the type targeted by the rule.

If recruitment has been jeopardized it has been jeopardized not by the proposed rule, but by the actions of the accounting firms themselves. As I discussed earlier, some of the firms have diverted investment and resources out of the audit function and into non-audit services, thereby reducing the attractiveness of the audit function as a career path. These accounting firms made a calculated decision to divert these resources and now want to argue that the rule is responsible for this.

It is a mistake for some of the accounting firms to say that the audit business is dying, is a commodity business, and cannot attract bright people. They have created the very environment in which accounting majors look elsewhere and audit staff "move over" to the consulting function as quickly as they can. With the income enjoyed by audit partners at the Big Five accounting firms, it is obvious that auditing remains a very profitable and satisfying profession that should continue to attract highly skilled professionals. The auditors should be promoting the virtues of their profession and talking about the reinvention of the audit in the new electronic economy to enable recruitment instead of denigrating it and using it as a tool to oppose this rule.

The second question raised by some of the accounting firms is whether the provision of consulting services actually enhances the quality of audits and a prohibition on performing consulting services will be counterproductive. This argument is misleading and seeks to shift the blame for lower quality audits from the auditors' business decisions to the SEC.
It is important to note that audit firms do not provide consulting services to improve the quality of the audits, but rather for mostly commercial considerations. The then-CEO of one of the Big Five audit firms was quoted not long ago in Business Week saying "If I had to trade an auditing account for other business, I would do it." What better evidence is there of the commercial focus of this firm?

It is simply not necessary for auditors to provide consulting services to enhance audit quality. There are many companies for which auditors currently do not provide consulting services. Would they admit that audits in these companies are of a lower quality than others? Of course not. Likewise, one could argue (and indeed the Big 5 firms did argue) that mandatory rotation of engagement partners would undermine the quality of audits on a similar rationale. The Commission long ago made the judgment that whatever benefits might be obtained from long term continuity of audit engagement partners is outweighed by the natural risks to independence and objectivity from such a close relationship; it should make a similar judgment here.

What is necessary to maintain audit quality is a sustained focus and investment in the audit profession in order to keep up with the complexity and sophistication of businesses in rapidly-changing industries. This has not been done because many accounting firms have diverted investment to developing the more lucrative consulting business. By retaining valuable resources within the audit function, firms can understand technologies, financial instruments, industries and companies sufficiently to perform quality audits.

Before concluding, we would like to respond to the SEC’s request for comment on various alternatives to the proposed rule. As I stated at the beginning, we do favor the bright line approach, which would prohibit auditors from providing services to audit clients other than those the proposed rule would permit. Based on my experience, it is clear that the systematic diversion of resources to non-audit services and the lack of focus on the audit as the core of the business jeopardizes the long-term health of the audit profession. For this reason, we could not support the alternative that would allow the provision of non-audit services that do not seemingly impair independence.

The firewall approach is similarly flawed. The problem is not the sharing of information that a wall could prevent, it is the systematic undermining of the stature of the audit that is caused by the diversion of management time and attention, and investment dollars. It is about tone at the top.

We would also oppose the fee analysis approach because it also fails to address the major problem of the accounting firms diverting resources into services other than the audit. This approach would require the SEC to draw arbitrary lines as to what percentage of the audit fee an accounting firm could earn in consulting fees before its independence is compromised. I think this would be impossible to determine and also misses the point. It leaves the incentive in place for auditors to become consultants to their audit clients, thereby jeopardizing independence.

In closing, we commend the SEC for taking this important first-step. This rule is necessary to ensure the long-term health and viability of the audit profession by restoring the audit as an end, not a loss leader for developing commercial business - and therefore to protect the integrity of our capital markets. This debate should not be just about proving a link between audit failures and a lack of independence. The debate should be whether the public interest is served by returning the accounting firms’ focus to the profession of auditing. It is vital that this occur and the proposed rule is a major step toward making this happen.