Public Documents of the XXVI[th] Annual Conference of the International Organization of Securities Commissions (IOSCO)

23-29 June, 2001, Stockholm, Sweden

Plenary 4

Auditor Independence

14. Auditor Independence,
Speech by Mr. Stephen G. Butler

International Chairman of KPMG, United States of America

28 June 2001

SGB Remarks to IOSCO Annual Conference

Good morning. It is my pleasure to speak to you today on the timely subject of auditor independence. The theme of your meeting this year, Securities Markets in the Information Age, provides an appropriate setting for this discussion and I thank the leadership of IOSCO for this opportunity.

Auditor independence is a subject that has always been central to the conduct of the audit profession. We are extremely sensitive to its importance, and we take great care to ensure that the conduct of our professionals preserves it. Our 1OO-year track record is strong.

For more than 2 years, the U.S. Securities and Exchange Commission sought to embroil the profession in a debate that many interested parties have described as unnecessary. The debate centered on whether non-audit services offered by public accounting firms, such as mine, negatively impact - of actual auditor independence - but an investor's perception as to whether an auditor appeared to be independent.

I should note that throughout my professional career, and for decades before that, the accounting profession and the SEC have enjoyed a tremendously relationship. Traditionally, when the Commission offered a recommendation for improving financial reporting, the profession seized the opportunity. Very often, in fact, the profession took the lead in proposing improvements through high-level panels of its own.

Regrettably, events of the two years have signaled a less constructive tone. The SEC went directly to the court of public opinion with high-profile verbal attacks on the profession regarding auditor independence. They spent a tremendous amount of valuable time pressuring the profession to accept an appearance standard for independence, rather than doing more to help investors address the true seismic changes going on in our financial markets.

At a time when trillions of dollars were being lost by investors due to declining stock values, regulatory attention was removed from the one reform that would have made the most difference - providing better quality information in the financial reporting process.

I'd like to spend a few minutes sharing my views on independence and offering my observations on the future, including why I believe we need a new business reporting model to sustain the health of our capital markets.

Background

I've spent my entire 33-year business career with KPMG. My background and my training - my understanding and my respect for the role of the accounting profession - are those of an auditor.

The values and vision I bring to work each day were molded by the auditor training I have received for more than 30 years.

I was taught that quality, integrity and objectivity are the hallmarks of our business; that when you sign your name to a public filing, you are committing your entire firm to your best independent judgment.

I learned that when you issue an opinion, you are putting your partners' capital on the line. And I learned that there is no immediate gain that can ever be worth compromising your independence because, ultimately, your reputation - and that of the firm you work for -is your most important asset.

During those 33 years, I have witnessed many changes -for business in general, and the profession in particular -and thru it all my profession has been committed to extensive and voluntary self-regulatory practices to preserve the quality and independence that are the backbone of our capital markets.

Those practices, include peer review - a concept that KPMG pioneered - and second partner review; as well as a system of strenuous requirements for auditor training and continuing education.

KPMG has always been a pioneer in quality control. We were the first public accounting firm to apply Total Quality Management principles to professional services, and the first firm to launch a formal client service measurement process across our entire organization.

And with the establishment of our Audit Committee Institute, KPMG was the first of the Big Five firms in the U.S. to dedicate resources exclusively to audit committee issues in order to support and improve the vital functions carried out by corporate audit committees.

KPMG is also known as an innovative firm. We develop and deliver services that embrace and enhance the audit, raise business performance and increase shareholder value. KPMG was the first firm to globally deploy a comprehensive risk-based audit approach -what we call the Business Measurement Process. This approach has been widely endorsed by the academic community and replicated by others in the profession. By using business processes as the focal point in assurance services, we are preparing to enter the world of instantaneous attestation.

KPMG also led the way in pursuing a plan to separate its consulting business into a freestanding business.

The Auditor Independence Debate

It is against the backdrop of this long history of integrity, quality and innovation, that the independence debate began.

It is essential that we view this issue in two parts. One part includes decades of practical experience, as well as research and public opinion testing - all of which supports the profession's position that there is no public crisis of confidence in the audit profession.

The other side includes regulatory posturing and media overstatement, particularly in the wake of recent proxy disclosure of engagement fees paid to auditing firms.

Fundamentally, I had no axe to grind on the scope of services issue. In fact, I could have benefited competitively by arguing the SEC's point of view. At the time this debate was raging, I was in the process of withdrawing KPMG from the consulting business in the United States - something we succeeded in doing in February of this year with a public sale of that business. But it is precisely because the facts didn't support what the profession's critics were saying, that we could not afford to sit back and be passive observers.

The profession, including KPMG, has been providing non- audit services to audit clients for more than 100 years, to the great benefit of investors, our clients and the economy. In my mind, the disincentives to compromise auditor objectivity are enormous. The risks include a potential career-ending event for the individual, and potential liability for the firm, far exceeding the fee from, any non-audit service.

An abundance of available research - spanning three decades - offers no proof that independence is impaired when non-audit services are delivered by accounting firms to their audit clients. Additional research has shown that the confidence of the investing public in the independence of accounting firms has not been eroded by the growth of non- audit services.

In the U.S., investigative parties such as the Cohen Commission in 1978¡ the AICPA Special Committee on Standards of Professional Conduct in 1986, and the Treadway Commission in 1987 all failed to uncover evidence that non-audit services impaired independence or audit quality.

More recently, in 1996, the U.S. General Accounting Office, after surveying a wide landscape of research, noted that, "None of these [earlier] studies reported any conclusive evidence of diminished audit quality or harm to the public interests, or any actual impairment of auditing independence....."

Finally, the Earnscliffe study conducted last year for the US Independence Standards Board supported the conclusion that investors do not perceive an appearance problem with the provision of non-audit services. The Earnscliffe study found a "positive view of auditors and the way in which they performed their jobs". Based on extensive focus group discussions with individual investors, the study found with respect to non-audit services that investors "were saying that they felt that the level of risk was modest, the track record was pretty good, and the checks and balances seemed to be functioning reasonably well".

And recent public opinion research has shown, time and again, that public confidence in independent auditors remains high, even in the face of more than 24 months of public lashing by the SEC. On this point, it is interesting to note that CPAs consistently rank higher than their peers in banking, law, IT consultancy, and management consultancy when it comes to honesty, objectivity and integrity.

In fact, in annual attitude and awareness studies conducted for the AICPA, the most recent published in December 2000, business executives consistently place CPAs above other professionals as it relates to competence, uncompromising integrity and reliability.

Earlier this month, researchers from the University of Waterloo and the University of South Florida released a working paper in which business executives strongly agreed with statements that they trust the integrity of reports issued by independent auditors, and that they have greater trust in assertions made by companies, other than there own, by a factor of almost 2 to 1 when those assertions have been assured by independent auditors.

What business and the investing public understands is that non-audit services are the logical extension of our core auditing skills, not our distancing from them. That they're built upon a 100-year record of integrity, not in spite of it. And that the interests of shareholders, corporations, and the public at large is central to what we do.

The SEC and, to some extent, the mainstream media in the U.S. don’t easily accept this. For example, a number of newspapers have been leaping at the opportunity to discuss what they see as an imbalance between audit and non-audit fees; information that is now readily available due to new proxy disclosure rules. They are forgetting a couple of facts.

First, the vast majority of non-audit services are part of the same directional model as the core financial statement audit. They are intended to create high quality information for companies and investors. They're not the consultative work the media thinks about when they hear the word “consulting”.

Second, in many instances, much of the cost of these additional services, that are labeled non-audit services, are in fact audit services that result from such things as registration statement and filings required by SEC regulations-services that must be provided by the Company’s primary auditor-and also statutory audits required by various national jurisdictions.

Summarizing this debate, it is clear that on the most fundamental issue each side agreed: the unshakable purpose of the independent audit is to protect the investing public. But there is a legitimate question as to whether regulatory activity over the last two years has done anything to significantly improve investor protections.

Regrettably, I must conclude that it has not. In my view, the opposite is true: the SEC took one part of the financial markets system that was working - investor trust in the auditor - and attempted to destroy that trust by manufacturing a crisis where none existed.

What investors and creditors require most urgently they’re not getting, and the diversions of the last two years have done nothing to remedy the situation.

Specifically, today's investors need reliable, timely, high- quality information so that they can make sound, informed decisions that are responsive to an Information Age economy. Trust in the auditor is an important prerequisite to that objective, and regulators should be working to build and sustain that trust. But it goes even further, and that's where I would like to focus the remainder of my remarks to you today.

The New Business Reporting Model Earlier this year, at the time current agreements on independence were being finalized between the SEC and the profession, the NASDAQ stock market was still in the midst of a frenzied and dramatic drop in market value, ultimately falling more than 60% from its high in March 2000.

In less than one year, investors loss trillions of dollars in market value, and yet the silence of the U.S. regulatory community offered a perplexing contrast. I believe the NASDAQ experience provides a clear proof-point that better information, provided by a better reporting model, could have helped investors adapt to the situation.

People in every walk of life are affected by business reporting. It is the cornerstone on which our process of efficient and effective capital allocation is built. To properly judge the opportunities and. risk of investment, they need access to complete information provided by the best sources, including data about the economy, industries, companies, and securities.

Unfortunately the current accounting model is out of date and cannot provide all that investor's need. It is based on the assumption that profitability depends on physical assets, like plant and machinery; and inventories. In other words, on the tangible inputs needed to produce tangible products. This is the accounting model of the Industrial Age.

But, as the theme of your conference suggests, we are no longer in the Industrial Age. We still have elements of it, of course, but we have moved more deeply into the Information Age.

Today's economy is different from anything we have dealt with before It is founded upon new technologies, globalization, and the increasing importance of intangibles, such as brands patents, relationships, people, systems and knowledge Companies are creating value in different ways, using new combinations of tangible and intangible assets

In the mid-199Os, the AICPA formed a Special Committee on Financial Reporting, the so-called "Jenkins Committee" - named after its Chairman, Edmund Jenkins, the current chair of the FASB It identified investor information needs that go far beyond what is required by the current financial reporting model In fact, to capture the idea of reporting non-financial information, the Committee's report adopted the broader term "business reporting", and produced an accounting model The report was based on research to determine investors' needs.

It is hard to believe that the report was produced six years ago and yet so little has been done in response. If investor' needs were not being met six years ago, it is even less like that their needs are being met today

That brings me to the current regulatory structure The SEC was established to administer statutes written before the invention of the digital computer, the Internet, on-line trading, on-line exchanges, on-line offering of securities, and the quantum jump in the globalization of the capital markets Its regulatory mindset reflects its origins It has a financial- statement, rather than a business-reporting, outlook It has not encouraged the innovation in business reporting that is vitally needed

There are also challenges with respect to the frequency of reporting The relative absence of up-to-date information with which to assess corporate earning capacity helps explain the volatility of today's share prices Investors cannot make effective decisions with out-of-date information Corporate diversification, alliances of all sorts, the rate and depth of economic change, and transnational relationships have enormously changed the risks facing modern corporations

Meanwhile, the use of the Internet for communications has been exploding Real-time disclosure of selected financial information on the Internet is clearly foreseeable. In these circumstances, the quarterly and annual reporting system is becoming less and less useful

Add this to the fact that financial systems employed by companies are increasingly powerful Cisco Systems, for example, has a system in place to “close its books” in mere hours - traditionally a process measured in weeks

By addressing the issues I have been describing, we will drive a frequency and richness of disclosure that is more helpful to investors because it is more closely aligned with the pace of change in corporate prospects

If we are going to modernize the accounting model, we must focus on three areas

- First, a broader “bandwidth” of information, such as was heralded by the Jenkins Committee
- Second, different distribution channels, namely, the Internet
- And third, increased reporting frequency, ultimately, on-line, real-time reporting

There is also a fourth imperative It is to continue to give accounting firms the freedom to innovate new audit strategies and technologies, so that when companies produce these new disclosures over the Internet, auditors can provide contemporaneous assurance that information is reliable

Closing

I believe the regulatory community should heed the advice of the Jenkins Committee and encourage registrants, auditors, and standards setters to focus on the development and presentation of more relevant and timely information to investors; and follow through by reducing regulatory barriers to useful innovations along those lines. I am pleased that support has been expressed in Washington DC for a top-to-bottom review of US securities laws, and I believe the markets would benefit from such an initiative

I’ll close by offering my support for the modernization of the current financial reporting model to provide investors, of all kinds, the information they need to assess how companies create value today -in the US and around the globe

That’s where our focus should be. We owe it to investors everywhere, and to the global economy, to make sure we adapt without delay Thank you for your time and attention