

SEC Hearing, July 26, 2000

ORAL STATEMENT

Chairman Levitt and Commissioners, I am honored to have the opportunity to participate in today's hearing on the Securities and Exchange Commission's proposal to revise the rules relating to auditor independence. I believe the Commission's proposed rule deserves careful consideration by all interested parties, and I applaud you for this initiative.

In my oral statement, I will focus on some trends we are seeing in the relationships between external auditors and national banks and my concerns about those trends. My written statement includes a broader discussion of the importance of independent external and internal audits for the safety and soundness of the banking system.

It is indisputable that independent auditors play a critical role in maintaining public trust in our financial markets and in the integrity of

corporate financial statements. Accordingly, ensuring not only the independence of external auditors, but also the appearance of independence, is vitally important for investors and other users of financial statements, including bank supervisors.

It is also important to recognize that the factors that influence independence may be extremely subtle and difficult to identify, and that the consequences of an impairment of independence may be difficult to document. In this sense, independence may really be more of a state of mind than a legal status. Thus, building safeguards for independence can present difficult challenges. In an ideal world, the external auditor should be free from any extraneous influences and motivations that might cause it to express anything less than its frank and forthright opinion.

The Commission's proposed rule would comprehensively modernize and strengthen the standards for determining independence. Most relevant to the OCC's concerns, the proposal would establish the

standard that an external auditor would not be deemed independent if it provided internal audit services for an audit client or an affiliate of an audit client, subject to limited exceptions. This part of the proposal is of great importance for bank supervisors and we support its adoption.

Recently, we have seen a growing number of national banks outsource some or all of their internal audit functions to auditing firms. This practice raises concerns that bank management and examiners must carefully assess. Specifically, a bank's board of directors and senior management must understand that these arrangements do not relieve them of their responsibilities for establishing, maintaining, and operating effective and independent audit programs. Management and the board cannot allow outsourcing arrangements to compromise the integrity or independence of either a bank's internal or external audit functions.

When a bank outsources its internal audit function to the same firm that performs the bank's external financial audit, however, the possibility for inherent conflicts and impairment of auditor

independence and audit integrity is greatest. Such arrangements introduce a number of risks, including, as the Commission has noted, questions about the independence of the external auditor, both in fact and appearance. In addition, these arrangements eliminate the normal checks and balances that can be expected to operate where the internal and external audit functions are performed independently, and they deprive management of the ability to have the bank's external auditors evaluate the quality of internal audit. Currently, the OCC and the other banking agencies do not impose a blanket prohibition on a bank's outsourcing internal audit work to the same external firm that audits its financial statements, because we follow the SEC's and AICPA's current rules and standards on auditor independence. However, we discourage this practice and have imposed a number of safeguards and quality controls to address our supervisory concerns. Guidance is set forth in a 1998 Interagency Policy Statement as well as our recently issued handbook on Internal and External Audits.

The OCC has seen a number of cases in which national banks have outsourced internal audit to the same firms that provide their external audits. Several of these arrangements have involved larger institutions and have involved extensive planning, coordination and consultation between the bank's senior management and the auditing firms' senior partners.

While these arrangements incorporate the various safeguards outlined in the agencies' Interagency Policy Statement, and have served to improve the quality of internal audits, I have strong reservations whether even these safeguards can sufficiently address the fundamental issue of external auditor independence. The pressures and influences that may come to bear on external auditors who also are seeking to perform the internal audit function may be exceedingly subtle and may not be effectively addressed by objective safeguards.

Even more problematic are the outsourcing arrangements that we are seeing among smaller community banks. In many of these cases,

neither the bank nor the outside auditors has the staff or resources to institute the safeguards outlined in the Interagency Policy Statement.

While we recognize that banks in some smaller communities may have a limited range of external firms to choose from, the maintenance of independence can be even more important in banks that lack the resources to manage their internal audit function effectively.

Having said that, I do have a concern about the impact of the rule on smaller banks. Under banking agency rules, banks with less than \$500 million in assets are not required to have independent external opinion audits -- although a substantial number in fact do. I would be concerned if a rigid application of a rule against outsourcing internal audit caused some smaller institutions to elect to forego such audits, in order to be able to continue outsourcing internal audit functions to the same firm they had been using for external opinion audits. This is an issue we would like to discuss further with you as your work with the proposal progresses.

Given the important and evolving role that external audits and auditors play in national banks' risk management programs, I believe the SEC's review of its auditor independence rule is timely and warranted. This review is consistent with many of the discussions taking place among bank supervisors, and I applaud the Commission's efforts to address this important issue in a balanced and careful manner.

Although I am very interested in the perspectives that other participants in these hearings and commenters will bring to this discussion, I believe that the SEC's proposal attempts to strike a reasonable balance in this area. In particular, I agree with the SEC's initial views that a blanket prohibition on providing any consulting or non-audit services to financial statement audit clients may be unduly broad, given the considerable expertise that audit firms can provide their clients.

With regard to arrangements involving the outsourcing of internal audit to the external auditor, however, I believe there are serious risks

both that the auditor's independence may be compromised and that banks will be deprived of the benefits that can flow from having internal and external audit functions performed independently. In light of the importance that we place on the audit functions in the conduct of our supervisory responsibilities, and given the subtlety of the pressures and influences that can come to bear in this area, I believe the Commission's proposal on outsourcing the internal audit to the external auditor is right on the mark and should be supported. We look forward to consulting with you and the other banking agencies on this subject as the Commission moves forward with this proposal.