UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHIEF ACCOUNTANT

December 9, 1999

Michael Conway
Chairman
SEC Practice Section Executive Committee
C/o KPMG Peat Marwick, LLP
1222 Park Avenue
New York, N.Y. 11001

Dear Mr. Conway:

The recent action taken by the Executive Committee of the SEC Practice Section (SECPS) to upgrade its membership requirements to better safeguard the independence of audit firms as to their publicly reporting audit clients is an important initial step in addressing issues that ultimately could threaten to undermine public confidence in the integrity of audited financial statements. In making this observation, however, we note that the new requirements essentially embody the procedures that many accounting firms in the profession are already following.

Nearly a year ago, we expressed concern to the SECPS that firms with public company audit clients practicing before the Commission may lack sufficient worldwide quality controls to assure their independence under the applicable Commission and professional rules. In the time since that letter, the SEC staff has identified additional, troubling examples that suggest not only a lack of sufficient global safeguards, but also a systematic failure by partners and other professionals within certain firms to adhere to even their own firm's existing controls.

While the recent amendments to the membership requirements are an improvement, we believe that prompt additional action is needed both to evaluate the nature and extent of the existing deficiencies in internal controls and oversight on a profession-wide basis and to develop a more comprehensive remedial solution. Failure to take action quickly, we believe, could seriously undermine public confidence in the current self-regulatory process and its dependence on internal controls of member firms and external peer review.

Impact on Clients of the Auditor's Failure to Maintain Independence

As you are aware, the lack of independence by firms has caused significant difficulties for registrants. It is the responsibility of each registrant to file with the Commission, financial statements audited by an "independent" auditor. An audit firm found lacking in independence causes a registrant to fail to fulfill this obligation, resulting in deficient filings under the federal securities laws. As a result, it is the registrant and its shareholders that bear the burden of the audit firm's failure to ensure its independence. As you know, violations of the independence rules often cannot be "cured" merely by ceasing the conduct that created the violation.

Employing effective quality controls ensuring the independence of professionals of firms providing audit services to public companies is in the best interest of all the participants in our capital markets. All of the participants -- from the accounting firms, the value of whose audits is ultimately judged by the market's perception of the objectivity and integrity of the audit opinions; to public companies, who are able to access capital at a lower cost through our capital markets; and to investors, who are able to have greater confidence in the quality and reliability of corporate financial reporting -- have an interest in this matter.

The Basic Requirements for a Comprehensive System of Independence Quality Controls

As member firms become more global in scope and their business relationships with public company audit clients become more complex, it is imperative that the firms continue to make substantial investments in designing and implementing strong systems of internal controls. These systems must inculcate firms' ever changing and varied professional staffs with an understanding of and sensitivity to the importance of the profession's independence requirements. In addition, these firms must develop state-of-the-art automated systems that identify conflicts early and serve as a platform for additional levels of testing to ensure that the safeguards actually are being complied with by the professionals in the firm and the firm itself. Consequently, we urge the SECPS and its members to review the membership requirements and existing internal controls in individual firms in the independence area to ensure that the following areas are sufficiently covered by member firms on a worldwide basis:

<u>Establishment of Written Independence Policies and Procedures.</u> Written policies and procedures should cover all professionals worldwide. The procedures should address all aspects of independence including business relationships, financial interests, fee arrangements and services.

<u>Require Firms to Automate Conflicts Verification Processes.</u> Firms need to develop a modern tracking system for audit engagements and financial investments by professionals. The sophistication of the system ultimately employed may be influenced by factors such as, the size of the firm, the number of professionals and offices, and the number of clients, etc. For larger firms, this should be a constantly updated, user friendly, "real time" electronic intranet-based tracking system.

Firms also need to develop a system whereby employees/partners post their trades on a timely basis into an electronic system that would maintain employee holdings and a constantly updated client list. This system also would quickly compare these investments against a client database. Firms need to gather data on new clients before accepting an engagement, to minimize instances where violations may occur.

Establishment of Firm-Wide On-Going Training Program. Firms need to establish for all members on-going training requirements on independence and ethics to raise awareness, sensitivity, and understanding of the applicable provisions. All professionals should be required to demonstrate a minimum level of competence with respect to professional standards, legal requirements, and firm policies and procedures.

Strengthening of Internal Inspection and Testing Program. Firms need procedures to monitor the quality of internal compliance with firm policies and procedures and the applicable rules of the profession, standard setters and regulatory bodies.

Firms need adequate procedures to audit, on a test basis, the completeness and accuracy of information submitted from employees and partners. Firms should have policies, procedures, and controls to monitor a client investment database to ensure that the information is updated as often as necessary to ensure compliance with the independence rules. Firms also should have policies, procedures, and controls to monitor the investments of the firm and its pension and retirement plans and any business arrangements with clients of the firm to ensure that these investments and arrangements do not violate any of the independence rules.

Creation of Profession and Firm Disciplinary Mechanism for Independence Violations. The profession and the firms must establish timely and effective disciplinary mechanisms against professionals who violate independence procedures both within the firm and the profession. As part of a new Commission Staff practice, we ask each firm that has identified an independence violation by its partners or employees; "What disciplinary action has the firm taken against the offending partner or employee?

Need for More Responsive Professional Quality Control Standard Setting Process. Continuous improvement is an important process within any organization today. In that regard, a process should be established to identify, when necessary, timely and responsive changes in professional quality control standards and the accompanying guidance for improvements.

Require Senior Management Supervision of Independence Process. Firms need an appropriate supervisory structure, including assigning responsibility to members of senior management who will have responsibility for ensuring compliance with the independence rules. These individuals should not have profit and loss responsibility.

Applicability in Global Firms

These policies, procedures and quality controls need to apply to all SECPS member firms and their international affiliates on a global basis. This would include any audit of the financial statements of an SEC registrant, its domestic and foreign subsidiaries or affiliates. An adequate global warning system is important, as many public companies today have a significant portion of their operations outside the United States. Consequently, significant portions of the audit for many U.S. reporting companies are performed in foreign countries. Global firms must ensure that audits of all portions of U.S. reporting companies are performed under the requirements imposed on U.S. auditors.

Application to Firms with Alternative Firm Structures

We have additional concerns about the quality control systems in place at firms that are performing audits under alternative firm structures. Policies, procedures and quality controls must apply to each of the various types of alternative firm structures, such as accounting firm consolidators and firms that sell financial interests in their consulting subsidiaries.

Importance of a Timely Response to Profession's Independence Controls Deficiencies

Given the impact that the lack of independence can have on SEC registrants as well as public confidence in the integrity of financial reporting, we believe that the profession should respond to these concerns promptly and devote a level of attention and resources commensurate with the seriousness of the matters raised. Consequently, revised membership requirements incorporating the recommendations made in this letter should be adopted by March 31, 2000, with a complete transition and implementation to be completed no later than January 1, 2001. To ensure that such an undertaking satisfies both the needs of the profession and the public interest, the Commission staff suggests a meeting, as soon as possible, to discuss an appropriate approach.

If you have any questions regarding the matters raised in the letter, you may contact Scott Bayless, Robert Burns or the undersigned at (202) 942-4400.

Sincerely

Lynn E. Turner

Lynn E. Turner
Chief Accountant

cc: William Allen, Esq., Chairman
Independence Standards Board

David A. Costello, President and Chief Executive Officer
National Association of State Boards of Accountancy