

MEMORANDUM

May 24, 2000

TO: Chairman Levitt

FROM: Lynn Turner
Chief Accountant



This memorandum responds to the questions regarding auditor independence presented to you in the letter from Congressman Bliley, Chairman of the Committee on Commerce, Congressman Oxley, Chairman of the Subcommittee on Finance and Hazardous Materials, and Congressman Tauzin, Chairman of the Subcommittee on Telecommunications, Trade, and Consumer Protection. The questions reiterate the need for reconsideration of the Commission's auditor independence rules, as I highlighted in a speech in January and you discussed publicly in your speech of May 10.

Question 1: What empirical evidence, studies or economic analysis does the SEC possess that demonstrates accounting firms having consulting relationships with audit clients are less independent than those firms that do not have such relationships? Are there any specific administrative findings that have concluded the provision of consulting services resulted in a specific audit failure by the same firm?

Several private sector studies have focused on a growing public concern regarding the objectivity and independence of auditors, in light of the expansion in nonaudit services being performed by auditing firms for their audit clients. For instance, the September 1994 report, Strengthening the Professionalism of the Independent Auditor, by the Advisory Panel on Auditor Independence (the Kirk Panel) states that, "Growing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function ... and by seeing the audit function as necessary just to get the benefit of being considered objective and to serve as an entrée to sell other services."

The 1994 report, Improving Business Reporting--A Customer Focus: Meeting the Information Needs of Investors and Creditors, by the AICPA Special Committee on Financial Reporting (the Jenkins Committee) states that, "Users are concerned about current pressures on auditor independence. They believe the need to maintain a good business relationship with clients in a competitive audit environment could, over time, erode auditor independence Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship."

In addition, the 1999 study sponsored by the Independence Standards Board ("ISB"), by Earncliffe Research & Communications noted that, "Most [interviewees] felt that the evolution of accounting firms into multi-disciplinary business service

consultancies represents a challenge to the ability of auditors to maintain the reality and the perception of independence While some believe that perceptions of the independence of auditors is already suffering some corrosion, more people take the view that damage is inevitable in the future if greater precautions are not taken to protect the perception of independence.”

It is important to remember that when providing nonaudit services to a company, the auditor owes a duty to management. However, when performing the audit, the auditor has a duty to act in the best interest of the investors. Notwithstanding the studies, no one can know the underlying motivation for auditors' decisions during an audit. As the accounting profession's "Principles of Conduct – Objectivity and Independence" states: "Objectivity is a state of mind Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.”

Unlike certain foreign countries, such as the United Kingdom, nonaudit relationships between companies and the auditors of their financial statements are not publicly disclosed by US companies. This results in a lack of transparency for investors regarding nonaudit relationships (and a lack of empirical evidence of the kind requested by the Congressional letter). Auditor independence turns on the auditor's willingness and freedom to decide issues in investors' best interests, even when they may be against the financial interests of management of a client-company. The pressure on today's auditors to generate nonaudit fees suggests that they might be unduly lenient to management's point of view in interpreting accounting principles or in the performance of audit procedures. Investor concerns generally are less about direct causation of audit failures and more about whether auditors can exercise the judgment that is needed in the current high-pressure business environment. We must address these concerns.

More than 20 years ago, the self-regulatory supervisor of the accounting profession raised concerns about the potential effects of the growth of nonaudit services on the independence of auditors (“... there is potential danger to the public interest and to the profession in the unlimited expansion of [nonaudit services] to audit clients ...,” 1979 Public Oversight Board Report, Scope of Services by CPA Firms 56). For many years, nonaudit services produced a small portion of firms' revenues. However, in recent years, fees from non-audit services have increased dramatically. Since 1993, the largest firms' auditing revenues have been growing by 9% per year on average, while nonaudit services have been growing at a rate of 27% per year. Auditing today accounts for just 30% of the largest firms' total revenues, down from 70% in 1977.

The independence of public accountants who audit public companies' financial statements is crucial to the credibility of financial reporting and, in turn, the capital formation process. The auditors' objective independent look at registrants' financial statements provides confidence in the reliability of those statements and encourages investment in the securities of public issuers. As the Supreme Court said,

The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the

investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost. Id. at 819-20 n.15.

The Commission's auditor independence regulations are designed to foster investor confidence in the objectivity and reliability of financial information. The staff is continuing to consider the pressures on auditors and the effects on investor confidence as we respond to your request for a rulemaking regarding auditor independence.

Question 2: What empirical evidence, studies, or economic analysis does the SEC possess that demonstrates accounting firms providing tax advice to audit clients are less independent than those firms that do not provide such advice? Are there any specific administrative findings that have concluded the provision of tax advice resulted in a specific audit failure by the same firm?

For the reasons discussed in response to Question 1, independence concerns do arise when auditors receive contingent fees based on identification of tax savings to an audit client. As with other nonaudit services, these arrangements put pressure on the auditor's ability to be objective about the financial statements. However, the SEC staff has never challenged or questioned the effect on auditor independence of providing tax advice in connection with routine tax services, such as preparing tax returns for clients. The staff considers these tax services to be different from other non-audit services because (1) the calculation of a company's taxes are a necessary part of auditing the financial statements, (2) there are detailed tax laws and rules that must be consistently applied, and (3) the Internal Revenue Service has the discretion to audit any tax return.

Question 3: What are the investment restrictions to which employees of the SEC are subject? How are they different from restrictions placed on accountants? What is the rationale for those differences? Is there evidence that share ownership by SEC personnel compromises their independence or ability to discharge their duties in accordance with the public interest? What are the similarities in access to material non-public information shared with auditors and with the SEC staff reviewing statements filed with the Commission? Estimate the number of violations that would exist if the stock restrictions applicable to the accounting profession were to be applied to the SEC and its staff on January 2, 2000.

Securities transactions by the Commission and Commission employees are governed by Rule 5 of the Commission's Conduct Regulation, 17 C.F.R. § 200.735-5. Rule 5 also covers the securities transactions of an employee's spouse, his or her minor child, and other members of his or her immediate household. Rule 5 is designed to ensure public confidence that Commissioners and Commission employees are not benefiting personally from their access to information about securities and securities markets. In general, the rule prohibits the types of trading that offer realistic possibilities of significant abuse. For example, this rule prohibits Commissioners and employees holding a Senior Executive Service position in the Division of Investment Management or the Office of Compliance Inspections and Examinations from investing in non-diversified registered investment companies. In addition, securities purchased by any employee must be held for a minimum of six months. Also, a criminal statute (18 U.S.C. § 208) and the U.S. Office of Government Ethics, Standards of Ethical Conduct for Employees of the Executive Branch (5 C.F.R. § 2635.401-403) prohibit SEC employees from working on particular matters in which they, or persons whose interests are imputed to them, have financial interests that would raise questions regarding their impartiality. The interests of the following persons are imputed to the employee: the employee's spouse, minor children, and general partners; an organization or entity in which the employee serves as officer, director, trustee, general partner or employee; and a person with whom the employee is negotiating for or has an arrangement concerning prospective employment.

Unlike a company's auditors, the staff in the Commission's Division of Corporation Finance and Division of Investment Management who review registration statements does not generally have access to a company's material non-public information. The majority of disclosure documents become public at the same time they are filed with the Commission. A small percentage of disclosure documents are pre-filed with the Commission on a confidential basis. The staff sometimes receives additional non-public information in response to its inquiries raised in connection with specific disclosure or accounting issues.

The SEC staff's access to entities that the Commission directly regulates (e.g., broker-dealers) is perhaps most comparable to auditors' access to their audit clients. The staff conducts on-site inspections of regulated entities. For this reason, SEC employees are prohibited from investing in these regulated entities. In addition, as stated above, an SEC employee's spouse, his or her minor children, and other members of his or her immediate household are subject to the same restrictions.

We have no methodology or data with which to estimate the number of violations that would exist if the securities restrictions applicable to the accounting profession were applied to the SEC and its staff.

Question 4: You and members of the Commission staff have suggested a new regulatory oversight and disciplinary process for the accounting process be adopted. Is the SEC developing recommendations on this proposal? How would the SEC receive input on its

recommendations? Under what specific grant of statutory authority would the SEC propose to implement these recommendations?

The SEC staff has spoken informally to Public Oversight Board ("POB") members and to members of the accounting profession about the proper components and arrangement for a modernized self-regulatory structure. Any proposal on restructuring would be proposed and implemented by the POB, not the SEC.

The POB is a private sector body that was created in 1977 in response to concerns expressed by members of Congress about the effectiveness of the profession's self-regulatory system. See the POB's 1978-1979 Annual Report. Charles A. Bowsher is the Chairman of the POB. Mr. Bowsher was the Comptroller General of the United States from 1981 to 1996 and was a partner of Arthur Andersen from 1971 to 1981. Donald J. Kirk is the POB's Vice Chairman. Mr. Kirk was Chairman of the FASB from 1978 to 1986. He has also been a partner of Price Waterhouse and a professor at Columbia Business School. The other members of the POB are: Robert F. Froehlke, Melvin R. Laird and Paul H. O'Neill. Mr. Froehlke was President and CEO of IDS Mutual Fund Group from 1987 to 1993 and also served as Secretary of the Army. Mr. Laird was Counsellor to the President from 1973 to 1974, served as Secretary of Defense from 1969 to 1973, and served in the United States Congress for nine terms. Mr. O'Neill is chairman of Alcoa. He served as Alcoa's chairman and chief executive officer from June 1987 to May 1999. Prior to joining Alcoa, Mr. O'Neill was president of International Paper Company.

The POB is funded by the American Institute of Certified Public Accountants ("AICPA"), which is the largest national professional institute of CPAs. The POB is responsible for overseeing and reporting on the self-regulatory programs of the AICPA's SEC Practice Section. The POB also monitors and comments on matters that affect public confidence in the integrity of the audit process.

Despite dramatic changes in the accounting profession, there has been no comprehensive reevaluation of the self-regulatory process since it was initially established in the 1970s. A more efficient, timely and effective process would better serve the markets and the profession. The POB has developed a proposal for an enhanced regulatory oversight and review process for the profession.

An independent oversight body is vital to protecting the integrity of the accounting profession. We believe that a modernized self-regulatory organization should include representatives of the public interest, be independent of the accounting firms that it oversees, and have the ability to carry out its responsibilities in a timely and effective manner. We believe that a restructured POB, which would oversee auditing and independence as well as the peer-review process, is the best way of achieving these goals.

Indeed, in the wake of large-scale financial fraud cases such as BCCI and Barings, the accounting profession in the United Kingdom recently adopted a new self-regulatory structure that brings more public oversight into the process. As the major

firms in the UK are the same firms that operate in the US, some of the enhanced oversight elements of the UK system may be appropriate here. Our hope is that those firms would seek a restructuring with similar oversight goals to benefit US investors.

Question 5: We understand the SEC has expressed its views on the question of independence primarily in interpretive guidance or no action letters issued by the staff. Have the policies in this interpretive guidance ever been subject to rulemaking subject to notice and comment? Identify all guidance which was adopted by rulemaking and the date of consideration and adoption.

The Commission's requirements in the area of auditor independence are found in Commission rules, interpretations, staff letters, staff reports, and in ethics rulings by the accounting profession. Rule 2-01 of Regulation S-X sets forth the "Qualifications of accountants" practicing before the Commission and states that under certain conditions the Commission will not recognize an accountant as independent from its audit clients. Rule 2-01, which in its original form dates back to 1933, predates the Administrative Procedures Act. The most recent amendments to Rule 2-01, which were adopted in 1983, were subject to notice and comment.

Rule 2-01 states:

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of § 210.2-01(b), the term "member" means (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents,

subsidiaries, or other affiliates, and (iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

Rule 2-01 recognizes that determining whether accountants are independent requires consideration of the facts and circumstances of each case. As a result, the Commission has encouraged registrants and their auditors to bring questions to the staff. Periodically, the staff has issued interpretations of Rule 2-01, which represent the staff's responses to the situations presented.

Many of these auditor independence interpretations are reprinted in Section 600 of the Codification of Financial Reporting Policies, "Matters Relating to Independent Accountants." These interpretations include text from financial reporting releases that explain the background and provide interpretive guidance for disclosure rules that promote auditor independence. The Codification also contains fact-specific examples in order to provide guidance in similar situations.

You have asked the staff to consider which interpretations need to be updated. We have been examining what changes are needed. We expect to recommend that the Commission update many of the interpretations in the context of a rulemaking on auditor independence that will be subject to public notice and comment.

Question 6: Members of the SEC staff have publicly supported restricting the scope of services offered by accounting firms to audit clients beyond current restrictions such as the prohibition on audit firms acting in a management capacity for audit clients. Are such considerations currently under consideration by the SEC or the staff? How would the SEC receive input on and implement any such changes?

As discussed in the response to Question 1, rulemaking that addresses scope of services and other independence issues appears warranted. Indeed, the ISB's public members have stated that because the reform of the auditor independence area would involve major public policy choices, an SEC rulemaking is the proper method for addressing this issue. The Commission would receive input on rulemaking proposals during the comment period in accordance with the Administrative Procedures Act. Because of the significance of any such proposals, we would solicit input from a wide range and large number of interested parties.

Question 7: Under Section 3(f) of the Exchange Act and Section 2(b) of the Securities Act, the SEC is required to consider efficiency, competition, and capital formation when

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engaging in rulemaking under the public interest standard. The legislative history accompanying these provisions, as well as a plain reading of the statute, makes clear a thorough cost benefit analysis performed by the Office of the Chief Economist must be undertaken prior to any such rulemaking. Has the SEC commenced cost benefit analysis of proposed changes to limitations on the scope of services offered by accounting firms to audit clients? If so, what are the findings of this cost benefit analysis?

Under Section 3(f) of the Exchange Act and Section 2(b) of the Securities Act, whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission will consider these factors as it engages in rulemaking on auditor independence just as it does for all rulemakings that require such consideration.

The Commission generally includes cost-benefit analyses in any release containing proposed rules and solicits public comments on the analyses. The Commission's Office of Economic Analysis plays an important role in the development of the analysis in the release. The Commission also looks to public commentators during the rulemaking process to provide empirical data that may further and improve that analysis. The Commission generally provides a summary of the final analysis in the adopting release. We expect the Commission to follow this process in a rulemaking on auditor independence.

Question 8: Regulation S-X provides that the SEC "will not recognize any certified accountant or public accountant who is not in fact independent." Has the SEC defined the principles by which it determines that an accountant is not in fact independent?

As noted above in response to Question 5, Rule 2-01, together with the Codification, specifies the principles and criteria by which the Commission determines that an accountant is not independent.

Question 9: Does the fact that audit firms are compensated for their services create an "appearance of conflict" problem? If direct compensation does not create an unacceptable appearance of conflict issue, how are more attenuated relationships between an auditor and its clients, such as the ownership of shares in an audit client by a spouse, child or son or daughter-in-law of an audit partner determined to be unacceptable violations of independence?

The fact that audit firms are compensated for their services by the very companies that they audit does create a threshold "appearance of conflict" problem. As you may know, Congress nevertheless decided that firms should be compensated by their audit clients rather than through other methods that Congress considered, such as companies being required to use federal auditors and federal licensing of auditors (see, for example, Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong. 55-60 (1933)). Congress specifically added to the Securities Act and other

federal securities laws the requirement that registrants file financial statements that have been audited by "independent" public accountants, and authorized the Commission to define the term "independent." The Federal Trade Commission, prior to the formation of the SEC, adopted the first rule implementing the statutory requirement that auditors be independent. The SEC adopted that rule and issued interpretations to give content to that term. Although the compensation structure poses inherent conflicts for the client and its auditor, the SEC has been careful not to permit financial relationships between the audit firm, its members and their family members and the audit clients, which might create additional pressures on persons performing the audit. The staff is considering how to modernize the independence rules as they pertain to family relationships and investments.

Question 10: What is your view of the proper role of the SEC and its chief accountant regarding the Financial Accounting Standards Board's ("FASB") agenda? What is the proper role of the Commission and its Chief Accountant regarding FASB's deliberations on new GAAP rules? Please identify all non-public meetings between SEC personnel and members of the FASB or the FASB staff concerning recent proposals to change the accounting treatment of business combinations.

The Commission has the authority to set accounting standards and to define accounting terms. Practically since its creation, however, the Commission has relied on the private sector for leadership in setting accounting standards. The FASB is the current private-sector body designated by the accounting profession to set accounting standards. It is widely believed that this long-standing public-private sector relationship has led to the creation of the best accounting standards in the world, which in turn contribute to the best markets in the world.

To maintain its ability to rely on the private sector, the Commission must be assured that the FASB operates in the public interest. Accordingly, the Commission oversees the FASB and its standards-setting process. The Commission neither rubber stamps nor dictates the FASB's agenda or the substance of FASB standards. Rather, the SEC staff evaluates each project and proposed standard to make sure that the FASB's process is operating in an open, fair, and impartial manner, and that each standard adopted is within an acceptable range of alternatives that serve the public interest and protect investors. Our oversight includes: (i) monitoring FASB project developments; (ii) meeting with the FASB's staff to discuss FASB projects and other matters of mutual interest; (iii) selectively reviewing comment letters; and (iv) observing select open meetings and public hearings.

Once a standard is adopted, the SEC staff continues to consult with the FASB staff on implementation issues. Each year, the SEC staff reviews thousands of public company filings that contain audited financial statements. These reviews place the SEC staff in a unique position to report to the FASB on issues that arise in the implementation, interpretation, and enforcement of its standards.

The SEC staff also works with the FASB outside of the formal standards-setting process. Senior members of my Office and the Division of Corporation Finance are

observers to various FASB task forces. Members of the staff participate in quarterly meetings of the Financial Accounting Standards Advisory Council ("FASAC"). This group of leaders in business, accounting, and academia consults with the FASB on major policy and agenda issues.

The Commission meets periodically with the FASB in open meetings to discuss matters of mutual concern, including accounting for business combinations. Since 1996, when the business combinations project was added to the FASB's agenda, Commissioners and staff have had quarterly briefings where the FASB members and staff discussed the status of the business combination project and other projects. This project also has been discussed at quarterly FASAC meetings since June 1996. Members of my staff and I also discussed the issue at a meeting with FASB staff and FASB Board Member Gaylen Larsen in August 1998. These meetings were part of the SEC's oversight process.

Question 11: Identify all private sector committees, commissions, boards or other groups created at the request of the Commission or yourself during your tenure at the SEC. For each group, identify the method and criteria by which members of these boards were selected, including the role you played in selecting members. What is the legal status of each of these commissions or boards? What are the terms of existence of these boards and the terms of their constituent members?

Consistent with the Commission's traditional close working relationship with the business and investor communities, the private sector has been encouraged to take the lead on a variety of accounting issues. As you know, looking to the private sector for leadership on issues of concern to the investing public is efficient and effective. Four groups were formed in response to recent developments in the accounting and auditing areas. We provided input regarding some of the candidates for the groups.

The Blue Ribbon Panel on Improving the Effectiveness of Audit Committees was formed in response to a challenge to corporate America to address a number of troubling accounting practices. The number of financial reporting failures in recent years led to questions about whether audit committees were properly discharging their duties. You called for the role of audit committees in overseeing the financial reporting process to be strengthened. In response, the NASD and the NYSE sponsored the Blue Ribbon Committee, which was comprised of leaders of the financial, accounting, and legal communities. The members represented a wide variety of views and perspectives. The Committee completed its work upon the issuance of its report in February 1999, which included recommendations for improving the functioning of audit committees and improving disclosure about audit committees.

The Independence Standards Board represents another public-private sector partnership. The ISB was created within the AICPA in response to increasing concerns about independence issues in the accounting profession. Upon the creation of the ISB, the Commission issued a policy statement (Financial Reporting Release No. ("FRR") 50, February 18, 1998) stating that the Commission intends to look to the ISB to provide

leadership in improving current auditor independence requirements and in establishing and improving accounting principles. The ISB is composed of eight members, divided equally between public members and practicing certified public accountants.

In response to significant changes to the methodology in the way audits of public companies were being conducted, in 1998, the POB created the Panel on Audit Effectiveness, chaired by Shaun F. O'Malley, former Chairman of Price Waterhouse, LLP. The Panel committed to perform a comprehensive review of the methods used to audit financial statements and determine if the present model and recent changes serve the interest of investors. The Panel is continuing to perform its work.

In 1999, Professor Jeffrey Garten, Dean of Yale's School of Management, was asked to gather a group of leaders from the business community, academia, the accounting profession, standard-setting bodies, and corporate America to discuss whether our business reporting framework can more effectively capture the momentous changes in our economy.

We have not included data on groups outside of the accounting and auditing areas because the focus of the Congressional letter is on these areas.

Question 12: In what ways did the SEC seek to influence the actions of the NASD and the NYSE as they considered the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees? Did SEC officials meet with self-regulatory groups charged with reviewing the recommendations regarding listing qualifications?

As noted above, the NYSE and NASD sponsored the Blue Ribbon Committee. The NYSE, NASD, and AMEX each developed rule proposals to amend their listing standards in response to the recommendations of the Blue Ribbon Committee. In accordance with statutory and rule requirements, the NYSE, NASD, and AMEX filed with the Commission the proposed changes. The Commission issued the proposals for public comment. Some of the amendments proposed by the NYSE, NASD, and AMEX related to disclosures that public companies would need to provide in SEC-required disclosure documents. Accordingly, the SEC staff's views were sought as the proposals and final rules were being crafted, and SEC staff met with staff of the NYSE and NASD to discuss issues of mutual concern. The NYSE, NASD, and AMEX filed final amendments to the listing standards with the Commission, and the Commission (through its Division of Market Regulation) subsequently approved them.

Question 13: What is the status of SEC consideration of rules issued by the Independence Standards Board (ISB) last December relating to investments in mutual funds and related entities? Given the consideration of these rules would be made under a public interest standard, what specific criteria would the SEC use to reject a proposed ISB standard?

See combined response to Questions 13 and 14 after Question 14.

Question 14: The SEC Chief Accountant stated the SEC intends to move forward with proposals to modify independence rules. Is it the SEC's intention to make recommendations to the ISB for action, or to undertake action outside the ISB process?

This discussion responds to Questions 13 and 14. The ISB has long-range goals of reviewing and updating the independence requirements and of adopting a conceptual framework for the resolution of auditor independence issues. The ISB staff also answers day-to-day inquiries regarding the application of the Commission's auditor independence regulations to specific situations. In FRR 50, however, the Commission specifically stated that it was not abdicating its responsibilities in this area and that its existing authority regarding auditor independence is not affected.

ISB rules take effect automatically without Commission review, unless those rules conflict with Commission rules. As the Congressional letter points out, Independence Standards Board Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities" (Dec. 1999) raised an issue under SEC rules because it conflicts with the definition of "member" in Rule 2-01. We are considering revising the definition in Rule 2-01 to, among other things, resolve the conflict with the ISB standard. Moreover, the staff believes that the modernization of the Commission's rules could greatly assist the ISB in its work by clarifying the purpose, definition, and test for auditor independence under the federal securities laws.

Question 15: In the area of rules and guidance on auditor independence please indicate whether each of the following situations would be a violation of auditor independence. For those that are a violation, justify why the situation should be grounds for an independence violation:

- *A partner's spouse participates in an employer sponsored benefit plan that invests in securities issued by an audit client with which the partner has no direct contact or responsibility. The benefit plan is the only option offered to the spouse by the employer.*
- *A partner's spouse participates in an investment club that owns 100 shares of stock of an audit client of the firm's Detroit office. The partner works out of the Seattle office and has no involvement with the client. The investment is not material to either spouse.*
- *The son-in-law of a tax partner is the beneficiary of a blind trust that has a de minimis investment in an audit client of the firm's Boston office. The tax partner works out of the Atlanta office and has no involvement with the client.*
- *A partner has a brokerage account with a securities firm that is not audited by the accounting firm. Cash in the brokerage account is automatically swept into a mutual fund that is audited by the firm's New*

York office. The partner works out of the Denver office, provides no services to the mutual fund, and is unaware the mutual fund is a client.

- *The grandparents of a partner's children purchase a share of stock in an audit client and hold the share pursuant to the Uniform Gift to Minors Act. The partner has no control over the purchase or disposition of the stock and does no work for the client.*

For the following situations also indicate what alternatives the couples would have to come into compliance with the independence restrictions.

- *A partner's spouse is an executive at company A, and through the only reasonable employer benefit plan has holdings in the company. The partner works for a firm which audits company B, though neither the partner's office nor the partner perform any work for company B. Companies A and B merge and the spouse retains both holdings and employment. The holdings are material to the couple. The firm audits the merged company.*
- *The spouse of a partner works in a non-management capacity for a non-public company that is an audit client. The spouse has holdings in the company which are material to the couple. Neither the partner's office nor the partner perform any work for the company. The company goes public.*
- *A manager's spouse is promoted to CFO of an audit client company. Neither the manager's office nor the manager perform any work for the company. The manager is promoted to partner.*
- *A partner's spouse works for a company as a non-management employee and participates in the stock option and 401(k) program. Neither the partner's office nor the partner perform work for the company. Due to fluctuations in stock price, the value of stock in the company represents 5.1% of the couples net worth on particular days.*

See combined response to Questions 15 and 16 after Question 16.

Question 16: Accounting independence prohibitions were drafted at a time when few women worked outside of the home. Given the prevalence of women in the workforce, both as accounting partners and as workers, managers or executives in public companies, does the SEC agree current independence restrictions are outdated and in need of modernization? Do the restrictions as they stand discourage wives and daughters from participating in the workforce?

As you stated in your May 10 speech at New York University, "We . . . need to reform those rules that unfairly impose burdens on dual-career families without a commensurate benefit to the investing public." Questions 15 and 16 raise the important issue of whether our rules and the AICPA's rules have an unduly negative affect on

women and two-career families. We are sensitive to this issue, and, of course, would not want any Commission rule to impede unnecessarily any person's access to the best job opportunities available. The hypotheticals illustrate why the staff is considering revising and updating the SEC's auditor independence rules, and why the accounting profession, in conjunction with the ISB, is considering updating its own rules.

In seeking to provide a reasonable balance between those who may and those who may not be able to influence the audit process for a particular client, we are considering whether to exclude certain persons from the scope of the independence restrictions. As we consider these issues, we are mindful of the important public policy interests these questions raise. We will seek to create a balance between our interest in protecting investors' confidence in the public markets and in freedom to work and invest for accountants and their families.