

## **SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 210 and 211**

**[Release Nos. 33-7993; 34-44557; IC-25066; FR-50A]**

### **Commission Policy Statement on the Establishment and Improvement of Standards Related to Auditor Independence**

**AGENCY:** Securities and Exchange Commission

**ACTION:** Policy statement

**SUMMARY:** The Securities and Exchange Commission (“SEC” or “Commission”) today amended Financial Reporting Release No. 50 (“FRR 50”) to state that it will no longer look to the Independence Standards Board (“ISB” or “Board”) for leadership in establishing and improving auditor independence standards applicable to auditors of the financial statements of Commission registrants. The deliberations and conclusions of the ISB contributed significantly to the development of the Commission’s new auditor independence regulations and disclosure requirements, which were adopted in November 2000. In light of the Commission’s new auditor independence rules, the Commission believes that many of the issues that led to the creation of the ISB have been resolved, and that going forward the best method to assure the independence of auditors is for the Commission and its staff to enforce and interpret its new rules. In addition, the Commission notes the recent increase in public participation on the American Institute of Certified Public Accountants’ (“AICPA”) Professional Ethics Executive Committee (“PEEC”) and encourages greater public membership on PEEC. The Commission staff, when appropriate, may work with the PEEC on discrete auditor independence issues. Standards previously adopted by the ISB and interpretations previously issued by the ISB

will continue to be authoritative to the extent they do not conflict with the Commission's rules and interpretations. In making this amendment to FRR 50, the Commission reaffirms that maintaining the independence of auditors is crucial to the credibility of financial reporting and, in turn, the capital formation process.

**EFFECTIVE DATE:** [Insert date 30 days after publication in the Federal Register]

**FOR FURTHER INFORMATION CONTACT:** John M. Morrissey, Deputy Chief Accountant, or Samuel L. Burke, Associate Chief Accountant, Office of the Chief Accountant, at (202) 942-4400, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-1103.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The Federal securities laws reflect the importance of independent audits in protecting investors by requiring, or permitting the Commission to require, that financial statements filed with the Commission by public companies, investment companies, broker/dealers, public utilities, investment advisers, and others, be certified (or audited) by independent public accountants,<sup>1</sup> and by granting the Commission the authority to define the term "independent."<sup>2</sup>

Since the Commission's creation in 1934, it consistently has emphasized the need for auditors to remain independent. The Commission's requirements are set forth in Rule 2-01 of Regulation S-X<sup>3</sup> and in the interpretations, guidelines and examples that are collected in Section 600 of the Codification of Financial Reporting Policies ("Codification") entitled "Matters Relating to Independent Accountants."<sup>4</sup> The Commission also makes publicly available the staff's written responses to requests for

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<sup>1</sup> For example, items 25 and 26 of Schedule A to the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. 77aa(25) and (26), and 17(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m, 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79e(b), 79j, and 79n, 8(b)(5) and 30(e) of the Investment Company Act of 1940, 15 U.S.C. 80a-8 and 80a-29, and 203(c)(1)(D) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. In accordance with these provisions, the Commission has required that independent accountants audit certain financial statements. See, e.g., Article 3 of Regulation S-X, 17 CFR 210.3-01 et seq.

<sup>2</sup> Section 19(a) of the 1933 Act, 15 U.S.C. 77s(a), 3(b) of the Exchange Act, 15 U.S.C. 78c(b), §20(a) of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79t(a), and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act.

<sup>3</sup> 17 CFR 210.2-01 (2000).

<sup>4</sup> Financial Reporting Codification, Section 600, "Matters Relating to Independent Accountants," reprinted in SEC Accounting Rules (CCH) ¶3,851, at 3,781.

informal advice on its independence requirements.<sup>5</sup>

For approximately 60 years, the Commission developed and maintained its own auditor independence requirements.<sup>6</sup> In 1997, after several months of discussions with representatives of the accounting profession, the Commission determined that it would look to the ISB, a private sector body composed equally of members from the accounting profession and from the public, to take a leadership role in establishing and maintaining auditor independence standards. In FRR 50,<sup>7</sup> issued February 18, 1998, the Commission announced its endorsement of the ISB. In doing so, however, the Commission stated that it was not abdicating its authority to modify or supplement ISB standards, to bring enforcement actions, or to take such other action as it may deem appropriate. In addition, FRR 50 noted that before any ISB standard or interpretation that conflicted with an SEC rule or interpretation could take effect, the SEC would have to amend its regulations to remove the conflict. Because of the experimental nature of the ISB, the Commission also stated in FRR 50 that it would review the operations of the ISB as necessary or appropriate and evaluate, within five years, whether the framework of the ISB was serving the public interest and protecting investors.<sup>8</sup>

During its tenure, the ISB deliberated and provided guidance on several important auditor independence issues, including the need for communications on auditor

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<sup>5</sup> See FRR 33 (November 25, 1988) and FRR 4 (October 14, 1982). See also, Office of the Chief Accountant, "Application of Revised Rules on Auditor Independence – Frequently Asked Questions" (January 16, 2001), which is available on the Commission's web site: [www.sec.gov](http://www.sec.gov).

<sup>6</sup> See generally, Office of the Chief Accountant, "Staff Report on Auditor Independence" (March 1994).

<sup>7</sup> Release Nos. 33-7507, 34-39676, IC-23029, FR-50 (February 18, 1998).

<sup>8</sup> *Id.*

independence issues among auditors, management, and audit committees,<sup>9</sup> and the impact on an auditor's independence of investments in mutual funds<sup>10</sup> and the retention by an audit client of a professional who formerly worked for the accounting firm.<sup>11</sup> The ISB members brought extensive and diverse business and professional experiences to the Board, and their discussions of these and other issues contributed significantly to the formulation of the Commission's new rules.<sup>12</sup>

In late 1999, the ISB members faced significant issues regarding the evolving alternative business structures being used by accounting firms and the nature and scope of non-audit services that the firms could perform for an audit client before they would be deemed to lack auditor independence. The public members of the ISB recognized that these were significant public policy issues that required input from a wider and more diverse audience than the ISB had been able to attract. These members, therefore, asked the Commission to assume this project.

The public ISB members' vision of the public interest in these issues was indeed correct. The Commission's rulemaking project generated approximately 3,000 comment letters and four days of public hearings in which the Commission heard directly the

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<sup>9</sup> Independence Standards Board, Independence Standard No. 1, "Independence Discussions with Audit Committees" (January 1999) ("ISB No. 1").

<sup>10</sup> Independence Standards Board, Independence Standard No. 2, "Certain Independence Implications of Audits of Mutual Funds and Related Entities" (December 1999) ("ISB No. 2").

<sup>11</sup> Independence Standards Board, Independence Standard No. 3, "Employment with Audit Clients" (July 2000) ("ISB No. 3").

<sup>12</sup> See generally "Revision of the Commission's Auditor Independence Requirements," Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56 (Nov. 21, 2000).

testimony of about 100 investors, accountants, lawyers, audit committee members, regulators, professional associations, and other witnesses.<sup>13</sup>

Although the Commission's rulemaking completely revised the Commission's auditor independence regulation, significant portions of the rule were built upon the foundation of the ISB's deliberations, draft documents, and standards. Upon completion of the Commission's rulemaking, it had addressed the vast majority of issues that had led to the creation of the ISB.

Following the Commission's rulemaking, the AICPA has begun a project to amend the ethics and independence rules established by its PEEC<sup>14</sup> to conform in several respects to the Commission's new rules.<sup>15</sup> Reducing the discrepancies between the Commission's and the profession's auditor independence regulations should reduce the confusion associated with having diverse standards and encourage compliance.

The AICPA Board of Directors and membership also voted to have public members (as opposed to members from the profession) comprise twenty-five percent of the PEEC membership, and to study whether additional public membership would be appropriate. The Commission believes that increased public participation on PEEC is essential to the credibility of the AICPA's independence and disciplinary processes and is

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<sup>13</sup> The Commission's proposing and adopting releases, comment letters submitted electronically, and copies of the testimony at the Commission's public hearings are available at the Commission's web site: [www.sec.gov](http://www.sec.gov).

<sup>14</sup> Among other things, PEEC develops the AICPA's standards of ethics and independence, promotes understanding and voluntary compliance with such standards, establishes and presents charges of violations of the standards to the Joint Trial Board for disciplinary action, and works to improve the profession's enforcement procedures.

<sup>15</sup> *See* AICPA, "Omnibus AICPA Proposal of Professional Ethics Division Interpretations and Rulings" (April 16, 2001).

hopeful that the AICPA Board will decide to further increase public participation on PEEC to achieve equivalent public and private representation.<sup>16</sup>

## II. Amendment of Financial Reporting Release No. 50

After careful consideration, the Commission amends section II of FRR 50 in that the Commission no longer will look to the ISB to provide leadership in establishing, improving, or maintaining auditor independence standards applicable to the auditors of Commission registrants, and will not consider ISB principles, standards, interpretations, and practices established or issued after the date of this amendment as having substantial authoritative support for the resolution of auditor independence issues.

The Commission's new rules address many of the issues that led to the creation of the ISB. The ISB's remaining agenda may not be sufficient either to attract to the ISB the same exceptionally high caliber of individuals as those who served on the Board for the past four years or to justify the cost to the profession of maintaining the ISB. In light of the AICPA's increase in public representation on the PEEC and the AICPA's continuing study of whether additional public membership on PEEC would be

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<sup>16</sup> Other countries have mandated public participation on such committees. For example, in the United Kingdom the Department of Trade and Industry, with the support of the accounting profession, has instituted a new regulatory framework for the accountancy profession that includes a new Ethics Standards Board. Under that framework, at least sixty percent of the Ethics Standards Board is to be independent from the profession – that is, not themselves subject to the disciplinary procedures of the accountancy bodies. Further, members of the profession have indicated their support for increased public participation on the PEEC. See Arthur Andersen press release dated November 15, 2000, "... With respect to the profession's self-regulation, we believe that public participation is positive and beneficial. We support efforts to continue to expand such public participation. To that end, we will work hard to achieve equivalent public and profession participation on the AICPA's Profession Ethics Executive Committee." See Deloitte & Touche statement dated November 15, 2000, "... We believe that the recent addition by the AICPA of public members to the PEEC is an appropriate and positive step toward enhancement of the profession's governance process. We support continued review of the benefits of further expanding public membership in the profession's Ethics Committee." See Joint statement issued by the AICPA, Arthur Andersen, LLP, Deloitte & Touche, LLP and KPMG, LLP, "... We believe that substantially increased public participation on the PEEC would be both appropriate and beneficial...".

appropriate, the Commission believes that, going forward and where appropriate, working with the PEEC on discrete issues provides an appropriate means to include the private sector in the process of maintaining and improving auditor independence requirements.

### **III. Continuing Authority of ISB Standards and Interpretations**

The Commission will continue to consider ISB Standard Nos. 1, 2, and 3, and ISB Interpretations 00-1, 00-2, and 99-1, to have substantial authoritative support for the resolution of auditor independence issues.<sup>17</sup> In FRR 50, the Commission encouraged registrants and auditors to ask the ISB staff for assistance in interpreting the existing auditor independence regulations. FRR 50 stated, however, that, unless or until ratified by the ISB, positions issued by the ISB staff would not be considered to be authoritative with respect to anyone other than the particular party requesting the interpretation.<sup>18</sup> Accordingly, the Commission will continue to view positions issued by the ISB staff to a particular party before the effective date of this amendment to be authoritative, but only as to the party that requested the interpretation. Of course, compliance with ISB pronouncements does not relieve registrants and accounting firms from also having to comply with the Commission's auditor independence requirements.

### **IV. Regulatory Requirements**

This general policy statement is not an agency rule requiring notice of proposed rulemaking, opportunities for public participation, or prior publication under the

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<sup>17</sup> See also "Revision of the Commission's Auditor Independence Requirements" Release. Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56 (Nov. 21, 2000) at n. 168 (discussing the Commission's interpretation of ISB Standard No. 1).

<sup>18</sup> FRR 50 at n.11.



provisions of the Administrative Procedure Act (“APA”).<sup>19</sup> Similarly, the provisions of the Regulatory Flexibility Act,<sup>20</sup> which apply only when notice and comment are required by the APA or another statute, are not applicable. For the reasons explained above the Commission believes that this statement of policy is in the public interest, considering the protection of investors and the promotion of efficiency, competition, and capital formation and provides a sound basis for the Commission to make significant contributions to meeting the needs of investors and capital markets.

**V. Codification Update**

The “Codification of Financial Reporting Policies” announced in Financial Reporting Release No. 1 (April 15, 1982) is amended as follows:

Delete the current text in Section 601.04, which appears under the caption “Statement of Policy on the Establishment and Improvement of Standards Related to Auditor Independence,” and replace it with the text in sections I, II, and III of this release.

The Codification is a separate publication of the Commission. It will not be published in the Federal Register/Code of Federal Regulations.

By the Commission.

Jonathan G. Katz  
Secretary

July 17, 2001

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<sup>19</sup> 5 U.S.C. 553.

<sup>20</sup> 5 U.S.C. 601-602.