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

THE CHAIRMAN

February 10, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
Room 2322
Rayburn House Office Building
Washington, DC 20515-6115

Dear Congressman Dingell:

Thank you for your letter concerning the independent consultant's report of PricewaterhouseCoopers LLP's violations of auditor independence regulations. As you know, I share your concerns about the importance of safeguarding the independence and objectivity of the accounting profession.

The enclosed memorandum from Lynn Turner, the Commission's Chief Accountant, describes many of the steps we have taken, and those that are underway, to ensure the continued objectivity of public company financial statement audits. As noted in Mr. Turner's memorandum, because the independence of auditors is critical to maintaining investors' confidence in our markets, the Commission has addressed auditor independence issues through our rulemaking, enforcement, and oversight programs.

As the accounting profession continues to evolve in response to market dynamics and competitive forces, I assure you that the Commission plans to remain actively involved in safeguarding the public interest in the integrity of the audit function. We have engaged and will continue to engage the leaders of the profession and its oversight programs in a dialogue to ensure that these core principles are not sacrificed.

I look forward to continuing to work with you on these and other important issues.

Sincerely,

Arthur Levitt

Enclosure

MEMORANDUM

January 19, 2000

TO: Chairman Levitt

FROM: Lynn E. Turner
Chief Accountant

RE: Auditor Independence Initiatives

This memorandum responds to correspondence from Congressman John D. Dingell regarding the independent consultant's report of violations by PricewaterhouseCoopers LLP of the Commission's, the profession's, and the firm's auditor independence regulations. In Congressman Dingell's letter, he asks what the Commission and the Independence Standards Board ("ISB") are doing to address auditor independence issues.

As you know, the Commission has taken several steps, and more efforts are underway, to gain added assurances that firms are complying with existing independence regulations. The Commission has brought and continues to pursue enforcement and disciplinary actions and has engaged in rulemaking to increase disclosure of Board activities in this area. In addition, the staff is encouraging improvements in self-regulatory programs, seeking better educational programs related to auditor independence and, through our oversight of the ISB, continuing to seek improvements in existing regulations.

Practically since its inception, the Commission has viewed the independence of auditors as crucial to the credibility of financial reporting and, in turn, the capital formation process. Investors in an impersonal securities market must depend on auditors to assess whether the financial information provided by public companies is comprehensive and reliable. The public's sense of confidence in "the numbers" depends in large part on reasonable investors perceiving auditors to be independent professionals who have neither mutual nor conflicting interests with their audit clients and who exercise objective and impartial judgment on all issues brought to their attention.

Enforcement

Because of this belief in the importance of independence issues, the Commission has not hesitated to bring enforcement and disciplinary actions when warranted. On January 14, 1999, the Commission, in an investigation that remains ongoing, censured PwC for violations of the auditor independence rules and improper professional conduct. Pursuant to the settlement reached with the Commission, PwC agreed to, among other things, complete an internal review supervised by an independent consultant appointed by the Commission. Congressman Dingell's letter refers to the findings in the consultant's report.

The internal review conducted by PwC has revealed the most serious concentration of violations of the independence regulations to date, but it is not the only enforcement action the Commission has taken in this area. For example, the Commission recently brought an action against an auditing firm whose independence from an SEC audit client was impaired because the firm, among other things, provided legal services to the client and a partner in the firm, acting as trustee over investments by family members of a person affiliated with the client, invested trust funds in client-issued securities. The Commission also has initiated actions in cases where the client had loaned funds to the auditor, where an affiliate of the firm had assumed management of the client, and where the auditor owned client securities. The staff will continue to recommend appropriate actions against firms and individuals who violate established auditor independence regulations.

Professional Oversight

In November 1998, I wrote to the SEC Practice Section ("SECPS") of the American Institute of Certified Public Accountants' Division for CPA Firms and encouraged the SECPS and its member firms to reassess whether the quality controls and training programs of firms were adequate to ensure compliance with auditor independence requirements. A copy of my letter is attached. In response, the SECPS upgraded its membership requirements in the area of auditor independence. In the correspondence noted below, however, the staff indicated that the new requirements essentially embodied procedures that many firms already were following and that additional action was necessary.

When the severity of the independence violations at PwC became apparent, I wrote to the Public Oversight Board ("POB") and, again, to the SECPS. These letters stated my disappointment that PwC's quality controls and the profession's self-evaluative programs had not uncovered and addressed these violations, and questioned whether similar violations might be occurring at other firms.

In my letter to the SECPS, I again expressed concern that SECPS member firms may not have sufficient worldwide quality controls to assure compliance with auditor independence regulations. I stated that prompt action is necessary to identify and remedy deficiencies in existing controls, and noted that a failure to do so could undermine public confidence in the current self-regulatory process. In addition, to guide the SECPS in its standard-setting efforts, my letter outlined the basic elements that should be incorporated into a firm's system of quality controls in order to assure that the firm maintains its independence from SEC audit clients. I subsequently met with representatives of the SECPS to discuss my letter and their ongoing standards setting projects in this area. The letter to the SECPS is attached for your information.

In my letter to the POB, I asked the POB to oversee the actions of the SECPS in the development, installation, and operation of new quality control systems. In addition, I urged the POB to undertake promptly a review of the adequacy of its peer review process as it relates to the testing of firms' compliance with auditor independence regulations. I also strongly recommended that the POB undertake a special review of current compliance with SEC and professional independence regulations by individual SECPS member firms. We have been encouraged by the POB's prompt commitment to perform these reviews. The findings and recommendations arising from these reviews should result in a comprehensive assessment of existing deficiencies both in firms' quality controls and in the peer review process, and lead to appropriate corrective action. My letter to the POB and the POB's response, in which the POB undertakes to perform the requested special reviews, also are attached for your information.

Rulemaking on Audit Committees

The Commission is not relying solely on the accounting profession to evaluate auditor independence issues. In a recent rulemaking initiative, the Commission laid the foundation for audit committees of public companies to be active participants in evaluating the independence of the auditors of their companies' financial statements. As you may recall, the ISB adopted a standard, effective July 15, 1999, that requires auditors to (1) provide each client's audit committee with a letter disclosing certain relationships and services that, in the auditor's judgment, may reasonably be thought to bear on independence, (2) confirm in that letter the firm's independence from the client, and (3) discuss the auditor's independence with the audit committee. In its recent rulemaking on audit committee disclosures, the Commission complemented this ISB standard by requiring that each audit committee disclose, among other things, whether it has received this letter from the auditor and discussed with the auditor the auditor's independence. Taken together, the ISB standard and the Commission's audit committee disclosure requirement should bring independence issues to audit committees' attention and stimulate their participation in identifying and resolving independence issues.

Education and Research

To facilitate audit committees' and other interested parties' understanding of the principles and rules related to auditor independence, the Commission ordered PwC to comply with an undertaking to establish a $2.5 million fund that is being used to develop educational programs and to conduct additional research in this area. The funds were placed in a separate account soon after the Order was issued in January 1999, with all interest earned on those funds going into the fund. The use of these funds and the development of the educational programs are being overseen by a panel consisting of a former Commission Chief Accountant, a former Chief Accountant for the Commission's Division of Enforcement (who currently is a Professor Emeritus of Accounting at the University of Virginia) and a former Academic Fellow in the Office of the Chief Accountant (who is a Professor of Accounting at Grand Valley State University in Grand Rapids, Michigan). We are encouraged by the plans for the educational program and expect that part of this program will be a high quality, interactive computer program that will allow businesspersons, accountants, lawyers, and others with an interest in the field to obtain a working knowledge of basic independence principles.

Independence Standards Board

Finally, we are continuing to work with the ISB on appropriate revisions of existing auditor independence regulations. While many of the existing rules reflect basic concepts that continue to provide sound guidance for the profession, other rules were written to apply in a business environment that may no longer exist. One of the ISB's primary tasks is to review, update, and instill a consistent logical approach to auditor independence regulations so that they may be readily applied by practicing auditors.

In January 1999, I referred several issues to the ISB as possible topics for the ISB's agenda. A copy of the referral letter is attached. As a result, the ISB is currently studying several issues, such as the potential impact on a firm's independence caused by its business structure, the provision of legal services to an audit client, and family relationships among individuals in the auditing firm and in the audit client. ISB task forces are examining these and other issues and, in some cases, public comments have been requested in response to discussion memoranda that identify possible threats to an auditor's independence and ways to address those threats. The ISB also has adopted a standard that provides guidance to auditors of mutual funds. Because this guidance conflicts with existing SEC regulations, it will not be effective unless or until the Commission removes or modifies its regulations. The Commission, however, will do so only if it finds that the new ISB standard serves the public interest.

Panel on Audit Effectiveness

As an area of added interest, the POB, at the SEC's request, recently formed a Panel on Audit Effectiveness. The charge to this Panel is to conduct a "top-to-bottom" review of how audits are conducted and to recommend improvements in the current audit process. Members of the Panel include Dennis H. Chookaszian, former Chair and CEO of CNA Insurance Companies; Paul Kolton, former Chairman and CEO of the American Stock Exchange; Bevis Longstreth, Counsel to Debevoise & Plimpton and former SEC Commissioner; Louis Lowenstein, Professor Emeritus of Finance and Law at Columbia University; Zoe-Vonna Palmrose, Auditing Professor at the University of Southern California; Aulana Peters, Partner at Gibson, Dunn & Crutcher and former SEC Commissioner; and Ralph Saul, former President of the American Stock Exchange and CEO of CIGNA Corporation. The Panel is chaired by Shaun F. O'Malley, former Chairman of Price Waterhouse LLP.

Auditor independence has become a prominent topic in the Panel's deliberations. We look forward to receiving the Panel's recommendations and, as appropriate, considering any suggested changes to the auditor independence regulations or to the process by which those regulations are established.

Conclusion

The initiatives to address auditor independence span the Commission's enforcement, rulemaking, and oversight programs. The staff continues to give this area high priority and to devote valuable staff resources to promote the concept of auditor independence, enforce adherence to existing rules, and oversee efforts to revise appropriately the independence regulations.

The staff would be pleased to answer any questions that Congressman Dingell or his staff may have in this area or to provide further information. I may be contacted at (202) 942-4422.

Attachments

A - Letter dated November 30, 1998 from Lynn E. Turner, Chief Accountant, to Michael Conway, Chairman, SEC Practice Section Executive Committee.

B - Letter dated December 9, 1999 from Lynn E. Turner, Chief Accountant, to Michael Conway, Chairman, SEC Practice Section Executive Committee.

C - Letter dated December 9, 1999 from Lynn E. Turner, Chief Accountant, to Charles A. Bowsher, Chairman, Public Oversight Board.

D - Letter dated December 21, 1999 from Charles A. Bowsher, Chair, to Lynn Turner, Chief Accountant.

E - Letter dated January 7, 1999 from Lynn Turner, Chief Accountant, to William T. Allen, Chairman, Independence Standards Board.

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

OFFICE OF
THE CHIEF ACCOUNTANT

November 30, 1998

Michael A. Conway
Chair
SEC Practice Section
c/o KPMG Peat Marwick LLP
55 E. 52nd St., Suite 3200
New York, New York 10055

Dear Mr. Conway:

In the last ten years there has been significant growth of accounting firms in areas of business other than traditional auditing services. In connection with that growth, firms have hired increasing numbers of persons who have not typically received the extensive formal training in auditing and ethics required to become certified public accountants. In addition, it is noteworthy that quality control systems required by the profession and implemented by firms were designed many years ago to address the requirements of firms predominantly made up of certified public accountants.

In light of these changes in the public accounting and auditing firms, questions have arisen as to whether firms' quality control systems adequately ensure the independence of members thereby ensuring the integrity and objectivity of today's audits. For example, in discussions I have had with members of the profession, we have discussed whether current training programs need to be changed and whether the current annual independence confirmation process is adequate.

My concern is elevated by the fact that the staff is encountering an increasing number of instances in which accounting firm's quality control systems have not been sufficient to identify and preclude significant independence problems from arising. The staff is seeing problems in areas as basic as ownership of stock in audit clients and in areas which necessitate more careful guidance on a firm wide basis such as providing valuation services or other areas where the auditor is auditing one's own work. It is disconcerting that these matters often arise when a company has filed a registration statement to sell securities and the company is then faced with the potential for having financial statements re-audited in order to resolve the matter.

Additionally, the staff has noted an increase in the number of auditor independence problems that have begun to surface in connection with audit reports included in filings with the Commission by foreign filers. As you may be aware, in recent years there has been a significant increase in the number of foreign companies registering securities for sale ("registrants") in the United States. The increase in foreign registrants inevitably necessitates the increased involvement of foreign auditing affiliates of major U.S. accounting firms.

Foreign affiliates of U.S. audit firms also provide a wide array of non-audit services. Members of these foreign affiliates may not be familiar with U.S. auditor independence requirements. For example, they may not be aware of prohibitions on reports to their audit clients of "valuations of contributions in kind," on the "fairness of exchange ratios in a business combination," and on providing legal advice. In order to provide these services, firms have hired large numbers of non-audit personnel who lack formal education in auditing and auditor independence and, thus, are unfamiliar with the independence requirements in general and the SEC independence requirements in particular.

The staff is concerned that the quality controls of firms with international affiliates may not be adequate to assure that foreign affiliated firms are independent from their audit clients that file audited financial statements with the SEC. It is important to note that the SEC does not accept compliance with foreign independence rules in lieu of or as a substitute for the SEC's independence rules and regulations.

Maintaining investor confidence in the independence of auditors is very important to our capital markets. Accordingly, in view of the aforementioned concerns, I am recommending that the SECPS and its respective members reassess whether the quality controls and training programs of firms and their affiliates that practice before the SEC are adequate to ensure compliance with the independence requirements set forth in the Securities Acts and the Commission's rules and regulations. I am available to discuss this matter with you at your convenience.

Sincerely,

Lynn Turner

Lynn Turner
Chief Accountant

cc: Robert Grafton, Arthur Andersen LLP
J. Michael Cook, Deloitte & Touche LLP
Philip A. Laskawy, Ernst & Young LLP
Stephen G. Butler, KPMG Peat Marwick LLP
James J. Schiro, PricewaterhouseCoopers LLP
William T. Allen, Independence Standards Board
A. A. Sommer, Jr., Public Oversight Board

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

OFFICE OF
THE CHIEF ACCOUNTANT

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

December 9, 1999

Charles A. Bowsher
Chairman
Public Oversight Board
One Station Place
Stamford, CT 06902

Dear Mr. Bowsher:

I am writing to inform you of my views on the recent actions of the SEC Practice Section ("SECPS") to upgrade its membership requirements in an effort to better safeguard the independence of audit firms as to their publicly reporting audit clients and to urge the Public Oversight Board ("POB") to take prompt and tangible steps to further safeguard the public interest.

As you may be aware, nearly a year ago, the SEC staff 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 from audit clients under the applicable Commission and professional rules. Since that time, the SEC staff has identified additional, troubling examples that suggest not only a lack of sufficient global safeguards, but also a systematic failure by professionals within certain firms to adhere to even their own firm's existing controls.

Please find attached a letter that I have sent to the SECPS expressing the SEC staff's belief that, while the new membership requirements are an improvement and initial step in the right direction, prompt additional action is needed both to evaluate the nature and the extent of the existing deficiencies in internal controls and oversight on a profession-wide basis, and to develop a more comprehensive remedial solution. In that letter, I expressed the SEC staff's belief that failure by the SECPS to take action quickly could seriously undermine public confidence in the current self-regulatory process and its dependence on internal controls of member firms and external peer review.

In view of the importance of these matters to the investing public, I am asking that the POB oversee the actions of the SECPS in responding to these concerns and the installation and operation of the systems discussed in the attached letter.

The Need for an Intensive Profession-Wide Evaluation of Independence Compliance

We also urge the POB to undertake promptly a review of the adequacy of its peer review process as it relates to testing of compliance with the Commission's and profession's independence requirements and quality controls. This testing needs to be rigorous and should test the design and effectiveness of internal controls, including testing of compliance by individual professionals with those controls.

We are concerned, for example, that the most recent letter of public comment issued in connection with the peer review of Coopers & Lybrand stated, "*[t]he Firm has extensive, appropriate policies regarding independence* (emphasis added). However, we noted several instances of noncompliance with respect to notifying an office's professional personnel of new clients of the office before work begins. The notifications subsequently were made, and no instances were noted where the Firm was not independent."

The Commission's January 1999 Order involving PricewaterhouseCoopers (AAER No. 1098), together with the observations of the peer reviewer noted above and several other instances of violations of auditor independence rules by other firms indicate that the peer review process as it relates to testing of controls over compliance with independence matters is inadequate or is not working properly. The compliance tests of peer reviews currently underway or about to be undertaken should be adjusted accordingly.

Finally, and most importantly, in light of these developments and in order to promote public and regulatory confidence in the profession's reliance on peer review and internal controls, we *strongly* recommend that the POB undertake a *special review* of SECPS member firms' current compliance with SEC and profession independence rules. The independence, integrity, and objectivity of the auditor are fundamental to maintaining the credibility of the profession and the special role it plays in the capital markets.

The staff believes that this broader study is warranted to ensure that the existing independence rules of the profession and the SEC are, in fact, being complied with. The findings and recommendations arising from such an investigation will hopefully result in a comprehensive assessment of any existing deficiencies of profession-wide internal controls and peer review thus leading to appropriate corrective action. Of course, as you consider how to implement such a review, we would suggest that representatives of the POB and the Commission staff meet soon to ensure that this endeavor results in the highest level of public confidence.

If you have any questions regarding the matters raised in the letter or wish to arrange a meeting, 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

Burns

POB
PUBLIC OVERSIGHT BOARD
One Station Place (203) 353-5300
Stamford, CT 06902 Fax (203) 353-5311

December 21, 1999

Mr. Lynn Turner
Chief Accountant
Securities and Exchange Commission
Judiciary Plaza
450 Fifth Street, N.W.
Washington, DC 20549

Dear Lynn:

I am writing in response to your letter dated December 9, 1999 that urges the Public Oversight Board to undertake several initiatives during the year 2000 relating to the SEC Practice Section (the "Section") and its member firms. We understand that the objectives of these initiatives are (a) to oversee the development of membership rules requiring member firms to strengthen quality control systems to further enhance and protect the independence of independent auditors, (b) to oversee firms' implementation of the strengthened systems, (c) to conduct a comprehensive special review of member firms' compliance with independence requirements of the profession, and (d) to review the adequacy of the peer review process as it relates to independence requirements.

Soon after the Christmas holidays, we will develop a work program, and identify the legal and auditing resources necessary to undertake the initiatives identified above. In developing our program we expect to meet with the Commission's staff to ensure that our program meets the Commission's objectives identified in your letter to Michael A. Conway, Chair of the Section, dated December 9, 1999.

In this regard, we have been monitoring the Section's development of an action plan to implement the changes identified in your letter. We believe that the Section has made progress in developing an action plan that is responsive to your letter. Accordingly, we expect that the Section will be able to finalize an action plan that will be agreed to by the Section's member firms, the POB, and the Commission.

We share the Commission's concern about the importance to the public of maintaining the independence, integrity and objectivity of the independent auditor.

Very truly yours,

Charles A. Bowsher

Charles A. Bowsher
Chair

cc: Michael A. Conway, Chair, SECPS Executive Committee
SECPS Member Firms' Peer Review Files
William T. Allen, Esq., Chair, Independence Standards Board
David A. Costello, President and Chief Executive Officer, National Association of State Boards of Accountancy

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

OFFICE OF
THE CHIEF ACCOUNTANT

January 7, 1999

Mr. William T. Allen, Chairman
Independence Standards Board
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Chairman Allen:

As we discussed at the November 3, 1998 meeting of the Independence Standards Board, the staff is requesting that the ISB place certain issues on its agenda. These issues are as follows:

Form of Structure and Practice of Independent Auditors

As you are aware, the form of practice of many public accounting and auditing firms is rapidly evolving. Already, the staff has forwarded on to the ISB for its consideration issues related to alternative structure forms. Some of these structures involve public entities that have acquired public accounting and auditing firms using various forms of consideration, consolidating the firm's employees into the buyer's organization, and then conducting audits through leasing of those employees back to the shell organization that remains from the target. In addition, the staff has been asked to address independence issues that would arise if a firm undertakes a public or private offering of its securities, or the securities of a subsidiary or affiliate.

The staff believes these evolving forms of practice raise very significant public policy issues. For example, would investors perceive an auditor to be independent from a client who invests in the firm? Would independence be impaired if an investor has a financial interest in a public accounting firm and then retains that firm to audit other companies in which the investor has an ownership interest? What is the impact on independence of a fiduciary responsibility of the CPA firm to its minority investors who are also audit clients? How would indemnification agreements among investment advisors, underwriters and bankers affect the independence of the CPA firm that is also the auditor for these firms? What would be the impact on independence of public ownership if the focus of the firm were on making consensus quarterly results as opposed to the integrity and objectivity necessary for an independent audit?

Some alternative firm structures also raise questions regarding independence with respect to clients of financial service firms that have acquired accounting firms, where a portion of the audit is performed by employees of the financial service firm. For example, what is the impact on auditor's independence when the service firm may consider providing debt or equity financing to a company or when the service firm's employees compensation is affected by services provided to audit client companies?

In light of its concerns, the staff is requesting the ISB to place on its agenda issues related to the form of structure and practice of independent auditing firms. These issues would encompass the alternative firm structure issue, the public or private offering issue, and all of the associated issues that arise from such structures. The staff believes these issues should be the subject of a neutral discussion memorandum, public hearings and a public exposure draft. Furthermore, the staff believes these issues should receive the ISB's highest priority given the quickly evolving developments in the marketplace. The staff believes that it is important a standard be completed on these issues by the end of 1999.

Valuation Services

Auditors may provide a range of valuation services to their clients. These services include rendering fairness opinions, placing values on assets and liabilities of acquired businesses that will be used for financial and income tax reporting purposes, and valuing stock options and derivative securities for financial and income tax reporting purposes.

A question that often is raised when the auditor provides these services is whether the auditor, who is expected to skeptically second guess the financial statement numbers prepared by management, may be the source of entries that appear in the financial statements that are the subject of the auditor's examination? The answer often is not clear. Recently the staff became concerned that an auditing firm performed much of the substantive work on valuations used by a registrant in the preparation of its financial statements. We believe it is necessary to look in some detail at the actual tasks and work that must be performed to arrive at a valuation, and then determine what tasks would impair and what tasks would not impair the independence of the auditor.

At the last ISB meeting, the staff requested that the ISB address this issue in the broad context of all types of valuations, rather than the narrower aspects of the valuations for derivatives, which the Independence Issues Committee is deliberating. We continue to believe this is an ISB level project and should be addressed in the broader context. We advised the IIC of our comments on this issue.

Mutual Fund Audits and Investments

Some mutual funds desire to have two sets of auditors. A question that has been raised is whether an auditor can audit some but not all of the funds under common management of a fund manager and invest, either directly or through a benefit plan such as a 401-K plan, in the funds the auditor does not audit. This question has become more significant as of late with the consolidation of the industry into fewer firms, and the funds becoming more focused on reducing costs and becoming more centralized in their operations. In addition, there are various legal actions being taken which have called into question the "independence" of the boards of the individual funds. As a result, some believe the funds should be viewed somewhat like a holding company or general partner where investing in an affiliate of the company or partner is prohibited. Others note, however, that the investors in each fund do not share economies or ownership with other funds and therefore the auditor of one fund does not impair its independence by investing in another fund of the same family of funds.

Other questions also arise as a result of the funds providing broker/dealer and other services through affiliates of the fund manager. Accordingly, the affect these relationships may have on independence also should be considered.

Legal Advisory Services

Press reports have cited the expansion of independent auditors into legal services. These services may involve representing clients before the Internal Revenue Service, providing advice on structuring corporate transactions and benefit plans, providing expert witness testimony on behalf of clients, etc. Providing legal services appears to be more predominant in foreign countries, but at least one recent press report cited one of the international firms as considering the acquisition of a New York law firm in the future. The Big Five accounting firms could provide the ISB with more accurate information as to the exact nature and types of services being provided.

The Commission has held in the Codification of Financial Reporting Policies, Section 602.02e.ii, that an accountant-attorney relationship with a client is inconsistent with the appearance of independence. This is due in part to the primary concerns attorneys have with the personal rights and interests of their clients and the advocacy role they are expected to undertake.

You may wish to consult with the American Bar Association Commission on Multidisciplinary Practice, which also is studying this issue.

Executive Compensation and Actuarial Consulting

The SEC Practice section of the AICPA has held that hiring persons for managerial, executive or director positions is a function that is properly the client's responsibility. In addition, certain actuarial services are also prohibited. For example, because the actuarial function is basic to the operations and management of an insurance company, auditors should not render services that serve as the basis for a determination of policy reserves and related accounts. Because the staff has had inquiries into these matters, it would encourage the ISB to adopt independence rules regarding such services.

The staff believes it is important that due consideration be given to the perspectives of investors as new rules are developed regarding the above topics. The staff has noted that some drafts of issues papers prepared by the IIC appear to provide an auditor's perspective on independence topics and certainly this should be considered. However, it is ultimately the investor who relies on the report of the independent auditor and who must consider the auditor to be independent. Accordingly, as issue papers, discussion memorandums, exposure drafts and final rules are prepared for the above topics, it is important that they seek and ultimately reflect the perspective of investors and other users of financial statements.

The staff would be pleased to discuss these matters with you or respond to any questions.

Sincerely,

Lynn Turner

Lynn Turner
Chief Accountant

cc: Arthur Siegel, Independence Standards Board
Dennis Spackman, National Association of State Boards of Accountancy