

January 13, 2003

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Strengthening the Commission's Requirements Regarding Auditor Independence

Dear Secretary Katz:

We are writing to comment on the U.S. Securities and Exchange Commission's ("the Commission") Notice of Proposed Rulemaking, *Strengthening the Commission's Requirements Regarding Auditor Independence*.¹ The proposed rule implements Sections 201 through 204, and Section 206 of the Sarbanes-Oxley Act of 2002,² requiring limitation of services offered by auditors to audit clients, rotation of audit partners, auditor disclosures to audit clients, and other provisions.³ The Office of Advocacy would like to take this opportunity to comment specifically upon the Commission's request for market information and the Commission's proposal to require audit partner rotation for small audit firms which have historically been exempt from such provisions.

The U.S. Small Business Administration's ("SBA") Office of Advocacy ("Advocacy") was established pursuant to Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. The Office of Advocacy is an independent entity within the SBA, so the views expressed by the Office of Advocacy do not necessarily reflect the views of the SBA or the Administration. The Regulatory Flexibility Act ("RFA"), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"), gives small entities a voice in the rulemaking process. The RFA requires Federal agencies, such as the Commission, to consider alternatives to avoid overly burdensome regulation of small entities.⁴ Advocacy is also required by Section 612 of the RFA to monitor agency compliance with the RFA.⁵

¹ *Strengthening the Commission's Requirements Regarding Auditor Independence*, 67 Fed. Reg. 76780 (2002) (to be codified at 17 C.F.R., pts 210, 240, 249, and 274) (proposed December 13, 2002).

² Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

³ Pub. L. No. 107-204, 116 Stat. 745 (2002) (amending Securities and Exchange Act of 1934, ch 404, 48 Stat. 881 (found at 15 U.S.C. §§ 78a et seq.)).

⁴ Pub. L. No. 96-354, 94 Stat. 1164 (1981) (codified as amended at 5 U.S.C. §§ 601-612).

⁵ 5 U.S.C. § 609.

I. Market Information

Once an agency has determined that the rule it intends to promulgate will have a “significant impact upon a substantial number of small entities,” the RFA requires the agency to complete an Initial Regulatory Flexibility Analysis (“IRFA”).⁶ In its IRFA, an agency must include “a description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply.”⁷ In addition, an IRFA must contain “a description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, *including an estimate of the classes of small entities which will be subject to the requirement.*”⁸

The Commission has determined that the proposed auditor independence rule are likely to have a significant impact on a substantial number of small entities, and has therefore included an IRFA with the preamble to its proposed rule published in the *Federal Register*.⁹ The Commission has included a section within this IRFA offering its description and estimate of the number of the entities which will fall within the purview of the proposed auditor independence rule.¹⁰ The Commission noted that it believes there are 2500 small registrants. However, the Commission notes that it possesses “limited data indicating revenues for accounting firms, and [it] cannot estimate the number of firms” which should be included in its IRFA as small entities.¹¹

With regard to the number of accounting firms to be affected, Advocacy generally advises agencies to estimate the number of small entities which their regulation will affect. Advocacy believes that the IRFA serves a vital role in analyzing proposed agency action for the benefit of the class of entities to be captured within the regulations. With respect to economic analysis, Advocacy advises agencies that:

The agency must balance the thoroughness of an analysis and the practical limits of an agency’s capacity to carry out the analysis. Agencies should consult available information on how to conduct an economic analysis, such as guidelines in OMB’s “Economic Analysis of Federal Regulations under Executive Order 12866” and should review small business data, including data referred to in Appendix C, “Small Business Statistics for Regulatory Analysis.”

If economic data are available, an agency should utilize the data in preparing an IRFA. When data are not readily available, the agency should consult with industry sources or

⁶ 5 U.S.C. §§ 603 (“Initial regulatory flexibility analysis”).

⁷ 5 U.S.C. § 603(b)(3).

⁸ 5 U.S.C. § 603(b)(4) (emphasis added).

⁹ 67 Fed. Reg. at 76809.

¹⁰ Within its IRFA, the Commission has noted that the definition of “small entity” applicable to Commission registrants is found in the Commission’s Rule 0-10(a), defining a “small business” or “small organization” as a company with less than \$5 million in assets in its most recent fiscal year. The Commission also stated that the definition of “small business” applicable to accounting firms includes businesses with less than \$6 million in revenues for the past fiscal year. 67 Fed. Reg. at 76810.

¹¹ 67 Fed. Reg. 76810.

other third parties to collect data. If none of the foregoing is productive, then agencies should solicit the data as part of the proposed rulemaking.¹²

Advocacy also encourages agencies to outline what steps they have taken in attempting to estimate the number of small entities that proposed rules would affect. While it is not clear from its IRFA what steps the Commission has taken to collect information on the number of potentially affected accounting companies, the Commission has requested comment on the number of entities to be affected. In response to the Commission's request for market data, Advocacy has collected available government statistical information on the accounting market, as well as contacted industry sources in order to determine the potential impact of the Commission's proposed auditor independence rule.¹³ Advocacy offers this information for the Commission's consideration.

a. Government statistical data on the accounting industry as a whole

The market for both private and public accounting services appears to be highly unconcentrated. The most recent U.S. Census statistics indicate that there were 51,645 audit firms in the United States with a similar number of offices, indicating that the great majority of all accounting firms consist of one office.¹⁴ As discussed below, it appears that the great majority of these firms fall within the SBA definition of "small business" (less than \$6 million in revenue).

While the U.S. Census cited above does not classify these firms according to revenue, an average per-firm revenue can be obtained through the use of publicly available IRS tax return information. The IRS indicates that in 1998 there were 46,407 tax returns for accounting firms organized as corporations.¹⁵ Of the firms captured by the IRS data, 99.18% (46,025) would likely qualify under SBA's definition as small businesses, because these firms have less than \$3 million in receipts, which is below the \$6 million

¹² Office of Advocacy, U.S. Small Business Administration, *Regulatory Flexibility Act: An Implementation Guide for Federal Agencies*, at 30 (available on Advocacy's website at <http://www.sba.gov/advo/laws/rfaguide.pdf>).

¹³ Advocacy provides much statistical information to agencies on the Advocacy website at <http://www.sba.gov/advo/stats/>.

¹⁴ See BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, *STATISTICS OF U.S. BUSINESS, 1998* (NAICS Code # 541211) (hereinafter *1999 Census*). This sector also employed 415,914 people in 1999, with a payroll for these employees of \$18,635,586,000. See *id.*

¹⁵ See IRS, 1998 CORPORATION SOURCE BOOK OF STATISTICS OF INCOME, *Income Tax Returns of Active Corporations with Accounting periods Ended July 1998 Through June 1999, Minor Industry 541215* (1998)(hereinafter IRS CORP. RETURNS).

revenue limit in the SBA size standard.¹⁶ A further 318 corporate filers are reported to have an average of \$5.7 million in receipts, indicating that the majority of these firms also had less than \$6 million in revenues.¹⁷ This leaves 63 firms out of 46,407, or about *one-eighth of one percent of the market* with more than \$6 million in revenues.¹⁸ Although there are a few extremely large accounting corporations within the accounting market taken as a whole, the industry is otherwise highly decentralized and the vast majority of firms appear to fall within the SBA definition of “small business.”¹⁹

b. *Available information on the number of affected firms*

The Commission’s own analysis of the accounting market from its previous *Auditor Independence Requirements of 2001* provides useful background on the market for public accounting. In 2001, the Commission stated that:

The available data indicate that most SEC registrants are audited by one of the largest accounting firms, using 1999 SECPS data, we identified 16,653 registrants who filed audited company financial statements with the Commission. Of those 16,653 registrants, the Big Five accounting firms audit 12,769 (76.7%) of these companies; the next three largest firms (referred to as the “second tier firms”) audit 942 (5.7%); the next 20 largest accounting firms audit 730 (4.4%); and the remaining 2,212 (13.3%) companies are audited by smaller accounting firms.²⁰

The Commission estimated that the top 28 firms audit a large part of the market, leaving around 13% to “smaller” firms, without defining the term. Advocacy’s research into IRS accounting corporation statistics show that only 63 firms had enough revenue in 1998 to

¹⁶ Determined by taking gross receipts for each asset class available and dividing by the total number of receipts to come up with an average. For example, there were 35,133 corporate filers with a total of \$6,199,236,000 in revenues. Dividing the total revenue by 35,133 gives us an average of \$176,450 in receipts per auditing corporation. *Id.* Further, in 1999, there were 13,341 auditing partnerships, accounting for a total of \$35,295,151,000 in receipts, for an average of about \$2.6 million per partnership. *See* IRS, PARTNERSHIP RETURNS, 1999 (1999) (hereinafter IRS PARTNERSHIP RETURNS). NAICS data also indicates that in 1998, there were 30,202 CPA firms with between 1 and 4 employees (including partners), or almost 60% of the 51,841 firms in existence. *See* BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, STATISTICS OF U.S. BUSINESS, 1998 (NAICS Code # 541211) (“1998 Census”). According to market participants, a useful indicator of firm profitability is revenues per employee, with a profitable firm averaging at least \$100,000 in revenues per employee. Telephone Interview by Michael See with Chad Piehl, Partner at Piehl Hanson Beckman, P.A. (July 1, 2002).

¹⁷ While there are certainly some firms within this range with greater than \$6M in revenue, since the average arrived at by the above described method was \$5.7M, it would appear that this asset class would be included within the small business set. Also, the average income for partnerships would also indicate that they would qualify as small businesses in a similar fashion.

¹⁸ *See* IRS CORP. RETURNS, *supra* note 15, at 3. This also roughly corresponds to older census data. Although the 1997 census used Standard Industry Classification codes versus the more modern North American Industry Classification codes, and would therefore be over-inclusive in the number of firms it included as accounting firms, the 1997 census indicated that there was a total of 82,063 accounting firms in the U.S., and 81,436 had receipts of \$7.5 million or less (99.24%). *See* BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, STATISTICS OF U.S. BUSINESS, 1997 (SICs Code # 8721).

¹⁹ Firms organized as partnerships reflect similar trends. *See* IRS PARTNERSHIP RETURNS.

²⁰ SEC, Final Rule: Revision of the Commission’s Auditor Independence Requirements, 65 Fed. Reg. 76008, 76066 (2000) (internal footnotes omitted).

exceed the SBA definition of small businesses.²¹ It would appear then that the vast majority of remaining “smaller accounting firms” are in actuality “small businesses” as defined under the SBA rules.

c. Results of Advocacy discussion with small industry members

Further, Advocacy has discussed the proposed rulemaking with small industry representatives, including accountants, American Institute of Certified Public Accountants (“AICPA”) staff, and accounting clients. Based upon information received from the AICPA’s SEC Practice Section (“SECPS”), the self-regulatory body that administers peer reviews for firms performing audits on public companies, there are approximately 767 audit firms performing SEC engagements. Of these 767 audit firms, 460 firms are currently exempt from the SECPS’ own partner rotation rule, meaning that they have less than ten partners and less than five SEC engagements. In fact, SECPS data indicates that 206 audit firms consist of three partners or less, and 263 firms of any size have only one SEC engagement. These 460 exempt firms currently audit approximately 765 small issuers.²²

II. Audit Partner Rotation Requirements

The RFA requires agencies to evaluate alternatives to proposed regulations “which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities.”²³ Advocacy recommends that the Commission include a small firm exemption to its audit partner rotation requirements. This exemption would ensure that small issuers which make up a small portion of the market capitalization in this country do not incur marked increases in audit costs in return for a negligible amount of investor protection.²⁴ Also, such a provision would ensure that small audit firms are not placed at a competitive disadvantage to larger audit firms.²⁵

²¹ See IRS CORP. RETURNS, *supra* note 15, at 3.

²² Telephone Interview by Michael R. See with William E. Balhoff, CPA Director, Postlethwaite & Netterville, in Baton Rouge, LA (Jan. 7, 2003)(in response to the Commission’s proposed rule on auditor independence, Mr. Balhoff compiled this data himself by reviewing SECPS member records for firm characteristics).

²³ 5 U.S.C. § 603(c).

²⁴ In a recent Commission meeting, Commission staff stated that they believed all Form SB filers constituted 3% of the market capitalization in the United States. The number of companies filing on Form SB is a distinctly larger universe of firms than Advocacy is concerned with in this case, as an exemption along the lines of the current AICPA exemption would only concern 765 small issuers. Therefore, Advocacy believes that these firms easily account for much less than 1% of market capitalization.

²⁵ It is worth noting that the Public Company Accounting Oversight Board, which was recently created by the same statute which serves as the Commission’s legal basis for implementation of audit partner rotation rules, rejected a similar five-year audit partner rotation measure designed to ensure auditor independence. See Stephen Labaton, *Six Months Later, New Audit Board Holds First Talk*, N.Y. TIMES, January 10, 2003, at A1 (Gillan proposal opposed by former SEC enforcement Chief Accountant Charles Niemeier and former SEC General Counsel Daniel Goelzer).

The Commission's proposed rule would label audit firms as not "independent" should the firms use the same lead or review partner to review a firm for more than five consecutive years.²⁶ The proposed rule would require audit and review partners to cease providing services to clients upon the completion of five consecutive fiscal years, then refrain from working on the engagement for five more years until they would be allowed to work on the engagement again.²⁷

The Commission's proposed five-year rotation rule follows closely with the AICPA's own rule, which currently requires all member firms to "assign a new audit partner to be in charge of each SEC engagement that has had another audit partner-in-charge for a period of seven consecutive years, and prohibit such incumbent partner from returning to in-charge status on the engagement for a minimum of two years."²⁸ However, the current AICPA SECPS requirements contain an exemption for small firms of less than ten partners performing less than five SEC engagements.²⁹

As discussed above, Advocacy believes there are approximately 460 small audit firms in this country providing audit services to 765 smaller reporting companies who are currently exempt from the AICPA SECPS prohibition on audit partner rotation. The SECPS exemption from rotation exists because small firms may be unable to rotate partners effectively, given industry specialization and initial knowledge-acquisition costs. Under the Commission's proposal, currently exempt small audit firms would be required to rotate audit partners every five years. Advocacy believes that currently exempt audit firms generally engage in small numbers of SEC engagements (e.g., 3 out of 300 clients), and may rationally decide to cease involvement in SEC engagements.³⁰

Advocacy is concerned that small issuers retaining the services of currently exempt small audit firms who decline to offer audit services to them may be forced to engage the services of larger audit firm. Advocacy believes that this could result in significantly increased audit costs to audit consumers in two ways. First, initial costs for new firms would rise, due to the need to familiarize auditors with the client firm's industry and business practices.³¹ Second, due to the effective elimination of smaller firms from the

²⁶ 67 Fed. Reg. at 76813. This provision would implement Section 203 of the Sarbanes-Oxley Act of 2002, which prohibits audit firms from auditing clients where their lead or review partners have audited the client "for each of the 5 previous fiscal years." Sarbanes-Oxley Act of 2002, at § 203.

²⁷ 67 Fed. Reg. at 76791 (preamble discussion of rule's intent). It is worthwhile to note that in passing the Sarbanes-Oxley Act, Congress refrained from implementing a *firm* rotation requirement, instead opting for a partner rotation requirement.

²⁸ See AICPA, SEC Practice Section Reference Manual, § 1000.08(e) ("Requirements of Members") (available at <http://ftp.aicpa.org/public/download/members/div/secps/referencemanual/Ref1000.pdf>).

²⁹ See *id.*, at (e)(1).

³⁰ Telephone Interview by Michael See with Charles E. Landes, Director of Audit and Attest Standards, AICPA (Jan. 3, 2003) (public audits make up a small portion of accounting practices for small firms), Telephone Interview by Michael See with William E. Balhoff, CPA Director, Postlethwaite & Netterville, in Baton Rouge, LA (Jan. 7, 2003) (approximately 3 out of 300 clients were SEC engagements).

³¹ See, e.g. Andrew Parker, *PwC Ready to Walk Away from Uneconomic Audits*, FINANCIAL TIMES, at P1, 2002 WL 104186569 (Dec. 12, 2002) (interview with Pricewaterhouse Coopers (PwC) global CEO, Samuel DiPiazza, stating that PwC would raise audit prices in addition to charging new clients initial risk

competitive market for audit services and the consolidation of the market, larger audit firms may gain some power over price, causing audit prices to rise.³²

For example, one audit consumer, a local bank filing under Form SB, offered the general observation that it expected its audit costs to rise from 20-25%, should it be forced to retain a new audit firm.³³ This client indicated that the price increase would come from the need for a new auditor to bring itself up to speed with the business of the bank and implement its audit procedures. Since this audit client's fees are already in the range of 5% of net income, the client is considering a going-private transaction given its low level of debt and equity financing.³⁴

Advocacy recommends small auditor flexibility to avoid negative impacts on the market for audit services. As previously outlined, currently exempt small auditors provide a significant portion of audit services. SEC engagements typically account for a small percentage of these auditors' practices.³⁵ Advocacy believes that these small audit providers, who are currently exempt from AICPA SECPS rotation requirements, may decline further SEC engagements due to inability to compete with larger firms that are capable of easily rotating partners among a large pool.

Advocacy recommends that the Commission use its exemptive authority³⁶ to exempt small audit firms currently exempt from the AICPA SECPS audit partner rotation requirements. While the Commission is charged with determining the ultimate level of flexibility it believes comports with the Commission's charge of investor protection, Advocacy believes that an appropriate standard for an exemption would be the existing small audit firm limit of five SEC engagements and ten partners, as such a level appears

assessment fee). It is also worth noting that audit firms may be forced to engage in an historic alteration of client engagement practices which will impose uncertain costs, as in the past, very few overall clients actually changed auditors. See Mary W. Sullivan, *The Effect of the Big Eight Accounting Firm Mergers on the Market for Auditing Services*, 45 J. L. & ECON. 375, 384 (2002) (showing historical pattern of declining trend in firms switching audit firms, with a low range of 20 per year).

³² This would occur through simple, unilateral price increases by remaining firms capable of engaging in partner rotation. See Mary W. Sullivan, *The Effect of the Big Eight Accounting Firm Mergers on the Market for Auditing Services*, 45 J. L. & ECON. at 396 (in antitrust analysis of large firm mergers, points out that smaller audit firms serve as market pressure keeping large firms from successfully unilaterally raising prices).

³³ See also Deepa Babington, *Accounting Industry Coming Back Strong: New Customers, Higher Fees Help*, HOUSTON CHRONICLE, at 1, 2002 WL 103974389 (Dec. 26, 2002) (discussing large firm price increases, with PwC raising fees by 15 to 25 percent), Liesbeth Evers, *Enron Causes Audit Fee Hike*, ACCOUNTANCY (U.K.), at P13, 2002 WL 11110119 (Nov. 20, 2002) (final four mega audit-firms reveal upcoming price increases).

³⁴ Telephone Interview by Michael R. See with Stephen P. David, President and CEO of Peoples Bank and Trust Company of Pointe Coupee Parish, in New Roads, LA (Jan. 9, 2003).

³⁵ Telephone Interview by Michael R. See with William E. Balhoff, CPA Director, Postlethwaite & Netterville, in Baton Rouge, LA (Jan. 7, 2003) (indicating that firm held 3 SEC engagements with a total of approximately 300 engagements).

³⁶ The Commission stated in its proposal that it does not believe class exemptions to be appropriate. However, Advocacy notes that the Commission possesses broad exemptive authority, contained within Section 36 of the Securities and Exchange Act.

to preserve the current level of competition for audit services without threatening the Commission's regulatory goals.

III. Conclusion

Advocacy appreciates the opportunity to provide its recommendations regarding the Commission's proposed rule on auditor independence. Thank you for your consideration and please do not hesitate to contact me or Michael See of my staff at (202) 205-6533 or Michael.See@sba.gov.

Sincerely,

Thomas M. Sullivan
Chief Counsel for Advocacy

Michael R. See
Assistant Chief Counsel for Advocacy

Cc: Robert K. Herdman, Chief Accountant, Office of the Chief Accountant
Brian D. Bullard, Chief Accountant, Division of Investment Management
Gerald J. Laporte, Chief, Office of Small Business Policy