



THE CHAIRMAN

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

July 11, 2003

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Ladies and Gentlemen:

Thank you for your June 5<sup>th</sup> letter in which you express concerns about accounting firms misusing certain provisions in the Commission's rules and certain statements in the Commission's releases when those firms provide guidance to clients on the application of the Commission's auditor independence rules.

I share your belief that auditor independence is vital to investor confidence in the audit process and in the reliability of the financial information that fuels our capital markets. The enclosed memorandum from Scott A. Taub, the Commission's Deputy Chief Accountant, discusses the specific concerns highlighted in your letter and emphasizes the serious responsibility of the audit committee to examine closely proposed audit and non-audit services before determining whether to approve them.

Many of the revised auditor independence rules, however, became effective on May 6, 2003 and other rules have transition provisions that will delay their implementation for up to a year from that date. While I appreciate and understand your concerns, I believe that it is appropriate to allow the rules to be implemented and for auditors and audit committees to gain experience with the application of the rules before we consider changes to them. To assist companies in applying the rules, I have asked the

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Office of the Chief Accountant to begin to prepare for publication a document containing frequently asked questions about the rules. Also, please be assured that, through its interactions with public companies and accounting firms, the Commission and its staff will continue to monitor the application of the revised auditor independence rules and will not hesitate to consider amendments if they are necessary or appropriate.

In addition, under the Sarbanes-Oxley Act of 2002, the Public Company Accounting Oversight Board is to play an important role in considering whether additional non-audit services should be impermissible, in granting case-by-case exceptions from the prohibitions on providing certain services, and in monitoring compliance with the auditor independence rules. The PCAOB should be given the opportunity to examine the issues and institute programs in these areas.

I hope this letter and the enclosed memorandum address your concerns about the Commission's auditor independence rules. If you would like to discuss these issues, please contact Mr. Taub at (202) 942-4400.

Thank you again for your letter and your interest in this important issue.

Sincerely,



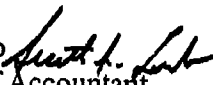
William H. Donaldson

Enclosure

MEMORANDUM

June 24, 2003

TO: Chairman Donaldson

FROM: Scott A. Taub   
Deputy Chief Accountant

RE: Auditor Independence Rules

SUBJECT: Correspondence from Representatives of Consumer Federation of America, U.S. Public Interest Research Group, Consumers Union, Consumer Action, and Common Cause

*Introduction*

In a letter dated June 5, 2003, representatives of the groups noted above (the "consumer groups") expressed concerns about accounting firms misusing certain provisions in the Commission's rules and certain statements in the Commission's releases when those firms provide guidance to clients on the application of the Commission's auditor independence rules.

The areas of concern highlighted in the consumer groups' letter are the audit committee's pre-approval of non-audit services through the application of policies and procedures; policies and procedures that allow the pre-approval of categories of fees; the provision of tax services to audit clients; the relationship of the principles underlying auditor independence to tax services; and the disclosure categories for fees paid by an issuer to the principal auditor of its financial statements. The consumer groups' letter also discusses their concern that accounting firms are minimizing the importance of an audit committee's responsibility to evaluate carefully each service provided by the auditor and consider those services in light of the three basic principles underlying the auditor independence provisions of the Sarbanes-Oxley Act of 2002 (the "Act").

The consumer groups' letter requests that the Commission rescind the provisions of the rule allowing the pre-approval of services through policies and procedures, codify the three basic principles for evaluating auditor independence, clarify that audit committees are expected to review all proposed non-audit services, prohibit tax planning services and tax services for company executives, and revise the fee disclosure rules.

The following discussion provides some discussion and clarification of the Commission's rules and releases, focusing on the areas discussed in the consumer groups' letter.

### ***Prior Commission actions***

In 2000, the Commission undertook its first detailed review of the auditor independence rules in over twenty years. That review led to a substantial strengthening of the Commission's auditor independence rules.<sup>1</sup> With the enactment of Title II of the Act less than two years later, Congress provided new statutory authority and guidance in this area. This Title added subsections (g) through (i) to section 10A of the Securities Exchange Act of 1934 ("Exchange Act"). These subsections, among other things, provide that an auditor of a company's financial statements may provide non-audit services that are not prohibited by the Act or by applicable rules only if the company's audit committee approves those services in advance. These subsections also specify certain requirements for pre-approval of those services.<sup>2</sup> Following adoption of the Act, the Commission again carefully reassessed its auditor independence rules and adopted amendments that conform those rules to the letter and spirit of the Act.<sup>3</sup>

### ***Audit committee pre-approval of non-audit services through the application of policies and procedures***

Rule 2-01(c)(7) of the Commission's auditor independence rules<sup>4</sup> states that an accountant is not independent of an issuer unless,

"in accordance with Section 10A(i) of the Securities Exchange Act of 1934 ... either:

- (A) Before the accountant is engaged by the issuer or its subsidiaries ... to render audit or non-audit services, the engagement is approved by the issuer's ... audit committee; or
- (B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer ...; *provided* the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee's responsibilities under the Securities Exchange Act of 1934 to management...."

The use of policies and procedures to pre-approve non-audit services, therefore, is subject to stringent restrictions:

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<sup>1</sup> See Release No. 34-7919 (Nov. 21, 2000).

<sup>2</sup> Sections 10A(g), (h), and (i) of the Exchange Act; 15 U.S.C. 78j-1(g), (h), and (i).

<sup>3</sup> See Release No. 34-47265 (Jan. 28, 2003).

<sup>4</sup> 17 CFR 210.2-01, *et seq.*

1. The policies and procedures must be *detailed* as to the *particular service* that will be provided by the auditor.
2. The audit committee must be informed of *each* service.
3. Such policies and procedures may *not delegate to management* the audit committee's responsibility to consider and approve each service.

The Commission's rule contains the same requirements as those in the statute regarding the need for the audit committee to be informed of each service and for the audit committee (as opposed to management) to make all decisions regarding the impact of each service on the auditor's independence. The Commission's rule goes a step farther by specifying that any policies and procedures must be detailed as to the particular services covered by those policies and procedures. As discussed below, this additional requirement is to ensure that the audit committee knows precisely what services are being pre-approved through the application of its established policies.

To add sunlight to the use of this method of approving non-audit services, the Commission's rules require that the audit committee's policies and procedures be disclosed to investors. Public companies also must disclose the types of non-audit services provided by the auditor.<sup>5</sup> Investors and others, therefore, may monitor how audit committees design and use policies and procedures to pre-approve non-audit services.

#### *Policies and procedures for the pre-approval of categories of fees*

The consumer groups' letter expresses special concern with guidance being disseminated by Ernst & Young LLP, which the consumer groups believe suggests that an audit committee may approve broad categories of services.

As noted above, the Commission's rule requires that an audit committee's policies and procedures be detailed as to the specific services that are within the scope of those policies and procedures. Any designation of broad categories, or an attempt to provide "blanket" approvals of large groups of services, would be contrary to this requirement. To the extent any schedule or cover sheet for a category of services is provided to the committee for its administrative convenience, that schedule or cover sheet must be accompanied by detailed backup documentation that spells out the terms of each non-audit service to be provided by the auditor that is being pre-approved by the audit committee. Such documentation should be so detailed that there should never be any doubt as to whether any particular service was brought to the audit committee's attention and was considered and pre-approved by that committee.

For example, a cover sheet may indicate that the audit committee is pre-approving the preparation of federal, state and local corporate tax returns. To comply with the rules regarding pre-approval, the backup documentation, however, must identify clearly each return and provide sufficient information for the audit committee to evaluate the impact

<sup>5</sup> Registrants must disclose the nature of services in the "audit-related," "tax," and "all other" categories of non-audit services. See Item 9(e)(2), (3) and (4) of Schedule 14A.

of the filing of that return on the auditor's independence. This would require information on each jurisdiction where a return is filed, the type or types of tax (income, property, real estate, etc.) owed in each jurisdiction, how often each return is prepared and filed, and any other appropriate information.

### *The provision of tax services to audit clients*

The consumer groups' letter also expresses concern about the auditor providing tax-planning services to an audit client and tax services to the client's executives. The consumer groups have asked that the Commission prohibit such services.

The Commission considered carefully the provision of tax services by the auditor to an audit client when it revised its auditor independence requirements earlier this year. Fundamental to the Commission's consideration was the fact that Congress expressly stated in the Act that tax services are permissible if approved in advance by the company's audit committee.<sup>6</sup> Congress might have taken this position because the provision of tax services by accounting firms to audit clients existed and continued without change when Congress formulated and enacted the securities laws in the 1930s. Tax services also are unique in that detailed tax laws and regulations must be consistently applied and the Internal Revenue Service, or equivalent state or foreign agency, has the discretion to audit any tax return.

Despite Congress's endorsement of audit committee-approved tax services as permissible services, the Commission made two important points in the release announcing the adoption of its rules. First, merely labeling a service as a "tax service" does not eliminate the potential for an impairment of independence. For example, representing a client before a tax court or similar fact-finding authority is not providing a tax service; it is acting as the client's advocate and is prohibited. Similarly, preparing the information and disclosures needed to report the effect of income taxes on a company's financial statements is not a tax service; it is preparation of financial statements and is inappropriate.

Second, the Commission cautioned audit committees to "scrutinize carefully" the impact on an auditor's independence of any transaction that is recommended by the auditor and that is unrelated to the company's business plans or operations. Such transactions often have the sole purpose of tax avoidance and may not be supported in specific Internal Revenue Code provisions or related regulations (or equivalent state or foreign rules and regulations). These transactions may be viewed as being initiated by the auditor, not by the company, and might result in the auditor performing a management function. They also may result in an auditor auditing the results of a transaction that, but for the auditor bringing the transaction to the company, the company would not have entered into or even considered. This might be viewed as resulting in an auditor auditing the results of his or her own transaction.

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Section 10A(h) of the Exchange Act; 15 U.S.C. 78j-1(h).

Congress clearly has placed on the audit committee the responsibility to consider the impact of tax services on the auditor's independence. The Commission, in its release, has identified heightened concerns with certain tax services and stressed the need for an audit committee to consider tax services thoroughly before approving them.

The provision of tax services to the executives of an audit client is not expressly addressed in the Act or in the Commission's rules. Nonetheless, an audit committee should review the provision of those services to assure that reasonable investors would conclude that the auditor, when providing such services, is capable of exercising objective and impartial judgment on all issues within the audit engagement.<sup>7</sup> If the company pays the fees for tax services provided to executives or any other employees of the company, then the company should describe those services under the "tax services" disclosure category, as discussed below.

#### *Relationship of the principles underlying auditor independence to tax services*

The consumer groups have asked about the use of the three principles underlying the auditor independence rules in evaluating the impact of tax services on an auditor's independence. The three underlying principles are that an auditor cannot function in the role of management, an auditor cannot audit his or her own work, and an auditor cannot serve in an advocacy role for his or her audit client. These principles currently are codified in a preliminary note to the Commission's auditor independence rules.<sup>8</sup>

The relationship of these underlying principles to the provision of tax services is tempered somewhat by Congress specifically describing tax services as permissible (if pre-approved by the audit committee), by the long history of auditors providing such services, by the unique set of laws and regulations that govern the provision of tax services, and by the potential for a governmental audit of each instance where the service is provided. As a result, the three principles have not been strictly applied to traditional tax services, such as tax compliance and preparation, tax planning, and the provision of tax advice. For example, when an auditor prepares a company's tax return, the fact that

<sup>7</sup> See Rule 2-01(b) of Regulation S-X, 17 CFR 210.2-01(b), which states:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether the accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and audit client, and not just those relating to reports filed with the Commission.

<sup>8</sup> Preliminary Note to Rule 2-01 of Regulation S-X; 17 CFR 210.2-01. The preliminary note contains not only these three principles but also a fourth principle -- that a relationship or provision of a service impairs an auditor's independence if it creates a mutual or conflicting interest between the auditor and the audit client. As stated in the preliminary note, the Commission will look in the first instance to these principles in considering the general independence standard reflected in Rule 2-01(b) of Regulation S-X, 17 CFR 210.2-01(b), as quoted in note 9, *supra*.

the amount of tax owed may impact the accrued tax liability reflected in the company's financial statements has not been deemed to impair the auditor's independence.

In certain circumstances, however, even traditional tax services might impair an auditor's independence. As noted above, one such circumstance may be when the service results in the auditor recommending abusive tax shelters to the company. Other circumstances also might result in the impairment of the auditor's independence. Audit committees, therefore, should not summarily approve such services, even if the auditor routinely or repeatedly has provided them in the past. At least once each year, each service should be evaluated carefully to assure that it is, in fact, a "tax service" and to identify any concerns with proposed tax services that would lead a reasonable investor to question the integrity of the audit or the reliability of the company's financial statements. For example, audit committees should consider whether the auditor inappropriately has supplanted the role of management and the Board in this area.

***Disclosure categories of fees paid by an issuer to the auditor of its financial statements***

In January of this year, the Commission revised its rules related to the disclosure of fees paid for services provided by the auditor of the company's financial statements. In doing so, the Commission amended the services included in the category of audit services, added the categories of "audit-related" services and "tax" services to the existing category of "all other" non-audit services, and required disclosure of fees paid during the last two years (in place of the previous one-year requirement). Significantly, the Commission also required that companies describe in qualitative terms the services within each of the "audit-related," "tax," and "all other" categories of services.

The consumer groups are concerned particularly with the revised definition of "audit services" and with the description of certain services as "audit-related" services.

The definition of audit services was revised, in part, because Congress, in adopting section 10A(i)(1)(A) of the Exchange Act, included in the meaning of "audit services" the issuance of comfort letters in connection with securities underwritings and statutory audits required for insurance companies for the purposes of compliance with state laws.<sup>9</sup> In the Commission's view, this implied a definition that would include services that generally only the auditor of the company's financial statements reasonably can provide. These services also include, among other things, the issuance of consents and the review of documents filed with the Commission.

The Commission also chose to adopt a category labeled "audit-related" services. In filings under the previous rules, some companies voluntarily had reported "audit-related" services as a sub-category of "all other" services. Under those rules, however, there was no definition or limitation on what was included in the "audit-related" category, which led to concerns about the meaning and consistency of the disclosure. The new rule requires that services in this category be "reasonably related to the performance of the

<sup>9</sup> 15 U.S.C. 78j-1(i)(1)(A).



audit or review of the registrant's financial statements."<sup>10</sup> The adopting release provides several examples of services that would be included in this category. Importantly, the Commission has required that each type of service included in this category be described to investors. As a result, investors should be able to determine if a company attempts to minimize fees for the "all other" category by categorizing certain services as "audit-related."

### *Audit committee scrutiny of auditor independence issues*

The consumer groups' letter expresses a concern that the advice given by Ernst & Young might give audit committees a sense that certain non-audit services provided by the auditor, particularly services provided on a routine basis or for relatively small fees, need not be given a careful or complete examination.

The Commission's position is clear. In several efforts, beginning with the implementation of the recommendations of the Blue Ribbon Committee to Improve the Effectiveness of Corporate Audit Committees in 1999<sup>11</sup> and continuing to the adoption of the revisions of the auditor independence rules in January of this year, the Commission has stressed the need for the audit committee to review carefully and thoughtfully any issues related to the auditor's independence. An audit committee should never "rubber stamp" management's or the auditor's conclusion about the impact of a service on the auditor's independence.

Due to ever changing conditions, services that have been provided in prior years might take on added or altered significance, and the audit committee should review them carefully each year to determine whether they should be approved for any forthcoming year.

Minimizing the review of certain services based on the relatively small size of the fees involved also would not be appropriate. There are relatively few exceptions to the auditor independence rules based on the materiality or size of relationships or transactions. Those exceptions that exist are described clearly in the rules and in the Commission's interpretive guidance. All transactions that fall outside of those narrow provisions should be given equal consideration by the audit committee.

As the Commission's independence release states, the audit committee plays a key role in evaluating and preserving the independence of the auditor of the company's financial statements. As has been seen in recent cases, a loss of investor confidence in the independence of the auditor, which in turn raises questions about the quality and integrity of the audit and of the company's financial statements, can have devastating effects on a company's financial position. The audit committee must take its role

<sup>10</sup> For example, fees that are related to the audits of, or attest engagements related to, a facet of a company's operations ("operational audits") should not be included in this category.

<sup>11</sup> See, e.g., Release No. 34-42266 (Dec. 22, 1999).

seriously and perform diligent analyses and reviews that allow the committee to conclude that reasonable investors would view the auditor as capable of exercising objective and impartial judgment on all matters brought to the auditor's attention.

### ***Conclusion***

The Commission staff shares the consumer groups' belief that auditor independence is vital to investor confidence in the audit process and, in turn, in the reliability of the financial information that fuels our capital markets. We also share their belief that the audit committee plays a vital role in this process and that audit committee members must exercise their judgment in a serious and thoughtful manner. Additionally, accounting firms providing advice to audit committees on these matters must exercise great care not to perform functions reserved for that committee and not to appear to unduly favor interpretations of the rules that might be viewed as promoting the sale of non-audit services.

Many of the revised auditor independence rules became effective on May 6, 2003, and other rules have transition provisions that will delay their full implementation for up to a year from that date. While the staff recognizes and appreciates the consumer groups' concerns, it may be appropriate to allow the rules to be fully implemented and to allow auditors and audit committees to gain experience with those rules before the Commission considers any changes in the rules. Through its interactions with public companies and accounting firms, the staff intends to continue monitoring the application of the revised auditor independence rules and will not hesitate to inform the Commission if revisions are considered necessary or appropriate.

This memorandum is intended to address the consumer groups' concerns about the Commission's auditor independence rules and to emphasize the serious responsibility of the audit committee to examine proposed non-audit services very closely before determining whether to approve them. If the consumer groups would like to discuss these issues, they may contact me at (202) 942-4400.