



FINANCIAL EXECUTIVES INSTITUTE

September 13, 2000

Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Dear Mr. Katz:

Financial Executives Institute (FEI) is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies throughout the U.S. and Canada. FEI's Committee on Corporate Reporting (CCR) appreciates the opportunity to comment on the Release, *Revision of the Commission's Auditor Independence Requirements*. CCR agrees that the protection of auditor independence is of great importance to ensuring continued public confidence in financial statements. We take great comfort from recent research findings that showed a high degree of trust in the integrity of financial statements and in the auditing process. While we support the SEC's broader objective to preserve that trust, we are deeply concerned that the measures proposed in the Release go far beyond what is necessary and, if finalized in its present form, would have significant adverse consequences for corporations and their audit firms. Moreover, CCR would prefer that the Independence Standards Board be allowed to continue with the processes currently underway to develop appropriate solutions in this area.

As financial officers, we benefit directly from robust, high quality financial audits of our companies conducted in accordance with the highest professional standards. It is critically important to us that violations of generally accepted accounting principles, inadequate financial controls, financial fraud and other matters affecting the quality of our financial reports be identified when they occur and are dealt with swiftly. Few, if any, events or disclosures have more catastrophic consequences for shareholder value than a sudden loss of investor confidence in a company's management. We therefore rely heavily on the independence of our audit firms and, in conjunction with our corporate audit committees, we review judiciously the amount and nature of non-audit services. We reject the oft-stated premise in the Release that non-audit services are used as

leverage to force the auditor to “bend to a client’s pressure” – we have as much to lose from impaired independence as our investors do, and we believe that any proposed rules in this area should be founded on that reality.

CCR believes that the development of standards in this area should be the responsibility of the Independence Standards Board (ISB), an independent and objective private sector body that is representative of the constituents that are directly or indirectly affected by the proposed rules. We urge the Commission to work through the rule-making processes of the ISB to produce rules concerning auditor independence, taking into consideration the concerns expressed below in this letter. In particular, we believe the proposed provisions regarding nonaudit services require further study and evaluation, and we urge that this aspect of the proposal be referred to the ISB. On the other hand, we would not object to rulemaking in the area of financial relationships and employee relationships because of the urgent need for updated guidance in those areas.

The General Standard for Auditor Independence

We agree that the concept of auditor independence should be based on the appearance, as well as the fact, of independence. However, we are aware that some individuals may take an extremely strict view of relationships and activities that might be perceived as potentially impairing independence. As a result, we are concerned that the ‘reasonable investor’ criterion proposed in the Release would be misinterpreted to produce unduly restrictive limitations in practice.

While the four principles may be helpful in focusing on sensitivities, they are not useful as dispositive criteria for judging independence matters.

- The first principle would prohibit a mutual interest with an audit client, but there can be many mutualities of interest that do not impair independence (e.g., mutual interest in the fair presentation of financial data; mutual financial interest if financial statements are challenged in a lawsuit). The first principle would also prohibit an interest in conflict with an audit client, and yet the essential characteristic that we expect from auditors is the ability to exercise professional judgment when differences arise.
- The third principle would prohibit functioning as management or an employee, but all nonaudit services could be viewed as functions that might otherwise be performed by management or employees.
- The fourth principle would prohibit acting as an advocate for an audit client, but this broad notion could be interpreted to encompass many types of activity in which the auditor speaks from professional expertise.

As discussed further in our comments on the SEC’s approach to non-audit services, the assessment of auditor independence is a complex matter that requires thorough and careful consideration of all pertinent facts and circumstances involving auditors and their clients. We believe that the strengthening of corporate audit committees coupled with the discussions between the auditor and the audit committee regarding independence, as

required under ISB No. 1, are a more appropriate response to addressing these issues than the aforementioned principles.

Financial relationships

CCR strongly agrees that the investment rules for non-covered persons need to be updated. We note that the ISB was on the verge of issuing an Exposure Draft addressing this matter but withheld it because of the SEC's decision to issue this proposed rule. As discussed above, we believe that the ISB should be allowed to proceed, with appropriate input from the SEC staff.

Proposed rule 2-01 (f) provides definitions of certain terms used in rule 2-01 that apply only to that rule and nowhere else in Regulation S-X. Proposed rule 2-01 (f) (4) defines an "affiliate of an accounting firm", a completely new term and concept not in any existing rules. This extraordinarily expansive definition attempts to capture those entities that are financially tied to or otherwise associated with the accounting firm enough to warrant being treated as if it is the accounting firm. An affiliate is any entity of which the accounting firm owns 5% or more of the equity and any officer, director, partner, or co-partner of any such entity. Proposed rule 2-01 (f) (5) defines an affiliate of an audit client as any entity (regardless of any materiality considerations as is the case in some respects under existing practice) that has "significant influence" over the audit client, or any entity over which the audit client has significant influence. The combination of these two expansive definitions will sweep in a whole host of new entities into the analysis of audit firm independence that reasonable people would agree do not pose a threat to independence.

CCR also believes that the SEC's proposed rules could be quite onerous to administer, and will likely cause auditors of large corporations to find themselves perpetually in violation, albeit at immaterial levels. As drafted, the rules would require extensive tracking and monitoring beyond that needed to guard against substantive independence concerns. For example, the proposed proscription of ownership in excess of 5% of any entity in which a client owns any interest – that is, even a single share – would seem to require continuous tracking against all of a client's worldwide interests, without materiality relief. We see tremendous difficulty in applying such rules as they relate to investments held in or through pension funds, mutual funds, and the like. Additionally, we are concerned by the potential prohibition of arms' length financial services that create neither economic leverage over the auditor nor an interest by the auditor in the success of the client.

Because of the need for practical rules that accomplish the substantive rulemaking objectives here without being unduly restrictive, we urge the Commission to work closely with the ISB to enable it to formulate rules that are not unnecessarily burdensome to the firms or their clients.

Nonaudit services

We wish to preface our comments in this area by reaffirming the position expressed by Phil Livingston in an FEI press release on auditor independence dated May 1, 2000: “Companies prefer to have all options open to them, to have freedom of choice in selecting consultants. Many times the audit firm has the best knowledge and understanding of the business and can provide certain consulting services more efficiently and economically than competing firms. However, companies time and again emphasized in written comments in the survey that they are very selective about the nature of consulting work they assign to their audit firm and that the company’s audit committee is actively informed and consulted before entering these engagements.” CCR believes that the ISB conceptual framework on auditor independence, which is nearing completion, will further enhance the effectiveness of audit committees in this area by providing additional guidance and insight on matters that bear on auditor independence; we believe that audit committees will ask the right questions and will make sure that any concerns they have are satisfied before reaching decisions about the appropriateness of using auditors for non-audit services. For reasons described below, we are concerned that what the Release describes as “prophylactic” measures to protect auditor independence, could have the unintended effect of a “scorched earth” policy on the ability of audit firms to meet the much more demanding requirements of audits in years to come.

There is no doubt that today’s business model and its underlying processes and controls are undergoing a rapid transformation. And yet the nature of the transformation at any given company is intensely personal and individual to its needs and its core competencies, such that no two firms are truly alike. One need look no further than the pervasive effect of the internet and the diverse ways in which e*commerce strategies and business processes have evolved to meet specific business needs and opportunities that this new technology presents. Inherent in each strategy and process are a host of risks that must be identified, understood, and controlled. Audit firms have a unique perspective and expertise regarding their client’s business that enable them to be better than others at providing insightful, cost-effective solutions to the myriad of issues that these risks present. Experience, finely-honed technical skills, and customer specific knowledge not only make audit firms valuable as consultants – they also make them much better auditors. A key issue underlying the proposed prohibitions on certain types of non-audit services is whether the such a ban will have the unintended consequence of stripping out a critical skill-set and knowledge-base, and perhaps even personnel, from the audit process. And if so, will those losses render audits less effective in the future? While the answer to this question is perhaps unknowable at this time, we believe Commission’s actions in this area should be guided by the philosophy of “first, do no harm...”

As discussed above, we urge the Commission to refer the question of nonaudit services to the ISB. However, given that nonaudit services is the most significant issue addressed in the Release, we offer the following observations on this topic.

- We agree that auditors should not provide clients with bookkeeping and related services (that is, services involving the maintaining of accounting records, preparing of financial statements, and generating disclosure data), but we believe auditors should be allowed to provide advice and support in the evaluation and design of internal control systems and procedures. We also believe that an exception should be provided for incidental assistance in preparing financial statements for subsidiaries and other constituent units where they are clearly inconsequential to the overall audit.
- The proposed broad prohibition of internal audit services – which would permit only nonrecurring, discrete reviews and operational audits – could preclude the auditor’s ability to evaluate, make recommendations about, or report on an audit client’s internal financial controls. These services can be of great value to a corporation, and we see nothing to be gained by prohibiting them.
- The prohibition of internal audit services could also amount to a requirement for all corporations to maintain a full-scope internal financial audit function, since the performance of any portion of such a function exclusively by the external auditor would apparently be prohibited. The argument advanced in the proposal – that the audit firm is not independent because it relies on its own work when it performs an audit without the existence of an internal audit function – does not demonstrate any risk to the objectivity and impartiality of the auditor.
- While a robust program of internal financial auditing may be a control strength, any proposed mandate along these lines should be undertaken as a separate rulemaking initiative and evaluated on its merits as a matter of governance and control, not a matter of independence.
- The types of management functions that would be prohibited under the proposed rule include, in addition to decision-making and supervisory functions, any ongoing monitoring functions. This broad prohibition would seem to rule out even those operational internal audit services that the proposal would otherwise allow. Consistent with our views on internal audit services, we do not support the prohibition of ongoing monitoring functions. Additionally, there could be many sensitive or critical areas where the corporation might want to utilize monitoring services of the external audit firm to supplement its own management processes. In our view, the prohibition of ongoing monitoring services would deny the corporation the benefits of a broad category of services by a trusted and knowledgeable firm, where there is no risk to objectivity and impartiality.
- The proposed rule would prohibit a broad range of human resources services, but we believe the breadth of these prohibitions should be carefully reconsidered. For example, the proposal would prohibit advising an audit client about its management or organizational structure. In our view, it is fully appropriate for an auditor to provide its observations and advice in this regard, whether in a management letter or in a separate engagement. Similarly, we do not believe it is necessary to prohibit all

services relating to recruiting, compensation design, employee evaluation, and employee testing.

- The proposal would also prohibit the rendering or supporting of expert opinions in connection with an audit client’s legal, administrative or regulatory matters. In these services, the accountant speaks from expertise rather than from a position of advocacy. The effect of this prohibition would be to deprive the audit client of an informed, objective, and expert view that could be useful or even essential to obtaining a fair outcome from the matter at hand, and we do not support such a prohibition.
- Finally, although the “supplementary information” section of the proposal indicates that tax-related services would not be affected, the accompanying discussion mentions only tax return preparation as clearly permissible. It does not mention tax counsel and advice, and it questions whether tax opinions should be prohibited. In our view, the prohibitions should not deprive audit clients of any of these important tax services by the external audit firm, and this should be made clear when final rules are adopted.

We believe that it will be difficult to develop an appropriate list of prohibited services that strikes the desired balance between providing reasonable safeguards of auditor independence and preserving the ability of auditors to perform audits in the most effective manner possible. We also believe that any rules must maintain the role of the Audit Committee as the focal point in determining whether activities and relationships should be judged to impair independence in the particular circumstances of a registrant and auditor. In that regard, we asked our members to identify services that, as a matter of policy, they do not allow their auditors to provide to them. Listed below are the services identified (for clarity, the nomenclature contained in the release is used to describe the services).

- Maintaining accounting records, preparing financial statements, generating disclosure data.
- Appraisal or valuation services, fairness opinions, contribution-in-kind reports.
- Actuarial services.
- Management services of a decision-making or supervisory nature.
- Broker-dealer, investment advisor, or investment banking services.
- Legal services (other than tax counsel/advice and tax opinions).

Alternatives Concerning Scope of Services

The proposal lists a number of alternative approaches that the Commission might adopt regarding the scope of services. These include a blanket prohibition of all nonaudit services, an approach that would identify the services that would be permissible (rather than the primary proposal that identifies the services that would be prohibited), a requirement that audit firms be restructured to separate nonaudit services into autonomous units, an approach that would set a ceiling on nonaudit fees, and an approach that would not specify any particular services as permitted or prohibited but would

instead require substantial disclosure. We do not believe that any of these approaches is superior to that taken by the primary proposal, that is, identifying nonaudit services that would be prohibited.

Disclosures About Nonaudit Services

Although we do not support the intricate detail proposed in the Release, CCR agrees with the SEC's conclusion that improved disclosure of non-audit services could be useful as an interim step, if it can be limited to a reasonable amount of detail and to data that will be useful in assessing real risks. Towards that end, we offer the following observations on the disclosure proposal in the Release:

- CCR believes that the SEC should adopt a more realistic threshold than the one proposed. Individual disclosure would be required for nonaudit services that exceed the lesser of \$50,000 or 10% of audit fees. This proposed threshold is tantamount to a requirement to individually disclose all non-audit services across the board – and that is not warranted by any demonstrated risk.
- The disclosure of individual nonaudit engagements also is burdensome, unnecessary, and unwarranted unless it can be limited to information that is useful to investors in judging independence. Beyond that, no useful purpose would be served by the disclosure. Similar to a previous comment, we believe that a more reasonable threshold should be established.
- The proposal would also require disclosure of the percentage of hours worked by individuals not employed by the auditor itself when that percentage exceeds 50%. It is not clear why this would be a disclosure of importance to investors.

We would be pleased to answer any questions you may have regarding this response. I can be reached at (203)-373-2458.

Sincerely,



Philip D. Ameen
Chair, Committee on Corporate Reporting