SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 240

[Release Nos. 33–7870; 34–42994; 35–27193; IC–24549; IA–1884; File No. S7–13–00]

RIN 3235–AH91

Revision of the Commission's Auditor Independence Requirements

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''SEC'' or ''Commission'') is soliciting comment on proposed rule amendments regarding auditor independence. The proposals modernize the Commission's requirements by providing governing principles for determining whether an auditor is independent in light of: investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients. The proposals would, among other things, significantly reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor. They would also identify certain non-audit services that, if provided to an audit client, would impair an auditor's independence. The scope of services proposals would not extend to services provided to non-audit clients. The proposals also would provide a limited exception for accounting firms that have certain quality controls and satisfy other conditions. Finally, the proposals would require companies to disclose in their annual proxy statements certain information about, among other things, non-audit services provided by their auditors during the last fiscal year.

DATES: Comments should be received on or before September 25, 2000.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. Comment letters should refer to File No. S7–13–00; this file number should be included on the subject line if e-mail is used. All comment letters received will be available for public inspection and copying in the Commission's Public Reference Room at the same address. Electronically submitted comments will be posted on the Commission's internet web site (http://www.sec.gov). [1]

FOR FURTHER INFORMATION CONTACT: John M. Morrissey, Deputy Chief Accountant, or W. Scott Bayless, Associate Chief Accountant, Office of the Chief Accountant, at (202) 942–4400, or with respect to questions about investment companies, John S. Capone, Chief Accountant, Division of Investment Management, at (202) 942–0590, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1103.

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Rule 2–01 of Regulation S-X [2] and Item 9 of Schedule 14A [3] under the Securities Exchange Act of 1934 (the ''Exchange Act''). [4]

I. Executive Summary

Independent auditors have an important public trust.[5] Every day, millions of people invest their savings in our securities markets in reliance on financial statements prepared by public companies and audited by independent auditors. [6] These auditors, using Generally Accepted Auditing Standards (''GAAS''), examine issuers'; financial statements and issue opinions about whether the financial statements, taken as a whole, are fairly presented in conformity with Generally Accepted Accounting Principles (''GAAP''). While an auditor's opinion does not guarantee the accuracy of financial statements, it furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional and that investors can therefore rely on them. Providing that assurance to the public is the auditor's over-arching duty. [7]

Investors must be able to put their faith in issuers' financial statements. If investors do not believe that the auditor is truly independent from the issuer, they will derive little confidence from the auditor's opinion and will be far less likely to invest in the issuer's securities. Fostering investor confidence, therefore, requires not only that auditors actually be independent of their audit clients, but also that reasonable investors perceive them to be independent.

One of our missions is to promote investor confidence in the reliability and integrity of issuers' financial statements. To promote investor confidence, we must ensure that our auditor independence requirements remain relevant, effective, and fair in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society. Some of the important developments in each of these areas since we last amended our auditor independence requirements in 1983 [8] include the following:

- Firms are becoming primarily business advisory service firms as they increase the number, revenues from, and types of non-audit services provided to audit clients,
- Firms and their audit clients are entering into an increasing number of business relationships, such as strategic alliances, co-marketing arrangements, and joint ventures,
- Firms are divesting significant portions of their consulting practices or restructuring their organizations,
- Firms are offering ownership of parts of their practices to the public, including audit clients,
- Firms are in need of increased capital to finance the growth of consulting practices, new technology, training, and large unfunded pension obligations,
- Firms have merged, resulting in increased firm size, both domestically and internationally,
- Firms have expanded into international networks, affiliating and marketing under a common name,
- non-CPA financial service firms have acquired accounting firms, and the acquirors previously have not been

[1] We do not edit personal, identifying information, such as names or e-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

[2] 17 CFR 210.2–01.

[3] 17 CFR 240.14a–101.

[4] 15 U.S.C. 78a *et seq.*

[5] This release uses the terms ''independent auditor,'' ''auditor,'' ''independent public accountant,'' ''accountant,'' and ''independent accountant'' interchangeably to refer to any independent certified or independent public account who performs an aduit of or reviews a public company's financial statements or whose report or opinion is filed with the Commission in accordance with the federal securities laws or the Commission's regulations.

[6] Public companies must have their annual financial statements audited by independent public accountants. *See, e.g.,* Items 25 and 26 of Schedule A to the Securities Act of 1933 (the ''1933 Act''), 15 U.S.C. 77aa(25) and (26) that expressly require that financial statements be audited by independent public or certified accounts. Public companies also must have their quarterly reports reviewed by independent accountants. *See, e.g.,* Article 10 of Regulation S–X, 17 CFR 210.10–01(d).

[7] The profession's principles of professional conduct state, ''Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.'' American Institute of Certified Public Accountants (''AICPA'') Professional Standards: Code of Professional Conduct (''AICPA Code of Professional Conduct''), ET § 53.

[8] Financial Reporting Release (''FRR'') No. 10 (Feb. 25, 1983).

subject to the profession's independence, auditing, or quality control standards,

• Firms' professional staffs have become more mobile, and geographical location has become less important due to advances in telecommunications and internet services, and

• Audit clients are hiring an increasing number of firm partners, professional staff, and their spouses for high level management positions.

Having considered these and other developments and their effect on auditor independence, we are proposing rule amendments. The proposals start from the premise that investor confidence in auditor independence turns on whether auditors are in fact independent and appear to be independent. To strengthen the basis for that confidence, the proposals focus on those who can influence a particular audit. The proposals articulate four principles that would govern our determination of whether an accountant is independent of its audit client. Specifically, the proposals provide that an accountant is not independent whenever, during the audit and professional engagement period, the accountant: (i) Has a mutual or conflicting interest with the audit client, (ii) audits the accountant's own work, (iii) functions as management or an employee of the audit client, or (iv) acts as an advocate for the audit client.

The proposals then describe certain relationships which, when considered in light of these principles, render an accountant not independent of an audit client. The relationships addressed by the proposals include, among others, the financial and employment relationships between auditors (or their family members) and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.

Financial and Employment Relationships. Current requirements attribute to an auditor ownership of shares held by widely dispersed audit firm personnel and their families. In light of some of the developments described above, these rules may unnecessarily restrict investment and employment opportunities available to firm personnel and their families. The proposals shrink significantly the circle of firm personnel whose investments are imputed to the auditor. They also shrink the circle of family members and former firm personnel whose employment impairs an auditor's independence.

Non-Audit Services. We have become increasingly concerned that the dramatic increase in the nature, number, and monetary value of non-audit services that accounting firms provide to audit clients may affect their independence. Accordingly, the proposals specify certain non-audit services that, if provided by an accounting firm to an audit client, impair an auditor's independence in light of the four governing principles.

For example, the proposals provide that an accounting firm would not be independent from an audit client to which the firm provides valuation and appraisal services. Some accounting firms provide these services to audit clients,[9] even though the firm's auditors must independently question the value of the appraised asset in auditing the audit client's financial statements. As such, the auditor may have participated actively in the process of developing asset values that are reported to investors in financial statements. The auditor then is required to challenge those same numbers during the audit. In this dual role as auditor and consultant, the accountant both oversees and answers to management, raising serious conflict of interest questions. Will the auditor be diligent and objective in reviewing the accounting firm's valuation work? If, during the audit, the auditor identifies a problem with the valuation or appraisal, will that auditor bring the problem to management's attention? Perhaps more important, even if the auditor made unbiased decisions, would investors believe that the auditor had been objective? [10]

The proposals do not extend to all non-audit services provided to audit clients. Not all non-audit services pose the same risk to independence. The proposals reflect what we believe to be a reasonable differentiation among various non-audit services, as well as our preference for narrowly drawn rules.

Quality Controls. Accounting firms and the public benefit when firms have effective quality controls that ensure the independence of audit professionals. These controls protect the public and the firms, on whose audits the public relies. Public companies benefit as well, since they are able to access capital at a lower cost through our capital markets. Therefore, for accounting firms that have certain quality controls, we are proposing a limited exception from the independence rules for certain independence failures that are cured promptly after discovery. This exception should encourage firms to institute controls to ensure the independence of the firm's personnel.

Disclosure of Non-Audit Services. Investors should have enough information to enable them to evaluate the independence of a company's auditors. The proposed rules would bring the benefits of sunlight to the auditor independence area by requiring companies to disclose in their annual proxy statements certain information about, among other things, the non-audit services provided by their auditors and the participation of leased personnel in performing the company's annual audit.

II. The Need To Preserve Auditor Independence

A. The Securities Laws Give Independent Auditors a Vital Mission and Responsibility

Capital formation depends on the willingness of investors to invest in the securities of public companies. Investors are more likely to invest, and pricing is more likely to be efficient, the greater the assurance that the financial information disclosed by issuers is reliable.[11] Independent auditors play a key role in providing that assurance. Auditors follow specified procedures set forth in GAAS and express their opinion

[9] *See* Independence Standards Board (''ISB''), ''Discussion Memorandum 99–3: Appraisal and Valuation Services,'' at 2–3 (Sept. 1999). The ISB was formed in 1997 to establish auditor independence standards applicable to audit and other attestation reports that are filed with us. Copies of standards issued by the ISB can be obtained from the ISB's web site at www.cpaindependence.org.

[10] As Statement on Auditing Standards No. 1 states, ''. . . an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making. Likewise, an auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased.'' AICPA Codification of Statements on Auditing Standards (''SAS'') No. 1, AU § 220.03. Indeed, a recent survey suggests that the complexity of the financial and business relationships between accounting firms and audit clients could diminish investors' confidence in the objectivity of auditors. In the 1999 study sponsored by the ISB, Earnscliffe Research & Communications found that many individuals interviewed believed that pressures on auditors have been increasing and are becoming problematic, and that ''auditors are developing a stronger interest in their relationship with management, perhaps at the expense of their responsibilities to shareholders.'' *See* Earnscliffe Research & Communications (''Earnscliffe''), *Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity,* at 9 (Nov. 1999) (''Earnscliffe Report'').

[11] *See generally* Codification of Financial Reporting Policies (the ''Codification'') § 601.01 (''[a]n investor's willingness to commit his capital to an impersonal market is dependent on the availability of accurate, material and timely information regarding the corporations in which he has invested or proposes to invest'').

on whether the financial statements, taken as a whole, fairly reflect the financial position, results of operations, and cash flows of the company.[12] Based on the independent auditor's opinion, investors have reason to believe that financial statements are materially accurate, fair, and complete.

The federal securities laws, to a significant extent, make independent auditors ''gatekeepers'' to the public securities markets.[13] These laws require, or permit us to require, financial information filed with us to be certified (or audited) by independent public accountants.[14] Without an opinion from an independent auditor, the company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities to the public.[15] The auditor is the only professional that a company must engage before making a public offering of securities and the only professional charged with the duty to act and report independently from management. Because it is the issuer's responsibility to file independently audited financial statements, if the auditor is not independent, the issuer's filings are deficient under the securities laws.

In the fiscal year ended September 30, 1999, 13,460 public companies filed annual reports with the Commission. In the same period, the aggregate dollar volume for public offerings filed with the Commission was $2.1 trillion. While our staff reviews a great many filings, it is not able to review in detail all of the financial statements filed with us. We therefore must rely heavily on the accounting profession to be primarily responsible for the integrity of the large volume of financial information that forms the cornerstone of our full disclosure system.[16]

In creating this system, Congress granted the accounting profession an important public trust. Congress considered creating a corps of government auditors to review and audit companies' financial statements. Congress also considered mandating federal licensing of auditors. Instead, Congress entrusted the accounting profession with the responsibility of auditing the financial statements of companies registered with the SEC.[17] In so doing, Congress gave the accounting profession both an enormously valuable franchise and a bedrock public responsibility.[18]

The Supreme Court has underscored the significant and unique role of the auditor. In *United States* v. *Arthur Young & Co.*,[19] the Court considered whether to extend to auditors certain confidentiality protections available to legal counsel representing a client and preparing for trial. The Court refused to extend the protections, citing principally the differences between the roles of counsel and auditor. A lawyer, the Court noted, is a confidential advisor and advocate with a duty to present the client's case in the most favorable light. In contrast, the Court stated that the ''independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client * * * [and] owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.'' [20] According to the Court, ''This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.'' [21] The Court's words largely echoed those of Congress,[22] the Commission,[23] and the accounting profession.[24]

B. Independence in Fact and Appearance

To fulfill the important role assigned to the auditor, the auditor must approach each audit with professional skepticism and must have a willingness and freedom to decide issues in an unbiased and objective manner, even when the auditor's decisions may be against the interests of management of

[12] The opinion of the auditor appears in a report that must include the word ''independent.'' *See* AICPA SAS No. 58, AU § 508.08.

[13] Steven M. H. Wallman, ''The Future of Accounting and Disclosure in an Evolving World: The Need for Dramatic Change,'' *Accounting Horizons,* at 81 (Sept. 1995).

[14] For example, Items 25 and 26 of Schedule A to the 1933 Act, 15 U.S.C. 77aa(25) and (26), and Section 17(e) of the Exchange Act, 15 U.S.C. 78q, expressly require that financial statements be audited by independent public or certified accountants. Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14 of the Public Utility Holding Company Act of 1935 (''PUHCA''), 15 U.S.C. 79e(b), 79j, and 79n, Sections 8(b)(5) and 30(e) and (g) of the Investment Company Act of 1940 (''ICA''), 15 U.S.C. 80a–8 and 80a–29, and Section 203(c)(1)(D) of the Investment Advisers Act of 1940 (''Advisers Act''), 15 U.S.C. 80b–3(c)(1), authorize the Commission to require the filing of financial statements that have been audited by independent accountants. Under this authority, the Commission has required that certain financial statements be audited by independent accountants. *See, e.g.,* Article 3 of Regulation S–X, 17 CFR 210.3–01 *et seq.* In addition, public companies must have their quarterly reports reviewed by independent accountants. Article 10 of Regulation S–X, 17 CFR 210.10–01(d) and Item 310(b) of Regulation S–B, 17 CFR 228.310(b). The federal securities laws also grant the Commission the authority to define the term ''independent.'' Section 19(a) of the 1933 Act, 15 U.S.C. 77s(a), Section 3(b) of the Exchange Act, 15 U.S.C. 78c(b), Section 20(a) of PUHCA, 15 U.S.C. 79t(a), and Section 38(a) of the ICA, 15 U.S.C. 80a–37(a), grant the Commission the authority to define accounting, technical, and trade terms used in each Act.

[15] ''An 'unqualified opinion' states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.'' AICPA SAS No. 58, AU § 508.10.

[16] This regulatory regime has been recognized by the courts. *See, e.g., Touche Ross & Co.* v. *SEC,* 609 F.2d 570, 580–81 (2d Cir. 1979).

[17] Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 55–60 (1933) (''1933 Senate Hearings''). During one hearing, Col. A. H. Carter, then president of the New York State Society of Certified Public Accountants, stressed the fact that outside accounting firms would be independent of management. During this discussion, Col. Carter, in differentiating between controllers employed by companies and independent accountants, stated, ''the public accountant audits the controller's accountant.'' Senator Barkley then asked, ''Who audits you?'' Col. Carter's oft-quoted reply was, ''Our conscience.'' *Id.* at 58.

[18] Payment of fees by the company to the auditor for performance of the audit and issuance of the auditor's opinion on the company's financial statements often is cited as a fundamental issue in the area of auditor independence. This fee structure was inherent in the decision by Congress in 1933 to have private sector auditors, rather than government employees, audit public companies. *Id.* Rather than being a reason for liberalization of the independence regulations, this payment structure should be a cause for exercising greater care by both companies and auditors in maintaining the auditor's independence. The National Association of Securities Dealers, Inc. (''NASD''), the New York Stock Exchange (''NYSE''), and the American Stock Exchange (''AMEX'') recently addressed this issue by changing their company listing standards to make it clear that the auditor is ultimately accountable to the board of directors and the audit committee, as opposed to management, and that the audit committee and the board of directors have the ultimate authority and responsibility to select, evaluate and, when appropriate, replace the auditor. *See* Order Approving Proposed Rule Change by the NASD, Exchange Act Rel. No. 42231, File No. SR–NASD–99–48 (Dec. 14, 1999); Order Approving Proposed Rule Change by the NYSE, Exchange Act Rel. No. 42233, File No. SR–NYSE–99–39 (Dec. 14, 1999); and Order Approving Proposed Rule Change by the AMEX, Exchange Act Rel. No. 42232, File No. SR–Amex–99–38 (Dec. 14, 1999).

[19] 465 U.S. 805 (1984).

[20] *Id.* at 817–18.

[21] *Id.* at 818.

[22] *See, e.g.,* Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 2d Sess., Federal Regulation and Regulatory Reform 35 (Subcomm. Print 1976) (also known as the Moss Report).

[23] *See, e.g.,* ''Relationships Between Registrants and Independent Accountants,'' Accounting Series Release (''ASR'') No. 296 (Aug. 20, 1981). *See also* Office of the Chief Accountant of the U.S. Securities and Exchange Commission, *Staff Report on Auditor Independence* (Mar. 1994) (''Staff Report'') for a detailed discussion of: (1) The background and need for auditor independence, (2) the current rules and interpretations of the Commission, the AICPA, and other nations, and (3) recent and proposed changes in those rules and interpretations.

[24] *See, e.g.,* AICPA SAS No. 1, AU § 220.03.

an audit client. According to a 1947 statement by the accounting profession, ''The independent auditor is under a responsibility peculiar to his profession to maintain strict independence of attitude and judgment in planning and conducting his examination and in expressing his opinion on financial statements.'' [25] Further, the AICPA's SAS No. 1 requires that ''in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor * * * he must be without bias with respect to the client.'' [26]

Because a principal purpose of auditor independence is to provide assurance to investors, the accounting profession has long required independence not only in fact but also in appearance. SAS No. 1 states, ''Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence.'' [27] Accordingly, ''Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.'' [28]

The 1979 Report of the Public Oversight Board (''POB'') echoes the point, noting that the appearance of independence is itself ''a key ingredient to the value of the audit function, since users of audit reports must be able to rely on the independent auditor. If they perceive that there is a lack of independence, whether or not such a deficiency exists, much of that value is lost.'' [29] The Supreme Court made the same point in the *Arthur Young* decision:

> The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. * * * If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.[30]

Auditor independence involves assumptions about human behavior that cannot be easily verified. [31] While conflicts of interest are easily described, their actual impact on the ''objectivity'' of particular auditors can never be precisely known, because ''objectivity,'' as the AICPA's professional standards note, ''is a state of mind.'' [32]

For this reason, the appearance standard serves an important legal purpose. It supplements an inquiry into the auditor's actual, subjective state of mind with an objective test: whether reasonable persons, knowing all relevant circumstances, would perceive that an auditor is independent. As the words connote, the appearance standard confines the inquiry into what is apparent and does not require an inquiry into the auditor's actual state of mind. The appearance standard, it should be stressed, is not a matter of ''public relations.'' It does not require the auditor to guess how persons with only a superficial understanding of the relevant facts would view his or her actions. Appearance is measured only with respect to reasonable persons knowing all the relevant facts and circumstances.

Independence rules also must be prophylactic.[33] Auditor independence requires auditors ''to be alert to a number of rather subtle influences. . . . [T]here is a considerable range of individual abilities within the profession; some accountants are strong enough and alert enough to control themselves under the most adverse and perhaps even the most subtle influences; others are not so fortunate.'' [34] Our task in this area is to identify and address the influences that reasonably could be expected to pose an unacceptable risk that an auditor would lose his or her objectivity or that reasonable persons would perceive a loss of objectivity.

C. The New Business Environment Calls for Modernized Rules

In recent years, there have been significant demographic changes, changes in the accounting profession, and changes in the business environment that have affected accounting firms. Some of the more significant changes that have drawn attention to our auditor independence requirements include the increase in dual-career families, an ever-increasing mobility among professionals, a broadening international presence of accounting firms, and the growth and profitability of non-audit services offered by accounting firms to audit clients. These changes have led us to re-evaluate whether our auditor independence requirements remain effective, relevant, and fair.

1. Financial and Employment Relationships

We propose to update the requirements regarding financial and employment relationships between auditors or their family members and audit clients.[35] The existing requirements, among other things, attribute to the auditor investments of the relatives of the auditor ''in varying degrees depending on the closeness of the [family] relationship,'' [36] regardless of the amount of the holdings. They also attribute to auditors the investments of all partners and many professional employees in the accounting firm, as well as their families. The existing attribution rules may be too restrictive, since traditional family structures have changed, family members are more dispersed, there is increased mobility of professional employees, and accounting firms themselves are expanding around the globe. Accordingly, our proposals narrow many of these requirements,

[25] The Council of American Institute of Accountants adopted an official statement on independence that was published in *The Journal of Accountancy* in July 1947.

[26] AICPA SAS No. 1, AU § 220.01–02.

[27] *Id.* at AU § 220.03.

[28] *Id.*

[29] POB, *Scope of Services by CPA Firms,* at 27 (Mar. 1979) (''1979 POB Report'') (quoting A. Arens and J. Loebbecke, *Auditing: An Integrated Approach* (Prentice-Hall 1976)).

[30] *Arthur Young, supra* note 19, at 819 n.15 (emphasis in original).

[31] The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees noted with respect to independent directors that, even absent objective verification, ''* * * common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices.'' The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the ''Blue Ribbon Committee''), *Report and Recommendations,* at 22 (1999) (the ''Blue Ribbon Report''). Copies of the Blue Ribbon Report are available at *www.nyse.com* or *www.nasd.com.*

[32] Article IV of the AICPA's Code of Professional Conduct provides, ''Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.'' AICPA Code of Professional Conduct, ET § 55.01.

[33] Earnscliffe reports that ''[w]hile some believe that perceptions of the independence of auditors is already suffering some corrosion, more people take the view that damage is inevitable in the future if greater precautions are not taken to protect the perception of independence.'' Earnscliffe Report, *supra* note 10, at 46.

[34] R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing,* at 223 (Am. Acct. Ass'n 1961).

[35] *See* illustrations in Appendix C of how some of the proposed rules would apply. They are provided for illustrative purposes only and necessarily exclude certain important details set forth in the proposed rules.

[36] Codification § 602.02.h.

while protecting investor confidence in the reliability of financial information.

The proposals similarly narrow existing restrictions on the employment of auditors' family members, former audit firm employees, and former audit client employees who leave companies to work in audit firms. For example, with respect to employment restrictions on auditor's relatives, the proposals liberalize our existing position in several significant respects. First, the proposals reduce the pool of people within audit firms whose independence is required for an independent audit. Second, the proposals identify specific positions, namely those in which a person is in a position to or does influence the audit client's financial records, that would impair an auditor's independence if held by the auditor's relative. Finally, under the proposals, only positions at an audit client held by the auditor's ''close family members'' affect the auditor's independence. These proposals liberalize our current position and the ISB's position as reflected in its recent Invitation to Comment.[37]

2. Scope of Services

(a) *A Historical Perspective on the Provision of Non-Audit Services.* In the 1970s, Congress seriously considered limiting the services independent public accountants could provide that were not directly related to accounting, even though at that time non-audit services did not constitute a large percentage of audit firms' businesses.[38] Although Congress did not take action, in 1979, the Chairman of the POB warned the public about dangers arising from the growth of non-audit services:

> The [POB] believes that there is possibility of damage to the profession and the users of the profession's services in an uncontrolled expansion of MAS to audit clients. Investors and others need a public accounting profession that performs its primary function of auditing financial statements with both the fact and the appearance of competence and independence. Developments which detract from this will surely damage the professional status of CPA firms and lead to suspicions and doubts that will be detrimental to the continued reliance of the public upon the profession without further and more drastic governmental intrusion.[39]

Our staff considered these issues in a 1994 Staff Report.[40] The Staff Report noted that much of the growth in non-audit services until then could be attributed to services provided to parties other than audit clients.[41] Accordingly, the Staff Report concluded that no change in our rules or the federal securities laws was warranted at that time, but the staff promised to ''continue to be alert to the development of problems of independence that may be caused by [non-audit services].''[42] The staff has kept a watchful eye on these matters.

Other industry observers also have followed developments in this area. After the Staff Report, there were at least three significant studies by the private sector and one by the General Accounting Office (''GAO''). These studies emphasized the continuing public concern regarding the objectivity and independence of auditors, particularly in light of the expansion of consulting and other non-audit services for audit clients. The Advisory Panel on Auditor Independence (also known as the Kirk Panel), in its September 1994 report, described the trend toward non-audit services as ''worrisome,'' because:

> [g]rowing reliance on nonaudit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function, by allocating disproportionate resources to other lines of business within the firm, and by seeing the audit function as necessary just to get the benefit of being considered objective and to serve as an entree to sell other services. . . .[43]

Similarly, the AICPA Special Committee on Financial Reporting (also known as the Jenkins Committee), in its 1994 report, found that users of financial statements believed that non-audit service relationships could ''erode auditor independence.'' The Report noted:

> [Users] also are concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship.[44]

Two years later, in 1996, GAO completed a thorough review of the accounting profession. In its report, GAO noted:

> GAO . . . believes that questions of auditor independence will probably continue as long as the existing auditor/client relationship continues. This concern over auditor independence may become larger as accounting firms move to provide new services that go beyond traditional services. The accounting profession needs to be attentive to the concerns over independence in considering the appropriateness of new services to ensure that independence is not impaired and the auditor's traditional values of being objective and skeptical are not diminished.[45]

Most recently, in 1999, Earnscliffe conducted interviews to assess the perceptions of different audiences about

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[37] *See* ISB, ''Invitation to Comment 99–1: Family Relationships Between the Auditor and the Audit Client'' (July 1999).

[38] *See* Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors, Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. (Comm. Print Nov. 1977). In the Report, the Subcommittee stated that it ''agrees with the Cohen commission and many others that the accounting profession must improve its procedures for assuring independence in view of the public's needs and expectations. Several activities of independent auditors have raised questions. Among them are public advocacy on behalf of a client, receiving gifts and discounts from clients, and maintaining relationships which detract from the appearance of arm's-length dealings with clients. Such activities are not appropriate.'' *Id.* at 16. The subcommittee also stated that ''[t]he best policy * * * is to require that independent auditors of publicly owned corporations perform only services directly related to accounting. Non-accounting management services . . . should be discontinued.'' *Id.* at 16–17.

In a letter to Harold Williams, Chairman, SEC, Senator Thomas F. Eagleton, Chairman, Subcomm. on Governmental Efficiency and the District of Columbia, of the Senate Comm. on Governmental Affairs, recommended that ''[t]here must be a requirement that independent auditors of publicly owned corporations perform only services directly related to accounting.'' Letter from Senator Thomas F. Eagleton to Harold Williams, dated Apr. 6, 1978 (reprinted in Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role (July 1978)).

[39] Letter from John J. McCloy, Chairman, POB (former Chairman of the Board of Chase Manhattan Bank and former President of The World Bank), to Walter E. Hanson, Chairman, Executive Committee, SEC Practice Section (''SECPS''), dated March 9, 1979, at 2.

[40] Staff Report, *supra* note 23, at 27–34. Between 1979 and 1981, public companies were required to disclose in their proxy statements certain information about non-audit services provided by their auditors. *See infra* Section II.C.4. (discussing these disclosure requirements). In the late 1980s, several of the large public accounting firms filed a petition with us seeking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. *See* Letter from Jonathan G. Katz, Secretary, SEC, to Duane R. Kullberg, Arthur Andersen & Co., dated Feb. 14, 1989 (denying the petition). In 1990, the staff stated that if certain conditions were met, it would not object to Arthur Andersen & Co.'s conclusion that certain business relationships between Andersen Consulting and audit clients of Arthur Andersen & Co. may be considered indirect business relationships. *See* Letter from Edmund Coulson, Chief Accountant, SEC, to Robert Mednick, Arthur Andersen & Co., dated June 20, 1990.

[41] Staff Report, *supra* note 23, at 33. *See infra* notes 47–67 and accompanying text (showing dramatic increase in nature, number, and dollar amount of non-audit services provided to audit clients since the issuance of the Staff Report).

[42] Staff Report, *supra* note 23, at 34.

[43] Advisory Panel on Auditor Independence, *Report to the Public Oversight Board of the SEC Practice Section, AICPA: Strengthening the Professionalism of the Independent Auditor,* at 9 (Sept. 13, 1994).

[44] Special Committee on Financial Reporting, AICPA, *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors,* at 104 (1994).

[45] GAO, *The Accounting Profession—Major Issues: Progress and Concerns,* at 8 (GAO/AIMD–96–98, Sept. 1996) (the ''GAO Report'').

auditor independence. In conclusion, Earnscliffe reported that, ''Most [interviewees] felt that the evolution of accounting firms to multi-disciplinary business service consultancies represents a challenge to the ability of auditors to maintain the reality and the perception of independence. . . .'' [46]

Taken together, these studies suggest that important constituencies see a connection between the business scope of accounting firms and auditor independence.

(b) *Recent Developments.* The menu of services offered by the firms to audit clients has grown dramatically and continues to grow. [47] Attached to this release, for commenters' convenience, is a list of services that auditors provide to their audit and non-audit clients.[48] Companies appear to be turning to their auditors for performance of their internal audit, pension, financial, administrative, sales, data processing, and marketing functions, among others.[49]

U.S. revenues for management advisory and similar services [50] for the five largest public accounting firms amounted to more than $15 billion in 1999, based on amounts calculated from data published in the Public Accounting Report.[51] Revenues for these service lines are now estimated to constitute half of the total revenues for these firms.[52] In contrast, these service lines provided only 13 percent of total revenues in 1981.[53] From 1993 to 1999, the average annual growth rate for revenues from management advisory and similar services has been 26 percent; comparable growth rates have been 9 percent for audit, and 13 percent for tax services.[54]

For the largest firms, the growth in management advisory and similar services involves both audit clients and non-audit clients. For the largest public accounting firms, MAS fees from audit clients have increased significantly over the past two decades. In 1984, only one percent of audit clients of the eight largest public accounting firms paid MAS fees that exceeded the audit fee.[55] The percent of Big 5 audit clients that paid MAS fees in excess of audit fees did not exceed 1.5 percent until 1997.[56] In 1999, 4.6 percent of Big 5 audit clients paid MAS fees in excess of audit fees,[57] an increase of over 200% in two years. For the five largest public accounting firms, MAS fees received from audit clients amounted to ten percent of all revenues in 1999.[58] Almost three-fourths of audit clients purchased no MAS from their auditors in 1999. This means that purchases of MAS services by one-fourth of firm's audit clients account for ten percent of all firm revenues.[59] In addition, the magnitude of MAS fees received from SEC registrants appears to distinguish the five largest accounting firms from other firms. The MAS fees received by the approximately 800 accounting firms with 1,000 or fewer SEC registrants as audit clients represent approximately one percent or less of total fees on average.[60]

Certain transactions raise questions about auditor independence. Some smaller firms are consolidating their audit practices and seeking public investors in the resulting company.[61] Other firms are entering into agreements to sell all of their assets except their audit practices to established financial services companies. As part of these agreements, the financial services companies also hire the employees of the accounting firm, and then lease back the majority or all of the assets and audit personnel to the ''shell'' audit firm. These lease arrangements allow the financial service firm to pay the professional staff for ''nonprofessional'' services for the corporate organization as well as professional attest services rendered for the audit firm.[62]

In February 2000, Ernst & Young announced that it would sell its management-consulting business to Cap Gemini Group SA, a large and publicly-traded computer services company headquartered in France.[63] KPMG recently split off its consulting business into a separate corporation (KPMG Consulting, Inc.), sold preferred stock convertible to between 18.2% and 19.9% of its outstanding stock to Cisco Corporation, and announced its intention to sell additional shares to the public in an initial public offering.[64] PricewaterhouseCoopers has publicly announced its intention to re-structure its audit and consulting businesses along similar lines.[65]

Under certain circumstances, these transactions could lead to violations of the independence rules, since the financial interests and relationships of the newly formed consulting entities would be imputed to the auditing firms. At a minimum, these transactions could raise serious public policy issues by creating relationships between firms and shareholders, strategic investors, and companies providing services to audit clients. In the case of Ernst & Young, our Chief Accountant, by no-action letter, stated that the Office of the Chief Accountant would not assert that Ernst & Young's independence from an audit client has been impaired solely because that audit client is also a client of, enters into a business relationship with, or is invested in by Cap Gemini. That no-action relief was based on, among other things, Ernst & Young's representations that: (1) Following the initial sale to Cap Gemini, Ernst & Young's equity interest would be reduced to zero within five years, (2) Ernst & Young would play no role in the corporate governance of the consulting company, and (3) Ernst & Young would

[46] Earnscliffe Report, *supra* note 10, at 46.

[47] Some firms are seeking to provide expanded services through joint ventures with audit clients or their affiliates. As noted above, as early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. *See* Letter from Jonathan G. Katz to Duane R. Kullberg, *supra* note 40.

[48] *See* Appendix A. The list was prepared by the ISB. *See* ISB, ''Discussion Memorandum 99–2: Evolving Forms of Firm Structure and Organization'' (Oct. 1999). Although the list is long, it is not comprehensive. Commentators may wish to review accounting firms' web sites and other sources for additional information about the services being provided by accounting firms.

[49] *See, e.g.,* ''KPMG spies rapid growth in 'shared services','' *Accounting Today*, at 12 (June 3–16, 1996); ''KPMG Restructures to Reposition Outsourcing,'' *Public Accounting Report*, at 1 (May 15, 1996).

[50] Management advisory services (''MAS'') are a subset of non-audit services.

[51] *See* Table 1 in Appendix B. The underlying data are reported in ''Special Supplement: Annual Survey of National Accounting Firms—2000,'' *Public Accounting Report* (Mar. 31, 2000).

[52] *See* Tables 1 and 2 in Appendix B.

[53] *See* Table 2 in Appendix B.

[54] *See* Table 1 in Appendix B.

[55] *See* Table 3 in Appendix B.

[56] *See* Table 3 in Appendix B.

[57] *See* Table 3 in Appendix B.

[58] *See* Table 4 in Appendix B.

[59] *See* Table 3 in Appendix B. Taken together, the data from tables 1, 3, and 4 indicate that in 1999 more than 12,700 clients of the five largest public accounting firms paid approximately $9.150 billion for accounting and auditing services. During that same period, approximately 3,300 of those companies that are SEC registrants paid approximately $3.062 billion for MAS and similar non-audit services.

[60] *See* Table 4 in Appendix B.

[61] *See, e.g.,* Rick Telberg, ''Anybody can do it! says small-firm consolidator,'' *Accounting Today,* at 5 (Jan. 4–24, 1999).

[62] ''Done Deal: HRB acquires M&P for $240 million cash, pension obligation,'' *Public Accounting Report,* at 1 (July 15, 1999); ''AmEx and Checkers Close The Deal,'' *Public Accounting Report,* at 1 (Mar. 31, 1997).

[63] ''Cap Gemini and Ernst & Young Have Agreed to Terms for the Acquisition of Ernst & Young Consulting'' (Feb. 29, 2000) (press release of Ernst & Young) (available at www.ey.com).

[64] KPMG Consulting, Inc., Form S–1, filed May 5, 2000.

[65] Diane B. Henriques, ''Auditing Firm Plans to Split Its Businesses,'' N.Y. Times, Feb. 18, 2000, at C8.

not have any co-marketing arrangements with the new entity.[66]

(c) *How Non-Audit Services Can Affect Auditor Independence.* The dramatic expansion of non-audit services may fundamentally alter the relationships between auditors and their audit clients in two principal ways. First, as auditing becomes an ever-smaller portion of a firm's business with its audit clients, auditors become increasingly vulnerable to economic pressures from audit clients. Second, certain non-audit services, by their very nature, raise independence issues. These concerns, described more fully below, have led us to consider whether our rules should limit—or even completely bar—an auditor's provision of non-audit services to audit clients.

(i) *Auditor Vulnerability to Economic Pressure From Audit Clients.* Large non-audit engagements [67] may make it harder for auditors to be objective when examining their client's financial statements. Under any circumstances, it can be difficult for an auditor to make a judgment that works against the audit client's interest. Where making that judgment may imperil a range of service engagements of the firm, of which the audit is a fairly small part, it may be unrealistic to expect that an auditor can ignore completely what the firm stands to lose by the auditor's action.

Our concern is not just that an auditor will give in to a client. It is that, as auditors become involved in a broad array of business arrangements with their clients, they come to be seen by themselves, their firms, their clients, and investors less as exacting, skeptical professionals who must be satisfied before signing off on the financial statements, and more like any other service vendor who must satisfy the client to make the sale.[68]

An expanded menu of relationships with an audit client may also give rise to a mutuality of interest between the auditor and client. This would be a significant concern in any era, but it may be especially important in an era when many ventures go quickly from start-up to apparent success to failure. For example, an audit firm may agree to perform the audit of a start-up company for fees significantly below market rates for a few years, in anticipation of ''recouping'' such an investment in the client through a subsequent initial public offering or performance of consulting services.

We also have concerns about the effect on an accounting firm's internal culture when the firm is trying to be an audit client's vendor of choice. As non-audit services become more important to a firm, that firm may care less about auditing and more about expanding its service lines. The factors that drive a high quality audit, including the core values of the auditing profession, may diminish in importance to the firm, as will the influence of those firm members who exemplified those core values in their own professional careers.

There appears to be growing public concern about audit firms' increasing provision of various non-audit services, and skepticism that firm safeguards adequately protect the fact and appearance of independence. Earnscliffe reports that auditors, audit committee chairs, chief executive officers, analysts, and regulators all, to some degree, recognize the independence risks posed by multifaceted relationships between auditors and their audit clients.[69] A majority of the Earnscliffe respondents felt that internal firm safeguards ''might ultimately be insufficient to sustain confidence in the independence of auditors.'' According to the Report, those respondents

> . . . felt that the judgement of observers would turn on how the financial incentives and penalties were organized: if it appeared that a firm had more upside in bending to a client's pressures, then internal processes would only be of limited value. Not everyone felt that this was the perception today, rather they were offering the view that internal firm safeguards had limited prophylactic value if the scrutiny were to become more punishing.[70]

(ii) *Independence Issues Inherent in the Nature of Certain Non-audit Services.* Providing certain non-audit services to an audit client can lead an audit firm to have a mutual or conflicting interest with the client, audit its own work, advocate a position for the client, or function as an employee or management of the client.[71] Auditor independence concerns arise, for example, when a company hires its audit firm to perform valuations of in-process research and development.[72] When an auditor in effect, even if not in form, makes decisions for management, he or she functions as a member of the management team and may develop a ''mutuality of interest'' with the audit client. After all, a ''consultant . . . will be judged by the ultimate usefulness of his advice in bringing success to management's efforts. He has had a hand in shaping managerial decisions and will be judged by management on the same basis that the management itself will be judged. How then can he claim to be completely independent?'' [73] The consultant is accountable to management, in contrast to the auditor, who must ''acknowledge[] no master but the public.'' [74]

(d) *Measuring Independence Impairments.* Some argue that no empirical evidence justifies our concerns. They argue that there is no evidence that providing non-audit services in general—much less particular types of non-audit services—leads to false financial reporting. Without this evidence, the argument goes, the Commission should not take steps to protect auditor independence.

It is common sense, however, and confirmed by studies, that a person's decision changes when he or she has a stake in the outcome of that decision.[75]

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[66] Letter from Lynn E. Turner, Chief Accountant, SEC, to Kathryn A. Oberly, Esq., Ernst & Young, dated May 25, 2000 (available at www.sec.gov).

[67] In 1999, Big 5 accounting firms received higher fees for MAS and other consulting services than for audits from approximately 600 audit clients. *See* Table 3 in Appendix B.

[68] Earnscliffe reports, ''The large majority of interviewees in each segment (including auditors) have sensed that in recent years accounting firms have lost their preoccupation with audits, and become much more preoccupied with growing new areas of consulting revenue. Many felt that within firms, the psychic and financial rewards were tilted heavily towards the consulting side, and that auditors who wanted to be well compensated and respected by peers, needed to support the growth of non-audit functions. This perception was even shared by a fair number of auditors. . . .'' Earnscliffe Report, *supra* note 10, at 14.

See also Statement of PricewaterhouseCoopers, ''In essence, we have become an organisation trying to follow two missions at the same time. One goal has been to assure financial market integrity and provide investor protection. The other has been to help clients succeed by guiding them through complex, large-scale business transformations. One goal demands objectivity and independence. The other demands a direct interest in our clients' success.'' Wall St. J., Feb. 22, 2000, at A17.

[69] Earnscliffe Report, *supra* note 10, at 28, 37–41.

[70] *Id.* at 20. Regarding the lack of effective safeguards, *see generally* ''Report of the Internal Investigation of Independence Issues at PricewaterhouseCoopers LLP'' (Jan. 6, 2000) (available on our web site, www.sec.gov). *See also* Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, Chairman, SECPS Executive Committee, dated Nov. 30, 1998 and May 1, 2000.

[71] *See generally* Paul M. Clikeman, ''Auditor Independence: Continuing Controversy,'' Ohio CPA J. (Apr.-June 1998); Mautz and Sharaf, *supra* note 34, at Ch. 8.

[72] *See infra* Section III.D.1.(b) (regarding the types of services that raise independence concerns).

[73] Mautz and H. Sharaf, *supra* note 34, at 222.

[74] Gary John Previts, T*he Scope of CPA Services* 33 (John Wiley & Sons, 1985) (citing Charles Reckitt, *The Public Accountant* (Philadelphia 1900)).

[75] *See* Max H. Bazerman, Kimberly P. Morgan, and George F. Loewenstein, ''The Impossibility of Auditor Independence,'' *Sloan Management Review*, at 89–94 (Summer 1997) (reviewing empirical research showing that ''[w]hen people are called on to make impartial judgments, those judgments are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's selfinterest,'' and concluding that, despite their best intentions, ''there is good reason to believe that auditors will unknowingly misrepresent facts and will

Furthermore, common sense dictates that the more someone—including an auditor—has at stake, the more likely his or her decision is to be affected.

Studies cannot always confirm what common sense makes clear. Except where an auditor accepts a payment to look the other way,[76] is found to have participated in a fraudulent scheme,[77] or admits to being biased, it is largely impossible to observe an auditor's state of mind or know whether an auditor's mind is ''objective.'' It is even harder to measure the impact a particular financial arrangement has on the auditor's state of mind. And it is similarly impossible to tie a questionable state of mind to a wrong judgment, a failure to notice something important, a failure to seek important evidential matter, a failure to challenge a management assertion, or a failure to consider the quality—not just the acceptability—of a company's financial reporting.[78] This is particularly true because auditing misjudgments may often go unnoticed.[79] As the POB noted, ''Specific evidence of loss of independence through MAS, a so-called smoking gun, is not likely to be available even if there is such a loss.'' [80]

Whatever the effect of non-audit service relationships on an auditor's conduct, there can be little question about the effect of these impairments on investor confidence. Gradual decreases in investor confidence may not be measurable, but their cumulative economic impact could not be more palpable. Investor confidence in the integrity of publicly available financial information is the cornerstone of our securities markets. That confidence is hard won and easily lost, and the Commission must act to protect it.

(e) *Whether to Prohibit All Non-Audit Services*. In developing these proposals, we considered whether independence is impaired whenever an auditor provides *any* non-audit service to an audit client, or whether certain non-audit services do not impair independence. We have tentatively concluded, pending public comment, that the better approach is to permit some significant non-audit services, though several factors weigh in favor of a blanket ban.

Prohibiting only some non-audit services does not address the increasing vulnerability of auditors to their audit clients and the corresponding link between the financial health of auditors and their clients. These concerns do not turn on the nature of the non-audit service involved, but arise simply because of the growing interdependence of auditor and client.

In addition, distinguishing between permissible and impermissible types of services raises difficult questions about services that do not fall squarely into precise categories. These questions will get only harder in the future as firms move to provide new and unforeseen services.

Finally, an approach that tries to distinguish between permissible and impermissible types of services depends heavily upon daily interpretations by the very firms the rules are intended to affect. In light of the powerful economic interests at stake, there is serious question whether it is fair or reasonable to expect accounting firms to evaluate the impact of new services on their own impartiality.

Despite these doubts, we believe that the measured approach we propose—establishing basic principles for evaluating any non-audit services' impact on independence, and identifying specific services that are plainly incompatible with independence—protects investor confidence in the audit process while allowing auditors to provide those services that are not reasonably viewed as creating a bias in the auditor. Our goal is to preclude non-audit services only to the extent necessary to protect the integrity and independence of the audit function. Of course, therefore, the proposals do not extend to services provided to non-audit clients.

3. *Quality Controls*

As accounting firms become more global and their business relationships with their audit clients become more complex, the need for quality controls to address independence becomes more apparent. Without strong quality controls, it may be difficult or impossible for an accounting firm to understand whether its independence may be impaired. For example, firms need quality controls to track whether the firm, or any covered person in the firm, has any direct investment in an audit client.

Our staff has stated that certain firms, particularly larger firms with public company clients, may lack sufficient worldwide quality controls.[81] The staff has urged certain firms to review existing quality controls and ensure that particular areas are covered.[82] Moreover, designing and implementing quality controls is not a one-time responsibility. We encourage accounting firms to continue to invest in state-of-the-art systems that can identify conflicts at an early stage to ensure a swift response. The speed of the response to a conflict, or potential conflict, is important to maintain public confidence in the self-regulatory process and the effectiveness of quality controls.[83]

We understand that many firms are already designing and implementing quality controls. We recently announced a voluntary compliance program, in which the Big 5 accounting firms agreed to report past violations of auditor independence rules.[84] In connection with the program, the firms also have agreed to design and implement quality controls specified by our Chief Accountant and have the POB issue public reports on the results of their efforts. The rules we propose today are intended to encourage firms to design and implement effective quality controls to address independence. Toward that end, the rules contain a limited exception for firms that have appropriate quality controls and meet other conditions.

4. *Proxy Disclosure*

From 1978 to 1982, we required companies to disclose in their proxy statements all non-audit services provided by their auditors.[85] We also required companies to include a statement of the percentage of the fees for all non-audit services compared to total audit fees, the percentage of the fee for each non-audit service compared to

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unknowingly subordinate their judgment due to cognitive limitations''); *see also* Robert A Prentice, ''The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing,'' Ohio St. L.J. (Fall 2000) (forthcoming).

[76] *See, e.g., SEC* v. *Jose Gomez*, Accounting and Auditing Enforcement Release (''AAER'') No. 57 (May 8, 1985).

[77] *See, e.g., SEC* v. *Christopher Bagdasarian and Sam White*, AAER No. 825 (Sept. 26, 1996).

[78] *See* AICPA SAS No. 90, AU § 380.11. Independence lapses perhaps are most likely to affect this gray area, where the answers are more a matter of judgment than of bright-line rule, and where judgments are out of the public view.

[79] Of course, all of these factors make it equally impossible to demonstrate empirically that an auditor's economic interests do *not* adversely affect the quality of the audit.

[80] 1979 POB Report, *supra* note 29, at 34 n.103. As the POB noted, ''[T]he Board recognizes that the nonexistence of such evidence does not necessarily mean that there have not been instances where independence may have been impaired. Not all situations where an auditor's objectivity is compromised will result in a lawsuit.'' *Id.* at 35.

[81] *See* Letter from Lynn Turner, Chief Accountant, SEC, to Charles Bowsher, Chairman, POB, dated Dec. 9, 1999; *see, e.g., In the Matter of PricewaterhouseCoopers, LLP*, AAER No. 1098 (Jan. 14, 1999).

[82] *See* Letters from Lynn Turner, Chief Accountant, SEC, to Michael Conway, *supra* note 70.

[83] *See id.*

[84] SEC Press Release, ''All Big 5 Accounting Firms Agree to Participate in Voluntary Program to Address Independence Violations; Safe Harbor Provided for Certain Violations'' (June 7, 2000).

[85] For a concise discussion of the Commission's previous rulemaking efforts in this area, *see* Staff Report, *supra* note 23, at 27–34.

total audit fees, and a statement whether each non-audit service was considered and approved by the audit committee of the board of directors or by the board itself.[86]

In connection with the disclosure requirement, we published an interpretive release [87] describing certain factors that independent accountants, audit committees, boards of directors, and managements should consider in determining whether a company's independent accountant should be engaged to perform non-audit services. These factors included the auditor's dependence on non-audit fees, the possibility of the auditor supplanting management's role in making corporate decisions, the possibility of creating a situation where an auditor may be required to review its own work, and the relation of the non-audit activity to accounting and auditing skills.

Although our concerns regarding the provision of consulting and other non-audit services remained unchanged, we later determined to rescind the formal interpretive release [88] and the proxy disclosure requirement.[89] Among other reasons, our review of proxy disclosures convinced us that accounting firms were not providing extensive non-audit services to their audit clients. Our review of the 1979 and 1980 proxy disclosures of approximately 1,200 registrants showed that fees paid by audit clients for non-audit services generally constituted a relatively small fraction of registrants' audit fees.[90] In addition, we noted that, even without the proxy disclosure requirement, investors had access to useful data concerning the relative levels of audit and non-audit services provided by firms to their audit clients. In particular, we noted that summarized information regarding the relationship between MAS and audit fees was provided to the SECPS by member firms and was publicly available. We also concluded that the efforts of audit committees and the accounting profession to monitor firms' provision of non-audit services generally had been effective.

As discussed above, however, in recent years there has been a dramatic growth in the number of non-audit services provided to audit clients and the magnitude of fees paid for non-audit services.[91] Moreover, there may be less information available to investors about these services since the SECPS has stopped publishing information about audit firms' provision of non-audit services. Further, information provided by the SECPS describes the mix of services provided by an accounting firm to all of its clients, while an investor generally is primarily interested in the services provided to an individual company. This information is not currently available.

Under circumstances where investors have less information about a matter that has become more important, we believe a disclosure requirement may once again prove useful to investors. Accordingly, we propose to reinstate a requirement that companies include in their proxy statements certain disclosures about non-audit services provided by their auditors during the last fiscal year. As we did while the requirement was in effect twenty years ago, we expect that both we and investors will learn from these disclosures and that they will have an impact on audit committees, investors, and accounting firms.[92] Disclosure may be particularly effective now that investors have unprecedented access to information about companies in which they invest. We believe that investors should have access to information regarding the company's auditors when making investment decisions and when voting to elect, approve, or ratify the selection of, the accounting firm as the principal auditor of a company's financial statements.

We also believe that audit committees, as well as management, should engage in active discussions of independence issues with the outside auditors. According to the Blue Ribbon Report, ''If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation.'' [93]

Recently, the ISB adopted ISB Standard No. 1, which requires each auditor to disclose in writing to its client's audit committee, all relationships between the auditor and the company that, in the auditor's judgment,[94] reasonably may be thought to bear on independence, and to discuss the auditor's independence with the audit committee.[95] Furthermore, we recently adopted new disclosure rules regarding audit committees and auditor reviews of interim financial information, in response to recommendations made by the Blue Ribbon Committee.[96] These new rules

[86] ''Disclosure of Relationships with Independent Public Accountants,'' ASR No. 250 (June 29, 1978). Prior to the implementation of this disclosure requirement, a private commission established by the AICPA (The Commission on Auditor's Responsibilities, known as the ''Cohen Commission'') reviewed the performance of non-audit services by auditors. The Cohen Commission found that outside of executive search and placement services, there was no evidence that the performance of such services compromised auditor independence. In spite of this finding, the Cohen Commission urged the accounting profession to take steps to diminish the concerns of a ''significant minority'' and recommended that the performance of non-audit services be evaluated by audit committees or boards of directors, and that registrants or auditors appropriately disclose such services. The Commission on Auditors' Responsibilities, AICPA, *Report, Conclusions, and Recommendations*, at 100–04 (1978).

[87] ''Scope of Services by Independent Accountants,'' ASR No. 264 (June 14, 1979).

[88] In withdrawing the interpretive release, we reaffirmed our views regarding the need for caution in the provision of non-audit services:

Although the Commission's views expressed in [the interpretive release] are unchanged and registrants and accountants must continue to carefully evaluate their relationships to ensure that the public maintains confidence in the integrity of financial reporting, the Commission is withdrawing that release because it may confuse independent accountants, audit committees and others who are trying to evaluate services performed or to be performed by the accountants. Moreover, the Commission believes it has achieved its objective in issuing [the interpretive release]. Accountants and their self-regulatory structure, audit committees, boards of directors and managements are aware of the Commission's views on accountants' independence and should be sensitive to the possible impact on independence of nonaudit services performed by accountants. The Commission believes it should be able to rely on these persons to ensure adequate consideration of the impact on accountants' independence of nonaudit services because they share the responsibility to assure that the public maintains confidence in the independence of accountants.

ASR No. 296, *supra* note 23.

[89] ''Rescission of Certain Accounting Series Releases and Adoption of Amendments to Certain Rules of Regulation S-X Relating to Disclosure of Maturities of Long-Term Obligations,'' ASR No. 297 (Aug. 20, 1981).

[90] ASR No. 296, *supra* note 23.

[91] *See supra* Section II.C.; see also Appendix B.

[92] The effect of the proposed disclosure would be similar to disclosure of management's discussion and analysis of financial condition and results of operations. *See* Item 303 of Regulation S–K, 17 CFR 229.303.

[93] Blue Ribbon Report, *supra* note 31, at 40.

[94] In a letter to the SECPS, ISB Chairman William Allen clarified the use of the auditor's judgment under the standard. He stated:

[I]n asking itself whether a fact or relationship is material in this setting the auditor may not rely on its professional judgment that such fact or relationship does not constitute an impairment of independence. Rather the auditor is to ask, in its informed good faith view, whether the members of the audit committee who represent reasonable investors, would regard the fact in question as bearing upon the board's judgment of auditor independence.

Letter from William T. Allen, Chairman, ISB, to Mr. Michael A. Conway, Chairman, Executive Committee, SECPS, dated Feb. 8, 1999. We believe that Chairman Allen's interpretation is appropriate.

[95] ISB Standard No. 1, ''Independence Discussions with Audit Committees'' (Jan. 1999).

[96] ''Audit Committee Disclosure,'' Exchange Act Rel. No. 42266 (Dec. 22, 1999). Companies also

require that companies include in their proxy statements reports of their audit committees that state whether, among other things, the audit committees have received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1,[97] and discussed with the auditors the auditors' independence. Our new requirements, and the new requirements of the ISB, the New York Stock Exchange, the National Association of Securities Dealers, Inc. and the American Stock Exchange [98] should encourage auditors, audit committees, and management to have robust and probing discussion of all issues that might affect investors' views of the auditor's independence.

D. The Need for a More Accessible Auditor Independence Framework

Currently, our auditor independence requirements are found in various Commission rules and interpretations. These have been supplemented over the years by staff letters, staff reports, and ethics rulings by the accounting profession.[99] Current Rule 2–01 of Regulation S–X sets forth the circumstances under which we will not recognize an accountant as independent.[100] Because Rule 2–01 does not address particular factual situations, we and our staff have issued interpretations of Rule 2–01 in response to public companies' questions about particular situations.[101] The proposed revisions to Rule 2–01 would consolidate and make more accessible the standards for auditor independence under the federal securities laws, reemphasize its importance, and provide a comprehensive framework for evaluating auditor independence. The proposed proxy disclosures, if adopted, should add to the body of knowledge regarding the provision of non-audit services.

The new rules should also assist the ISB in its work. In FRR No. 50,[102] we stated that we would look to the ISB to provide leadership in improving auditor independence requirements and in establishing and maintaining a body of independence standards applicable to auditors of public companies.[103] In the same manner, we previously have endorsed the establishment of the Financial Accounting Standards Board (''FASB'').[104] Among other things, the ISB sets standards and its staff answers day-to-day inquiries regarding the application of our auditor independence requirements to specific situations confronting auditors and their clients.

The ISB has requested more guidance from us. For example, the ISB noted in ISB Standard No. 2,[105] the standard would not take effect until the SEC revises its rules on independence. Accordingly, our proposals and the attendant modifications to the Codification, if adopted, would enhance the ability of the ISB to make its standards effective. In addition, by providing a comprehensive framework, the new rules, if adopted, should assist the ISB in making future decisions regarding auditor independence matters.[106]

III. Discussion of Proposed Rules

A. Qualifications of Accountants

Section 2–01(a) would remain unchanged and require that in order to practice before the Commission an auditor must be in good standing and entitled to practice in the state of the auditor's residence or principal office. This requirement has existed since the Federal Trade Commission first adopted rules under the 1933 Act.[107] It acknowledges our deference to the states for the licensing of public and certified public accountants.

B. The General Standard for Auditor Independence

Proposed rule 2–01(b) sets forth the basic test of an auditor's independence. Under that test, we will not recognize as independent an accountant who, with respect to an audit client, is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all

should note the requirement to disclose interests and relationships with its auditors under Item 509 of Regulation S–K, 17 CFR 229.509, and Item 509 of Regulation S–B, 17 CFR 228.509.

[97] ISB Standard No. 1, *supra* note 95.

[98] Orders Approving Proposed Rule Changes by AMEX, NASD, and NYSE, *supra* note 18.

[99] We have brought a number of enforcement cases in which we charged auditors with violations of the independence rules. *See, e.g.*, *In the Matter of Pricewaterhouse Coopers, LLP,* AAER No. 1098 (Jan. 14, 1999); *In the Matter of Moore Stephens, et al.*, AAER No. 1135 (May 19, 1999).

[100] Rule 2–01 states:

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of § 210.2–01(b), the term ''member'' means (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and (iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

17 CFR 210.2–01.

[101] Many of the interpretations are reprinted in Section 600 of the Codification. These interpretations include selected text from FRRs that explain the background, provide interpretive guidance for disclosure rules that promote auditor independence, and describe examples in which the staff and the Commission made a determination about a particular auditor's independence. Although the Commission updates the Codification to include the text from releases as rules are amended, the examples in the Codification have not been revised since 1983. *See* FRR No. 10, *supra* note 8. Since 1982, instead of waiting until there are a sufficient number of interpretations to warrant a Commission release that would amend the Codification, the Commission staff has placed its independence interpretive letters in a file where they are immediately available to the public. *See* FRR No. 33 (Oct. 17, 1988) and FRR No. 4 (Oct. 14, 1982).

[102] FRR No. 50 (Feb. 18, 1998).

[103] In FRR No. 50, however, we said that we were not abdicating our responsibilities in this area and that our existing authority regarding auditor independence was not affected. ISB standards and interpretations do not take precedence over our regulations or interpretations. As a result, if an ISB standard conflicts in any way with our rules or interpretations, the ISB standard or interpretation does not take effect unless or until we amend our existing regulation. *See* FRR 50, at 7 n.10.

[104] *See* ASR No. 150 (Dec. 20, 1973) (recognizing establishment of the FASB); ASR No. 280 (Sept. 2, 1980) (commenting on FASB's role in establishing and improving accounting principles).

[105] ISB Standard No. 2, ''Certain Independence Implications of Audits of Mutual Funds and Related Entities,'' at 2 ¶ 5 (Dec. 1999).

[106] *See generally* FRR No. 50, *supra* note 102 (regarding SEC's endorsement of ISB); ISB, ''Discussion Memorandum 00–1: A Conceptual Framework for Auditor Independence,'' at 1 (Feb. 2000) (regarding the purposes of a conceptual framework).

[107] Federal Trade Commission, *Rules and Regulations Under the Securities Act of 1933,* art. 14 (July 6, 1933).

issues encompassed within the auditor's engagement.[108] The general standard in paragraph (b) recognizes that an auditor must be independent in fact and appearance. Appearance is measured by reference to reasonable investors knowing all the relevant circumstances. As noted above,[109] independence in fact and the appearance of independence are inseparable.

To make the general standard more specific, paragraph (b) identifies four governing principles for determining when an auditor is not independent. The four principles incorporate situations that we believe reasonable investors would agree impair an auditor's independence. They are when the auditor:

- Has a mutual or conflicting interest with the audit client,[110]
- Audits the accountant's own work,[111]
- Functions as management or an employee of the audit client,[112] or
- Acts as an advocate for the audit client.[113]

We believe these four basic principles provide a framework for analyzing auditor independence issues, in that actions inconsistent with one or more of these principles would result in a lack of auditor independence. We apply these principles in the remainder of the rules.

We request comment on the general standard and the four proposed principles. Do these four principles appropriately address the concept of auditor independence? If not, why not? Please describe any alternative formulation and why it is preferable. Some believe a basic principle of auditor independence is that the auditor will not subordinate his or her judgment to others.[114] Should this be included in the proposed principles? Are there additional principles that should be included, and, if so, what are they, and do they reflect an impairment of independence?

Should the concept of mutual or conflicting interests be limited to economic interests? Would that limitation reach areas such as employment of close family members by an audit client? What forms of activities engaged in by accountants involve auditing their own work? What forms of activities constitute advocacy? Are there situations in which an auditor may act as an advocate for the audit client that would not impair the auditor's independence? If so, what are these, and why would they not impair independence? For instance, the principle regarding advocacy is not intended to prevent the accounting firm from explaining or defending (in court, if necessary) its work in an audit. Should that principle be modified to make that explicit? If so, how? Should accounting firms be permitted to lobby for an audit client before Congress, state legislatures, regulatory agencies, or other similar bodies?

C. Specific Applications of the Independence Standard

Proposed rule 2–01(c) ties the general standard and four principles of paragraph (b) to specific applications.[115] It provides that an accountant is not independent under the standard of paragraph (b) if, during the audit and professional engagement period, the accountant has any of the financial, employment or business relationships with, provides certain non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5), or otherwise does not comply with the standard of paragraph (b). Paragraphs (c)(1) through (c)(5) address separately situations in which an accountant is not independent of an audit client because of: (i) A financial relationship, (ii) an employment relationship, (iii) a business relationship, (iv) the provision of non-audit services, or (v) the receipt of contingent fees.[116]

While paragraph (c) specifies a number of the relationships and other situations that might impair an auditor's independence, this list is not exhaustive. We cannot foresee all situations in which an auditor might lack independence. Accordingly, paragraph (c) includes a catch-all reference to any other situation in which an accountant "otherwise does not comply with the standard of paragraph (b) of this section." [117]

Auditor independence is more than a requirement imposed by the federal securities laws. Accountants have both a professional and ethical duty to remain independent of their audit clients,[118] including an obligation to "avoid situations that may lead outsiders to doubt their independence." [119] Accordingly, accountants may have to take steps to remain independent even if the steps are not specified in proposed rule 2–01.

In certain situations, the best course may be for the accountant to ask to be removed from the audit engagement. Neither we nor the profession's standards-setters can foresee every business or employment relationship, or investment that could affect the hundreds of decisions that an auditor must make during the course of an audit. On occasion, there may be a relationship, apart from those contemplated by any standard or rule, that has an important meaning to an individual accountant and could create, or be viewed as creating, a conflict with the accountant's duty to investors.[120] We therefore encourage accountants to seek to recuse themselves from any review, audit, or attest engagement if reasonable investors would view the accountant's ability to exercise objective and impartial judgment as compromised by *any* personal, financial, or business relationship, whether or not specifically discussed in the Commission's, the ISB's, or the profession's rules.

Paragraphs (b) and (c) require the accountant to be independent "during the audit and professional engagement period." [121] This term is defined in proposed rule 2–01(f)(6) to mean the period covered by any financial statements being audited or reviewed, and the period during which the auditor is engaged either to review or audit financial statements or to prepare a report filed with us, including at the

[108] *Cf.* Staff Report, *supra* note 23, at 12–16. *See also* SEC, *Tenth Annual Report of the Securities and Exchange Commission,* at 205–207 (1944), which states:

> [T]he Commission has found an accountant to be lacking in independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on the questions confronting him.

[109] *See supra* Section II.B.

[110] *See, e.g.,* Codification §§ 601.01 & 601.04.

[111] *See, e.g.,* Codification § 602.02.c.i.

[112] *See, e.g.,* Rule 2–01(b), 17 CFR 210.2–01(b); Codification § 602.02.d.

[113] *See, e.g., Arthur Young, supra* note 19, at 819 n.15 (1984); Codification §§ 602.02.e.i and ii.

[114] *See* AICPA Code of Professional Conduct, ET § 102.01 (regarding integrity and objectivity).

[115] *See* illustrations in Appendix C, *supra* note 35.

[116] A number of the specified situations are based on examples in the current Codification and the AICPA and SESPS membership rules.

[117] We anticipate that the ISB and, when appropriate, our staff, will continue to implement and apply these principles to new and evolving transactions and events in the future.

[118] *See* AICPA SAS No. 1, AU § 220.03; AICPA Code of Professional Conduct, ET § 101. Of course, accountants also have to comply with applicable state law on independence. *Id.*

[119] AICPA SAS No. 1, AU § 220.03.

[120] *Cf. AUSA Life Ins. Co.* v. *Ernst & Young,* 206 F.3d 202 (2d Cir. 2000) (noting "E&Y's failure lay in the seeming spinelessness" of the audit engagement partner and that "[p]art of the problem was undoubtedly the close personal relationship between" that partner and the company's chief executive officer, a former co-partner in the firm) (quoting 991 F. Supp. 234, 248 (S.D.N.Y. 1997) (district court opinion)).

[121] AICPA Code of Professional Conduct, ET § 101.02 (as revised Feb. 28, 1998).

date of the audit report.[122] The use of the word ''during'' in paragraphs (b) and (c) is intended to make clear that an accountant will lack independence if, for example, he or she is independent at the outset of the engagement but acquires a financial interest in the audit client during the engagement.

1. Financial Relationships

Proposed rule 2–01(c)(1) sets forth the general rule regarding financial relationships that impair independence and is substantially similar to current Rule 2–01(b). Both state that a direct or material indirect financial interest in an audit client will impair an auditor's independence with respect to that audit client. The remainder of paragraph (c) of the proposed rule provides a non-exclusive list of relationships in which an accountant has a direct or material indirect financial interest in an audit client and is, therefore, not independent. Accountants should not assume that financial interests not specifically described in (c)(i) through (c)(iv) do not impair independence.

(a) *Investment in audit client.* Proposed rule 2–01(c)(1)(i) provides that an accountant is not independent with respect to an audit client if the accounting firm, any covered person in the firm, or any immediate family member of any covered person has any direct investment in the audit client or in an affiliate of the audit client. Under current rules, the ''direct financial interest'' requirement prevents all partners in an accounting firm, all managers in the office performing the audit, and all persons on the engagement team, from having any financial interest in the audit client. This approach was intended to give effect to the principle of loyalty that the firm and all of its employees owe to public investors. It is based on the belief that the public generally perceives a firm as one entity in which individuals may have equal access to confidential client information, shared confidences, and common personal and financial interests.

Under the proposal, as under the current rules, the accounting firm (including its affiliates, such as its pension plan) cannot have a direct investment in an audit client and remain independent of that audit client. The proposal otherwise increases significantly the group of persons within the firm who can invest in an audit client without impairing the auditor's independence. Under proposed paragraph (c)(1)(i), the group of persons who cannot invest is limited to ''covered persons in the firm'' and their immediate family members. As explained in greater detail below, we define ''covered persons'' in proposed rule 2–01(f)(13) to include the ''audit engagement team,'' those in the ''chain of command,'' all other partners, principals, shareholders, or professional employees providing any professional service to the audit client or its affiliate, and any other partner, principal, or shareholder in an ''office'' that participates in a significant portion of the audit.[123] The proposal, like the current rule, would attribute all investments by a covered person's ''immediate family members''—that is, the covered person's spouse, spousal equivalent, and dependents—to the covered person.[124]

Paragraph (c)(1)(i)(A) applies to any direct investment in an audit client ''such as stocks, bonds, notes, options, or other securities.'' As the language of the rule makes clear, this is not an exclusive list of all covered ownership interests. In addition, as under current law, the rule cannot be avoided through indirect means. For instance, an accountant who cannot have a direct investment in the audit client by virtue of being a covered person in the firm, may not hold the investment through a corporation or as a member of an investment club.[125]

Under paragraph (c)(1)(i)(A), a direct investment in an affiliate of an audit client would be treated the same as an investment in the audit client. ''Affiliate of the audit client'' is defined in proposed rule 2–01(f)(5) to mean an entity that has significant influence over the audit client, or over which the audit client has significant influence.[126] Our concern is that, in both cases, there is a melding of financial interests and managerial functions of the entity and the audit client such that one can influence the accounting policies and financial transactions of the other. Once an audit client can exercise ''significant influence'' over the operating or financial policies of an entity, then under GAAP,[127] information from the financial statements of that entity will be reflected in the financial statements of the audit client. Similarly, if an entity can exercise influence over the audit client, information from the audit client's financial statements will be reflected in the entity's financial statements. In this case, the revenues and income of the audit client would directly affect the earnings of the entity in which the accountant has an investment.

Proposed rule 2–01(c)(1)(i)(A) applies only to a limited class of people, namely an accounting firm, as well as covered persons in the firm and members of their immediate families. Proposed rule 2–01(c)(1)(i)(B) applies to a larger class of people, including an accounting firm's partners, principals, shareholders, professional employees, and their immediate family members, the close family members of covered persons in the firm,[128] and any ''group'' of the foregoing persons.[129] Under proposed rule 2–01(c)(1)(i)(B), an accountant is not independent with respect to an audit client when any such person or group holds more than five percent of an audit client's outstanding voting securities or otherwise controls the audit client. We selected the five percent level, in part, because it triggers a separate filing with the Commission,[130] and therefore, in certain circumstances, the accountant will have an independent means of knowing the status of those persons' investments.

Proposed rule 2–01(c)(1)(i)(C) is a specialized application of the direct financial interest rule. It provides that an accountant is not independent when

[122] Proposed rule 2–01(f)(6) states that the engagement period ends when the registrant or accountant notifies the Commission that the registrant is no longer the accountant's audit client. This notice typically would occur when the registrant files with the Commission a Form 8–K with disclosures under Item 4 ''Changes in Registrant's Certifying Accountant.'' In some cases, however, a Form 8–K would not be required, such as when the registrant is a foreign private issuer or when the audited financial statements of a non-reporting company are filed upon its acquisition by a public company. Notification to the Commission in these cases would occur by the filing of the next audited financial statements of the foreign private issuer or the successor corporation. Registrants or auditors in these situations, however, may provide earlier notice to the Commission on Form 6–K or other appropriate means.

[123] *See infra* Section III.I.10, for a complete discussion of the term ''covered persons in the firm.''

[124] *See infra* Section III.I.11. for a complete discussion of the term ''immediate family members.''

[125] *Compare* Codification § 602.02.b.ii (Example 1); *cf. infra* Section III.C.1.(a). (regarding indirect investments).

[126] We recognize that this definition of affiliate is different from the current definition in Rule 1–02. We believe, however, that the revised definition is appropriate in the context of our proposals in this release.

[127] Accounting Principles Board (''APB'') Opinion No. 18, ''The Equity Method of Accounting for Investments in Common Stock,'' at ¶ 17 (1971).

[128] *See infra* Section III.I.9. for a complete discussion of the term ''close family members''.

[129] ''Group'' is defined in proposed rule 2–01(f)(14) to mean when two or more persons act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant. This definition is based on Exchange Act Rule 13d–5(b)(1).

[130] Schedules 13D and 13G, 17 CFR 240.13d–1. Schedules 13D and 13G are intended to alert the market to accumulations of a public company's securities that might indicate a potential change of control of the company.

the accounting firm, any covered person in the firm, or any covered person's immediate family member serves as voting trustee of a trust or executor of an estate containing the securities of an audit client. In these positions, the firm or person typically makes investment decisions, or participates in making investment decisions, concerning the securities of the audit client. In this role, the firm or person typically has a fiduciary duty to preserve or maximize the value of the assets. We believe that this warrants treating the trustee or executor's interest as a direct financial interest in the audit client and deeming the auditor's independence impaired.

Proposed rule 2–01(c)(1)(i)(D) covers material indirect investments in an audit client. It describes the circumstances in which independence is impaired because of investments by the accounting firm, any covered person in the firm, any immediate family member of a covered person, or any group of these people in: (i) Non-client entities that have an investment in an audit client (''non-client investors''), or (ii) companies in which an audit client also has invested (''common investees''). The current rule generally recognizes that these investments create a mutuality of interest if the auditor or the audit client owns more than five percent of the entity's equity securities.[131]

In both the ''non-client investor'' and ''common investee'' scenarios, an intermediary is placed between the auditor and the audit client. In one case, the auditor has invested in an entity that, in turn, has invested in the audit client. In the other, the auditor and the audit client are linked through a mutual financial interest in seeing their common investment grow and prosper. Because these financial ties are indirect, we believe that use of a materiality threshold continues to be appropriate. Accordingly, under the proposed rule, accounting firms, covered persons, and covered persons' immediate families can own up to five percent of an entity that invests in an audit client or of an investee in which an audit client also invests.[132]

It should be remembered, however, that should the ''non-client investor'' or the ''common investee'' become an affiliate of the audit client, then as described under paragraph (A) regarding direct investments, the auditor may not have *any* investment in the intermediary entity. For example, assume auditor A invests in non-client company B, which owns an equity interest in audit client C. A may own up to five percent of the equity of B without impairing its independence from C, provided B does not ''significantly influence'' or is not ''significantly influenced'' by C. As discussed above, if such significant influence exists, then B is an affiliate of C and, under paragraph (A) regarding direct investments, A may not invest in B without impairing its independence from C. Similarly, assume auditor A invests in non-client company Z, and audit client C also invests in company Z. A may own up to five percent of the equity of company Z without impairing its independence from C, provided Z does not ''significantly influence'' or is not ''significantly influenced'' by C.

Proposed rule 2–01(c)(1)(i)(D) does not make a distinction for an indirect investment in an audit client by an auditor through an investment company. As a result, an auditor would not be independent if the auditor owns more than 5% of the outstanding stock of an investment company and the investment company holds an investment in an audit client.[133] The proposed rule, however, does not impose a limit on the portion of an investee company's (including an investment company's) assets that may be invested in the audit client, assuming the auditor owns less than five percent of the investee company and the investee is not an affiliate of the audit client. For example, an operating company or an investment company (Company A) could have a significant portion of its assets invested in Company B, and an auditor could own up to five percent of Company A's stock and audit Company B, so long as B is not an affiliate of A.

We considered limiting the portion of an investee company's assets that could be invested in an audit client without impairing auditor independence. We request comment on whether there should be a limit on the portion of an investee's total assets that can be invested in an audit client without independence being impaired in addition to, or in place of, the proposed indirect investment test. If so, where should the limit be set? Would a 10% or 25% level be appropriate?

If we use that approach, should the rule for registered investment companies turn on their diversification status?[134] Limitations on material indirect investments in an audit client may be difficult for auditors to apply in practice when they invest in an investment company. Auditors have no easy way to determine how much of an investment company's assets are invested in an audit client or how much of an issuer's securities are owned by an investment company because many investment companies' portfolios change frequently. Because funds are required to disclose their diversification status in their registration statements, accountants could easily determine, by looking at a fund's registration statement, whether an investment in the fund by the accounting firm, a covered person in the firm or such person's immediate family might impair an accountant's independence under the rule. Should we permit an investment in any registered investment company that is ''diversified'' under the ICA, provided it is not part of the same investment company complex as an audit client?[135] Would this be one way to prevent inadvertent violations of the independence rules?

We solicit comment on all aspects of the financial interest rules in paragraph (c)(1)(i). In particular, would reasonable investors be concerned that investments of the sort described in this section would impair an auditor's independence? Should the restrictions on financial ownership interests apply to all partners (but not their immediate family or employees of the firm) of an audit firm, as the partners represent the partnership?

Is the five percent threshold for financial interest in an audit client by persons who do not influence the audit appropriate? For example, would reasonable investors perceive a firm's independence to be impaired if a partner or employee in an office that did not work on the audit, held four percent of the audit client? If the five percent threshold is not appropriate, what threshold is appropriate, and which individuals should be subject to the restriction?

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[131] Codification § 602.02.b.iii. We have used the term ''material'' in our proposed rules in the sense that it has been used in our current independence rules. *See, e.g.,* ASR No. 79 (Apr. 8, 1958). This should not be confused with the meaning of the term ''material'' in other federal securities law contexts. *See* Staff Accounting Bulletin No. 99 (Aug. 13, 1999).

[132] Paragraph (c)(1)(i)(D)(*1*) and (*2*) refer to ''ownership'' of an entity. Ownership interest is determined based on the form of organization. For example, for a corporation, ownership is based on ownership of a class of voting securities. For a partnership, ownership is based on ownership of a partnership interest or unit.

[133] Also, an auditor would not be able to invest in an investment company if the investment company is an affiliate of the audit client. *See* proposed rule 2–01(c)(1)(i)(A).

[134] Generally, a diversified management investment company is a company that with respect to 75% of its total assets may not invest more than 5% of its total assets in a single issuer and may not own more than 10% of the outstanding securities of a single issuer. *See* Section 5(b)(1) of the ICA, 15 U.S.C. 80a–5(b).

[135] *See infra* Section III.I.12. for a discussion of the ''investment company complex'' definition.

Furthermore, is it appropriate to base the determination, as we do, on ownership of five percent or more of a company's equity securities? Should we be more specific and indicate whether to account for common and preferred shares, and voting and non-voting shares? If so, what types of shares should be included (*i.e.*, voting shares only)? If the determination depends on ownership of outstanding voting shares, should all shares, regardless of the number of votes different classes of shares have, count the same?

Would reasonable investors perceive an accountant's independence to be impaired if any partner, shareholder, or professional employee of the accountant's firm has an investment in an audit client that is more than five percent of the individual's net worth, even if it represents less than five percent of the ownership of the audit client's equity securities?

Suppose that ABC Accounting Firm audits XYZ Corp. Partner A is a covered person in the firm for the XYZ audit. In the following situations, would a reasonable investor be concerned about the independence of the auditor:

(i) A grandchild of Partner A owns more than five percent of the equity of XYZ Corp;

(ii) Partner A's siblings each own four percent of the equity of XYZ Corp. The siblings do not act together in their investment activities in such a way as to constitute a group under the proposed definition of group;

(iii) Partner A's brother-in-law owns ten percent of the equity of XYZ Corp;

(iv) Partner A's sister-in-law owns 20 percent of the equity of XYZ Corp; or

(v) Five partners of ABC Accounting Firm, none of whom are covered persons and not acting as a ''group,'' each own four percent of the equity of XYZ Corp.

Are there other persons whose investment in the XYZ Corp. may cause concern regarding the independence of Partner A?

We solicit comment on all aspects of the proposals regarding investments in audit clients in paragraph (c)(1)(i)(D). Do investments in an intermediary affect the auditor's independence when the intermediary has an investment in an audit client that an auditor could not have directly without impairing the auditor's independence? If the auditor has an investment greater than five percent in the intermediary, but the intermediary has an investment in the audit client that is less than five percent of the audit client, is the auditor's independence impaired? What if the intermediary's investment is less than five percent of the audit client but material to the auditor or intermediary?

Suppose that the pension fund of ABC Accounting Firm has a 4.9 percent ownership of DEF Corp. DEF is not an audit client of ABC. DEF in turn has a substantial investment in XYZ Corp., an audit client of ABC. DEF and XYZ are not affiliates. Would a reasonable investor perceive that the accountant's independence was impaired? Is five percent an appropriate threshold? Would a lower threshold enhance investor confidence in auditor independence? The proposed rule on material indirect investments includes investments by the accounting firm, any covered person in the firm or any of his or her immediate family members, or any group of such persons. Should other persons be included?

Suppose that the pension fund of ABC Accounting Firm has a 4.9 percent ownership of DEF Corp. DEF is not an audit client of ABC. XYZ Corp., an audit client of ABC, has a substantial investment in DEF, but XYZ and DEF are not affiliates. Would reasonable investors perceive that the accountant's independence was impaired? The proposed rule includes investments by the accounting firm, any covered person in the firm or any of his or her immediate family members, or any group of such persons. Should other persons be included? Are there any investments that you believe would impair an auditor's independence that the proposed rules permit? If so, what are they, and why do they raise independence concerns?

(b) *Other financial interests.* Proposed rule 2–01(c)(1)(ii) describes other financial interests of an auditor that would impair an auditor's independence with respect to an audit client because they create a debtor-creditor relationship or other commingling of the financial interests of the auditor and the audit client. In some situations (*e.g.*, bank deposits or insurance), the continued viability of the audit client may be necessary for protection of the auditor's own assets or for the auditor to receive a benefit (*e.g.*, insurance claim). These situations reasonably may be viewed as creating a self-interest that competes with the auditor's obligation to serve only investors' interests. We discuss several of these situations here.

(i) *Loans/debtor-creditor relationships.* The proposals provide that the accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any loan (including any margin loan) to or from an audit client, the officers of an audit client or an affiliate of an audit client, the directors of an audit client or an affiliate of an audit client, or record or beneficial owners of more than five percent of the equity securities of an audit client or its affiliate. We considered adding to the proposal the AICPA's Ethics Ruling on loans to or from audit clients.[136] The ruling indicates that any loan would impair the auditor's independence, unless the loan was from a financial institution; acquired in accordance with that institution's normal lending procedures, terms and requirements; kept current as to all its terms; and, was: (1) An automobile loan or lease collateralized by the automobile; (2) a loan on the cash surrender value of an insurance policy; (3) a ''passbook loan'' collateralized by cash deposits at the same institution; or (4) credit cards or cash advances on checking accounts with an aggregate balance not paid of less than $5,000. We are proposing a more liberal approach since our proposal sets the credit card balance threshold at $10,000, permits a mortgage loan not obtained during the period of the audit or professional engagement, and because, unlike the AICPA ruling, the proposed rule covers only the relatively small group of entities and people that could influence the audit.

We solicit comment on our approach to loans. Should we expand the rule to cover close family members as opposed to just immediate family members? For example, would a $1,000,000 home loan from an audit client to the auditor's brother-in-law be perceived as affecting the independence of the audit partner? Does the answer change if the loan is unsecured? Are there other categories of loans that should be excluded, similar to car loans? Are there circumstances under which a loan to or from an audit client would not impair an auditor's independence?

(ii) *Savings and checking accounts.* The proposals provide that an accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any savings or checking account at a bank or savings and loan that is an audit client or its affiliate, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation (''FDIC''). Would reasonable investors perceive an accountant's independence to be

[136] *See* AICPA Code of Professional Conduct, ET §§ 101.02, 101.07 (Ethics Rulings 101–1–A–4, 101–5).

impaired if an accountant or the accountant's immediate family member has any savings or checking account at an audit client or the audit client's affiliate? Would an accountant's independence be impaired if a covered person maintained a balance in a non-federally insured bank that is an audit client? Are there other institutions that are similar to a bank or savings and loan that should be included? Are any of the risks to independence mitigated by depository insurance similar to that provided by the FDIC? Why or why not? Would the financial condition of the bank or other depository institution affect reasonable investors' perceptions?

(iii) *Broker-dealer accounts*. The proposals provide that an accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any of the covered person's immediate family members has any brokerage or similar account maintained with a broker-dealer that is an audit client or an affiliate of an audit client if any such accounts include any asset other than cash or securities (within the meaning of ''security'' provided in the Securities Investor Protection Act (''SIPA'')), or where the value of the assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation (''SIPC'') advance for those accounts, under Section 9 of SIPA. Our proposal is rooted in a concern that, to the extent that the assets of an accountant (or covered persons or their family members) in a broker-dealer account are exposed to loss in the event of the broker-dealer's financial failure, the accountant has an interest in the financial condition of the broker-dealer.

When an accounting firm, a covered person, or a covered person's immediate family member maintains such accounts at an audit client, would reasonable investors perceive that auditor independence is impaired? Should covered persons be considered not independent if they have an account with a broker-dealer that is an audit client, regardless of whether the assets in the account are subject to a SIPC advance? Are there better ways to identify broker-dealer accounts that impair an auditor's independence? For example, the proposal's provision on loans and debtor-creditor relationships provides that a margin loan impairs an auditor's independence. Should the provision concerning broker-dealer accounts state that maintaining a margin account with a broker-dealer impairs an auditor's independence as to that broker-dealer, whether or not any margin debt exists? Are there other types of accounts that might be maintained with a broker-dealer that the rule should specifically identify as impairments to independence? If so, what types of accounts, and why do they impair, or appear to impair, independence?

Should the rule specifically address short positions, or the writing of options, in an account with a broker-dealer? If so, should the rule provide that those types of accounts, when held by the accounting firm, any covered person in the firm, or such person's immediate family member, impair independence as to the broker-dealer with whom the account is maintained?

Is it impractical for accountants (and covered persons and family members) to monitor whether the assets in their broker-dealer accounts are within the amounts subject to a SIPC advance? Are there preferable alternative formulations that would accomplish the goal of deeming independence to be impaired only in those situations where the accounts include assets that are exposed to loss in the event the broker-dealer fails? Or is that goal too narrow? Should the rule impose additional limits on accounts even though the assets in the accounts stay within the amounts subject to a SIPC advance? For example, an auditor might control several different types of accounts, each of which qualify for SIPC coverage. Should the rule impose some limit on the number or total assets of such accounts with a broker-dealer audit client? What should those limits be, and why?

Would it be preferable to provide that independence is impaired as to any broker-dealer audit client with whom the accountant (or covered person or covered person's family member) maintains any account, regardless of whether the account's assets are within the limits subject to a SIPC advance?

In addition to SIPC protection, broker-dealers sometimes purchase insurance from private insurers to protect customer assets. Should the rule take that type of insurance into account? If so, how?

(iv) *Futures commission merchant accounts*. The proposals provide that the accountant will not be independent when the accounting firm, or any covered person in the accounting firm, or any covered person's immediate family member has any futures, commodity, or similar account maintained with a futures commission merchant (''FCM'') that is an audit client or an affiliate of the audit client. This proposal is rooted in a concern that, to the extent that the assets of an accountant (or covered persons or their family members) in an FCM account are exposed to loss in the event of the FCM's financial failure, the accountant has an interest in the financial condition of the FCM. We solicit comment on whether maintaining such accounts could impair, or would appear to reasonable investors to impair, an auditor's independence. Are there different types of FCM accounts or different types of assets maintained in FCM accounts that should be distinguished from each other for purposes of determining auditor independence? What distinctions should be made? Are there conditions under which an accountant (or covered person or covered person's family member) could maintain an account with an FCM but have no interest in the financial condition of the FCM? If so, what are those conditions? How, if at all, should the rule take those conditions into account?

(v) *Credit cards*. We are proposing that credit card balances of $10,000 or less owed by a firm, a covered person, or any covered person's immediate family member to an audit client or its affiliate, not be deemed to impair an auditor's independence.[137] We do not believe that a relatively minor credit card balance would create or appear to create a mutuality or conflict of interest with the lender-audit client. Furthermore, a strict prohibition of such accounts might unnecessarily affect a firm's ability to assign staff to provide short-term technical advice to the audit engagement team. Would reasonable investors perceive an accountant's independence to be impaired if a covered person held a credit card balance in excess of $10,000 with a lender that is an audit client? Is $10,000 an appropriate limit?

(vi) *Insurance products*. Proposed rule 2–01(c)(1)(ii)(F) provides that an auditor's independence is impaired whenever the accounting firm, any covered person in the firm, or any immediate family member of a covered person holds any individual insurance policy originally issued by an insurer that is an audit client or an affiliate of an audit client. Additionally, under the proposed rule, an auditor's independence is impaired if the audit firm obtains professional liability coverage from an audit client or its affiliate. Holding these policies creates a mutual interest in the continuing viability of the insurer.

We solicit comment on whether an accountant's independence is impaired, and on whether reasonable investors would perceive an accountant's independence to be impaired, if the

[137] *See* proposed rule 2–01(c)(1)(ii)(E).

accountant or a member of the accountant's immediate family originated an individual insurance policy with an insurance company that is an audit client or an affiliate of an audit client. Should the proposed rule cover all insurance policies, or be limited, such as to life insurance policies? Would an accounting firm's independence be impaired if the accounting firm acquired from an audit client insurance such as (i) insurance for litigation or indemnification losses, (ii) group health, or (iii) group life insurance policies? Should an accounting firm be permitted to purchase professional liability coverage through an audit client?

(vii) *Investment companies.* Proposed rule 2–01(c)(1)(ii)(G) sets forth the rule for investment by accounting firms, covered persons and covered persons' immediate family members in an investment company or a related entity. The proposed rule provides that an auditor is not independent if the auditor invests in any entity in an investment company complex if the audit client is also an entity included in that investment company complex. Proposed rule 2–01(f)(16) defines ''investment company complex'' as an investment company and its investment adviser or, if the company is a unit investment trust, its sponsor; any entity controlled by, under common control with, or controlling the investment adviser or sponsor, such as the distributor, administrator or transfer agent; and any investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the ICA [138] that is advised by the same adviser or a related adviser, or sponsored by the same sponsor or related sponsor.

Proposed rule 2–01(c)(1)(ii)(G) makes clear that when an audit client is part of an investment company complex, the accountant must be independent of each entity in the complex. The proposed rule follows ISB Standard No. 2 on this point. Under ISB Standard No. 2, the firm and those in the firm who are in a position to influence an audit must be independent from each fund in the fund complex *and* each entity in the fund complex in order to be independent with respect to *any* fund or entity in the complex.[139]

In addition to the requirement that the auditor have no investment in any entity in the investment company complex, the auditor also must be independent with respect to its other relationships with entities within the complex. For example, an auditor could not be a director for an entity within an investment company complex while auditing an entity in the complex.

Should we follow the standard of ISB Standard No. 2 that an accountant must be independent of the entire investment company complex to be independent of any entity in that complex? Is this standard sufficiently clear and capable of implementation? If not, what modifications are needed? Does this standard have implications outside the area of investments (*e.g.*, employment relationships, business relationships, or the provision of non-audit services) that go beyond what is necessary to safeguard independence?

Are there certain complex capital structures, such as master/feeder or fund of funds, that require specific clarification as to an auditor's independence when the auditor audits one or more entities in that structure? Are there any unique implications of applying the proposed independence rules to investment companies, investment advisers, sponsors of unit investment trusts, and affiliated or unaffiliated service providers? If so, what are they and how should they be addressed?

(c) *Exceptions.* Proposed rule 2–01(c)(1)(iii) would provide two limited exceptions to the financial relationship rules. These exceptions recognize that there are situations in which an accountant, by virtue of being given a gift of or inheriting a financial interest from a third party, or because the accounting firm has taken on a new audit client, may lack independence solely because of events beyond the accountant's control. In these circumstances, and provided the financial interest is promptly disposed of or the financial relationship is promptly terminated, we believe that reasonable investors would not necessarily perceive the accountant to be incapable of exercising objective and impartial judgment.

(i) *Inheritance and gift.* Proposed rule 2–01(c)(1)(iii)(A) provides that an accountant's independence will not be impaired if any person acquires a financial interest through an unsolicited gift or inheritance that would cause the accountant to be not independent under (c)(1)(i) or (c)(1)(ii), and the financial interest is disposed of as soon as practicable, but no longer than 30 days after the person has the right to dispose of such interest. We solicit comment on all aspects of the gift and inheritance exception. Does the exception capture all situations in which a person subject to the financial relationship rules might enter into a restricted financial relationship and yet not give rise to any independence concerns? Are there situations in which an accounting firm might have no option but to receive its fee in its audit client's stock as a result of a court settlement? If so, should there be an exception for these situations, and how would such an exception work? Does the rule provide affected persons with adequate means to ''cure'' the lack of independence? For example, should the rule expressly allow a covered person to recuse himself or herself from an engagement or the chain of command rather than disposing of the financial interest?

Would an accountant's independence be impaired if the covered person was restricted from disposing of the financial interest for an extended period? For example, suppose XYZ Corp. is the audit client of ABC Accounting Firm. Partner A is a covered person in the firm. Partner A becomes the beneficiary of a testamentary trust fund that includes $2 million in equity securities of XYZ Corp. This amount constitutes 40 percent of the amount of the trust, and 30 percent of Partner A's net worth. The terms of the trust fund prohibit disposing of the XYZ investment for a period of five years. Would a reasonable investor perceive ABC's independence to be impaired?

Assume the same facts as above, except that the securities are received directly by Partner A. Would placing those securities in a ''blind trust'' remedy the independence question? Can an individual be impartial if he or she knows what securities are held in the blind trust?

(ii) *New audit engagement.* Proposed rule 2–01(c)(1)(iii)(B) is designed to allow accounting firms to bid for and accept new audit engagements, even if a person has a financial interest that would cause the accountant to be not independent under the financial relationship rules. This exception is available to an accountant so long as the accountant did not audit the client's financial statements for the immediately preceding fiscal year, and the accountant was independent before the earlier of either accepting the engagement to provide audit, review, or attest services to the audit client; or commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

[138] Section 3(c) of the ICA excludes from the ICA certain companies that otherwise would be investment companies. 15 U.S.C. 80a–3(c). These companies include, among others, hedge funds and real estate pools.

[139] ISB Standard No. 2, ''Certain Independence Implications of Audits of Mutual Funds and Related Entities,'' at ¶ 3 (Dec. 1999).

The new audit engagement exception of proposed rule 2–01(c)(1)(iii)(B) is necessary because an auditor must be independent, not only during the period of the auditor's engagement, but also during the period covered by any financial statements being audited or reviewed.[140] Because of an existing financial relationship between an accounting firm or one of its employees and a company (that is not an audit client), an accounting firm may not be able to bid for or accept an audit engagement from the company without this exception. For example, where a firm's pension plan or a covered person in the firm owns the stock of a potential audit client during the period of the financial statements to be audited or reviewed, the accounting firm could not compete for the audit engagement but for this exception. This exception allows firms to bid for and accept engagements in these circumstances, provided they are otherwise independent of the audit client and they become independent of the audit client under the financial relationship rules before accepting the engagement or beginning any audit, review, or attest procedures.

We solicit comment on all aspects of the new audit engagement exception. Will the exception, as a practical matter, allow accounting firms to bid for and accept new audit engagements when they become available? Is the exception appropriate even though the auditor's independence would otherwise be considered impaired? Should the exception also extend to employment relationships, business relationships, or the provision of non-audit services? Does the existence of an employment relationship or the provision of non-audit services during the period covered by the financial statements raise independence concerns that cannot be ''cured'' before beginning the engagement in the same way that a financial relationship during this period can?

(d) *Audit Clients' Financial Relationships.* Proposed rule 2–01(c)(1)(iv) provides that an accountant is not independent when its audit client has invested, or otherwise has a financial interest in the accounting firm or an affiliate of the accounting firm.

(i) *Investments by the audit client in the auditor.* Under proposed rule 2–01(c)(1)(iv)(A), an accountant's independence is impaired with respect to an audit client when the audit client or an affiliate of an audit client has, or has agreed to acquire, any direct investment in the accounting firm or its affiliate, whether in the form of stocks, bonds, notes, options, or other securities. This impairment occurs primarily for two reasons.

First, the accountant may be placed in the position of auditing the value of the securities of the accounting firm or its affiliates that are reflected as an asset in the financial statements of the audit client. This could result when an auditor in an accounting firm whose shares are held by the audit client must value the shares of that accounting firm held by the audit client for purposes of including that valuation in the audited financial statements.

Second, the accountant reasonably may be assumed to have a mutuality of financial interest with the owners of the firm and of the firm's affiliates, including an audit client-shareholder. The audit firm, as management, will be responsible to its shareholders, and one of the shareholders may be an audit client. Thus, there may be situations where a shareholder-audit client is in a position to influence the accountant because the accountant would owe a fiduciary responsibility to that audit client-shareholder and would be accountable to that audit client for the accounting firm's activities.[141] For example, an audit client-shareholder is legally entitled to receive certain notices, invoke ''dissenters' rights,''and nominate candidates for directors under most state corporation laws. Consequently, an accountant, as management, would have fiduciary obligations to an audit client-shareholder who, acting alone or in combination with other shareholders, may be in a position to exercise some measure of influence over the accountant.

Are there other situations in which an audit client could have a financial interest in the accounting firm that would impair independence? For example, would a reasonable investor perceive an accountant's independence to be impaired if the audit client's CEO held a substantial investment in the accounting firm? Would it make a difference if the investment was significant to the CEO's net worth? Should there be a maximum allowable investment by audit clients in their auditors? If so, what should the threshold be? Does it matter if the investment is material to the investor or one of its affiliates?

(ii) *Underwriting.* Few transactions are as significant to the financial health of a company, including an accounting firm, as the sale of its securities, whether in private or public offerings. In an offering, an underwriter either buys and then resells a company's securities or receives a commission for selling the services. In either circumstance, were an audit client to act as underwriter of an accounting firm's or its affiliate's securities, the audit client would assume the role of advocate or seller of the accounting firm's securities. Moreover, depending on the terms of the underwriting, the underwriter could for a time become a significant shareholder of the accounting firm. There also may be indemnification agreements that place the underwriter and auditor in adversarial positions.

Relying on an audit client to sell the accounting firm's securities plainly impairs independence. The accounting firm would have a direct interest in ensuring the underwriter's viability and credibility, either of which could be damaged as the result of an audit. Moreover, the auditor would have a clear incentive not to displease an audit client to which it had entrusted a critical financial transaction. Similar conflicts of interest may arise if an audit client or an affiliate of an audit client performs other financial services for an accounting firm or its affiliates, such as making a market in the accounting firm's or its affiliate's securities or issuing an analyst report concerning the securities of the accounting firm or its affiliate.

We request comment on whether we have addressed all situations in which the independence concerns arise because the audit client or its affiliate performs a financial service for the accounting firm or an affiliate? Are there financial services that an audit client or its affiliate could provide to its auditors or the accounting firm or its affiliate that would not raise these concerns? For example, would reasonable investors perceive an accountant's independence to be impaired if an audit client or an affiliate of an audit client made a market in the securities of the accounting firm or prepared and issued research reports on the accounting firm?

2. Employment Relationships

Proposed rule 2–01(c)(2) sets forth the employment relationships that impair an auditor's independence. This paragraph is based on the premise that when an accountant is either employed by an audit client, or has a close relative

[140] *See supra* Section III.C.

[141] *See* Letter from POB to ISB, dated Jan. 12, 2000 (''[p]ublic ownership in an audit firm or in its parent or in an entity that effectively has control of the audit firm would add another form of allegiance and accountability to those identified by the Supreme Court—a form of allegiance that in our opinion will be viewed as detracting from, if not conflicting with, the auditor's 'public responsibility' '').

or former colleague employed in certain positions at an audit client, the accountant might not be capable of exercising the objective and impartial judgment that is the hallmark of independence.

As with the financial relationships provision, paragraph (c)(2) sets forth the general standard that an accountant is not independent if the accountant has an employment relationship with an audit client or an affiliate of an audit client. The proposed rule then provides a non-exclusive list of relationships that are inconsistent with the general rule of paragraph (c)(2). Again, accountants should not assume that all employment relationships not specifically described in (c)(2)(i) through (c)(2)(iv) do not impair independence. All non-specified employment relationships are subject to the general tests of paragraphs (b) and (c)(2).

(a) *Employment at audit client of accountant.* Proposed rule 2–01(c)(2)(i) continues the principle set forth in current Rule 2–01(b) that to be independent, neither the accountant nor any member of his or her firm can be a director, officer, or employee of an audit client. The paragraph therefore provides that an accountant is not independent if any current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or an affiliate of an audit client, or serves as a member of the board of directors or similar management or governing body of the audit client or an affiliate of the audit client. In the most basic sense, the accountant cannot be employed by his or her audit client and be independent.

(b) *Employment at audit client of certain relatives of accountant.* Proposed rule 2–01(c)(2)(ii) specifies the family members of the auditor whose employment in certain positions by an audit client or its affiliate will impair the auditor's independence. For the employment category, the interests and relationships of a covered person's close family members—that is, the covered person's spouse, spousal equivalent, dependents, parents, nondependent children, and siblings—are attributed to the covered person in the firm. This stands in contrast to the investment category, where only the interests of the covered person's immediate family members (*i.e.,* spouse, spousal equivalent, and dependents) are attributed to the covered person. We believe this distinction is justified because, while some close family members' investments may not be known to a covered person, the place and nature of such family members' employment should be obvious, and thus may affect the covered person's objectivity and impartiality.

We do not consider an audit client's employment of even a close family member, however, to impair an auditor's independence unless that family member is in a position to, or does, influence the preparers or the contents of the accounting records or financial statements of the audit client or its affiliate. The proposed rule uses the defined term ''accounting or financial reporting oversight role'' to describe the persons in this group. The term is defined in proposed rule 2–01(f)(3). To reduce uncertainty, the definition lists those positions that generally carry with them the type of influence about which we are concerned. These positions include: a member of the audit client's board of directors (or similar management or governing body), chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

The proposed rule eliminates the so-called ''five hundred mile rule.'' Under that rule, when a family member has an interest in or relationship with an audit client, consideration is given to whether the geographic separation of that family member from both the person in the firm and the conduct of the audit lessens the negative impact of that interest or relationship on the auditor's independence.[142] When an auditor's relative is not geographically distanced from the auditor and the audit, the auditor and his or her relatives are said to be in ''closely linked business communities'' and the auditor's independence is deemed to be impaired. However, considering whether family members are in ''closely linked business communities'' no longer seems relevant in today's world of instantaneous international communications and global securities markets. Accordingly, the proposal dispenses with this test of auditor independence.

We solicit comment on all aspects of proposed rule 2–01(c)(2)(ii). Does the proposal use an appropriate definition of what constitutes close family members whose employment by an audit client results in an impairment of an auditor's independence? If not, how should it be revised? Should the definition of close family member be expanded to include extended family relationships, such as in-laws? Would reasonable investors perceive an accountant's independence to be impaired if the audit client's CEO was the brother-in-law of a covered person? Would employment by an audit client of friends, neighbors, or other persons having emotional or financial ties with covered persons, but not within the definition of close family member, impair an accountant's independence?

Would reasonable investors perceive an accountant's independence to be impaired if a close family member of a covered person were employed by an audit client in a capacity that did not enable the family member to influence the preparers or contents of the accounting records or financial statements of the audit client or its affiliates? The ISB has suggested that independence is impaired if an immediate family member of a person on the audit engagement team is employed by the audit client in any position, or if a close family member holds a ''key position'' at an audit client.[143] Is the ISB's stricter position with respect to immediate family members necessary to ensure an auditor's independence?

Is the definition of the positions that may enable employees to influence the accounting records appropriate? Would independence be impaired by other employment positions held by close family members with an audit client, such as vice president of human resources, assistant controller, or manager of internal audit?

(c) *Employment at audit client of former employee of accounting firm.* Proposed rule 2–01(c)(2)(iii) describes the circumstances under which an auditor's independence will be impaired by an audit client's employment of a former partner, shareholder, principal, or professional employee of the accounting firm. When these persons retire or resign from accounting firms, it is not unusual for them to join the management of former audit clients or to become members of their boards of directors. Registrants and their shareholders may benefit from the former partner's accounting and financial reporting expertise. Investors and the public in general also may benefit when individuals on the board or in management can work effectively with the auditors, members of the audit committee, and management to provide informative financial statements and reports.

When these persons, however, assume positions with the firm's audit client and also remain linked in some fashion to the accounting firm, they could be in a position to influence the content of the

[142] *See generally* Codification § 602.02.h.

[143] ISB, Invitation to Comment 99–1, *supra* note 37, at 9.

audit client's accounting records and financial statements on the one hand, or the conduct of the audit, on the other. This is particularly true when the individual, while at the accounting firm, was in some way associated with the audit of the client. The perceived close association between a member of the board of directors or of senior management[144] may create the impression of a mutuality of interest.[145]

As accounting firm partners leave their firms and accept management positions with former audit clients, some have questioned whether these individuals compromised their independence in order to secure positions with audit clients.[146] Others have questioned the continuing personal relationships between the former partner and the individuals at the firm who audit the client's financial statements.[147] There is also the risk that the former partner's familiarity with the firm's audit process and the audit partners and employees of the firm will enable him or her to alter the outcome of the audit.[148]

As with the current requirements, the proposed rule recognizes that an auditor's independence with respect to an audit client may be impaired when former partners, shareholders, principals, or professional employees of the firm are employed in an accounting or financial reporting oversight role at the firm's audit client or an affiliate of the audit client. We are also proposing, however, that independence will not be impaired if certain steps are taken to disassociate the individual from the firm. Under the proposed rules, the former partner, shareholder, principal, or professional employee must not: (i) Influence the firm's operations or financial policies, (ii) have a capital balance in the firm, or (iii) have a financial arrangement with the firm, other than a fully-funded, fixed payment retirement account.

The rule provides that, under certain conditions, use of a ''rabbi trust'' as a mechanism to make fixed retirement payments to a former partner or employee of the accounting firm would not impair an auditor's independence.[149] Specifically, under the proposed rule, use of a ''rabbi trust'' does not impair an auditor's independence as long as the amount owed to the individual is immaterial to the firm, the payments from the trust are fixed as to time and amount, and the chances of the firm entering bankruptcy or insolvency are remote.

We request comment on our approach in (c)(2)(iii). Should a former partner now employed by the audit client, be permitted to retain financial ties to the audit firm without impairing the independence of the auditor? What if the financial ties are material to the former auditor but not to the firm? Would reasonable investors perceive an accountant's independence to be impaired if a former employee of the accounting firm, who continued to hold a 401(k) investment with the accounting firm, became employed by the audit client? Does it matter if the former partner's position at the audit client is not one in which he or she will have influence over the company's audit, accounting records, or financial statements?

If an audit partner or other professional employee leaves an accounting firm and joins the audit client during the course of an audit, does this impair the accounting firm's independence? Should the rule depend on whether the person leaving the accounting firm is a senior partner within the firm, an audit manager with management responsibilities for the audit, or non-managerial audit staff?

Should we require a mandatory ''cooling off'' period for former partners and professional staff of an audit firm who join an audit client? Should registrants have to disclose on a timely basis if they hire a partner or other senior audit professional assigned to the company's audit.[150] If so, where should the disclosure appear?

(d) *Employment at accounting firm of former employee of audit client.* Proposed rule 2–01(c)(2)(iv) describes the circumstances under which employment of a former officer, director, or employee of an audit client or its affiliate as a partner, principal, or shareholder of the accounting firm will impair an auditor's independence. This provision, in a sense, mirrors the restrictions on employment by an audit client of former partners or employees of an accounting firm.

When the employee of an audit client joins an accounting firm, the independence rules must ensure that the former employee is not in a position to influence the audit of his or her former employer.[151] Participating in that

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[144] *See generally AUSA Life Ins. Co.* v. *Ernst & Young, supra* note 120.

[145] *See* Auditing Standards Division, AICPA, ''Audit Risk Alert—1994, General Update on Economic, Accounting, and Auditing Matters,'' at 35 (1994).

A few litigation cases suggest auditors need to be more cautious in dealing with former coworkers employed by a client. None of these cases involved collusion or an intentional lack of objectivity. Nevertheless, if a close relationship previously existed between the auditor and a former colleague now employed by a client, the auditor must guard against being too trusting in his or her acceptance of representations about the entity's financial statements. Otherwise, the auditor may rely too heavily on the word of a former associate, overlooking that a common interest no longer exists.

[146] *See* Paul M. Clikeman, ''Close revolving door between auditors, clients,'' *Accounting Today,* at 20 (July 8–28, 1996). *Cf. In the Matter of Richard A. Knight,* AAER No. 764 (Feb. 27, 1996) (individual allegedly learned of accounting misstatements while he was engagement partner for firm conducting audit and resigned to become registrant's executive vice president and chief financial officer).

[147] *See, e.g., AUSA Life Ins. Co.* v. *Ernst & Young, supra* note 120; AICPA Board of Directors, *Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession,* at 4 (June 1993) (''AICPA Board Report''); *see also* Staff Report, *supra* note 23, at 51–52; In addressing an example of this problem, the court in *Lincoln S&L* v. *Wall,* 743 F. Supp. 901, 917 n.23 (D.D.C. 1990) wrote:

Atchison, who was in charge of the Arthur Young audit of Lincoln, left Arthur Young to assume a high paying position with Lincoln. This certainly raises questions about Arthur Young's independence. Here a person in charge of the Lincoln audit resigned from the accounting firm and immediately became an employee of Lincoln. This practice of ''changing sides'' should certainly be examined by the accounting profession's standard setting authorities as to the impact such a practice has on an accountant's independence. It would seem that some ''cooling off period'' perhaps, one to two years, would not be unreasonable before a senior official on an audit can be employed by the client.

[148] In response to these and other concerns, the AICPA Board of Directors suggested in 1993 that we prohibit a public company from hiring the partner responsible for the audits of that company's financial statements for a minimum of one year after the partner ceases to serve that company. *See* AICPA Board Report, *supra* note 147, at 4. Our staff has indicated, however, that, if implemented, this suggestion would take the form of the firm's independence being impaired for one year from the date the individual left the audit engagement, rather than as a prohibition on hiring the former partner. Staff Report, *supra* note 23, at 52 n.146. *See also* Committee of Sponsoring Organizations of the Treadway Commission (''COSO''), ''Fraudulent Financial Reporting: 1987–1997: An Analysis of U.S. Public Companies,'' at 21 (1999) (finding, with respect to companies where there was fraudulent financial reporting, that among 44 companies for which there was information available on their CFO's background, 11 percent of the companies' CFOs had previous experience with the companies' audit firms immediately prior to joining the company).

[149] To avoid adverse tax consequences to the individual, accounting firms often settle their retirement obligations to former partners by fully funding a ''rabbi trust'' from which payments will be made to the individual. As defined by proposed rule 2–01(f)(18), a ''rabbi trust'' is an irrevocable trust whose assets are not available to the firm until all benefit obligations have been met but are subject to claims of the firm's creditors in bankruptcy or insolvency.

[150] *See* Letter from Association for Investment Management and Research to Arthur Siegel, Executive Director, ISB, dated Feb. 29, 2000, at 4 (''AIMR Letter'').

[151] Of course, once an employee of an accounting firm, the person would also be subject to all other independence requirements applicable to other firm members. For example, if the former audit client employee becomes a covered person, he or she could have no financial interest in the audit client. *See* proposed rule 2–01(c)(1)(i)(A).

audit might require the former employee to audit his or her own work. Accordingly, the rule provides that independence is impaired unless the former employee does not participate in and is not in a position to influence the audit of the financial statements of the audit client or its affiliate for any period during which he or she was employed by or associated with that audit client or its affiliate.

We solicit comment on whether additional or other procedures should be implemented when a former employee of an audit client joins the accounting firm? If so, what should they be? Should the rule also apply to professional employees of the accounting firm?

3. Business Relationships

Proposed rule 2–01(c)(3) describes the business relationships that impair an auditor's independence from an audit client. It continues the Codification's current standard that an auditor's independence with respect to an audit client is impaired when the accounting firm, or a covered person in the firm, has a direct or material indirect business relationship with an audit client, an affiliate of an audit client, or either of their officers, directors, or shareholders holding five percent or more of the audit client's equity securities.[152] As is true today, under proposed rule 2–01(c)(3), an accountant's independence is not impaired solely because the accountant has a business relationship with the audit client in which the accountant provides professional services to the audit client except for those specified in rule 2–01(c)(4) or acts as ''a consumer in the ordinary course of business.''

Because of recurring issues in this area, we have attempted to set forth in proposed rule 2–01(f)(11) a workable definition of ''consumer in the ordinary course of business.'' In general, an accountant acts as a ''consumer in the ordinary course of business'' when the accountant buys ''routine'' products or services on the same terms and conditions that are available to the seller's other customers or clients.[153] An accountant is not acting as a ''consumer'' if it resells the client's products or services. Likewise, a purchase is not ''in the ordinary course of business,'' nor is the product ''routine,'' if it is significant to the firm or its employees. For example, an over-the-counter purchase of office supplies at customary prices would be considered in the ordinary course of business. Purchasing items other than on normal, customary terms, or acting as an agent, value-added reseller, or marketer of the client's products, however, would not be acting as a consumer in the ordinary course of business.

We considered whether to address each business relationship that would impair an auditor's independence. Because there are vast, varied, and constantly shifting types of business relationships, we determined not to attempt to identify all such business relationships. We have retained, however, a number of the examples currently found in the Codification to provide guidance on permissible and impermissible business relationships.[154]

We solicit comment on all aspects of paragraph (c)(3). Is the definition of ''consumer in the ordinary course of business'' appropriate? If not, how should it be modified? Should an auditor be allowed to resell its audit client's products? For example, should an auditor be allowed to act as a reseller of a client's software products to other clients of the auditor? Would the answer change if the sales to the auditor exceed some percentage of the client's revenues such as ten percent?

Should an auditor be permitted to enter into any of the following types of business relationships with an audit client without impairing independence, and why or why not: (i) Strategic alliances such as joint marketing arrangements of the products or services of the audit client or auditor; (ii) joint ventures or other similar activities to develop or market new products or services; or (iii) prime/subcontractor relationships? Should any of these relationships be permitted if they do not result in the auditor and audit client sharing any revenues, costs or profits? Should any of these relationships be permitted if they do not result in any revenue, cost or profit sharing that is material to the audit partner, the audit firm, or the audit client?

Are there other business relationships that impair independence that the rules do not cover? Should we retain the ''direct or material indirect business relationship'' formulation or are there other formulations that would provide additional or more precise guidance? Should we adopt rules addressing particular business relationships based on the examples of direct and material indirect business relationships in the Codification?

In addition, we request comment on business relationships between other persons or entities related to the accountant that might affect the independence of the accountant. For example, suppose that XYZ Corp., an audit client of ABC Accounting Firm, manufactures coffee mugs. The spouse of Partner A, who is the partner in charge of the audit of XYZ, purchases coffee mugs from XYZ Corp., applies decorative logos, and sells the mugs to customers. The spouse purchases the mugs at a price that is below the normal selling price. Would a reasonable investor perceive that accountant's independence to be impaired?

D. Non-Audit Services

Historically, accounting firms have provided consulting and other non-audit services to their audit clients.[155] As noted elsewhere in this release, however, for many years consulting services for SEC registrants constituted a relatively minor portion of the firms' revenues.[156] In recent years, firms have expanded the scope of services they offer to audit and other clients.[157]

Current Rule 2–01 states that our independence requirements apply to ''any professional employee involved in providing [on behalf of an accounting firm] any professional service'' to an audit client. The current rule further states that in making independence determinations, we will consider ''all relevant circumstances, including evidence bearing on all relationships between the accountant and [the client].''[158] Our independence requirements, therefore, apply to all persons at an accounting firm who provide non-audit services to audit clients, and we consider those services in making independence determinations. These principles remain unchanged in the rule proposal.

The proposed rules, like our current independence requirements, govern

[152] *See* Codification § 602.02.g. As under the current business relationship standard, the term ''business relationships'' does not encompass sales of professional services by the accounting firm to a company.

[153] The definition of ''consumer in the ordinary course of business'' does not include situations in which an accountant sells, rather than purchases, the audit client's products or services.

[154] *See infra* Section IX.

[155] The AICPA describes ''consulting services'' as follows:

Consulting services differ fundamentally from the CPA's function of attesting to the assertions of other parties. In an attest service, the practitioner expresses a conclusion about the reliability of a written assertion that is the responsibility of another party, the asserter. In a consulting service, the practitioner develops the findings, conclusions, and recommendations presented. The nature and scope of work is determined solely by the agreement between the practitioner and the client. Generally, the work is performed only for the use and benefit of the client.

AICPA Professional Standards: Consulting Services—Definitions and Standards, CS § 100.02.

[156] *See supra* Section II.C; *see also* Appendix B.

[157] *See* Appendix A.

[158] Rule 2–01(c).

non-audit services provided by an accountant to an audit client during the audit and professional engagement period. They do not govern non-audit services when provided to persons other than audit clients. We request comment on this approach.

1. The Proposals

(a) *General Rule.* Proposed rule 2–01(c)(4) states the general rule that an auditor's independence is impaired if providing services to an audit client or its affiliate is inconsistent with the standard in proposed rule 2–01(b). The rule is derived from current Rule 2–01 and our releases that have been incorporated into the Codification. Proposed rule 2–01(c)(4) identifies certain services that are incompatible with the principles set forth in proposed rule 2–01(b), even when the audit client, by contract or otherwise, accepts ultimate responsibility for the work performed or for any decision made.

The rule does not provide an all-inclusive list of the services that are incompatible with proposed rule 2–01(b). Whether the provision of a non-audit service not specified in the proposed rule impairs an accountant's independence will be measured against the four general principles set forth in proposed rule 2–01(b). We request comment on whether there are any services listed in Appendix A that would raise independence concerns if provided by the accounting firm to the audit client? If so, what are they, and why do they raise independence concerns? Are there other non-audit services that are not on the list in Appendix A that raise independence concerns? If so, what are they, and why do they raise independence concerns?

We request comment on whether, if you are a registrant, your company, board of directors, or audit committee have a policy or practice of not hiring your independent auditors to provide non-audit services, other than income tax services. We request comment from registrants about what non-audit services you hire your auditor to provide, other than tax services.

We also request comment on whether allowing certain non-audit services to be provided to audit clients is a viable approach, or whether banning all non-audit services for audit clients is the only appropriate approach. Should such a ban exclude tax services?

(b) *Specific Non-Audit Services that Impair Independence.*

(i) *Bookkeeping or other services related to the audit client's accounting records or financial statements.* Currently, an auditor's independence is impaired if the auditor provides bookkeeping services to an audit client or an audit client's affiliate.[159] Proposed rule 2–01(c)(4)(i)(A) continues that position. When an accounting firm provides bookkeeping services for an audit client, the auditor auditing that client's financial information may be auditing his or her accounting firm's work. If, during an audit, an auditor must audit the bookkeeping work performed by his or her accounting firm, it is questionable that the auditor could, or that reasonable investors would believe that the auditor could, remain objective and impartial. If the auditor found an error in the bookkeeping, the auditor could well be under pressure not to raise the issue with the client, if raising the issue could jeopardize the firm's contract with the client for bookkeeping services.

Because there may be bookkeeping tasks that do not involve financial information or that do not otherwise need to be considered in the audit, we have narrowed the definition to services involving maintaining or preparing the audit client's or its affiliate's accounting records or financial statements, or generating financial information to be disclosed by the audit client, or its affiliate, to the public.[160]

We request comment on whether performing bookkeeping or preparing financial records or statements for an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. If not, why not? Should the definition of bookkeeping be further clarified? If so, how? Does the definition cover all the bookkeeping services that would impair an accountant's independence?

(ii) *Financial information systems design and implementation.* Under the proposed rule, an accountant is not independent if the accountant designs or implements a hardware or software system that is or will be used to generate information that is significant to the audit client's financial statements taken as a whole. By "significant" we refer to information that is reasonably likely to be material to the financial statements of the audit client or its affiliate. Since materiality determinations cannot be made before financial statements are generated, the accounting firm by necessity will need to evaluate the general nature of the information rather than only system output during the period of the audit engagement. An accountant, for example, would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning (ERP) system.[161]

Designing or implementing systems affecting the financial statements may create a mutual interest between the client and the accountant in the success of that system, supplant a fundamental business function, or result in the accountant auditing his or her own work. For example, if an auditor designs and installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on its own work. When an accountant audits the accountant's own work, investors may perceive that the accountant will be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or implemented.

Our proposed rule would not, however, cover services in connection with the assessment, design, and implementation of internal accounting and risk management controls. Accountants often gain an understanding of their audit clients' systems of internal accounting controls. With this insight, auditors often become involved in diagnosing, assessing, and recommending to audit committees and management, ways in which their audit client's internal controls can be improved or strengthened. These services can be extremely valuable to companies, and they may also bring benefits to the performance of a quality audit, such as through increased knowledge of the audit client's business.

At the same time, we recognize that when an auditor designs and implements its audit client's internal accounting and risk management control systems, some might believe that the auditor will lack objectivity if called upon to audit financial statements that are derived at least in part from data from those systems. Testing of these controls is often an integral part of any

[159] Codification § 602.02.c.i.

[160] As noted in section 602.c.iii of the Codification, we determined not to raise questions of independence solely because a foreign office of, or a foreign firm associated with, a domestic accounting firm performs limited, routine, or ministerial bookkeeping services for a foreign division, subsidiary or investee of a domestic registrant which is a client of that firm. The Commission stated that a comparison of the fees for the bookkeeping services and the audit should provide a fair test for determining the significance of the work to the registrant and the accountant and, indirectly, the possible effect on the firm's independence. Accordingly, the Commission limited the fees for such services to the greater of $1,000 or one percent of the total audit fee for the registrant. The Commission continues to recognize the need for relief in this area and has therefore retained this section of the Codification.

[161] This includes designing or implementing such a system for an affiliate of the audit of client, if the system is used to generate information that is significant to the audit client's financial statements taken as a whole.

audit of the financial statements of a company. Do such services result in the auditor auditing their own work? Would such services impair an auditor's independence if the auditor were required to issue an opinion on the effectiveness of the control systems that he or she designed or implemented?

We believe there is relatively little reason for concern about an audit firm's work on hardware or software systems that are unrelated to the audit client's financial statements or accounting records. Accordingly, our proposed rule does not prohibit an accounting firm from providing such services for non-financial or tax purposes where the results of the valuation do not have a direct impact on the financial statements.

We request comment on whether designing or implementing financial information systems poses a threat to an auditor's independence. Is an auditor's independence impaired when the auditor designs, selects or helps select, implements, or tests computer software and hardware systems that generate financial data used in or underlying the financial statements? Why or why not?

Whether a system is used to generate information that is ''significant'' to the audit client's financial statements may depend on the size of the engagement. Does the magnitude of the fees for such services make a difference? For example, if the auditor is hired to do a major new system design and implementation for which the fees will exceed the audit fee, is the auditor's independence impaired or would reasonable investors perceive the auditor's independence to be impaired? What if the consulting fees do not exceed the audit fee, but are significant in relation to the audit fee? What if the consulting fees are much larger than the audit fee?

Is having the audit committee pre-approve these computer systems consulting arrangements sufficient to monitor and ensure the auditor's independence? Why or why not? Would disclosure of such an arrangement make a difference? Why or why not?

Some believe that with the current pace of technological innovation, the quality of audits in the future will be even more dependent on internal controls over the electronic processing of information and data. If so, is auditor independence impaired if auditors are permitted to design and implement the systems that process the information and data, then audit these systems in the course of the audit engagement?

(iii) *Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.* The proposals would provide that the auditor is not independent if the auditor provides appraisal or valuation services, fairness opinions or contribution-in-kind reports,[162] where there is a reasonable likelihood that the results will be audited by the auditor.[163] Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction. Providing these services to audit clients raises several auditor independence concerns. When it is time to audit the financial statements, the accountant could well end up reviewing his or her own work, including key assumptions or variables that underlie an entry in the financial statements.[164] Also, where the appraisal methodology involves projection of future results of operations and cash flows, the accountant that prepares the projection could have a mutuality of interest with the client in attaining forecast results. The auditor may feel constrained by the valuation and appraisal issued by the firm, and as a result, the auditor may be unable to evaluate skeptically and without bias the accuracy of that valuation or appraisal. Our proposals do not prohibit an accounting firm from providing such services for non-financial (*e.g.,* tax) purposes.

We request comment on whether providing appraisal or valuation services and issuing fairness opinions or consideration-in-kind reports to audit clients would impair, or appear to reasonable investors to impair, an accountant's independence. Does providing valuation or appraisal services that are unrelated to the financial statements, such as for income tax purposes impair an accountant's independence?

Some believe that providing valuations and appraisals does not impair the auditor's independence when the amounts involved are likely to be immaterial to the financial statements that later would be reviewed by the auditor. Should we provide an exception in our rule to cover this situation? If so, would the auditor/consultant be able to determine in advance of the valuation work being performed whether amounts may be material to the financial statements currently and in the future?

Are there certain types of appraisal or valuation services, or certain instances in which they are provided, that do not raise auditor independence concerns? Are there circumstances in which an accounting firm may be required by law or regulation to provide such services, either in the United States or abroad? If so, please describe them. How should our rules address them?

(iv) *Actuarial services.* The SECPS defines actuarial services to include: (i) assisting management to develop appropriate methods, assumptions, and amounts for policy and loss reserves presented in financial reports, based on the company's history, current practice and future plans; (ii) assisting management in the conversion of financial statements from a statutory basis to one in conformity with GAAP; (iii) analyzing actuarial considerations and alternatives in federal income tax planning; and (iv) assisting management in the financial analyses of various matters, such as proposed new policies and business acquisitions.[165] Providing actuarial services may affect amounts reflected in an audit client's financial statements and result in an accountant auditing his or her own work.

The proposals, therefore, provide that the accountant is not independent if the auditor provides any advisory service involving the determination of policy reserves and related accounts for the audit client or its affiliate, unless the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. The SECPS already prohibits member accounting firms from providing certain actuarial services.

Does providing actuarial services to an audit client, such as the calculation of actuarial reserves or determining key actuarial assumptions, impair an auditor's independence? Sometimes auditors provide consulting services to their audit clients concerning employee benefit plans. While the consulting services may range from providing tax advice to complete development and ongoing administration of the plan and plan records, many of these services

[162] Contribution-in-kind reports in certain foreign countries require the auditor to express an opinion on the fairness of a transaction, the value of a security, or the adequacy of consideration to shareholders.

[163] The ISB has identified threats to the independence of firms that perform appraisal and valuation services for audit clients. *See* ISB, Discussion Memorandum 99–3, *supra* note 9, at 7–9 (Sept. 1999).

[164] *See generally* Codification § 602.02.c.

[165] *See* SECPS, Organizational Structure and Functions of the SECPS of the AICPA Division for CPA Firms, at § 1000.35 (June 1997) (''SECPS Manual'').

require computation of future benefit levels. Does providing such services impair an auditor's independence with respect to the audit client or the audit of the plan?

Auditors also sometimes prepare or assist an audit client in preparing its annual pension plan reports, from which the financial data are derived to be used in recording the appropriate pension plan information in the financial statements. Does providing this service for an audit client impair the independence of the auditor? Would the auditor's independence be impaired if management provided all of the significant data and key assumptions, and the auditor merely input these data into its computer model to generate the necessary information for the accounting records and financial statements?

Are there certain circumstances under which an accountant can provide actuarial services to an audit client without impairing independence? Have we appropriately described the actuarial services that give rise to independence concerns?

(v) *Internal audit outsourcing.* The line between performing management functions and performing an audit is not always clear. Our staff has received numerous questions about where to draw this line in general, and where to draw this line with respect to ''internal audit outsourcing'' in particular. Companies ''outsource'' internal audit functions by contracting with an outside source to perform all or part of their audits of internal controls. As emphasized by the Committee of Sponsoring Organizations (''COSO''), internal auditors play an important role in evaluating and monitoring a company's internal control system.[166] As a result, internal auditors are, in effect, part of a company's system of internal accounting control.

Since the external auditor generally will rely, at least to some extent, on the internal control system when conducting the audit of the financial statements,[167] the auditor would be relying on its own work performed as part of the internal controls and internal audit function. In essence, by outsourcing the internal audit function, the auditor assumes a responsibility of the company and becomes part of the company's control system, as opposed to providing consulting advice. Also, there may well be a mutuality of interest where management and the external auditor become partners in creating an internal control system and share the risk of loss if that system proves to be deficient.

Proposed rule 2–01(c)(4)(i)(E) provides that an auditor is not independent when the auditor performs certain internal audit services for an audit client or an affiliate. This does not include nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function. It also does not include operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

In 1996, the Ethics Committee of the AICPA published a revised ruling concerning internal audit outsourcing.[168] It states that AICPA members may perform ''extended audit services,'' including internal audit outsourcing services, provided the member or his or her firm does not act or appear to act in a capacity equivalent to a member of client management or as an employee. Under the ruling, an AICPA member may conduct ''separate evaluations'' of the effectiveness of a client's internal controls.[169] The client, however, among other things, must designate a competent member of management to: (i) Be responsible for the internal audit function, (ii) determine the scope, risk, and frequency of internal audit activities, including those to be performed by the member, (iii) evaluate the findings and results arising from the internal audit activities, and (iv) evaluate the adequacy of the audit procedures performed and the findings resulting from performance of those procedures. The ruling also contains examples of activities that, if performed by the member, would be considered to impair that member's independence.[170] The staff has interpreted the language of this ruling narrowly: if the performance of internal audit work entails *any* managerial or employee function, audit independence is adversely affected.

The COSO Report defines certain tasks for management related to separate evaluations, including deciding on scope; analyzing control evaluation work by internal auditors; prioritizing high risk areas; considering the scope, time-frame, methodology, tools, input to be used, and means of reporting findings; reviewing findings; and ensuring follow-up actions are taken. *Id.* at 76.

As noted above, the proposal does not follow the AICPA because we believe performing an internal audit function results in the auditor assuming a management function and, during the audit, relying on a system that the auditor has helped to establish or maintain. We solicit comment on whether internal outsourcing would impair, or would appear to reasonable investors to impair, an auditor's independence. Does it impair an auditor's independence if the auditor does not outsource the internal audit function of the audit client, but rather performs individual audit projects for the client? Would it impair the auditor's independence if the auditor performs only operational audits that are unrelated to the internal controls, financial systems, or financial statements?

(vi) *Management functions.* Proposed rule 2–01(c)(4)(i)(F) provides that an accountant's independence is impaired with respect to an audit client for which the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or an affiliate of the audit client, or performs any decision-making, supervisory, or ongoing monitoring functions. This provision is consistent with the provisions of existing Rule 2–01(b).

We request comment on whether there are circumstances under which an accounting firm can perform or assume management functions or responsibilities for an audit client without impairing independence?

(vii) *Human resources.* Proposed rule 2–01(c)(4)(i)(G) provides that an auditor's independence is impaired with respect to an audit client when the

[166] *See also* Committee of Sponsoring Organizations of the Treadway Commission (''COSO''), *Internal Control—Integrated Framework,* at 7 (1992) (the ''COSO Report'').

[167] AICPA SAS No. 55, AU § 319 (effective for audits on or after Jan. 1, 1990).

[168] AICPA Code of Professional Conduct, ET § 101.15 (Omnibus Proposal of Professional Ethics Division Interpretations and Rulings (June 1996)).

[169] COSO Report, *supra* note 166, discussed what constitutes an acceptable internal control system. Monitoring, according to the report, has two parts: ongoing monitoring activities and separate evaluations. The first is a management function, and the second is not.

''Ongoing monitoring'' occurs in the course of operations, and includes regular management and supervisory activities. *Id.* at 3. Ongoing monitoring procedures are built into the normal recurring operations of an entity. *Id.* at 72. Separate evaluations, on the other hand, are not conducted on a continuing basis. The scope and frequency of separate evaluations depend primarily on management's assessments of the effectiveness of the ongoing monitoring procedures and the amount of information necessary for management to have reasonable assurance about the effectiveness of the internal control system. *Id.* at 3, 71.

[170] *Supra* note 168. These examples include the performance of ongoing monitoring activities that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both; and the performance of routine activities in connection with the client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function.

auditor recruits, hires, or designs compensation packages for, officers, directors, or managers of the audit client or its affiliate. Under the proposed rule, an auditor's independence also is impaired when the auditor advises an audit client about its or its affiliate's management or organizational structure, when it develops employee evaluation programs, or conducts psychological or other formal testing of employees.[171]

Assisting management in human resource selection or development places the auditor in the position of having an interest in the success of the employees that the auditor has selected, tested, or evaluated. Accordingly, an auditor may be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the auditor to be reluctant, because doing so would require the auditor to acknowledge shortcomings in its human resource service. The auditor would also have other incentives not to report such employees' ineffectiveness, including that the auditor would identify and be identified with the recruited employees.

We request comment on whether providing human resource services would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there any types of human resource and employee benefit services rendered that are included in Appendix A that do or do not impair an auditor's independence?

Is an auditor's independence impaired when the accounting firm does an executive search for an audit client? Would an auditor's independence be impaired if the auditor provided personnel hiring assistance for only non-executive or non-financial personnel?

Does it impair an auditor's independence if the auditor provides consultation with respect to the compensation arrangements of the company's executives? Is an auditor's independence impaired if the auditor outsources an audit client's human resource department or similar functions? Are there circumstances in which outsourcing these functions would not impair independence?

(viii) *Broker-dealer, investment adviser or investment banking services.* The proposed rule provides that an accountant is not independent if the accountant acts as a securities professional for an audit client or an affiliate of the audit client. Examples include serving as a broker-dealer, promoter, underwriter, investment adviser, or analyst of the audit client's or an affiliate of the audit client's securities; designing the audit client's or its affiliate's system for compliance with broker-dealer or investment adviser regulations; or recommending the purchase or sale of securities issued by an audit client or its affiliate. Our existing regulations take note of the mutuality of interest created by providing services of this type.[172] Selling—directly or indirectly—an audit client's securities is incompatible with the auditor's responsibility of assuring the public that the company's financial condition is fairly and accurately presented.

We solicit comment on whether providing these services would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there situations in which an accountant could serve as a promoter or underwriter of an audit client's or an affiliate of an audit client's securities without impairing independence?

Broker-dealers often give advice and recommendations on investments and investment strategies. Investment advisers give similar advice. The value of that advice is measured principally by the performance of a customer's securities portfolio. When the customer is an audit client, the accountant has an interest in the value of the audit client's securities portfolio, even as the accountant values the portfolio as part of an audit.

When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended. For example, if an auditor uncovers an accounting error in a client's financial statements, and the auditor had, in an investment adviser capacity, recommended that client's securities to investment clients, the auditor performing the audit may be reluctant to recommend changes to the client's financial statements if the changes could negatively affect the value of the securities recommended by the auditor to its investment adviser clients. We solicit comment on whether recommending the purchase or sale of the securities of an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Will there be an independence impairment if the accountant's broker-dealer customers or investment adviser customers hold substantial positions in audit client securities, even though the accountant did not recommend those securities? We request comment on whether acting as a broker-dealer or an investment adviser for an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence.

An accountant acting as a securities analyst for an audit client or an affiliate of an audit client has a mutuality of interest with the audit client. An analyst often prepares research reports that are used to promote or market the securities of their client. In addition, an auditor may be placed in a conflict if the audit results in the auditor obtaining information that casts doubt on the analyst's opinion. We solicit comment on whether serving as a securities analyst for an audit client's or an affiliate of an audit client's securities would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which an accountant could act as a securities analyst for an audit client's or an affiliate of an audit client's securities without impairing independence?

Independence issues also arise when an accountant designs an audit client's or an affiliate of an audit client's system for complying with broker-dealer or investment adviser regulations. To the extent that, during the performance of the audit, the auditor relies on the controls that are part of compliance systems designed by the accountant, the accountant will end up in the position of auditing its own work.

We solicit comment on whether designing an audit client's or an affiliate of an audit client's system for compliance with broker-dealer or investment adviser regulations would impair, or would appear to reasonable investors to impair, an auditor's independence. If an accountant has an audit client who is a broker-dealer or an investment adviser, and the accountant designs the client's system for regulatory compliance, will the financial audit necessarily encompass reviewing or auditing any aspect of that system or its performance?

We further solicit comment on the scope of the proposal. Are there other securities professional services that the

[171] This proposal is consistent with SECPS Manual § 1000.35, *supra* note 165.

[172] Rule 2–01(b), 17 CFR 210.2–01(b); Codification § 602.02.e.iii. These regulations indicate that activities such as recommending securities, soliciting customers, and executing orders provide investors with sufficient reason to question the auditor's ability to be impartial and objective.

rule should expressly identify as impairing independence?

(ix) *Legal services.* The proposed rule provides that an accountant is not independent of an audit client if the accountant provides any service to the audit client or its affiliates that, in the jurisdiction in which the service is provided, may be provided only by someone licensed to practice law. This proposal is consistent with current regulations, under which legal services are deemed to be incompatible with auditor independence.[173] A lawyer's core professional obligation is to advance clients' interests. Rules of professional conduct require the lawyer to ''represent a client zealously and diligently within the bounds of the law.'' [174] The lawyer must ''take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor * * *. In the exercise of professional judgment, a lawyer should always act in a manner consistent with the best interests of the client.'' [175] Unlike an auditor, a lawyer takes basic direction from the client. In addition, a lawyer has a near absolute duty to safeguard the confidences of his or her client.[176] We have long maintained that an individual cannot be both a zealous legal advocate for management or the client-company, and maintain the objectivity and impartiality that are necessary for an audit. As noted above, the Supreme Court has agreed with our view. In *Arthur Young,* the Supreme Court emphasized, ''If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.'' [177]

We recently reiterated our views in a settled enforcement action.[178] In addition, the staff wrote to the American Bar Association and to its Commission on Multidisciplinary Practices (''ABA Commission'') explaining the impairment of auditor independence that is created when a firm provides both audit and legal services to an entity required to file audited financial statements with the SEC.[179] In its final report, the ABA Commission adopted this view. In discussing legal and attest services, the report states, ''The Commission explicitly recognizes their incompatibility. It does not believe that a single entity should be allowed to provide legal and audit services to the same client.'' [180] We continue to believe that a fundamental conflict exists between the roles of an independent auditor and an attorney.[181]

We request comment on whether providing legal services to an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there any particular legal services that should be exempted from the rule? Does making the rule's application depend upon the jurisdiction in which the service is provided leave the rule subject to any significant uncertainty, or pose the prospect of any significant complexity or unfairness? Should there be any exception for legal services provided in foreign jurisdictions? If so, why?

(x) *Expert services.* The proposed rule states that an accountant's independence is impaired as to an audit client if the accountant renders or supports expert opinions for the audit client or an affiliate of the audit client in legal, administrative, or regulatory filings or proceedings (''expert services''). Clients retain experts to lend authority to their contentions in various proceedings by virtue of the expert's specialized knowledge and experience. The provision of expert services by the accountant creates, at the very least, the appearance that the accountant is acting as the client's advocate in pursuit of the client's interests. The appearance of advocacy (and the corresponding appearance of mutual interest) created by providing expert services is sufficient to deem the accountant's independence impaired.[182] Our proposals would not prohibit an auditor from testifying as a fact witness to its audit work for a particular audit client. In those instances, the auditor is merely providing a factual account of what he or she observed and the judgments he or she made.

We solicit comment on whether providing expert services on behalf of an audit client or an affiliate of an audit client would impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which providing audit clients with expert services in legal, administrative, or regulatory filings or proceedings should not be deemed to impair independence? We also solicit comment on whether an auditor should be permitted to serve as a non-testifying expert for an audit client in connection with a proceeding in which the auditor's work does not provide a basis for testimony by an expert.

An auditor may provide an audit client a written report or ''opinion'' on the application of an accounting principle to a particular transaction in accordance with AU § 625. Such advice aids the audit client in determining the appropriate accounting for a transaction. However, an auditor may also provide such an opinion that is not used primarily by the audit client in the preparation of its financial statements, but rather to market a product to third parties. Does it impair the independence of the auditor when it issues an opinion on the application of an accounting principle that is used primarily to market a product to third parties?

(xi) *Tax services.* The proposed rule would not affect tax-related services provided by auditors to their audit clients. Tax services are unique, not only because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return. We do not think that the Congressional purpose for requiring independent audits is thwarted by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

We are considering whether special considerations apply when the auditor provides a tax opinion for the use of a third party in connection with a business transaction between the audit client and the third party. The tax opinion may be vital in the audit client's efforts to induce the third party

[173] Codification § 602.02.e.ii.

[174] *See, e.g.*, D.C. Rules of Professional Conduct, Rule 1.3(a).

[175] *Id.* at cmts. 1, 5.

[176] *Id.* at Rule 1.6.

[177] *Arthur Young, supra* note 19, at 819–20 n.15.

[178] *In the Matter of Charles Falk,* AAER No. 1134 (May 19, 1999) (formally disciplining an attorney/accountant who gave legal advice to an audit client of another partner in his accounting firm).

[179] Letter from Harvey J. Goldschmid, Lynn E. Turner, and Richard H. Walker, SEC, to Philip S. Anderson, President, American Bar Association, dated July 12, 1999; Letter from Lynn E. Turner, Chief Accountant, SEC, to Sherwin P. Simmons, Chair, Commission on Multidisciplinary Practice, dated Jan. 22, 1999. Except with respect to the matter of auditor independence, we have not taken a position on the development of multidisciplinary practices.

[180] American Bar Association Commission on Multidisciplinary Practice, *Report to the House of Delegates,* at 5 (July 2000) (footnote omitted). The report is available at www.ABAnet.org/cpr/mdpfinalrep2000.html.

[181] *See also* ISB, ''Discussion Memorandum 99–4: Legal Services'' (Dec. 1999).

[182] Existing auditor independence regulations recognize the problem posed by expert services. *See* Codification §§ 601.01 & 602.02.e. Moreover, in connection with its report on auditor independence, the GAO cited a congressional staff report issued in 1977 that ''raised concerns involving situations where accountants testify before public bodies advocating positions that are favorable to their clients.'' GAO Report, *supra* note 45, at 47. That congressional study related to auditing firms' testimony before Congress on oil and gas pricing issues and stated, ''Conflicts of interest occur when 'Big Eight' firms influence governmental authorities on matters which affect their corporate clients.'' Subcomm. on Reports, Accounting and Management of the Senate Comm. on Government Operations, ''The Accounting Establishment: A Staff Study,'' 95th Cong., 1st Sess., Doc. No. 95–34, at 67 (1977).

to enter into the transaction, particularly when the transaction is tax-driven. Under those circumstances, the auditor may be acting as an advocate for the audit client by actively promoting the client's interests.

We request comment on whether providing tax opinions, including tax opinions for tax shelters, to an audit client or an affiliate of an audit client under the circumstances described above would impair, or would appear to reasonable investors to impair, an auditor's independence. Should the rules provide that independence is impaired whenever the auditor provides any tax opinion or any tax opinion that will affect the audit client's financial statements? Does rendering a tax opinion to an audit client affect an auditor's independence considering an auditor must reach an opinion that the financial statements taken as a whole, including the tax accounts, are fairly presented? Are there circumstances in which providing audit clients with tax opinions should not be deemed to impair independence? Are there other tax-related services that if provided to an audit client, would impair, or would appear to reasonable investors to impair, an auditor's independence?

2. Alternatives

We are considering a number of alternatives concerning scope of services. We encourage public comment on each alternative. We may adopt a rule based on one or more of these alternatives instead of the proposed rule or in combination with the proposed rule.

As discussed above, some have suggested that auditors should be prohibited from providing *any* non-audit service to audit clients.[183] We are considering drawing this bright line. This approach may provide investors with the greatest assurance of an auditor's independence. Some believe that such an approach should contain an exception, referred to as an exclusionary rule, that would permit non-audit services to be provided if: (i) Before any non-audit service is rendered to the audit client, the client's audit committee finds that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm or affiliate to render such non-audit service and that no other vendor of such service can serve those interests as well; (ii) a written copy of that finding is submitted promptly to the SEC and POB; and (iii) the company discloses such finding by the audit committee and the amount paid and expected to be paid to the audit firm or affiliate for such service in the company's next proxy statement for the election of directors.[184]

Is a complete break between audit and non-audit services necessary to give investors confidence that auditors will act without bias and with complete objectivity and independence? Would a complete break be useful for instilling such confidence in investors? Is the exclusionary rule a reasonable alternative to a prohibition on non-audit services? How should the exclusionary rule be modified?

We are also considering whether the rules should identify services that would not impair an auditor's independence. These would include services that are a natural outgrowth of the audit process, by building on information learned, and analyses conducted, during the audit. Examples might include business risk assessments, tax services, actuarial valuations of pension and other post-employment benefits or similar liabilities, consulting on the client's internal controls, and similar services. If we pursue this alternative, we might also include a provision stating that these services would nevertheless impair independence if they involved the auditor in making management decisions, operating the client's internal controls or information systems, marketing the client's products, or sharing risks or rewards with the client. We solicit comment on this alternative.

We are also considering whether the independence problems raised by expanded non-audit services can be avoided by structuring a firm to segregate its audit and non-audit businesses into separate autonomous units. Under this approach, the audit, income tax, and certain consulting practices, such as financial advisory and business risk management services, would be placed into an ''audit entity.'' Information and computer technology services, e-commerce, business process reengineering, strategic planning, and other remaining consulting practices would be placed into a separate ''consulting entity.'' Each entity would be managed by individuals not associated with the other entity. Both the audit entity and the consulting entity would be owned and to some extent governed by a common partnership or corporation (''holding entity''), whose board and management would be elected by the respective subsidiary entities. Partners of the audit entity and the consulting entity would own the holding entity.

The holding entity board of directors could be structured to give either entity—or neither—a majority of representatives on the board. The holding entity would retain certain rights, including the right to approve significant transactions, investment, borrowings, or business alliances. The audit and consulting entities would enter into agreements not to compete with each other. In addition, the holding entity, the audit entity, and the consulting entity might share similar, but not identical names, such as ABC Global, ABC LLP, and ABC Consulting, respectively. Partners in the audit entity and consulting entity might market the other entity's services.

In these arrangements, it is common that there would be some level of direct or indirect profit sharing between the audit and consulting entities. The amount of shared profits might depend on whether each met or fell below certain earnings targets. The impact of the profit sharing on an individual owner or partner in the audit or consulting entity would depend on his or her ownership interest in the respective entity. There could also be profit sharing between the audit entity and the consulting entity arising from investments made in other companies.

We request comment on whether such a structure would create a sufficient ''firewall'' between the audit entity and the consulting entity such that the auditor's independence would not be impaired with respect to any services provided by the consulting entity. Are there other ways to construct a firewall that should prevent the consulting entity from being considered an affiliate of the audit entity for purposes of determining the audit entity's independence? Would the independence of the audit entity be impaired if the consulting entity entered into business relationships, such as strategic marketing alliances, with an audit client of the audit entity? Would the independence of the audit entity be impaired if it continued to provide consulting services that generated revenues or profits that were material to the audit entity? Would the independence of the audit entity be impaired if the consulting entity acquired either material or immaterial investments in clients of the audit entity? Would the audit entity's independence be impaired if clients of the audit entity invested in the consulting entity?

[183] *See supra* note 38; The Panel on Audit Effectiveness (''O'Malley Panel''), *Report and Recommendations: Exposure Draft,* at ch. 5, p. 9 (May 31, 2000) (''O'Malley Report''). A copy of the O'Malley Report is available at www.pobauditpanel.org.

[184] *Id.* at 10.

We could require the audit entity and consulting entity to have completely separate management and financial operations, not to ''co-brand'' or use similar names or logos, not to share more than a *de minimis* amount of revenues or earnings (no organization's or partner's earnings would change by more than three percent annually), not to have an equity interest in each other, and not to be contractually or otherwise obligated to refer clients to one another. We request comment on whether any or all of these requirements would suffice to prevent impairments to the audit entity's independence resulting from activities or relationships of the consulting entity.

Under the auditing literature, an auditor is required to discuss matters that may affect the audit with personnel responsible for providing non-audit services to the client-company.[185] Does this requirement prevent the use of firewalls? Are investors harmed if communications between the audit and consulting entities are hindered? If communication is not hindered and there would remain a free flow of information between the audit and consulting entities, should we require other measures to assure independence of the auditors? If we were to pursue this alternative, are there other conditions that should be considered?

We are also considering an alternative that would provide that non-audit services impair independence only when the aggregate fees for those services surpass a certain level in relation to the audit fee. For example, we could adopt a rule stating that an auditor's independence would be impaired if the fees for all non-audit services (excluding tax services) during the most recent fiscal year, and the fiscal year in which the services would be provided, were or would be more than 25 percent of the fee for the audit of the client's financial statements. Does the size of the consulting fees relative to audit fees affect independence? Is the proposed fee comparison an appropriate measure by which to determine whether independence is impaired? If not, what level of non-audit service fees, relative to audit fees, should trigger an impairment of independence?

We also solicit comment on whether not to preclude certain non-audit services, but instead to require companies to disclose substantial information about all the non-audit services received from their auditors. Under this alternative, investors, and not regulators or other interested parties, would decide whether their perceptions of auditor independence were affected by the provision of non-audit services to audit clients. Is disclosure alone sufficient to preserve investor confidence in financial information? Can an impairment of auditor independence be avoided merely by disclosing it?

Several of the largest accounting firms have announced that they have sold, or intend to sell, certain non-audit service lines. We solicit comments relating to those developments and their bearing on this proposed rule. Will the economic forces that gave rise to these transactions cause all or most major accounting firms to divest all or a portion of their consulting service lines? Will economic forces cause those accounting firms that have divested certain consulting service lines to create similar service lines in the future?

3. Transition

We recognize that adoption of the proposed rules could require a registrant to decide between continuing to engage an auditing firm to audit its financial statements and continuing to engage that firm to provide certain non-audit services. It may not be feasible for the registrant and the auditor to cease all ongoing or scheduled non-audit engagements immediately. The company may need time to find a new provider of those services, to complete works in progress, and to provide for a smooth transition from one provider of services to another.

As a result, we propose to include a transition period of two years. Under the proposal, for the two years following the effective date of the rule, providing the non-audit services set forth in subsection (c)(4)(i) to an audit client or an affiliate of an audit client will not impair an accountant's independence from the audit client, if the following holds true: (i) The non-audit services are performed pursuant to a written contract in effect on or before the effective date of this rule; and (ii) performing those services would not impair the auditor's independence under pre-existing requirements of the Commission, the ISB, or the U.S. accounting profession. We believe that two years provides a reasonable time period for the auditor and the audit client to make the necessary elections and conform to the new rules.

We solicit comment on the proposed transition provisions. Do the proposed transition provisions allow an adequate period for implementation? Should the period be longer? If so, how long and why? Could the period reasonably be shorter? If so, what is the shortest transition period that we could reasonably adopt? Are there any conditions other than the two specified in the proposed rule that should be satisfied in order for the services specified in section 2–01(c)(4)(i) not to impair independence during the transition period? Should the condition described in section (c)(4)(ii)(A)—that the non-audit services performed during the transition period be pursuant to a written contract in effect on or before the effective date of the rule—require that the contract be in writing?

E. Contingent Fees

Proposed rule 2–01(c)(5) provides that an accountant is not independent under the standard of paragraph (b) of the rule if the accountant provides any service to an audit client or an affiliate of an audit client for a contingent fee, or receives a contingent fee from an audit client or an affiliate of an audit client. Contingent fee arrangements will typically result in the auditor having a mutual interest with the client. If, for example, a firm arranged to receive an audit fee of $200,000, but half of that fee was contingent upon the audit client successfully completing an initial public offering within the following year, the auditor would have a mutual interest with the audit client in the success of the client's planned IPO, and in the continuing viability of the audit client. That mutuality of interest could influence the auditor's conduct of the audit.

A ''value added'' fee may be another example of a contingent fee arrangement that presents independence problems. An accounting firm might arrange to provide a non-audit service to a client for a ''value added'' fee, meaning that the amount of the fee will depend upon the additional value, profit, or other benefit recognized by the client because of the non-audit service. For example, an audit may undertake a study of certain types of a client's expenditures in order to identify greater amounts of qualifying expenses that would result in greater income tax credits. Fees for such services might be based on a percentage of the tax credits generated, a base fee plus a percentage of tax credits generated over a pre-determined base amount, or a base fee plus a ''value added'' amount to be added to the base fee.

The accounting firm will have an interest in a high valuation of the benefit to the client from the service that had been provided for a contingent fee. In the situation described above, the accounting firm's economic benefit will be greater if the tax credits are maximized, a position that is

[185] AICPA SAS No. 22, AU § 311.04b and AUI § 9311.03.

inconsistent with an auditor who would have to act independently in assessing the accuracy of the impact on the income tax accounts and financial statements of the tax credits.

Rule 302 of the profession's ethics rules states that an AICPA member may not receive a contingent fee for the performance of any service. The AICPA Rule further states:

[A] contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.[186]

Contingent fees are not specifically mentioned in our current regulations, though contingent fees are prohibited by the AICPA Rules.[187] In view of the increase in consulting activities and business relationships among accounting firms, their affiliates, and SEC registrants, however, we believe that it is advisable to state explicitly in the proposed rule that receiving contingent fees from an audit client impairs the auditor's independence.[188] Consistent with the AICPA Rule, however, our proposed definition of "contingent fees," in proposed rule 2–01(f)(12), contains an exception for fees that are fixed by courts or by federal, state, or local governments.

We solicit comment on whether contingent fee arrangements impair, or would appear to reasonable investors to impair, an auditor's independence. Are there circumstances in which, or particular types of services for which, a contingent fee arrangement would not impair independence?

We also solicit comments on whether our proposed definition of contingent fees is adequate. For example, an auditor might charge an audit client fees for professional services priced significantly below market price with the expectation of higher fees in connection with or after a securities offering. Though these arrangements may involve no legal obligations between the parties, they could have the same effect. Should our definition of "contingent fees" include fees that are substantially below the fair market value of the services provided? Are there fee arrangements, such as commissions, that are not included within the proposed definition but that should be included because they would impair an auditor's independence? Should the exception for fees fixed by courts or public authorities be deleted?

F. Quality Controls

Paragraph (d) of the proposed rules establishes a limited exception for accounting firms that maintain certain quality controls and satisfy certain conditions. We are proposing this exception to encourage accounting firms to adopt internal quality controls that ensure the independence of the firm's auditors. In addition, we are proposing this section so that accounting firms that have appropriate controls will not be deemed to lack independence when the particular auditor did not know, and was reasonable in not knowing, the circumstances giving rise to the impairment.

Notwithstanding attempts to maintain independence, we recognize that situations may arise where an accountant's independence inadvertently becomes impaired. A covered person's independence may be impaired, for example, because his or her family member made an investment in an audit client and the covered person was not aware of the investment. We propose, therefore, that in certain situations an accounting firm's independence will not be impaired if: (i) The covered person did not know, and was reasonable in not knowing, the circumstances that gave rise to the lack of independence;[189] (ii) the covered person's lack of independence was corrected promptly after the covered person or the accounting firm became aware of it; and (iii) the accounting firm maintains a quality control system that provides reasonable assurance that the accounting firm and its employees do not lack independence.

The third condition for the exception—a quality control system—is the first line of defense to guard against independence impairments with respect to a client. We understand that accounting firms vary significantly in size and in the nature of their practices, and we propose that the quality controls that the firm establishes be tailored to the firm's size and practice.

Proposed rule 2–01(d)(3)(i)–(vii) describe the elements of a quality control system that large accounting firms that audit public companies must have in place to qualify for the limited exception.[190] Many of these elements are set forth in a 1999 letter from our staff to the SECPS.[191] In the letter, the staff noted that the requirements reflect procedures that many accounting firms are implementing or already following. While the proposed rules would require only large firms to incorporate these elements in their control systems to qualify for the limited exception, we encourage all firms to adopt them and note that, depending on firm size and the nature of its practice, some of these elements may be essential to a quality control system. We discuss those elements here.[192]

1. Written Independence Policies and Procedures

The largest firm's independence policies and procedures must be reduced to writing. We expect that the policies and procedures would be comprehensive and would cover all professionals in the accounting firm and

[186] AICPA Code of Professional Conduct, ET § 302.01.

[187] Under our current Codification, however, a contingent fee might constitute a financial interest in an audit client. For example, Codification § 602.02.b.v. states in part:

If fees for audit *and other professional services* are owed to an accountant for an extended period of time and become material in relation to the fee expected to be charged for a current audit, there may be a question concerning the accountant's independence with regard to the current audit because the accountant may appear to have a direct interest in the results of operations of the client. Generally, prior year audit *and other unpaid fees* should be paid before a current audit engagement is commenced in order for the accountant to be deemed independent with respect to the current audit. (Emphasis added.)

[188] The staff has become aware of an increasing number of situations where firms are sharing with their consulting clients the risk that the firm's advice will add value to the project or transaction. In such situations, the firms are paid through contingent fees or similar arrangements, or payments to the firm may be deferred until contemplated transactions occur or benefits from the project begin to be realized. If the consulting client is also an audit client, however, these payment mechanisms would be considered to be contingent fees and impair the firm's audit independence.

[189] The exception does not apply to situations where the covered person was aware of the circumstances but did not know that the circumstances impaired the covered person's independence.

[190] Under the proposed rule, these procedures apply to those firms that have as clients 500 or more companies that have a class of securities registered with us under Section 12 of the Exchange Act, 15 U.S.C. § 78*l*.

[191] *See* Letters from Lynn Turner to Michael Conway, *supra* note 70. The SECPS adopted independence quality control membership requirements in April 2000.

[192] The quality control policies and procedures would consist of policies and procedures for the accounting firm. Proposed rule 2–01(d)(3)(i). Under the proposed rules, the term accounting firm includes affiliates of the firm. Proposed rule 2–01(f)(2). The definition of affiliate of the accounting firm would include, among other things, all persons and entities with which the firm is publicly associated by co-branding or using the firm's name, initials, or logo. Proposed rule 2–01(f)(4)(E). One effect of this provision, therefore, is that the term accounting firm would include all of the firm's affiliates worldwide. We expect that the written policies and procedures, therefore, would apply to the firm and its affiliates worldwide. *See* Letters from Lynn Turner to Michael Conway, *supra* note 70.

address all aspects of independence, including financial, employment, and business relationships, and fee arrangements.

2. Automated Systems

Large firms must have automated systems to identify financial relationships that may impair independence. We expect that these systems would provide a reasonable basis for tracking audit clients and financial investments by firm professionals. We anticipate that large firms will employ a sophisticated electronic system updated on a regular basis that would allow employees to post their investments to the system, and that would maintain a list of employee holdings and check them against a current list of clients. We propose to require these systems track only financial relationships.

3. Training

Large firm quality controls also must include annual or ongoing firm-wide training about auditor independence. This training should be designed to raise awareness and understanding of the applicable rules. Each professional in a large accounting firm should be able to demonstrate a minimum level of competence with respect to professional standards, legal requirements, and firm policies and procedures.

4. Internal Inspection and Testing

An internal inspection and testing program to monitor adherence to independence requirements is an important part of quality controls. To qualify for the limited exception, large firms must monitor compliance by their firm, their firm partners and their firm professional employees with the applicable independence rules of the profession, standard setters, and other regulatory bodies. This would entail procedures to audit, on a test basis, the completeness and accuracy of information submitted by employees and partners, and information in a client investment database. We expect that firms would have policies, procedures, and controls to monitor the investments of the firm itself and its pension and retirement plans, and any business arrangements with firm clients. We encourage firms to monitor compliance with their own policies and procedures as well.

5. Notice of Names of Senior Management Responsible for Independence

We also propose to require, with respect to large firms, that all firm members, officers, directors, and employees be notified of the name and title of the member of senior management responsible for compliance with the independence requirements. This would require firms to assign responsibility to members of senior management for ensuring compliance with the independence rules.

6. Prompt Reporting of Employment Negotiations

A firm professional would not be independent if he or she were to audit a client while simultaneously negotiating employment with that client. The quality control system of a large firm, therefore, would contain written policies and procedures to require firm professionals to report promptly to the firm as soon as they begin employment negotiations with an audit client. The large firm also would have appropriate procedures in place to remove any such professional from that audit client's engagement immediately and to review that professional's work related to that client.

7. Disciplinary Mechanism

Finally, we propose to require that large firms' quality control systems also have a disciplinary mechanism for enforcement.

We request comment on whether these are the appropriate elements of an effective quality control system. Are there other quality controls that should be required? For example, are these quality controls sufficient to address all situations where the audit firm leases personnel? Under the proposed rules, these procedures apply to those firms that have as clients 500 or more companies registered with us under section 12 of the Exchange Act. Is 500 the appropriate number? Is there another test that we should use to determine which firms must adhere to these procedures to qualify for the exception? We request comment on whether these are the appropriate controls on which to condition the exception, or whether other conditions would be appropriate.

The Big 5 firms are comprised of both U.S. and foreign members. Should these quality controls apply to both U.S. and the foreign firms? Do the foreign firms require a transitional or phase-in period? Should the exception also be provided to a firm that has adopted the specified quality controls, but did not know and was reasonable in not knowing that a partner or employee lacked independence, and the lack of independence was cured promptly after the firm became aware of it? Should the term ''promptly'' be defined in terms of a period of time?

G. ''All Relevant Circumstances''

Proposed rule 2–01(e), reciting the standard currently found in current Rule 2–01(c), provides that we will look to all relevant circumstances in making independence determinations, including all relationships between the accountant and the audit client or its affiliates, and will not confine ourselves solely to the relationship between the audit client and the corporate entity whose name appears on the audit client's filing. Reasonable investors would consider all appropriate circumstances in evaluating an auditor's independence. Paragraph (e) of the proposed rule expresses this principle and makes clear that an independence determination cannot be based on an artificially limited set of the relevant facts.

We solicit comment on paragraph (e). Does paragraph (e) adequately capture the relevant circumstances for making an independence determination? Are there other considerations that should be expressly mentioned in this paragraph?

H. Proxy Disclosure Requirement

We are proposing to reinstate a proxy disclosure requirement. The proposed proxy disclosure requirement varies somewhat from the proxy disclosure requirement rescinded in 1982. Like the 1979–82 proxy disclosure requirement, the proposal would require companies to: (i) Describe specifically each professional service provided by its auditor, and (ii) indicate whether the company's audit committee or, where no such committee exists, board of directors approved the service and considered the effect that the provision of each disclosed service could have on the auditor's independence.[193] We are proposing to require disclosure of the specific non-audit services provided by an auditor to an audit client because we believe that an investor needs the information to form a judgment about independence. We also believe that investors will be aided by disclosure as to whether the audit committee or board of directors considered this issue: Among other things, this information will enable investors to make judgments about whether their interests have been adequately considered by the audit

[193] The O'Malley Panel has recommended that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee regarding auditors' services. The Panel set forth factors for audit committees to consider in determining the appropriateness of a service. *See* O'Malley Report, *supra* note 183, at ch. 5, pp. 7–8.

committee or whether the investors should make further inquiry.

Unlike the earlier proxy disclosure requirement, the current proposal would require companies to disclose the fee paid for each non-audit service and the aggregate audit fee for the most recent fiscal year. Additional disclosures would be required only if a company's auditor leased or otherwise acquired from another entity the professionals it needed to perform a majority of the audit of the company's financial statements.

1. Disclosure of Fees

The proposal would generally require a company to disclose the fee paid for each non-audit service performed by its auditor and the fee charged for the annual audit. An exception to these general disclosure requirements is that issuers would not have to describe a non-audit service, nor disclose the fee for that service, if the fee was less than $50,000 or ten percent of the company's audit fee, whichever is smaller. We are proposing this exclusion to allow companies to avoid disclosure of *de minimis* items.

Earnscliffe asked respondents in its survey whether disclosure could potentially improve auditor independence. ''A fair number of [respondents] advocated a requirement of full disclosure as a way to both deter an unhealthy relationship between auditor and client, and to inform investors of any risks related thereto.'' [194] Like the respondents surveyed, we believe that disclosure could have a positive impact on auditor independence.

We note that, in this area, the United Kingdom has long required disclosure of annual audit fees, and since 1989, it has required disclosure of fees for non-audit services provided by their auditors. ''The [British] government believes that the publication of the existence of, and extent of, non-audit consultancy services provided to audit clients will enable shareholders, investors, and other parties to judge for themselves whether auditor independence is likely to be jeopardized.'' [195]

We request comment on whether the disclosure requirement will be useful to investors and enhance auditor independence. Will disclosure impede the ability of audit client's to obtain valuable non-audit services or have any negative affect? We also request comment on whether the disclosure regarding the approval of the audit committee should be made by the audit committee in its report under Item 306 of Regulation S–K. Is the information required to be disclosed appropriate or should other information be required? Should we require companies to disclose separately the fee paid for tax services? For example, should we require companies to disclose fees by a range in which they fall? Would the disclosure of audit and non-audit fees be more appropriate in Form 10–K (for example, for all companies or for those companies that are not required to prepare proxy statements or information statements) or footnotes to the financial statements, as done in the U.K.?

We further request comment on the exclusion for non-audit services that cost the lesser of $50,000 or ten percent of a company's annual audit fee. Should we set different levels for this *de minimis* exclusion? If so, what should these levels be? What is the appropriate scope of the exclusion? As proposed, the disclosure requirement applies only to the registrant. In the case of an investment company complex, should the rule extend beyond the registrant to require disclosure of all of the professional services that are provided to the investment company complex?

2. Leased Personnel

Under the proposal, a company would have to disclose if its principal auditor leased or otherwise acquired from another entity the personnel it needed to perform a majority of the audit of the company's financial statements. This disclosure requirement responds to the recent move by accounting firms to sell their non-audit practices to financial services companies. Often in these transactions, the partners and employees become employees of the financial services firm. The accounting firm in essence becomes a ''shell'' that then leases assets, namely professional auditors, back from those companies to complete audit engagements. In such an arrangement, audit professionals become full-or part-time employees of the financial services company, but work on audit engagements for their former accounting firm. They receive compensation from the financial services firm and in some situations from the accounting firm.[196] We believe that investors should be informed when individuals who have personal interests that may affect their objectivity are performing the bulk of the audit. [197]

We request comment on the proposal to require disclosure when the principal audit firm signing the audit opinion uses personnel from another entity to perform a majority of the work on the audit engagement.

I. Definitions

In this section of the release, we provide a more detailed explanation of those defined terms not discussed in the preceding sections. Proposed rule 2–01(f) provides definitions of certain terms used in rule 2–01. These definitions apply only to rule 2–01 and not to other sections of Regulation S–X. Rule 1–02 of Regulation S–X provides definitions of terms used in the remainder of Regulation S–X. Are the different scopes of the two sets of definitions sufficiently clear, or should we amend current Rule 1–02 to make it explicit?

1. ''Accountant''

Proposed rule 2–01(f)(1) defines the term ''accountant.'' The proposed rules are written in terms of an accountant's independence from the audit client. The definition of ''accountant'' set forth in Rule 2–01(f) includes the accounting firm in which the auditor practices and, accordingly, makes clear that an individual accountant's lack of independence may be attributed to the firm.

2. ''Accounting Firm''

Proposed rule 2–01(f)(2) is the first of several definitions that are used to describe the entities or groups whose actions may cause an accountant to lack independence. The ''accounting firm'' includes the organization (whether organized as a partnership, corporation, limited liability company, or otherwise) that is engaged in the practice of public accounting or furnishing accountant's reports with respect to financial statements, reports, or other documents filed with the Commission, and all of the firm's divisions, subsidiaries, and departments. The definition also includes all ''affiliates of the accounting firm,'' including its pension, retirement,

[194] Earnscliffe Report, *supra* note 10, at 33.

[195] Michael Firth, ''The Provision of Nonaudit Services by Accounting Firms to their Audit Clients,'' *Contemporary Accounting Research*, at 6 (Summer 1997). Firth hypothesized that companies with potentially high agency costs (*i.e.,* companies in which directors do not control management or which have a large amount of debt) would limit the non-audit services provided by their auditors because the appearance of a lack of auditor independence would increase their cost of capital. Firth's findings were consistent with his hypothesis.

[196] The ISB cites threats to independence arising from these structures and identifies quality controls to ensure the independence of the auditors in these situations. *See* ISB, ''Discussion Memorandum 99–2: Evolving Forms of Firm Structure and Organization,'' at 20 (Oct. 1999).

[197] AICPA SAS No. 1, AU § 543 also sets forth guidance on when a principal auditor discloses and makes reference to another auditor who performs an audit of a component of the entity.

investment, or similar plans. The definition of ''affiliate of the accounting firm'' is discussed below.

The ''accounting firm'' does not include individual partners or employees of the firm. For the purposes of these independence rules, we are proposing that a distinction be made between investments in which the ''accounting firm'' has the primary legal rights or obligations, and investments in which individual partners or employees have the primary legal rights or obligations.

3. ''Affiliate of the Accounting Firm''

Proposed rule 2–01(f)(4) defines ''affiliate of the accounting firm.'' [198] This definition attempts to capture those entities that are financially tied to or otherwise associated with the accounting firm enough to warrant being treated like the accounting firm for purposes of our independence requirements. While part of the definition draws on the definition of ''affiliate'' used in other areas of the securities laws, the definition is broader than those other provisions.

Proposed rule 2–01(f)(4)(i)(A) states that an ''affiliate of the accounting firm'' includes any person controlling, controlled by, or under common control with the firm, shareholders of more than five percent of the firm's voting securities (or similar interests entitling a person to vote), and entities five percent or more of whose securities (or similar interests entitling a person to vote) are owned by the firm. The rule also includes any officer, director, partner, or co-partner of any of the foregoing entities, or persons. This portion of the definition is based generally on the provisions in section 2(a)(3) of the ICA [199] and the definition of ''affiliate'' in Regulation S–X.[200]

Paragraphs (C) through (F) of proposed rule 2–01(f)(4)(i) describe those who are ''affiliates of the accounting firm'' because they are business partners of the accounting firm. In general, these include certain: (i) Joint ventures in which the accounting firm participates, (ii) entities that provide non-audit services to the accounting firm's audit clients and with which the accounting firm has certain financial interests or relationships, and (iii) entities involved in ''leasing'' professional services to the accounting firm for their audits. The definition also includes all other entities with which the accounting firm is publicly associated in certain ways.[201]

The category of joint ventures and partnerships takes into account recent changes in accounting firms' structures and alliances with third parties. It generally would attribute to the auditor actions and interests of certain entities in joint ventures or partnerships in which the parties agree to share revenues, ownership interests, appreciation, or certain other shared economic benefits. The category is based on the notion that such agreements create a mutuality of interest between the auditor and its partner or shareholder because the revenue or profits accruing to each party depend, to some degree, on the efforts of each. Their interests are wedded.[202] Accordingly, under the proposals, the business partner's relationships with or interests in the accounting firm's audit clients would be attributed to the auditor.

The definition of ''affiliate of an accounting firm'' also includes any entity that provides non-audit services to an audit client, if the accounting firm has an equity interest in, shares revenues with, loans money to, or if any covered person has certain direct business relationships with, the consulting entity. Under these circumstances, the actions and investments of the consulting entity are fairly attributed to the accounting firm because the accounting firm's interest in the consulting entity creates a mutuality of interest in the promotion and success of the entity's consulting projects.

The proposed definition of ''affiliate of the accounting firm'' also attributes to the auditor the actions and interests of persons ''co-branding'' or using the same (or substantially the same) name or logo, cross-selling services, or using co-management. Where the auditor has taken steps to identify itself publicly with another person, the auditor shares, and will be perceived to share, a mutuality of interest with that other person.

Would the relationships described in the preceding three paragraphs impair, or appear to reasonable investors to impair, an auditor's independence? Are there any that should be excluded from the definition of ''affiliate of the accounting firm'' for purposes of determining impairments to independence?

The proposed definition of ''affiliate of the accounting firm'' also addresses the situation where full- or part-time employees of an entity other than the firm signing the audit report perform a majority of the audit engagement. The proposal provides that if an auditor ''leases'' personnel from an entity to perform audit procedures or prepare reports to be filed with the Commission, and the ''leased'' personnel perform a majority of the hours worked on the engagement, then the actions and interests of the ''lessor,'' the lessor's board of directors, executive officers, persons with responsibility for management, quality control, or technical supervision over the leased personnel, and shareholders of five percent or more of the lessor's securities, are attributed to the audit firm. In these situations, we believe that this proposal strikes a balance between those entities and persons who reasonably could influence the auditor and the audit process, and those who may be associated with the lessor but have no real or perceived ability to influence the audit.

Would the relationships described in the preceding paragraph impair, or appear to reasonable investors to impair, an auditor's independence? Does the answer depend upon the percentage of the hours worked on the engagement that are attributable to leased personnel? If so, where should the line be drawn and why?

Finally, the proposed definition of ''affiliate of the accounting firm'' excludes persons whose sole business relationship with an accounting firm is to share certain services or facilities, such as a joint training facility or billing office, so long as neither the auditor nor the other person profits from the shared services. The latter restriction is necessary to assure that the auditor and audit client have not joined together in a profit-seeking venture.

We seek comment on the proposed definition of ''affiliates of an accounting firm.'' Should persons or entities other

[198] As noted above, the definitions used in the rest of Regulation S–X, including the definition of ''affiliate,'' would not apply to proposed Rule 2–01.

[199] 15 U.S.C. § 80a–2(a)(3).

[200] 17 CFR 210.1–02(b).

whether all investments and relationships of an affiliate of an accounting firm, as described in the preceding paragraph should be attributed to the audit firm for purposes of evaluating its independence from its audit clients. Should the answer depend upon the percentage of the accounting firm's securities (or similar voting interests) that the affiliate owns? If the latter, at what percentage of ownership should we draw the line beyond which independence is impaired, and, accordingly, draw the line by which we define ''affiliate of the accounting firm?'' If the ''affiliate'' holding the ownership interest is an entity, should the definition of ''affiliate of the accounting firm'' also include any officer, director, partner, co-partner or shareholder of more than five percent of the voting securities of that entity? Does the proposed definition identify all persons that should be considered affiliates for purposes of determining impairments to independence?

[201] There is also an exception from the definition of ''affiliate of the accounting firm'' for certain persons or entities with which the accounting firm shares services, such as training or billing facilities. Proposed rule 2–01(f)(4)(ii).

[202] *See generally*, Letter from Jonathan G. Katz to Duane R. Kullberg, supra note 40, at 4.

than those identified in the proposed rule be included as affiliates?

4. ''Affiliate of the Audit Client''

Proposed rule 2–01(f)(5) defines ''affiliate of an audit client'' as any entity that has ''significant influence'' over the audit client, or any entity over which the audit client has significant influence. The definition thus makes clear that it covers both ''upstream'' and ''downstream'' affiliates of the audit client, including the audit client's corporate parent and subsidiary.

We use the term ''significant influence'' in the definition to signal that the ''affiliates of an audit client'' should be determined in light of the principles in Accounting Principles Board (''APB'') Opinion No. 18.[203] APB No. 18 clarifies the term ''significant influence.'' This accounting literature recognizes that ''significant influence'' can be exercised in several ways: representation on the board of directors; participation in key policy decisions; material inter-company transactions; interchange of personnel; or other means. APB No. 18 also recognizes that an important consideration is the extent of the equity investment, particularly in relation to the concentration of other investments. In order to provide a reasonable degree of uniformity in application of this standard, the Board concluded that,

> [A]n investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.[204]

We believe that the ''significant influence'' test is appropriate because it results in the marriage of financial information between the audit client and the entity influenced by, or influencing, the financial or operating policies of the audit client, including those over which the audit client has control or that control the audit client. Should we, however, consider a different definition of an ''affiliate of an audit client?'' What other test would be appropriate? Rather than using a test that sets a presumption of influence at an equity investment of 20%, is a different investment threshold more appropriate? Should it be higher or lower, and why?

5. ''Audit and Professional Engagement Period''

The proposed definition of ''audit and professional engagement period'' uses language from current Rule 2–01(b) and indicates that the auditor must be independent during the period covered by any financial statements being audited or reviewed (the ''audit period''), and during the period that the auditor is engaged either to review or audit financial statements or to prepare a report (the ''professional engagement period''). The proposed definition also provides that the ''professional engagement period'' begins when the auditor signs the initial engagement letter or begins review or audit procedures, whichever is earlier, and ends when the registrant or the accountant notifies the Commission that the registrant is no longer the accountant's audit client.

The proposed definition makes clear that we agree with the ''auditor of record'' notion described in AICPA Ethics Ruling 101–1. That ruling states:

> The period of a professional engagement starts when the [AICPA] member begins to perform any professional services requiring independence for an enterprise, lasts for the entire duration of the professional relationship, which could cover many periods, and ends with the formal or informal notification of the termination of the professional relationship either by the member, by the enterprise, or by the issuance of a report, whichever is later. Accordingly, the professional engagement does not end with the issuance of a report and recommence with the signing of the following year's engagement.[205]

We solicit comment on the proposed definition. Does the proposed definition cover the appropriate period? Is the definition appropriate for all situations in which the professional engagement ends or do we need to provide an alternative definition for some types of registrants, such as foreign private issuers, or for certain types of engagements? Could this portion of the definition be made more specific by referring to Form 8–K or other Commission filings?

6. ''Audit Client''

The term ''audit client'' is defined in proposed rule 2–01(f)(7) as the entity whose financial statements or other information is being audited, reviewed, or attested. This is how ''audit client'' is commonly used. Use of the term ''audit client'' in this rule in no way changes our position that the auditor ''owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.''[206]

7. ''Audit Engagement Team''

Proposed rule 2–01(f)(8) defines the term ''audit engagement team.'' The ''audit engagement team'' includes the people in the accounting firm that are obviously in a position to influence the audit. Members of the ''audit engagement team'' are included within the category of ''covered persons in the firm,'' which is the term used to indicate the persons in the firm subject to a number of the specific rules in paragraph (c) of proposed rule 2–01.

The ''audit engagement team'' includes all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews, and all persons who consult, formally or informally, with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

We solicit comment on this definition. Should any other persons be included on the audit engagement team? Should any of the persons included on the audit engagement team not be included?

Could the definition's inclusion of persons consulted on an audit create a disincentive for an auditor to seek, or for others to provide, assistance on an audit, and thereby adversely affect the quality of the audit? Is there a realistic possibility that auditors will be impeded significantly in their efforts to secure expert consulting assistance because experts would have to terminate any interest in the audit client before consulting? For example, XYZ Corp is an audit client of ABC Accounting Firm. Industry Expert A, who is not otherwise a covered person in the firm with respect to XYZ Corp, holds an investment in XYZ Corp. Accountant B, who is a covered person, seeks the advice of Industry Expert A. A declines to offer advice because liquidation of the investment would create adverse tax consequences. In situations like this, are there likely to be other industry experts in the firm without investments in the audit client that the accountant could consult? Should the definition of covered persons be limited to assure that all appropriate expertise is available for every audit engagement?

[203] APB Opinion No. 18, ''The Equity Method of Accounting for Investments in Common Stock'' (Mar. 1971).

[204] *Id.*¶ 17.

[205] AICPA Code of Professional Conduct, ET§ 101.02.

[206] *Arthur Young, supra* note 19, at 818.

8. ''Chain of Command''

Proposed rule 2–01(f)(9) defines the term ''chain of command.'' This term is defined broadly to refer to the group of people in the accounting firm who, while not directly on the audit engagement team, are capable of influencing the audit process either through their oversight of the audit itself or through their influence over the members of the audit engagement team. Like the ''audit engagement team,'' persons in the ''chain of command'' are included as ''covered persons in the firm,'' and therefore are subject to a number of the specific rules in paragraph (c) of proposed rule 2–01.

Under the proposed definition, the ''chain of command'' includes all persons having any supervisory, management, quality control, compensation, or other oversight responsibility over either any member of the audit engagement team or over the conduct of the audit. It also includes all partners and managers who may review, determine, or influence the performance appraisal or compensation of any member of the audit engagement team and any other person in a position to influence the audit engagement team's decisions during the conduct of the audit, review, or attestation engagement.

We solicit comment on the definition. Should additional persons be included in the chain of command? Should prominent partners, principals or shareholders in the firm, such as a chairman, CEO, member of the governance board, office managing partner or managing partner of the national technical office always be considered to be in the chain of command? Should any of the persons included in the chain of command not be included? Specifically, is it appropriate to include managers in this group? Is the definition capable of being consistently applied under different accounting firms' management structures?

9. ''Close Family Members''

Proposed rule 2–01(f)(10) defines ''close family members'' to mean a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling. These terms should be understood in terms of contemporary family relationships. Accordingly, ''spouse'' means a husband or wife, whether by marriage or under common law; ''spousal equivalent'' means a cohabitant occupying a relationship generally equivalent to that of a spouse; ''parent'' means any biological, adoptive, or step parent; ''dependent'' means any person who received more than half of his or her support for the most recent calendar year from the relevant covered person; ''child'' means any person recognized by law as a child or step-child; and ''sibling'' means any person who has the same mother or father.

''Close family members'' includes the persons separately defined as ''immediate family members'' (spouse, spousal equivalent, and dependent), and adds certain family members who may, as a general matter, be thought to have less regular, but not necessarily less close, contact with the covered person in question (parent, nondependent child, and sibling). One of our reasons for distinguishing the two groups is that the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence.

We considered whether we should follow this approach further and further into a covered person's family, making impairment depend upon increasingly substantial relationships to the audit client the further removed the family member is from the covered person. The proposed definition of ''close family members,'' for example, does not include in-laws.

We solicit comment on the proposed definition of ''close family members.'' Should the definition include family members in addition to those proposed? Is the proposed definition too inclusive? Should we adopt some type of formula that would reach family members who are further removed from the covered person if those family members have substantial enough relationships to the audit client? How would such a formula work? Instead, are these situations appropriately handled under the general standards of paragraphs (b) and (c)(2) of the rule?

10. ''Covered Persons in the Firm''

Proposed rule 2–01(f)(13) defines the term ''covered persons in the firm.'' The term includes four basic groups: (i) The ''audit engagement team;'' (ii) the audit engagement team's ''chain of command;'' (iii) any other professional employee of the accounting firm who is, or during the audit client's most recent fiscal year was, involved in providing any professional service to the audit client, its parents, subsidiaries, or other affiliates; and (iv) all other professional employees from an ''office'' of the accounting firm that participates in a significant portion of the audit.

The ''audit engagement team'' and the ''chain of command'' are discussed above. We have also included as ''covered persons in the firm'' those professionals who provide consulting and non-audit services to the audit client. We did so because the auditing literature, quite appropriately, directs the audit engagement team to discuss certain matters with the firm personnel responsible for providing such services to that client.[207]

We have also included as ''covered persons in the firm'' all other professional employees from an ''office'' of the accounting firm that participates in a significant portion of the audit. (The definition of ''office'' is separately discussed below.) We included these people because we believe they are generally in a position to influence the audit. They are the ones most likely to interact with the audit engagement team on substantive matters and to exert influence over the audit engagement team by virtue of their physical proximity to, or relatively frequent contact with, the audit engagement team.

Nevertheless, under the proposal, an accounting firm employee in a distant part of the world, or even down the street, could own an audit client's securities, have a family member in a financial position at the client, or enter into a business relationship with a client without necessarily impairing the firm's independence from the audit client. We expect that many partners and employees who previously could not own securities issued by an audit client will be able to do so under the proposed rule. It should be noted that insider trading restrictions prohibit any partner, principal, shareholder, or employee of the firm, whether or not he or she performs any service for the client, from trading on any nonpublic information about that client.[208]

We believe that the lines drawn in the proposed rule provide a reasonable balance between those who may and those who may not be able to influence the audit process for a particular client. In general, all those who may have a connection with, or directly or indirectly influence, the audit have been included.

We solicit comment on the definition of ''covered persons in the firm.'' Are there other persons in the firm who should be included, such as all partners? Are there persons included in the definition who should not be

[207] AICPA SAS No. 22, *supra* note 185.

[208] *See* ''Selective Disclosure and Insider Trading,'' Securities Act Rel. No. 7787 (Dec. 20, 1999). As discussed in footnote 109 of that release, an individual working at an accounting firm may be liable for insider trading for misappropriating information about a client, even if he or she did not perform services for that client.

included? Is the concept of a ''significant portion of the audit'' sufficiently familiar to accountants to be a useful standard?

A person who is not a covered person at the time an audit engagement begins may be consulted about the audit as the engagement progresses. Once consulted, that person becomes a member of the audit engagement team and, therefore, a covered person in the firm. That person must dispose of any financial interest in the audit client completely and irrevocably before participating in any discussion with another covered person concerning the audit engagement. The proposal would not allow the person consulted to participate in a discussion about the audit engagement and then ''cure'' an independence impairment by later disposing of his or her financial interest in the audit client.

Likewise, a person may become a covered person by rotating on to an engagement or being promoted into the chain of command. In these situations, the person must also dispose of any financial interest in the audit client completely and irrevocably before becoming a covered person.

11. ''Immediate Family Members''

Proposed rule 2–01(f)(15) defines ''immediate family members'' to mean a person's spouse, spousal equivalent, and dependent. These terms have the same meaning as they do in the definition of ''close family members.''

''Immediate family members'' is a narrower group than ''close family members.'' Again, part of our premise in distinguishing the two groups is that the less immediate the family relationship to the covered person, the more substantial that family member's relationship to the audit client should be before we deem it to impair the auditor's independence. By circumscribing the group of ''immediately family members,'' we mean to identify those persons who have such regular and close contact with a ''covered person,'' that it is fair, for independence purposes, to attribute to the covered person any financial and employment relationships that family member has with the audit client.

We solicit comments on the definition of ''immediate family members.'' Should the definition include family members in addition to those proposed? Is the proposed definition too inclusive? Are there any qualifications that should be added to the definition, such as not including spouses who are separated from, and living apart from, the covered person?

12. ''Investment Company Complex''

Proposed rule 2–01(f)(16) provides a definition of ''investment company complex'' that is loosely based on ISB Standard No. 2. ISB Standard No. 2 defines ''mutual fund complex'' to mean ''[t]he mutual fund operation in its entirety, including all the funds, plus the sponsor, its ultimate parent company, and their subsidiaries.'' [209]

Our proposed rule defines ''investment company complex'' to include an investment company and its investment adviser, or if the company is a unit investment trust, its sponsor; any entity controlled by, under common control with, or controlling the investment adviser or sponsor of a unit investment trust, such as a distributor, fund administrator, or transfer agent; and any investment company or an entity that would be an investment company but for the exclusions provided by section 3(c) of the ICA and that is advised by the investment adviser or sponsored by the sponsor, or an entity that is controlled by, under common control with, or controlling the investment adviser or sponsor. The definition does not include sub-advisers whose role is primarily portfolio management and who provides services pursuant to a subcontract with, or are overseen by, an adviser in the complex. As proposed, an auditor generally would not be precluded from investing in other investment companies advised by an investment company audit client's sub-adviser. We request comment on whether the auditor of an investment company should be independent of other investment companies that have an adviser that is the sub-adviser of an audit client investment company. Sub-advisers are excluded only when their duties are limited to portfolio management. Should they be excluded only in this circumstance? Is the definition of sub-adviser clear and capable of implementation, or is another definition preferable?

As proposed, the definition would require an auditor to be independent of all companies that would be investment companies but for the exclusions set forth in section 3(c) of the ICA. Should the auditor of an investment company be independent of all investment type products (*i.e.,* hedge funds, venture capital funds, commodity pools, real-estate pools) offered by the adviser or sponsor of the investment company?

The rule would preclude auditors of a unit investment trust from investing in other investment companies sponsored by the sponsor of the unit investment trust and any other entity in the same investment company complex. We have defined sponsor as the entity that establishes the unit investment trust. Is such a definition sufficiently clear and capable of implementation? If not, how should it be modified so as to be sufficiently clear?

We solicit comment on the proposed definition of ''investment company complex.'' Does the definition include all entities that should be within the investment company complex? Does the definition include any entities that should not be included? For example, under the proposed rule, we focus on the integral role of an investment adviser in the investment company complex. But, for some fund groups, the principal underwriter or administrator plays a predominant role in organizing and managing the overall operations of the investment companies in the investment company complex. Should the auditors be independent of the administrator or principal underwriter? Should the auditors be independent of other fund groups who use the same principal underwriter or administrator?

13. ''Office''

Proposed rule 2–01(f)(17) defines ''office'' to mean a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines. The term ''office'' is used in the rule to help delimit the persons who are considered ''covered persons'' and, therefore, plays a role in identifying those firm personnel who cannot have financial or employment relationships with a particular audit client or affiliate of an audit client without impairing the firm's independence.

We give ''office'' a meaning that does more than merely refer to a distinct physical location where the firm's personnel work. By ''office'' we mean to encompass any reasonably distinct sub-group within an accounting firm, whether constituted by formal organization or informal practice, where the personnel who make up the sub-group generally serve the same clients, work on the same matters, or work on the same categories of matters. In this sense, ''office'' may transcend physical boundaries, and it is possible that a firm may have a sub-group that constitutes an ''office'' even though the personnel making up that sub-group are stationed at various places around the country or the world.

At the same time, we intend for ''office'' also to include reference to a physical location. For this reason, ''office'' will generally include a distinct physical location where the firm's

[209] ISB Standard No. 2, *supra* note 139.

personnel work. We recognize, however, that in some cases thousands of firm personnel may work at a single, large physical location, but physical divisions may nonetheless effectively isolate different sub-groups of personnel from each other in ways that will warrant treating each sub-group as a separate ''office'' under the proposed definition.

We solicit comments on the proposed definition of ''office.'' Does the definition provide a useful framework for identifying firm personnel who reasonably should be included within the definition of ''covered persons?'' Is there an alternative definition that would better serve the objective of identifying persons firm-wide whose geographic or professional proximity to the firm's work for a particular audit client suggests that their financial or employment relationships with that audit client should be deemed to impair the firm's independence? Should ''office'' be defined more narrowly, such as by limiting it to persons who work in the same physical location? To the extent that the definition does include physical location, should ''office'' be defined more strictly, by providing that all firm personnel working at the same physical or geographic location will, in all cases, constitute a single office?

J. Codification

As previously discussed, the Commission's current auditor independence requirements are found in various rules and interpretations. Section 600 of the Codification provides interpretations and guidance not otherwise available in the current rule. The proposed rule attempts to articulate clearly situations and circumstances, such as financial relationships, employment relationships, and non-audit services that impair auditor independence. Accordingly, we are proposing to delete interpretations included in the Codification that are reflected in, or that have been superseded by, the proposed rule.[210] The current Codification contains background information and interpretations that may continue to be useful in situations not specifically or definitively addressed in the proposed rule. Examples of these items concern business relationships, unpaid prior professional fees, indemnification by clients, and litigation.

Should the background information and other relevant items included in the Codification be maintained in their current form? Are there additional items that should be modified? Are there items that are proposed to be deleted but should be maintained in the Codification?

IV. General Request for Comments

We request comment on the proposals, other matters that may have an impact on the proposals, and your suggestions for additional changes. In addition, in considering whether to adopt rule amendments on auditor independence, the Commission will consider what effect, if any, its actions might have on the states and on state law. Specifically, the Commission will consider whether the rule amendments (i) could alter the relationships between federal and other authorities, (ii) require expenditures by state officials, or (iii) preempt state or local law. The Commission's rules affect only those auditors that perform audits for companies required to file financial statements and auditors' reports with the Commission, whereas state regulations often affect a much broader category of auditors and companies.

The Commission's proposals are not intended to alter the relationship between federal and state authorities. In general, states have patterned their regulations after those of the AICPA or the National Association of State Boards of Accountancy. Many state independence regulations may be more permissive, in some respects, than the Commission's current regulations. These differences would continue under the proposals. The proposals do not require state officials to undertake licensing regimes or otherwise make any financial outlays. Furthermore, our proposals would not affect the ability of the states to adopt different regulation in those areas they currently regulate. We solicit comment on whether the proposals would affect specific state laws or require any expenditures by state officials. We also request comment on whether or how these proposals would alter the relationship between federal and state authorities.

V. Cost-Benefit Analysis

We have identified certain costs and benefits of the proposals. We request comment on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of the proposed amendments. We encourage commenters to identify or supply relevant data concerning the costs or benefits of the proposed amendments.

A. Costs and Benefits of the Proposals Regarding Investments in and Employment Relationships With Audit Clients

The proposals clarify and, in some cases, eliminate, certain existing regulations under which an accountant's independence is impaired by fellow accounting firm employees or their family members having an investment in or holding a position at an audit client. As explained above,[211] changes in business practices and demographics, including an increase in dual-career families, may warrant a change in our auditor independence requirements to prevent them from unnecessarily restricting the employment and investment opportunities available to auditors and members of their families. To this end, the proposals take a more targeted approach and focus on those persons who are involved in or can influence an audit. In addition, the proposals create a limited exception for accounting firms that have quality controls that provide reasonable assurance of independence.

1. Benefits

We believe that our proposals on investment and employment restrictions provide several benefits. Eliminating certain investment and employment restrictions should benefit auditors and their families by permitting them a wider range of investment and employment opportunities. Currently, according to annual reports filed by accounting firms with the SECPS, the five largest audit firms employ approximately 115,000 professionals. Other public accounting firms that audit SEC registrants employ an estimated 5,000 to 25,000 professional staff. Our proposals would benefit these 120,000 to 140,000 accounting firm professional employees and their families by enabling them to invest in some public companies that, under the current rules, they cannot invest in without impairing the independence of the companies' auditors. In addition, under the proposals, unlike under current rules, family members of some audit firm employees could be employed by audit clients and their affiliates without impairing auditor independence.

Expanding the set of investment opportunities available to auditors and their family members may increase the return they can earn on their investments and improve their ability to reduce risk through diversification. Similarly, expanding the set of employment opportunities available to

[210] The Codification in its entirety remains in effect until any final rule is adopted.

[211] *See supra* Section II.

the family members of audit firm employees has the potential to increase their compensation. Finally, opening up the employment opportunities available to auditors and their family members increases their freedom of choice with respect to employment opportunities. This could improve the non-pecuniary, as well as financial, benefits of employment.

We request comment on the estimate of the number of individuals who are likely to benefit from the proposed amendments. Is a better estimate available? Is it possible to estimate the annual benefits to these individuals from having a wider range of investment choices? Is it possible to estimate the benefits that these individuals may achieve on an annual basis because of a wider range of employment choices? Would eliminating investment and employment regulations provide other benefits to these individuals? Are there other individuals who would benefit from the proposals regarding investment and employment relationships?

In addition to eliminating certain restrictions, the proposals clarify the independence requirements. Currently, these requirements are found in various Commission rules, Commission interpretations, staff letters and staff reports. The proposals consolidate the requirements. As a result, the proposals should provide clearer guidance to accountants and their families, issuers and their audit committees, regulators, courts, administrative law judges, and others. The proposals also put this guidance in an easily accessible format that should save these parties costs in ascertaining and complying with the regulations. Is it possible to quantify these benefits? Would additional parties be affected by the proposed clarification of our investment and employment restrictions?

Finally, the proposals encourage, but do not require, accounting firms to establish quality control systems that provide reasonable assurance that they are complying with our auditor independence requirements. The proposals do so by providing that an accounting firm's independence will not be impaired solely because one of its employees does not comply with the independence rules if, among other things, the firm has adequate independence quality controls in place.

GAAS already requires firms to have quality controls for their audit practices and refers auditors to the ''Statements on Quality Control Standards'' (''SQCS'') for guidance regarding the elements of those systems.[212] SQCS No. 2 states that firms' controls should provide ''reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances, perform all professional responsibilities with integrity, and maintain objectivity in discharging professional responsibilities.'' [213] In addition to requirements imposed by GAAS, public accounting firms that are SECPS members must comply with independence quality control membership requirements. Among other things, member firms with at least 7,500 professionals must implement an electronic tracking system by no later than December 31, 2000.[214] Our proposals, therefore, do not impose, even indirectly, a requirement for internal controls that does not already exist under GAAS and SECPS membership requirements.

The proposals, however, do clarify the GAAS requirement for firms with more than 500 SEC registrants as audit clients by identifying procedures that should be part of their quality control systems.[215] This aspect of the proposals could benefit the largest public accounting firms by reducing uncertainty about the required minimum characteristics of any quality control system they institute.

In addition, any public accounting firm implementing a quality control system in compliance with this limited exception should benefit because we would be narrowing the circumstances in which independence would be impaired. This aspect of the proposals also should provide investors with the assurance of improved quality control systems of any firms that implement them, and inform investors and others who rely on audited financial statements about the minimum characteristics of the quality control systems maintained by these accounting firms. This should reduce uncertainty among investors and increase investor confidence.

What methods are available to estimate the benefits that these accounting firms would receive from the limited exception and the reduced uncertainty about the minimum characteristics required for quality control systems? What methods are available to estimate the benefits to investors and others because of enhanced assurance that firms possess quality controls with minimum characteristics described in this section? Are there other benefits arising from the proposed amendment?

We request comment, including supporting data if available, on the benefits of the proposals regarding investment and employment relationships.

2. Costs

Modification of our investment and employment restrictions may require accounting firms, their employees, or others to incur transaction costs, such as one-time costs to modify existing systems that monitor investments and employment relationships, and training costs to make all professional staff aware of the revised rules. Is it possible to estimate these costs? Are there additional costs that would be borne by any individual or entity other than those identified?

As discussed above, the proposals provide an incentive—namely a limited exception from the auditor independence requirements—for accounting firms to establish quality controls. In the case of the largest firms, the proposals specify what we believe to be the minimum characteristics of these systems.[216] For the largest firms, implementing such a quality control system would likely entail costs to enhance or alter the firm's existing system. Because seeking the limited exception is elective, such costs will be assumed voluntarily, if at all, by accounting firms that decide that the benefits of this limited exception outweigh the cost of any incremental changes that are necessary to make their quality control systems meet the proposals' standards.

In addition, to minimize costs, we have tailored these quality control proposals in recognition of current industry requirements and practices. As noted above, under GAAS and, where applicable, under SECPS membership requirements, accounting firms must have a system of quality controls, including policies and procedures, to

[212] AICPA SAS No. 25, AU § 161, n. 1.

[213] AICPA Professional Standards: SQCS, QC § 20.09.

[214] Letter from Michael A. Conway, Chairman, Executive Committee, SECPS, to the Managing Partners of SECPS Member Firms, dated April 2000 (available at www.aicpa.org).

[215] The specified criteria for a quality control system only apply to the largest accounting firms. For other firms, the proposal states that a firm's quality control system should take into account the size and nature of the firm's practice. Again, this is in general conformity with GAAS, which states, ''The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.'' AICPA SAS 25, AU § 161.02.

[216] Other public accounting firms would have the flexibility to adopt a system to comply with the proposed requirement in light of the nature and size of their practice.

provide the firm with reasonable assurance that personnel maintain independence in all required circumstances.[217] Moreover, it is prudent business practice to maintain reasonable quality controls.[218] An accounting firm that chooses to upgrade its existing quality control system to comply with the limited exception should incur only the incremental costs of implementing any improvements beyond what is required by GAAS and SECPS membership requirements.

We seek comment, and supporting data if available, on these and any other costs of our investment and employment proposals, including the quality control proposals. Is it possible to quantify the initial costs accounting firms may incur to modify their quality control systems? Is it possible to quantify the incremental costs that may be incurred by the largest accounting firms that choose to put in place a quality control system that meets the specified criteria?

B. Costs and Benefits of Restricting Certain Non-Audit Services

As more fully described above,[219] there is increasing concern that the growth of non-audit services provided to audit clients affects the independence of auditors. If investors lose confidence in auditors' ability or willingness to provide an unbiased and impartial examination of companies' financial statements, then investors' trust in the reliability of publicly available financial information, and in the integrity of the securities markets, may be damaged.

Currently, accounting firms may not provide certain services to their audit clients without impairing their independence. Our proposals extend and clarify those restrictions by setting forth four basic principles that should be used to evaluate the effect of non-audit services on an auditor's independence, and by designating certain non-audit services that, if performed by an auditor for an SEC registrant that is an audit client, impair the auditor's independence.

Our proposals on the provision of non-audit services may affect four distinct groups: investors, issuers, public accounting firms, and other potential providers of non-audit services. The benefits and costs arising from the proposed amendments are examined for each group.

1. Benefits

(a) *Investors.* For the reasons explained above, the Commission believes that the proposals will enhance auditor independence and thereby enhance the reliability and credibility of financial statements of public companies.[220] We expect these benefits to inure primarily to investors who, if the proposals are adopted, should be able to review public companies' financial statements with greater assurance that reliance on the statements will lead to more informed investment decisions. We seek comment on whether it is possible to quantify the benefits of the proposals to investors, and if so, how.

(b) *Issuers.* Issuers may benefit from the proposed scope of services regulations in several respects. First, the proposals eliminate certain uncertainties as to when a registrant's auditor will not be recognized as independent. The proposals eliminate these uncertainties by setting forth not only four general principles by which to analyze non-audit services, but also by listing certain non-audit services as incompatible with the concept of auditor independence. Accordingly, in the future, issuers can know that if their auditor provides any of the listed services, the auditor will not be independent for purposes of Commission filings.

Second, if the proposals increase investor confidence in financial reporting and thereby encourage investment, they may facilitate capital formation. In such a scenario, issuers would be able to attract capital at lower rates of return, or in circumstances in which they currently cannot raise capital.

Finally, the proposals may increase the utility of annual audits to issuers. For example, by requiring issuers to obtain certain information technology services, such as implementation of an accounting information system that is used to generate data significant to the financial statements as a whole, from a vendor other than their auditor, the proposals should result in someone other than the non-audit services provider reviewing that system during the course of the audit. As a result, issuers may get an independent "second opinion" of the system from the audit. Furthermore, as a result of the proposals, issuers may avoid pressure from their auditors to purchase non-audit services.

(c) *Other Consulting Firms.* Consulting firms that do not engage in public accounting also may benefit from the proposals. Such consulting firms may receive revenue from certain consulting engagements that, but for our proposals, would have gone to the client's auditor. Moreover, to the extent that a registrant's auditor has advantages in competing to provide consulting services to an audit client by virtue of the auditor's personal relationships with officers of the audit client or increased awareness of potential consulting engagements through proximity to an audit client, our proposals may improve competition in the market for the provision of consulting services. This improved competition could benefit any consulting firm with comparative advantages in providing the necessary non-audit services.[221]

(d) *Public Accounting Firms.* We anticipate that the proposals will confer two primary benefits on public accounting firms. First, the proposals should clarify what non-audit services may be provided to an audit client without jeopardizing auditor independence. Second, the proposals could improve competition in the market for the provision of non-audit services by public accounting firms. Because the restrictions on providing non-audit services to an audit client would apply equally to all accounting firms, the overall impact of the proposed restrictions may be to re-distribute the restricted non-audit services among the public accounting firms.[222]

In addition, as noted above, a registrant's auditor may have advantages in competing to provide non-audit services to its audit client that are not based on the auditor's skill or cost advantages in providing that service. To the extent that such advantages exist, the proposals may improve competition in the market for non-audit services. If a public accounting firm has a comparative skill or cost advantage in providing a particular non-audit service, that public accounting firm may benefit from any enhanced competition because its comparative advantage over other public accounting firms in providing that service would be more likely to lead to non-audit assignments from other public accounting firms' audit clients. Might these enhancements to

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[217] AICPA SQCS, QC § 20; AICPA SAS No. 25, AU § 161.

[218] Some firms are already developing or improving quality control systems. At least one Big 5 accounting firm has begun the process of installing a computerized tracking system that monitors employee investments. *See* Elizabeth MacDonald, "Top Accounting Industry Group Sets Conflict-of-Interest Compliance Rules," Wall St. J., Feb. 2, 2000, at B2.

[219] *See supra* Section II.C.

[220] *See supra* Section III.D.1.

[221] This would also benefit the issuers that contract for these non-audit services.

[222] As noted above, some of this work may be re-distributed to consulting firms that do not engage in public accounting.

competition change the way accounting firms invest in various of their service lines? For example, might accounting firms begin to re-invest more heavily in their audit function?

We request comment, including supporting data, on the benefits of the proposals.

2. Costs

Our proposals on non-audit services may impose costs on issuers and public accounting firms. We request comment on whether these proposals may impose costs on other groups.

(a) *Issuers.* The proposed amendments have the effect of restricting issuers from purchasing certain non-audit services from their auditors. Currently, the five largest public accounting firms audit approximately 12,800 public companies. Other public accounting firms audit approximately 3,900 public companies. According to reports filed with the AICPA, of the 12,800 public companies audited by the so-called ''Big 5,'' approximately 9,500 did not purchase any consulting services from their auditor in the most recently reported year. Of the approximately 3,900 registrants that are audited by other public accounting firms, approximately 3,100 did not purchase any consulting services from their auditor.

For the 12,600 registrants that did not purchase any consulting services from their auditor, the proposed amendments would not have affected their purchase of non-audit services in the most recently reported year. In the future, however, these registrants could be affected by the proposals insofar as the proposals reduce their flexibility in the purchase of non-audit services.

Of the approximately 4,100 registrants that were reported to have purchased non-audit services from their auditor, many may have purchased non-audit services that are not covered by the proposals. In the future, these issuers could continue to procure the same services from their auditor.

Issuers that purchased from their auditor non-audit services that are covered by the proposals, however, will have to look to other professional services firms, including other public accounting firms, to provide these services in the future. The fact that many issuers currently purchase non-audit services from firms other than their auditor suggests that there is a competitive market for non-audit services. Therefore, issuers who are precluded by the proposals from purchasing such services from their auditor likely will be able to purchase these services from other vendors. These issuers may incur costs from having to use a separate vendor, including the possible loss of any synergistic benefits of having a single provider of both audit and non-audit services. For example, they may incur costs locating a new vendor and developing a business relationship with that vendor.

We request comment on whether it is possible to quantify the costs arising from employing separate vendors for certain consulting services, and if so, how. We also request comment on the accuracy of the estimated number of issuers that would be affected by the proposed amendment. What percentage of SEC registrants use a competitive bidding process in selecting providers of non-audit services? What percentage ''sole source'' non-audit assignments? For issuers that currently acquire from their auditor non-audit services that are prohibited by the proposals, what is the additional cost of using a competitive bidding process to acquire non-audit services? Are there any benefits to the issuer of employing such a process? Under our proposed rule, how often, if at all, would an issuer be unable to find a vendor other than their auditor to provide a covered non-audit service on a comparable basis?

(b) *Public Accounting Firms.* Some public accounting firms provide a wide variety of services both to audit and non-audit clients. Our scope of services proposals are likely to affect these firms in several ways. The primary cost for these firms is that they individually may lose one source of revenue because they will no longer be able to sell certain non-audit services to their audit clients. Based on the accounting firms' SECPS reports, however, it appears that, on average, public accounting firms with fewer than 1,000 SEC registrants as clients earn less than 1% of their total fees from providing management consulting services to audit clients.[223]

The anticipated loss of revenue would primarily affect the Big 5 firms. Some members of the Big 5 provide extensive non-audit services to their audit clients. However, at least two of the Big 5 have recently sold or taken steps to separate their consulting practice from their audit practice. And, at least one other Big 5 firm has announced its intention to separate its consulting and its audit practices. In addition, the SECPS reports of the Big 5 show that almost 75% of their audit clients that are SEC registrants purchased no management consulting services from their auditor. Accordingly, the proposals appear likely to impose significant costs only on those members of the Big 5 that do not plan to separate their audit and non-audit practices (or at least that portion of their non-audit practice that provides those non-audit services listed in proposed rule 2–01(c)(4)).[224] Even then, because only about 25% of these firms' SEC audit clients buy non-audit services from their auditors, the proposals will only impose costs with respect to, at most, 25% of these firms' client relationships.

In addition, because our proposals would affect all auditors, the overall impact of the proposed restrictions may be merely to redistribute certain non-audit services among public accounting firms.[225] To the extent these services are only redistributed, there should be no net loss of revenue to public accounting firms as a whole.

We request comment on these costs and our estimates of the number of accounting firms and issuers that will be affected. Is it possible to quantify these costs? Is there any reason to believe the costs in the form of lost revenue will not be offset by equal benefits to other public accounting firms and other consulting firms?

A complete prohibition on accounting firms' providing any non-audit services could impose other, different costs on public accounting firms, such as depriving accounting firms of expertise they could have obtained from consulting activities that can be employed in audit engagements, preventing ''synergies'' from a better understanding of the client, and harming accounting firms' ability to recruit and retain employees. Our proposed rule does not ban accounting firms from providing all non-audit services, nor does it ban accounting firms from providing any non-audit services to entities other than their audit clients. It only adds certain non-audit services to those that accounting firms are already precluded from providing to a particular audit client if they wish to maintain independence from that audit client.

Nonetheless, we have considered whether our proposals are likely to impose any of these other costs on public accounting firms. For example, we have considered that the provision

[223] Of course, these firms and other firms that do not currently earn any such revenues would be precluded from earning such revenues in the future from the covered non-audit services.

[224] Public accounting firms that are separating their consulting practices would be affected if they subsequently determined to re-acquire or recreate consulting practices that included these listed services.

[225] Of course, as noted above, some of the non-audit services now provided by auditors may be redistributed to consulting firms that are not engaged in public accounting.

of non-audit services may enhance an auditor's expertise and thereby improve the efficiency or effectiveness of the audit. Our proposals would not preclude public accounting firms from developing or maintaining such expertise through consulting engagements, however. Under the proposals, public accounting firms could provide any non-audit service to clients that are not audit clients as to which they must be independent under the federal securities laws, and thereby develop or maintain their expertise. Moreover, to the extent that the effect of the proposals is merely to redistribute the provision of non-audit services among the public accounting firms, this redistribution may permit each of the firms to maintain its expertise in various of these services.

We request comment on whether our proposals on non-audit services would impose costs on accounting firms or others because accountants would have diminished expertise. If so, is it possible to quantify these costs? We also request comment on what effect, if any, reducing the pool of clients to which accounting firms can sell certain non-audit services will have on the firms' profit margins.

Our proposals also may affect what some contend are synergies (or ''knowledge spillovers'') that arise from providing non-audit services to an audit client. Research on enhanced efficiency or effectiveness of providing non-audit services to audit clients is inconclusive.[226] Anecdotal evidence that argues against knowledge spillovers is found in the recent sale or proposed sale of the consulting divisions of several large public accounting firms. If efficient and effective audits require the expertise that can be most efficiently maintained through the provision of consulting services to audit clients, these firms would be unlikely to sell their consulting practices. Thus, the sale of these consulting practices, coupled with the results of previous research, provide evidence that is inconsistent with the existence of synergies that would be negatively affected by our proposed amendments.

We seek comment on whether there are knowledge spillovers that would be lost under the proposals. If so, is there some means of quantifying this cost? Would knowledge spillovers be a concern for some or all of the non-audit services covered by our proposals? We also seek comment on whether there is evidence as to the mechanisms by which knowledge spillovers occur. For example, please provide an average of the number of hours billed on particular audit engagements by consulting personnel as a fraction of total audit hours and the number of hours of audit staff time billed for consulting services covered by the rule to an audit client of that staff member.

Finally, some accounting firms have suggested that their recruiting and employee retention would be affected if they could not provide non-audit services. According to this argument, employees or potential employees are more interested in joining accounting firms in which they will be able to engage in both audit and non-audit work, or at least have the option of engaging in both audit and non-audit work.

We seek comment on whether our proposals impose a cost of this type on accounting firms. Do a significant number of accounting firm employees engage in both: (i) audit activities, and (ii) non-audit activities that are prohibited as a result of our proposal, as part of their work? Have a significant number of accounting firm employees shifted from providing audit services to providing non-audit services that are covered by these proposals? Do the proposals significantly reduce the non-audit work available to professional audit staff? If so, how?[227]

C. Costs and Benefits of the Proposals to Add Disclosure Requirements

Our proposals require public companies, under certain circumstances, to disclose information about the non-audit services provided by their auditor, the fees for those services, and the audit fee. The proposals also require public companies to disclose, when relevant, that more than 50% of the audit was performed by personnel who are full-or part-time employees of an entity other than the audit firm.

The disclosure of non-audit services provided by a company's auditor is intended to allow investors to judge for themselves whether they believe that a particular service affects the independence of the auditor. Such disclosures have been provided in the United Kingdom for several years.

The disclosure regarding the usage of leased personnel to perform an audit is intended to allow investors to know when personnel of an entity, other than the audit firm, performed a majority of the audit so that investors can consider the independence of the other entity. Under such circumstances, the independence of the other entity and its personnel may be as relevant—if not more relevant—to auditor independence than the independence of the auditor itself.

1. Benefits

As discussed above,[228] there is growing concern about the impact of non-audit services on auditors' independence. In addition, as noted above, while the SECPS collects information on non-audit and audit fees from its member firms, it no longer publishes this information. Accordingly, such information is not readily available to, or easily accessible by, the investing public. Further, this information provides a description of service line activities by the public accounting firm for all of its clients, rather than for each audit client.

The proposals would remedy this situation. The proposed disclosure related to non-audit services provided by auditors to audit clients would give investors insight into the full relationship between a company and its auditor. In so doing, the proposed disclosure would replace uncertainty about the nature and scope of such relationships with facts about the services provided by the auditor to the company. This information may help shareholders decide, among other things, how to vote their proxies in selecting or ratifying management's selection of an auditor.

The disclosure regarding the auditor's use of another entity's employees to perform a majority of the audit work also provides important information to investors. Investors may need to know when a majority of the audit work is performed by persons who have financial, business, and personal interests in addition to, or different

[226] Two studies in the 1980s documented that audit fees were generally greater, after controlling for other factors, for clients that also purchased nonaudit services from the same public accounting firm. *See* Zoe-Vonna Palmrose, ''The effect of nonaudit services on the pricing of audit services,'' *Journal of Accounting Research,* at 405–11 (Autumn 1986); Dan A. Simunic, ''Auditing, consulting, and auditor independence,'' *Journal of Accounting Research,* at 679–702 (Autumn 1984). The authors of these studies nonetheless concluded that this evidence was consistent with the hypothesis that the joint provision of audit and nonaudit services may give rise to ''knowledge spillovers'' (i.e. enhanced efficiency or effectiveness). More recent research documents that these higher fees are associated with increased audit effort (in labor hours). *See* Larry R. Davis, David N. Ricchiute, and Greg Trompeter, ''Audit Effort, Audit Fees, and the Provision of Nonaudit Services to Audit Clients,'' *Accounting Review,* at 135–50 (Jan. 1993). The results of the Davis et al. study therefore cast doubt on the knowledge spillover hypothesis.

[227] This argument also assumes that accounting firms will not be engaged in both audit and nonaudit work. Our proposals, of course, do not prevent accounting firms from continuing to provide any nonaudit services to companies other than their audit clients.

[228] *See supra* Section II.C.

from, persons employed by the auditor. This disclosure is significant because it reveals when the ''principal auditor'' (the auditor performing a majority of the audit work) is an entity other than the firm signing the audit opinion.

We believe that the benefits of the proposed disclosure rules would include increased market efficiency due to improved information and transparency concerning the credibility and reliability of companies' financial disclosures. The value of these benefits is not readily quantifiable. We solicit comment, including supporting data if available, on the benefits of the proposed disclosure rule.

2. Costs

We believe that the proposed disclosure rule will impose relatively minor reporting costs on issuers. Generally, information about auditor independence is readily available to registrants. One basis for that information is ISB Standard No. 1, which requires auditors to report certain independence issues to the audit committees of their audit client-registrants.[229] In addition, the SECPS requires members to report annually to the audit committee, or similar body, the total fees received from the company for management advisory services during the year under audit, and a description of the types of such services rendered.[230] As a result, companies should have ready access to the information on fees paid to their auditor for non-audit services. The proposed disclosure requirement would merely require issuers to pass certain of this information on to shareholders.

For purposes of the Paperwork Reduction Act, we have estimated that our proposed disclosure rules would, on an annual basis, impose 2,473 additional burden hours on all Schedule 14A filers and 63 additional burden hours on all Schedule 14C filers, for an aggregate annual total of 2,536 additional burden hours.[231] That estimate is based on current burden hour estimates and the staff's experience with such filings. We further estimate that approximately 75% of the extra burden hours, or 1,902 hours, will be expended by companies' internal staff, and the remaining 25%, or 634 hours, by outside professional help.[232] These percentage estimates, which are based on current burden hour estimates and the staff's experience with such filings, reflect the time companies would spend preparing the additional disclosures in the proxy statement or information statement.

Assuming that the internal staff costs the company an average of about $85 per hour, the aggregate annual cost for internal staff assistance would amount to approximately $161,670. If we assume that the outside professional assistance would have an average cost of approximately $175 per hour, the aggregate annual paperwork cost would be approximately $110,950. The total annual costs would accordingly be about $272,620. We request comment on the reasonableness of these estimates and their underlying assumptions.

In addition, as noted above, some issuers would have to disclose the percentage of hours expended on the engagement by ''leased'' employees. We currently lack information on the number of issuers that would be affected by the proposed disclosures on ''leased'' employees. We expect, however, that this disclosure will be required only in rare situations where the firm has sold its non-attest practice to a financial services company and is leasing back its employees. In these situations, former employees of the firm become full-or part-time employees of the financial services company and are ''leased'' back to the accounting firm to perform audit work. This disclosure should not require any additional recordkeeping by the firm because the amount of hours performed on an audit by the lessor and by the ''leased'' personnel should be readily available from the firm's billing records. This information also should be readily available to the registrant because of the communications requirements under ISB Standard No. 1, as discussed above.

We seek comment on these and any other costs of the proposed disclosure rules. Are there any other potential costs we have not considered?

VI. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Act Analysis (''IRFA'') in accordance with the Regulatory Flexibility Act,[233] regarding the proposed amendments to Rule 2–01 of Regulation S–X and item 9 of Schedule 14A under the Exchange Act. The following summarizes the IRFA.

As discussed in greater detail in the IRFA and in other sections of this release, there have been significant changes in accounting firms, changes in the business environment, and demographic changes since we last amended our requirements regarding the independence of auditors of financial statements filed with us. The IRFA notes that we are re-evaluating whether our auditor independence requirements remain effective, relevant and fair. In this regard, we are proposing amendments to our current requirements to address investments by auditors or their family members in audit clients, employment of auditors' family members and former partners by audit clients, and the scope of services provided by audit firms to their SEC audit clients. The IRFA also discusses the proposed proxy disclosure requirements by public companies regarding non-audit services provided by their auditors.

The IRFA sets forth the statutory authority for the proposed rules. It also discusses small entities subject to the rules.[234] The IRFA states that approximately 2,500 Exchange Act reporting companies are small businesses and approximately 227 investment companies are small businesses. The IRFA also states that the Small Business Administration defines small business, for purposes of accounting firms, as those with under $6 million in annual revenues.[235] We cannot estimate the number of firms with less than $6 million in revenues.

The IRFA indicates that the proposed rules would affect two primary groups, auditors and registrants. The IRFA states that the rules could potentially affect auditors in three areas: investments and

[229] ISB Standard No. 1, *supra* note 95. In addition, SAS No. 61 provides additional guidance on topics that an auditor should discuss with the audit committee (or board of directors if there is no such committee) of each registrant. AICPA SAS No. 61, AU § 380.

[230] SECPS Manual, *supra* note 165, at § 1000.08(i).

[231] Approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

[232] These assumptions are based on the staff's experience with these filings. We believe that a company's internal staff will typically carry most of the burden of preparing the proposed additional disclosures, and will consult with outside professionals only on specific issues that the company may periodically encounter in preparing the proxy statement or information statement.

[233] 5 U.S.C. § 603.

[234] For the purposes of this analysis, the Commission has defined ''small business'' in Securities Act Rule 157 as any entity whose total assets on the last day of its most recent fiscal year were $5 million or less and is engaged, or proposes to engage, in small business financing. 17 CFR 230.157. A registrant is considered to be engaged, or to propose to engage, in small business financing under this rule if it is conducting, or proposes to conduct, an offering of securities which does not exceed the dollar limitation prescribed by Section 3(b) of the Securities Act. 15 U.S.C. 77c(b). The Commission also has defined small business in Rule 0–10 of the Investment Company Act as an investment company that has assets of $50 million or less as of the end of its most recent fiscal year. 17 CFR 270.0–10.

[235] 13 CFR 121.201.

employment relationships; non-audit services; and quality controls. With regard to investments and employment relationships, the IRFA states that the proposed rules would liberalize certain restrictions on investments by, and employment opportunities available to, accountants and their families. In this sense, compliance requirements are being relaxed.

With regard to non-audit services, the IRFA states that the vast majority of SEC registrants are audited by one of the Big Five firms, which clearly are not small entities. The IRFA explains that we have data regarding the approximately 776 accounting firms with fewer than 20 SEC audit clients,[236] which would tend to be smaller accounting firms. As the IRFA explains, we do not believe that the proposed amendments regarding consulting and non-audit services would have a significant impact on a substantial number of small accounting firms.

With regard to quality controls, the IRFA explains that the proposed rules establish a limited exception for accounting firms that institute certain quality controls and satisfy other conditions. The proposed rules, therefore, encourage, but do not require, accounting firms to adopt quality controls that ensure the independence of the firms' auditors. The IRFA explains that GAAS already require firms to have quality controls over their audit practices, and the standards refer to the SQCS for guidance regarding the elements of those systems.[237]

The proposals, however, clarify the GAAS requirement for the quality controls of firms with more than 500 SEC audit clients by setting forth certain procedures that should be part of their quality controls. For firms with fewer than 500 SEC audit clients, a firm's quality control system should take into account the size and nature of the firm's practice. For smaller firms, therefore, the proposals incorporate GAAS requirements, but do not add new requirements.

The proposed proxy disclosure rule would require registrants to disclose certain information to shareholders regarding auditor independence and regarding fees for audit and non-audit services. The proposed rules also address situations where more than 50% of the audit is performed by personnel that are full or part-time employees of another entity.

We do not believe that the proposed proxy disclosure requirement would have a significant impact on a substantial number of small entities. These requirements would apply to small businesses only if they are otherwise subject to the proxy rules. We estimate the number of those entities to be no more than 2,700, including 227 investment companies. The proposed disclosures relate to only one item on the proxy statement, and the information should be readily available to registrants because of the requirements of ISB Standard No. 1. Finally, the proposals provide an exclusion from the disclosure requirements for *de minimis* items.

As explained in the IRFA, the Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing adverse impact on small entities. In that regard, we considered the following alternatives: (a) Differing compliance or reporting requirements that take into account the resources of small entities; (b) the clarification, consolidation or simplification of compliance and reporting requirements under the rule for small entities; (c) use of performance rather than design standards; and (d) an exemption from the coverage of the proposed amendments for small entities.

As noted, because neither the proposals to modernize the independence rules for investments and employment relationships nor the proposed proxy disclosure requirements should have a significant economic impact on a substantial number of small entities, we did not make special provisions for small entities. Regarding the provision of non-audit services by accounting firms, including small accounting firms, we have, above, solicited comment on a number of alternative regulatory approaches. The IRFA states that because of the limited amount of non-audit services that small accounting firms provide to their SEC audit clients, we believe that the adoption of any of these alternatives would not have a significant impact on a substantial number of small businesses or small accounting firms.

The IRFA explains that the use of performance rather than design standards or providing an exemption from the coverage of the proposed amendments for small entities are not viable because it is not possible to design performance standards that would carry out our statutory mandate and we believe investors receive a significant benefit from knowing that an independent professional has examined the financial statements of a registrant, including a small registrant, with skepticism.

The IRFA includes information concerning the number of small entities that may be affected by the proposed amendments and the nature of the impact on those entities. We encourage the submission of comments with respect to any aspect of the IRFA. In particular, we seek comment on the number of small entities that would be affected by the proposed rules; the nature of the impact; how to quantify the number of small entities that would be affected; and how to quantify the impact of the proposed rules. Comment is specifically requested regarding the number of small accounting firms that might be affected by the proposed rules, and the effect, if any, that the proposed rules would have on those firms. Please describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. A copy of the IRFA may be obtained by contacting Robert Burns, Chief Counsel, (202) 942–4400, at the Office of the Chief Accountant, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1103.

VII. Paperwork Reduction Act

Certain of the provisions in the proposed amendment to item 9 of Schedule 14A contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), and the Commission has submitted them to the Office of Management and Budget (OMB) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The collections of information are titled ''Regulation 14A (Commission Rules 14a–1 through 14b–2 and Schedule 14A)'' and ''Regulation 14C (Commission Rules 14c–1 through 14c–7 and Schedule 14C).'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Regulation 14A (OMB Control No. 3235–0059) was adopted pursuant to section 14(a) of the Exchange Act[238] and prescribes information that a company must include in its proxy statement to ensure that shareholders

[236] ''Special Supplement: Annual Survey of National Accounting Firms—2000,'' *Public Accounting Report* (March 31, 2000); Annual Reports to SECPS, Annual reports filed with AICPA Division for CPA firms; SECPS Reports, Reports prepared by the AICPA Division for CPA firms.

[237] AICPA SAS No. 25, AU § 161 n.1.

[238] 15 U.S.C. 78n(a).

are provided information that is material to their voting decisions. Regulation 14C (OMB Control No. 3235–0057) was adopted pursuant to section 14(c) of the Exchange Act [239] and prescribes information that a company must include in an information statement when a shareholder vote is to be held but proxies are not being solicited. Schedule 14C refers to Schedule 14A for the disclosure requirements related to the company's independent accountants.

The proxy disclosure requirements in section 14 of the Exchange Act apply to those entities that have securities registered with the Commission under section 12 of that Act. The likely respondents, therefore, include entities with more than 500 shareholders and more than $10 million in assets (section 12(g)) [240] and entities with securities listed on a national exchange (section 12(b)).[241] Approximately 9,892 respondents file proxy statements under Schedule 14A and approximately 253 respondents file information statements under Schedule 14C. We based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year.

We estimate that the total reporting burden for Schedule 14A is 179,144 hours, or approximately 18 hours per respondent. We estimate that the total reporting burden for Schedule 14C is 4,582 hours, or approximately 18 hours per respondent. These estimates include increases of 2,473 hours for Schedule 14A and 63 hours for Schedule 14C based on estimates that the proposed amendments will add one hour to the reporting burden of one-quarter of the respondents, and will not add to the burden of the other respondents. These increases are based on the fact that the information needed to make these disclosures should be readily available to the respondents and the fact that, based on information provided to the SECPS, approximately 75 percent of Commission registrants receive no non-audit services from the auditors of their financial statements and, accordingly, will not be required to make any disclosures under the proposed amendments.

We believe the proposed disclosure will bolster confidence in the securities markets by informing investors about: (i) non-audit relationships between the auditor and the audit client, and (ii) situations in which a majority of the audit work is performed by employees of an entity other than the principal audit firm signing the audit opinion. As discussed in other sections of this release, there is growing concern about the impact of non-audit services on auditors' independence. The disclosure will bring the benefit of sunshine to non-audit relationships and replace uncertainty about the nature and scope of such relationships with facts about the services provided by an auditor to each audit client. This information may be material to an investor's decision to vote on the selection or ratification of the auditor. The disclosure regarding the auditor's use of another entity's employees to perform a majority of the audit work also provides important information to investors. Investors may need to know when a majority of the audit work is performed by persons who have financial, business, and personal interests in addition to, or different from, persons employed directly by the auditor.

Compliance with the disclosure requirements is mandatory if the audit client is subject to the proxy or information disclosure requirements and either (i) the audit client has received non-audit services from the auditor of its financial statements, or (ii) the auditor used employees of another entity to perform a majority of the audit work. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility, (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information, (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected, and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, with reference to File No. S7–13–00. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–13–00, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VIII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[242] we are requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commenters should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts.[243] We expect that in some ways the proposals will increase competition by removing the accountant's competitive advantage in bidding on or otherwise obtaining non-audit work required by audit clients.[244] We request comment on any anti-competitive effects of the proposals.

In addition, Section 3(f) of the Exchange Act requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[245] We believe that the proposals will increase investor confidence in the integrity of the audit process and in the audited financial information that they use daily to make investment and voting decisions. This increased sense of confidence should promote market efficiency and capital formation. The modernization of our rules should allow more accountants, and their families, to invest in a wider range of investment opportunities. According to information provided to the SECPS, over 100,000 individuals will have more freedom of choice in their financial investments.

[239] 15 U.S.C 78n(c).

[240] 15 U.S.C. 78*l*(g).

[241] 15 U.S.C. 78*l*(b).

[242] Pub. L. No. 104–121, tit. II, 110 Stat. 857 (1996).

[243] 15 U.S.C. 78w(aa)(2).

[244] *See supra* Section V. for a discussion of this issue.

[245] 15 U.S.C. § 78c(f).

This should increase the efficiency of the markets. We request comment on these matters.

IX. Codification Update

The ''Codification of Financial Reporting Policies'' announced in Financial Reporting Release No. 1 (April 15, 1982) is proposed to be amended as follows:

1. By removing section 602.01.
2. By removing section 602.02.a.
3. By removing section 602.02.b.i.
4. By removing section 602.02.b.ii to remove examples 2, 3, 4, 7, 8, and 10, and redesignate examples 5, 6, and 9 as examples 2, 3, and 4.
5. By removing section 602.02.b.iii.
6. By amending section 602.02.b.iv to remove the first three introductory paragraphs.
7. By amending section 602.02.c.i to remove the last two paragraphs.
8. By amending section 602.02.c.ii to remove examples 1, 2, 3, 4, 5, 7, 8, and 9 and redesignate example 6 as example 1.
9. By amending section 602.02.d to remove the two introductory paragraphs, remove examples 2, 3, 4, 5, 6, and 7, and redesignate example 8 as example 2.
10. By removing section 602.02.e.ii.
11. By removing section 602.02.e.iii.
12. By amending section 602.02.f to remove the introductory paragraph, remove examples 1, 2, 3, 4, and 5, and redesignate examples 6 and 7 as examples 1 and 2.
13. By amending section 602.02.g to remove examples 5, 15, 18, 19, and 22 and remove examples 6, 7, 8, 9, 10, 11, 12, 13, 14, 16, 17, 20, 21, 23, and 24 as examples 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, and 19, respectively.
14. By removing section 602.02.h.
15. By adding section 602.01, captioned ''Discussion of Rule 2–01,'' to include the text in the adopting release that discusses the final rules, which, if the proposed rules are adopted, would be substantially similar to topic III of this release.
16. By amending section 602.02 to redesignate sections 602.02.b.ii, 602.02.b.iv, 602.02.b.v, 602.02.c.i, 602.02.c.ii, 602.02.c.iii, 602.02.d, 602.02.e.i, 602.02.e.iv, 602.02.f, 602.02.g, 602.02.i.i, and 602.02.i.ii as sections 602.02.a.i, 602.02.a.ii, 602.02.a.iii, 602.02.b.i, 602.02.b.ii, 602.02.b.iii, 602.02.c, 602.02.d.i, 602.02.d.ii, 602.02.e, 602.02.f, 602.02.g.i, and 602.02.g.ii, respectively.

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

X. Statutory Bases and Text of Amendments

We are proposing amendments to Rule 2–01 of Regulation S–X and Item 9 of Schedule 14A under the authority set forth in Schedule A and Sections 19 and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, Sections 5, 10, 14, and 20 of the Public Utility Holding Company Act of 1935, Sections 8, 30, and 38 of the Investment Company Act of 1940, and Sections 203 and 211 of the Investment Advisers Act of 1940.

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77aa(25), 77aa(26), 78j–1, 78*l*, 78m, 78n, 78o(d), 78u–5, 78w(a), 78*ll*(d), 79e(b), 79j(a), 79n, 79t(a), 80a–8, 80a–20, 80a–29, 80a–30, 80a–37(a), unless otherwise noted.

2. By amending § 210.2–01 by revising paragraphs (b) and (c) and adding paragraphs (d), (e) and (f) to read as follows:

§ 210.2–01 Qualifications of accountants.

(a) * * *

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Under this standard, an accountant is not independent whenever, during the audit and professional engagement period, the accountant:

(1) Has a mutual or conflicting interest with the audit client;

(2) Audits the accountant's own work;

(3) Functions as management or an employee of the audit client; or

(4) Acts as an advocate for the audit client.

(c) An accountant is not independent under the standard of paragraph (b) of this section if, during the audit and professional engagement period, the accountant has any of the financial, employment or business relationships with, provides any of the non-audit services to, or receives a contingent fee from, the accountant's audit client or an affiliate of the audit client, as specified in paragraphs (c)(1) through (c)(5) of this section, or otherwise does not comply with the standard of paragraph (b) of this section.

(1) *Financial relationships.* An accountant is not independent under the standard of paragraph (b) of this section if the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as the financial relationships specified in this paragraph (c)(1).

(i) *Investment in audit client.* An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client or an affiliate of an audit client, such as stocks, bonds, notes, options, or other securities.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities, or otherwise controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust or executor of an estate containing the securities of an audit client.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client, including:

(*1*) Ownership of more than five percent of an entity that has an ownership interest in the audit client; or

(*2*) Ownership of more than five percent of an entity of which the audit client has an ownership interest.

(ii) *Other financial interests in audit client.* An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) *Loans/debtor-creditor relationship.* Any loan (including any margin loan) to or from an audit client, an affiliate of an audit client, or an audit client's or an affiliate of an audit client's officers, directors, or record or beneficial owners of more than five percent of the audit client's or affiliate's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms and requirements:

(*1*) Automobile loans and leases collateralized by the automobile;

(*2*) Loans fully collateralized by the cash surrender value of an insurance policy;

(*3*) Loans fully collateralized by cash deposits at the same financial institution; and

(*4*) A mortgage loan collateralized by the accountant's primary residence provided the loan was not obtained while the borrower was a covered person in the firm or an immediate family member of a covered person in the firm.

(B) *Savings and checking accounts.* Any savings, checking or similar account at a bank, savings and loan or similar institution that is an audit client or an affiliate of an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer.

(C) *Broker-dealer accounts.* Any brokerage or similar accounts maintained with a broker-dealer that is an audit client or an affiliate of the audit client, if:

(*1*) Any such accounts include any asset other than cash or securities (within the meaning of ''security'' provided in the Securities Investor Protection Act); or

(*2*) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of the Securities Investor Protection Act.

(D) *Futures commission merchant accounts.* Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client or an affiliate of the audit client.

(E) *Credit cards.* Any credit card balance in excess of $10,000 owed to a lender that is an audit client or an affiliate of an audit client.

(F) *Insurance products.* Any individual policy or professional liability policy originally issued by an insurer that is an audit client or an affiliate of an audit client.

(G) *Investment companies.* Any investment in any entity in an investment company complex if the audit client is also an entity in the same investment company complex. When the audit client is an entity that is part of an investment company complex, the accountant must be independent of each entity in the investment company complex.

(iii) *Exceptions.* Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, the accountant will not be deemed not independent if:

(A) *Inheritance and gift.* Any person acquires a financial interest through an unsolicited gift or inheritance that would cause an accountant to be not independent under paragraphs (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no longer than 30 days after the person has the right to dispose of the financial interest.

(B) *New audit engagement.* Any person has a financial interest that would cause an accountant to be not independent under paragraphs (c)(1)(i) or (c)(1)(ii) of this section, and:

(*1*) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and

(*2*) The accountant is independent under paragraphs (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

(*i*) Accepting the engagement to provide audit, review, or attest services to the audit client; or

(*ii*) Commencing any audit, review or attest procedures (including planning the audit of the client's financial statements).

(iv) *Audit clients' financial relationships.* An accountant is not independent when:

(A) *Investments by the audit client in the auditor.* An audit client or an affiliate of an audit client has, or has agreed to acquire, any direct investment in the accounting firm or its affiliate, such as stocks, bonds, notes, options, or other securities.

(B) *Underwriting.* An audit client or an affiliate of an audit client, including a broker-dealer or other entity, performs any service for the accounting firm related to underwriting, offering, making a market in, marketing, promoting, or selling securities issued by the accounting firm, or issues an analyst report concerning the securities of the accounting firm.

(2) *Employment relationships.* An accountant is not independent under the standard of paragraph (b) of this section if the accountant has an employment relationship with an audit client or an affiliate of an audit client, such as the employment relationships specified in this paragraph (c)(2). An accountant is not independent when:

(i) *Employment at audit client of accountant.* A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or an affiliate of an audit client or serves as a member of the board of directors or similar management or governing body of the audit client or an affiliate of the audit client.

(ii) *Employment at audit client of certain relatives of accountant.* A close family member of a covered person in the firm is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) *Employment at audit client of former employee of accounting firm.* A former partner, shareholder, principal, or professional employee of an accounting firm is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client, unless the individual:

(A) Does not influence the accounting firm's operations or financial policies;

(B) Has no capital balances in the accounting firm; and

(C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the firm) pursuant to a fully funded retirement plan or rabbi trust.

(iv) *Employment at accounting firm of former employee of audit client.* A former officer, director, or employee of an audit client or an affiliate of an audit client becomes a partner, shareholder, or principal of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client or an affiliate of the audit client covering any period during which he or she was employed by or associated with that audit client or an affiliate of the audit client.

(3) *Business relationships.* An accountant is not independent under the standard of paragraph (b) of this section if the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, an affiliate of an audit client, or with an audit client's or an affiliate of an audit client's officers, directors, or record or beneficial owners of more than five

percent of the audit client's or affiliate's equity securities. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services or is a consumer in the ordinary course of business,

(4) *Non-audit services.* (i) Even if the audit client accepts ultimate responsibility for the work that is performed or decisions that are made, an accountant is not independent under the standard of paragraph (b) of this section when the accountant provides certain non-audit services to an audit client or an affiliate of an audit client, such as:

(A) *Bookkeeping or other services related to the audit client's accounting records or financial statements.* Any service involving:

(*1*) Maintaining or preparing the audit client's or an affiliate of the audit client's accounting records;

(*2*) Preparing the audit client's or an affiliate of the audit client's financial statements; or

(*3*) Generating financial information to be disclosed by the audit client or an affiliate of the audit client to the public.

(B) *Financial information systems design and implementation.* Designing or implementing a hardware or software system used to generate information that is significant to the audit client's financial statements taken as a whole, not including services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls.

(C) *Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.* Any appraisal or valuation service for an audit client or an affiliate of an audit client, or any service involving a fairness opinion or contribution-in-kind report where it is reasonably likely that, in performing an audit in accordance with generally accepted auditing standards, the results will be audited by the accountant.

(D) *Actuarial services.* Any advisory service involving the determination of policy reserves and related accounts for the audit client or an affiliate of an audit client, unless the audit client or its affiliate uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

(E) *Internal audit outsourcing.* Internal audit services for an audit client or an affiliate of an audit client, not including nonrecurring evaluations of discrete items or programs and operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

(F) *Management functions.* Acting, temporarily or permanently, as a director, officer, or employee of an audit client or an affiliate of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client or affiliate of the audit client.

(G) *Human resources.* Recruiting, hiring, or designing compensation packages for officers, directors, or managers of the audit client or an affiliate of the audit client; advising about the audit client's or affiliate of the audit client's management or organizational structure; developing employee evaluation programs; or conducting psychological or other formal testing of employees.

(H) *Broker-dealer, investment adviser, or investment banking services.* Acting as a securities professional, such as a broker-dealer, promoter, underwriter, analyst of the audit client's or an affiliate of the audit client's securities, investment adviser, or in any capacity recommending the purchase or sale of an audit client's or an affiliate of an audit client's securities, or designing the audit client or an affiliate of the audit client's system to comply with broker-dealer or investment adviser regulations.

(I) *Legal services.* Providing any service to an audit client or an affiliate of an audit client that, in the jurisdiction in which the service is provided, could be provided only by someone licensed to practice law.

(J) *Expert services.* Rendering or supporting expert opinions for an audit client or an affiliate of an audit client in legal, administrative, or regulatory filings or proceedings.

(ii) *Transition.* Until [insert date two years from the effective date of this section], providing to an audit client or an affiliate of an audit client the non-audit services set forth in paragraph (c)(4)(i) of this section will not impair an accountant's independence with respect to the audit client if:

(A) The non-audit services are performed pursuant to a written contract in effect on or before [insert the effective date of this section]; and

(B) Performing those services did not impair the auditor's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(5) *Contingent fees.* An accountant is not independent under the standard of paragraph (b) of this section if the accountant provides any service to an audit client or an affiliate of an audit client for a contingent fee, or receives a contingent fee from an audit client or an affiliate of an audit client.

(d) *Quality controls.* An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know, and was reasonable in not knowing, of the circumstances giving rise to the lack of independence;

(2) The covered person's lack of independence was corrected promptly after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence. For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934, a quality control system will not provide such reasonable assurance unless it has at least the following features:

(i) Written independence policies and procedures;

(ii) An automated system to identify financial relationships that might impair the accountant's independence;

(iii) An annual or on-going firm-wide training program about auditor independence;

(iv) An annual internal inspection and testing program to monitor adherence to independence requirements;

(v) Notification to all firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

(vi) Written policies and procedures requiring all firm professionals to report promptly to the firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and

(vii) A disciplinary mechanism to ensure compliance with this section.

(e) In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client or the affiliates of the audit client, and not just those relating to reports filed with the Commission.

(f) *Definitions of terms.* For purposes of this section:

(1) *Accountant,* as used in paragraphs (b) through (e) of this section, means a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) *Accounting firm* means the organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting or furnishing accountant's reports with respect to financial statements, reports, or other documents filed with the Commission, and all departments, divisions, parents, subsidiaries, and affiliates of the accounting firm, including its pension, retirement, investment or similar plans.

(3) *Accounting or financial reporting oversight role* means that the person is in a position to, or does influence the contents of the accounting records or financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

(4) *Affiliate of the accounting firm.* (i) ''Affiliate of the accounting firm'' means:

(A) Any person directly or indirectly controlling, controlled by, or under common control with the accounting firm, including:

(*1*) Any person or entity directly or indirectly owning, controlling, or holding the power to vote five percent or more of the accounting firm's outstanding voting securities, partnership units, or other interest entitling a person to vote; and

(*2*) Any person or entity five percent or more of whose outstanding voting securities, partnership units, or other interest entitling a person to vote are directly or indirectly owned, controlled, or held by the accounting firm;

(B) Any officer, director, partner, copartner, or shareholder of more than five percent of the voting securities of a person described in paragraph (f)(4)(A) of this section;

(C) Any joint venture, partnership, or other undertaking in which the accounting firm participates and in which the parties agree to any form of shared benefits, including any form of shared revenue, income, or equity appreciation;

(D) Any entity that provides non-audit or other professional services to one or more of the accounting firm's audit clients, and in which the accounting firm has any equity interest in, has loaned funds to, or shares revenues with, or with which the accounting firm or any covered person in the firm has any direct business relationship;

(E) All persons and entities with which the accounting firm is publicly associated by co-branding; using the accounting firm's name, initials, or logo; cross-selling services; or using co-management; and

(F) If the accounting firm leases, or otherwise routinely acquires on a temporary or continuous basis, the services of personnel employed full- or part-time by another party (the ''lessor'') and the leased personnel perform a majority of the hours worked on the engagement or supporting the accountant's reports filed with the Commission, the lessor and the lessor's board of directors, executive officers, and all persons with management, supervisory, compensation, or other oversight responsibility for the leased personnel, and shareholders of five percent or more of the lessor's equity securities.

(ii) ''Affiliate of the accounting firm'' does not include parties that share with an accounting firm training facilities, technical knowledge, databases, or billing facilities but that have no other business or financial relationship with the accounting firm, provided that the accounting firm pays a reasonably proportionate and fair share of the costs and expenses associated with such items, and the party charges all participants no more than the costs and expenses incurred to operate or maintain the shared facility or database.

(5) *Affiliate of the audit client* means an entity that has significant influence over the audit client, or over which the audit client has significant influence, including the audit client's parent and subsidiary.

(6) *Audit and professional engagement period* includes both:

(i) The period covered by any financial statements being audited or reviewed (the ''audit period''); and

(ii) The period of the engagement to audit or review the client's financial statements or to prepare a report filed with the Commission (the ''professional engagement period'').

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements), or begins review or audit procedures, whichever is earlier; and

(B) The professional engagement period ends when the client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

(7) *Audit client* means the entity whose financial statements or other information is being audited, reviewed, or attested.

(8) *Audit engagement team* means all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult, formally or informally, with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(9) *Chain of command* means all persons having any supervisory, management, quality control, compensation, or other oversight responsibility over either any member of the audit engagement team or over the conduct of the audit. The ''chain of command'' includes all partners, principals, shareholders, and managers who may review, determine, or influence the performance appraisal or compensation of any member of the audit engagement team and any other person in a position to influence the audit engagement team's decisions during the conduct of the audit, review, or attestation engagement.

(10) *Close family members* means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(11) *Consumer in the ordinary course of business* means a purchaser of routine products or services on the same terms and conditions that are available to the seller's other customers or clients, as long as the purchaser does not resell the product or service or receive a commission or other fee for selling the product or service.

(12) *Contingent fee* means any fee where payment, or the amount of the fee paid or due, is contingent, in whole or in part, on the result, including the value added, of any transaction or event, other than completion of the work or delivery of the product giving rise to the fee. A fee is not a ''contingent fee'' if it is fixed by a court or by any federal, state, or local governmental agency.

(13) *Covered persons in the firm* means the following partners, principals, shareholders, and employees of an accounting firm:

(i) The ''audit engagement team;''

(ii) The ''chain of command;''

(iii) Any other partner, principal, shareholder, or professional employee of the accounting firm who is, or during the audit client's most recent fiscal year was, involved in providing any professional service to the audit client or an affiliate of the audit client; and

(iv) Any other partner, principal, or shareholder from an ''office'' of the accounting firm that participates in a significant portion of the audit.

(14) *Group* means when two or more persons act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.

(15) *Immediate family members* means a person's spouse, spousal equivalent, and dependent.

(16) *Investment company complex.* (i) ''Investment company complex'' includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by, under common control with or controlling the investment adviser or sponsor in paragraph (f)(16)(A) of this section; or

(C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. § 80a–3(c)) that has an investment adviser or sponsor included in this definition by either paragraphs (f)(16)(A) or (f)(16)(B) of this section.

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

(17) *Office* means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.

(18) *Rabbi trust* means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*(d), 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

4. By amending § 240.14a–101 to add paragraph (e) to Item 9 to read as follows:

§ 240.14a–101 Schedule 14A Information required in proxy statement.

* * * * *

Item 9. *Independent public accountants.* * * *

* * * * *

(e)(1) Describe each professional service provided during the most recent fiscal year by the independent public or certified public accountant (as defined in Article 2 of Regulation S–X, 17 CFR 210.2–01) that is the registrant's principal accountant. A service does not have to be disclosed if the fee for that service was, is, or will be less than the lesser of $50,000 or 10 percent of the fee for the audit of the registrant's annual financial statements.

Instruction to paragraph (e)(1). Specifically describe each service. Broad general categories such as ''tax matters'' or ''management advisory services'' or ''management consulting services'' are not sufficient.

(2) Indicate whether, before each disclosed professional service was rendered, the audit committee of the board of directors, or if there is no such committee then the board of directors, approved the service and considered the possible effect of the service on the principal accountant's independence.

(3) Disclose the fee for each disclosed professional service.

(4) Disclose the aggregate fee for the audit of the registrant's financial statements for the fiscal year most recently completed and for the reviews of the financial statements included in the registrant's Forms 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for that fiscal year.

(5) If greater than 50 percent, disclose the percentage of the hours expended on the principal auditor's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

* * * * *

By the Commission.

Dated: June 30, 2000.

Margaret H. McFarland,

Deputy Secretary.

Note: Appendices A, B, and C to the preamble will not appear in the Code of Federal Regulations.

Appendix A

Services Offered by Professional Accounting Firms

Accounting and Auditing Services

1. Year-end audit. This may include assisting the client in calculating the amount of the income taxes owed, valuing stock options and other stock compensation arrangements under FAS 123, and drafting and typing up the financial statements.
2. Review of interim (monthly, quarterly) financial statements.
3. Compilation of financial statements.
4. Bookkeeping services (some firms offer this as a computer bookkeeping service).
5. Valuations of derivatives at fair market value for accounting purposes.
6. Assistance in preparation of and review of filings with the SEC, including initial public offerings.
7. Underwriter comfort letters for SEC and non-SEC filings.
8. Audit of Management's Discussion and Analysis in SEC filings.
9. Agreed upon procedures engagement (the client and auditor agree to procedures the auditor is to perform with respect to tasks such as testing a royalty arrangement or compliance with a loan agreement, and the auditor then issues a report on his or her findings).
10. Audit or review of financial forecasts or projections. This includes such documents included in offering memoranda.
11. Providing advice on how to interpret new accounting pronouncements, including providing sample journal entries.
12. Audits of financial statements of pension plan financial statements.
13. Director examinations of financial institutions.
14. CPA WebTrust—an engagement to review the security of a company's website that is conducting electronic commerce over the internet.
15. Assisting international companies in conforming their financial reporting to U.S. financial reporting practices (GAAP conversions).
16. Technical opinions on accounting matters to clients of other accounting firms.

Business Controls

1. Ethics and Responsible Business Practices—a service that helps clients address the sources of internal wrongdoing and eliminate barriers to responsible business practices.
2. Evaluation, design and implementation of internal accounting and financial reporting controls, policies and procedures.
3. Evaluation, design and implementation of management and business controls over various business functions such as management reporting systems, research and development, etc.
4. Examinations of internal controls.

5. Business Fraud and Investigation Services—helps companies identify, manage and minimize integrity risks, such as suspected management or alleged employee fraud.

Tax Services

1. Preparation of federal and state individual income tax returns.
2. Preparation of federal and state corporation tax returns.
3. Individual and corporate tax planning (including federal, state, and local taxes).
4. Personal financial planning for individuals including client employees and executives.
5. Income tax planning for executives including employee compensation and benefit plans (see below).
6. Investment planning.
7. Programs for planning for college.
8. Retirement planning programs.
9. Estate planning including preparation of wills, trusts, etc.
10. Representation of clients in tax negotiations and disputes with the IRS.
11. Review of property tax assessments.
12. Succession planning.
13. Serve as or provide tax advice to executors and trustees.
14. Tax credit reviews to determine maximum allowable credits (*e.g.,* research and development credits).
15. Trade and customs services—ensures compliance with trade laws and regulations while trying to avoid, reduce, or defer overall customs duties.
16. Transfer pricing studies and evaluation, documentation, and modification of existing policies.
17. Valuation services.
18. VAT Services.

Financial Services

1. Treasury management services including design, development and implementation of policies and procedures.
2. Credit management services including design, development and implementation of credit policies and procedures.
3. Design and structuring of financial instruments.
4. Assisting investment banking firms with the design of financial instruments and financing transactions.
5. Assistance with finding/identifying equity parties or financing parties.
6. Identification and selection of banks.
7. Assistance with or preparation of financing and loan applications.
8. Loan review services.
9. Regulatory advisory services.

Information Systems Technology

1. Selection of new hardware and software systems. This may include activities such as performing a ''needs analysis,'' preparation of a request for proposals, and overseeing, assistance with, or performance of demonstrations.
2. Implementation of new hardware and software systems. This may include:

- Full on-site team to perform all implementation services.
- Project administration of another consulting team.
- Development of necessary manual and computer control systems.
- Providing necessary computer programmers.
- Software design and programming.
- Ongoing support functions.

3. Consulting on Y2K issues such as:

- Inventory of Y2K system problems.
- Development of Y2K remediation program.

4. Development of IT management and/or strategic plans.
5. Evaluation and selection of telephone systems.
6. Business continuity planning and information security services.
7. Application controls consulting.
8. Electronic commerce services.
9. Reporting on the processing of transactions by service organizations.

Employment Benefit Programs

1. Designing and developing employee compensation programs including:

- Stock option programs.
- Retirement plans.
- Executive compensation arrangements.
- Deferred compensation and bonus arrangements.

Business Reengineering

1. Benchmarking of best practices including business and financial reporting practices.
2. Reengineering of business processes including:

- Manufacturing processes.
- Research and development processes.
- Review of spending levels (*e.g.,* for general and administrative expenses).
- Plant layout design.

3. Review of manual processes that feed into computerized information systems.
4. Staff reduction programs.

Outsourcing

Outsourcing of such client functions as:
1. Information systems. This may include outsourcing the management or the entire data processing and information systems group.
1. Internal audit function.
2. Tax department.
3. Office of the Chief Financial Officer.
4. Accounting department.
5. Human resource department.
6. Risk management function.

Corporate Finance

1. Deal due diligence.
2. Candidate targeting.
3. Preparation of offering memorandums.
4. Lead advisor for private placements
5. Merger transaction advice on:

- Structuring of transactions.
- Tax implementations.
- Sourcing capital.
- Preparation of pro forma financial statements and projections.
- Reengineering acquired businesses.
- Cost reduction and synergistic studies.

6. Appraisal and valuation of targets assets, including receivables, inventories, property, plant and equipment, intangible assets and in-process research and development.
7. Fairness opinions.
8. In some foreign jurisdictions, the firms act as stock transfer agents.
9. ''Turnaround'' business advisors.

Marketing and Distribution

1. Evaluation of marketing and distribution channels.
2. Development of marketing and distribution channel plans and consulting on the implementation of such plans.

Legal Services

1. Corporate and commercial legal services to national and international companies worldwide.
2. Assistance to law departments and general counsel to enhance and measure performance.

Litigation Support

1. Case management.
2. Expert accounting and financial reporting witnesses.
3. Damages experts and witnesses.
4. Environmental litigation experts.
5. Securities litigation experts.
6. Antitrust services.
7. Construction disputes.
8. Service of detailed data to provide cost-effective, proactive strategies and solutions to complex business disputes.

Other

1. Government Contract Consulting—helps companies understand and address business risks associated with negotiating, contracting with, and performing under contracts for the sale of goods or services with U.S. federal, state, local and foreign governments.
2. Advise government entities that are privatizing on commercialization, restructuring, competition, changing organization attitudes, customer satisfaction and policy adjustment; provides other grant-aided work in emerging markets.
3. Real Estate—provides advice about increasing the profitability of real estate assets through the acquisition, development, management and disposition of single assets or portfolios of properties. Services also include strategic planning, consolidation studies, surplus property planning, valuations, and outsourcing consulting.
4. Services for middle-sized companies—includes cash management, payroll needs, business relocation services, and shareholder meetings.
5. Insolvency/executory services—acting as receivers, liquidators, bankruptcy trustees, or advisors to debtor or creditor groups.
6. Specific services for health insurers and other health care organizations.

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APPENDIX B

Table 1
Estimated U.S. Revenues for Big 5/Big 6 Public Accounting Firms
Source: PAR

	1999	1998	1997	1996	1995	1994	1993
Total	$ 30,616	$ 25,917	$ 20,492	$ 17,305	$ 15,051	$ 13,291	$ 12,162
Estimated revenue mix by service line							
A&A	30%	30%	33%	36%	38%	44%	45%
Tax	19%	19%	20%	20%	20%	20%	22%
MCS & Other	51%	51%	47%	44%	42%	36%	32%
Estimated revenue by service line							
A&A	$ 9,150	$ 7,812	$ 6,738	$ 6,195	$ 5,762	$ 5,823	$ 5,485
Tax	$ 5,764	$ 4,871	$ 4,110	$ 3,477	$ 2,968	$ 2,673	$ 2,714
MCS & Other	$ 15,702	$ 13,234	$ 9,618	$ 7,633	$ 6,321	$ 4,796	$ 3,856
Compound growth rate of estimated U.S. revenues from 1993 to 1999							
A&A	9%						
Tax	13%						
MCS & Other	26%						

Table 2
Composition of Big 5 (Big 6/Big 8) U.S. Revenues by Service
Source: PAR, Annual Reports to SECPS, and SECPS Reports

Year	A&A		Tax		MCS & Other	
	Average	Median	Average	Median	Average	Median
1981	NA	NA	NA	NA	15%	13%
1984	NA	NA	NA	NA	16%	14%
1986	NA	NA	NA	NA	18%	18%
1988	55%	57%	23%	23%	22%	20%
1993	46%	51%	23%	22%	30%	27%
1994	45%	51%	20%	21%	34%	28%
1995	40%	43%	20%	20%	40%	35%
1996	37%	40%	21%	22%	42%	39%
1997	34%	36%	21%	21%	45%	42%
1998	31%	34%	20%	19%	49%	47%
1999	31%	33%	19%	18%	50%	49%

NA indicates that item is not reported or not available

Abbreviations of service lines:
A&A - accounting and auditing
MCS & Other - management consulting services and other non-audit, non-tax services

Table 3

Range of MCS Fees to Audit Fees for SEC Audit Clients of Big 5 (Big 6/Big 8) Firms

Source: Annual Reports to SECPS and SECPS Reports

Year	# clients	0%	1-25%	26-50%	51-100%	> 100%	>50%	>25%
1984	10,110	NA	NA	NA	NA	1.0%	NA	NA
1986	11,439	NA	NA	1.9%	1.2%	1.2%	2.5%	4.4%
1988	10,386	75.4%	19.1%	2.4%	1.6%	1.4%	3.1%	5.5%
1989	11,164	77.3%	17.0%	2.5%	1.8%	1.5%	3.2%	5.7%
1990	11,277	81.2%	13.5%	2.4%	1.5%	1.3%	2.8%	5.2%
1991	11,520	83.4%	12.5%	1.9%	1.4%	0.8%	2.2%	4.1%
1992	11,809	79.2%	16.5%	2.1%	1.1%	1.1%	2.2%	4.3%
1993	12,362	83.8%	11.5%	2.2%	1.3%	1.2%	2.5%	4.7%
1994	12,841	82.6%	12.5%	2.1%	1.4%	1.3%	2.8%	4.9%
1995	12,793	81.8%	13.4%	2.3%	1.2%	1.2%	2.4%	4.7%
1996	11,755	77.8%	16.1%	2.6%	1.9%	1.5%	3.4%	6.1%
1997	11,846	78.1%	14.8%	2.9%	2.1%	2.1%	4.2%	7.1%
1998	12,348	73.6%	16.5%	3.6%	3.1%	3.2%	6.4%	10.0%
1999	12,769	74.3%	14.3%	3.7%	3.0%	4.6%	7.6%	11.3%

NA indicates that item is not reported or not available

Table 4

MCS Activity for Public Accounting Firms Based on Number of SEC Audit Clients For Most Recent Reporting Year

Source: SECPS Report

# clients	# firms	Average number of SEC clients	Average MCS fees from SEC clients to total fees	Average MCS fees from SEC clients to total MCS fees
> 1000	5	2554	10.0%	22.8%
100 - 1000	3	314	1.0%	3.6%
20-99	20	36	1.0%	9.9%
3 – 19	258	6	.9%	7.4%
2	167	2	.5%	3.3%
1	351	1	.4%	5.0%

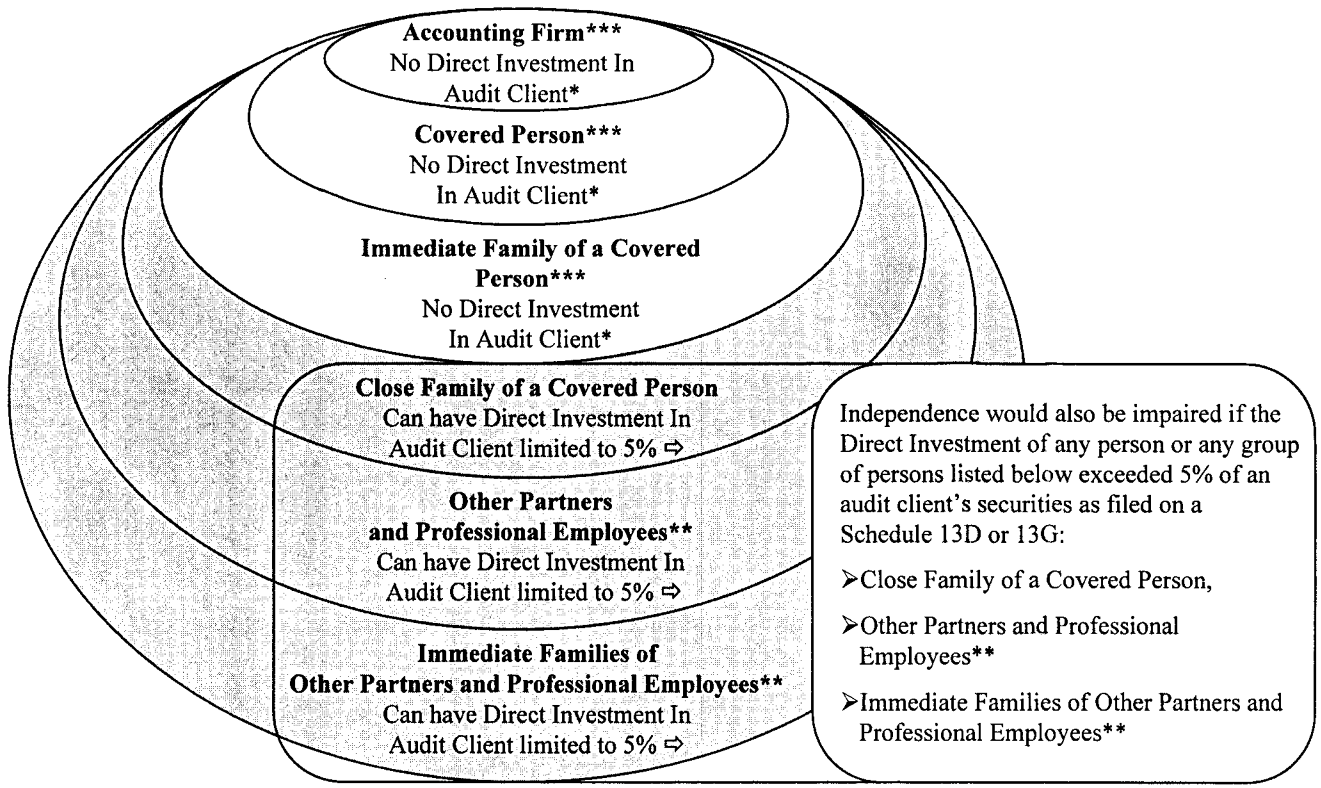
Information sources:

PAR - Public Accounting Report, "Special Supplement: Annual Survey of National Accounting Firms – 2000, March 31, 2000.

Annual Reports to SECPS - Annual reports filed with the AICPA Division for CPA Firms SECPS member public accounting firms

SECPS Reports - Reports prepared by the AICPA Division for CPA Firms

APPENDIX C
PROPOSED RULES
Investment in Audit Client
Reg. § 210.2-01(c)(1)(i)(A),(B) and (C)



* Includes affiliates of the audit client

** Other Partners and Professional Employees includes partners, principals, shareholders and professional employees that are not covered persons

***The accounting firm, a covered person and the immediate family of a covered person can not be a voting trustee of a trust or executor of an estate containing the securities of an audit client.

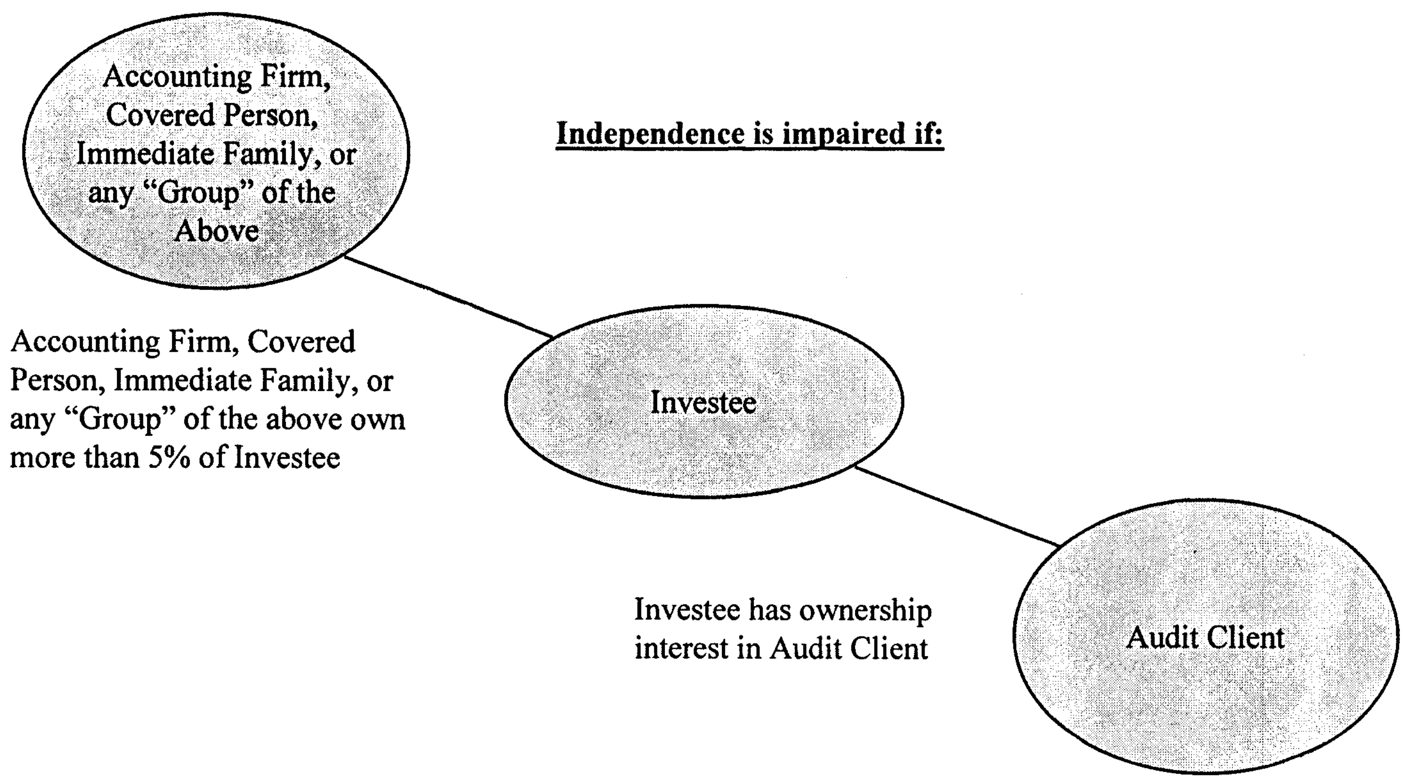
APPENDIX C (Continued)

PROPOSED RULE

Material Indirect Investments

Reg. § 210.2-01(c)(1)(i)(D)(1) Investment in Audit Client

Independence is impaired if:

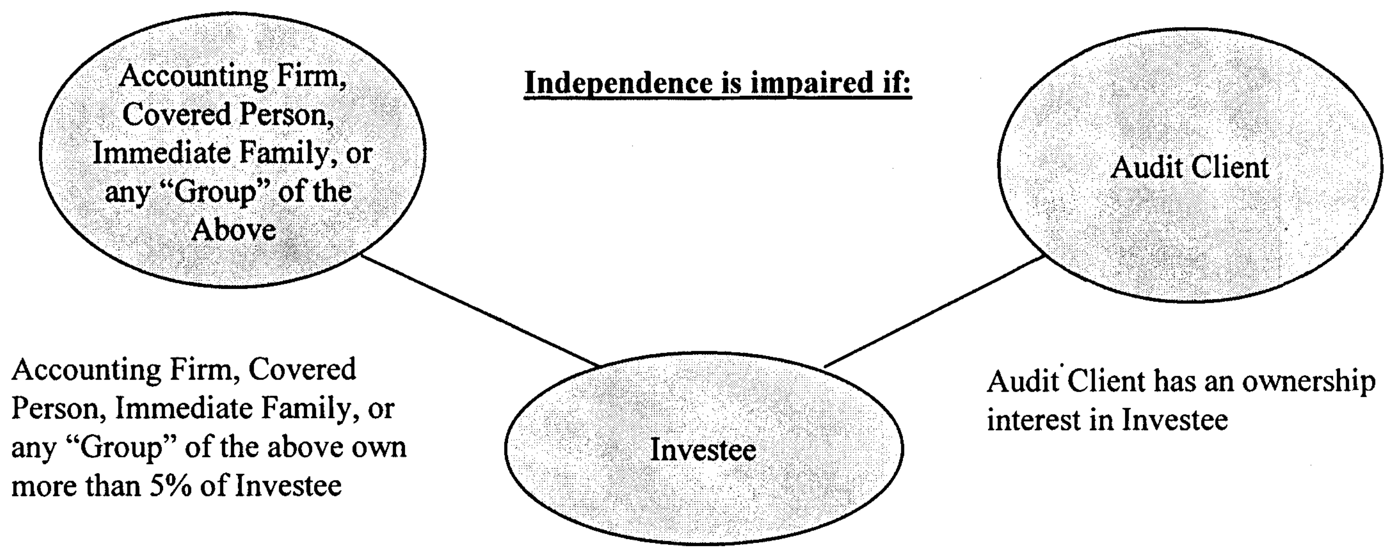


APPENDIX C (Continued)

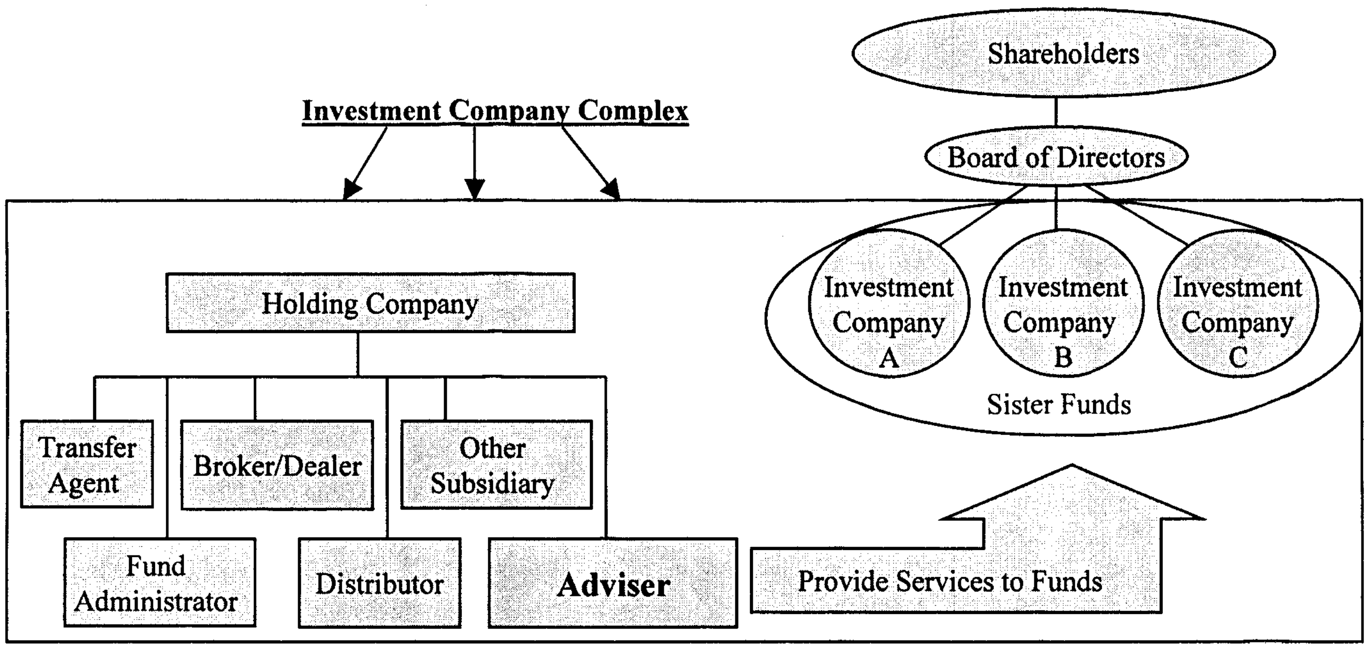
PROPOSED RULE

Material Indirect Investments

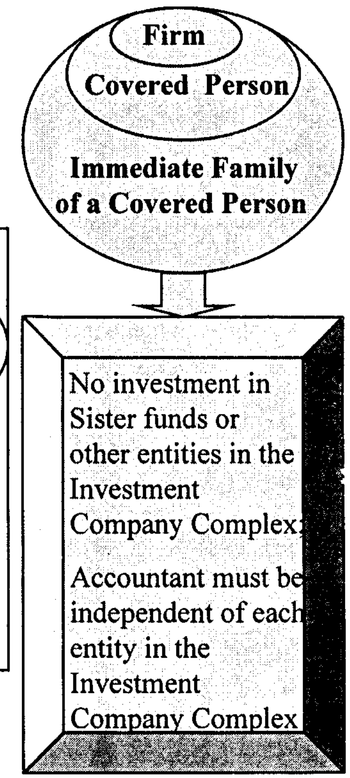
Reg. § 210.2-01(c)(1)(i)(D)(2) Investment in Audit Client



APPENDIX C (Continued)
PROPOSED RULE
Investment Company Complex
Reg. § 210.2-01(c)(1)(ii)(G)

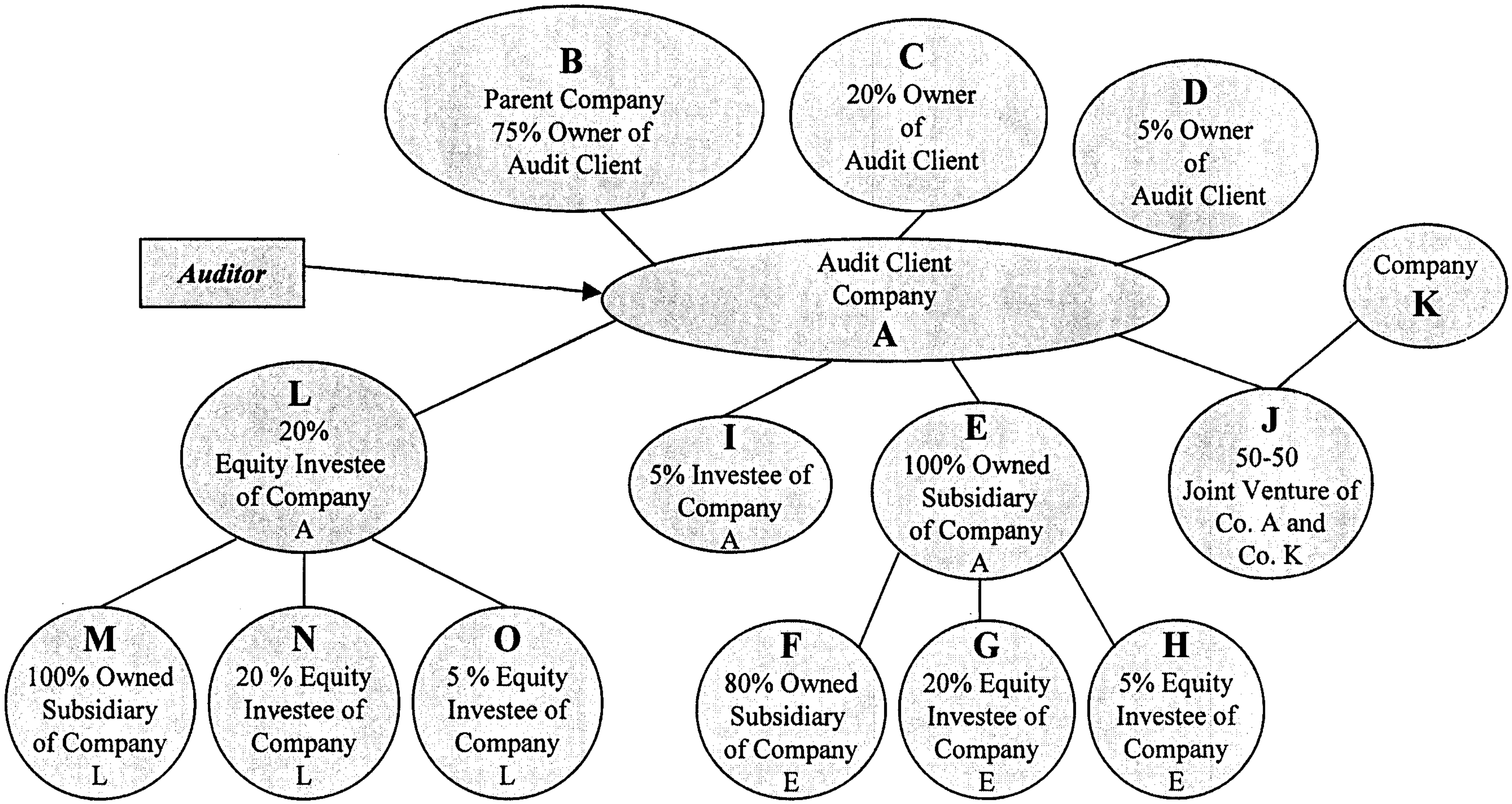


When Auditing Any Entity in an Investment Company Complex



Reg. § 210.2-01(f)(16)(i) "Investment Company Complex" includes:
(A) An investment company and its investment adviser or sponsor;
(B) any entity controlled by, under common control with, or controlling the investment adviser or sponsor in paragraph (f)(16)(A) of this section; or
(C) any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 that has an investment adviser or sponsor included in this definition by either subparagraph (f)(16)(A) or (f)(16)(B)
(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.
(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

APPENDIX C (Continued)
PROPOSED RULE
Affiliates of the Audit Client
Reg. § 210.2-01(f)(5)



NOTE: A detailed analysis follows applying the proposed rules to Direct and Material Indirect Financial Interests in the Audit Client and Affiliates of the Audit Client, Employment of Relatives of a Covered Person, and Non-Audit Services

BILLING CODE 8010–01–C

Direct Investments in the Audit Client or an Affiliate of the Audit Client

Section (c)(1)(i)(A) of the proposed rule states that an accountant is not independent when the Accounting Firm, any Covered Person in the firm or a member of the Immediate Family of a Covered Person in the firm has any direct investment in an ''Audit Client'' or an ''Affiliate of the Audit Client.'' Section (f)(5) of the proposed rule defines ''Affiliate of the Audit Client'' as an entity that has significant influence over the audit client, or over which the audit client has significant influence. Also, under APB No. 18 as noted in the release, there is a presumption of significant influence where an entity owns 20% or more of an audit client or where the audit client owns 20% or more of an entity. For purposes of these examples, we assume that there are no other factors rebutting the presumption of significant influence under APB No. 18.

Both and C own 20% or more of the Audit Client. In addition, the Audit Client owns 20% or more of E, which in turn owns 20% or more of F and G. The Audit Client also owns 20% of L which in turn owns 20% or more of M and N. Finally the Audit Client owns more than 20% of J. Thus, in addition to being precluded from directly investing in A, the Accounting Firm, any Covered Person in the firm and the Immediate Families of Covered Persons in the firm would be precluded from directly investing in companies B, C, E, F, G, L, M, N, and J since these entities are affiliates of the audit client.

With respect to D, I, H, and O there is no presumption of significant influence since D only owns 5% of the Audit Client and the Audit Client only owns 5% of I and the entities over which A has significant influence, E and L, only own 5% of H and O, respectively. Under APB No. 18, as noted in the release, there could be other indicia that would cause D's ownership of the audit Client or the Audit Client's ownership of 5% of I (as well as E's ownership of H or L's ownership of the Audit Client or the Audit Client's ownership of 5% of I (as well as E's ownership of H or L's ownership of O) to rise to the independence would be impaired by direct investments in those entities.

J is an Affiliate of the Audit Client because the Audit Client owns more than 20% of J and thus has ''significant influence'' over J. However, K is not an Affiliate of the Audit Client because the Audit Client does not have ''significant influence'' over K and the accountant's independence would not be impaired by direct investments in K.

Therefore, the Accounting Form, Covered Persons and the Immediate Families of Covered Persons would not be precluded from investing in D, I, H, O, and K. Investments in D, I, H, and O could not exceed 5% of the voting interests of these entities as described under ''Material Indirect Investment in an Audit Client or an Affiliate of the Audit Client'' below.

Investments Reportable on Schedule 13D or 13G or Otherwise Control the Audit Client

Section (c)(1)(i)(B) of the proposed rule states that an accountant would not be independent if any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G with the Commission indicating record or beneficial ownership of more than five percent of an audit client's equity securities, or otherwise controls an audit client.

As noted above, partners and professionals in the firm other than covered persons, and their immediate families and the close family members of covered persons would not be precluded from investing in the audit Client, A. Section (c)(1)(i)(B) of the proposed rule operates to, among other things, preclude professionals in the firm from acting as a group to control the audit client. Thus, the accountant would not be independent when any partner or professional in the firm other than a covered person, a member of their immediate family, or the close family member of a covered person filed a Schedule 13D or 13G (generally required for investments over 5%) with the Commission or otherwise controlled the Audit Client, A.

Material Indirect Investment in an Audit Client or an Affiliate of the Audit Client

Section (c)(1)(i)(D) of the proposed rule states that an accountant would not be independent if the accounting firm, any covered person in the firm or the immediate family member of a covered person or any group of these persons owned more than 5% of an entity that has an ownership interest in the audit client or more than 5% of an entity of which the audit client has an ownership interest.

Assuming that D, I, H, and O are not affiliates, the accounting firm, a covered person in the firm or the immediate family of a covered person or any group of these persons could own up to 5% of these entities without impairing independence since a 5% investment would be considered an immaterial indirect investment in the Audit Client, A.

Employment of Relatives of a Covered Person

Section (c)(2)(ii) of the proposed rule states that an accountant will not be independent if a close family member of a covered person in the firm is in an accounting or financial reporting oversight role at an audit client or an affiliate of an audit client or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

As noted above, B, C, E, F, G, L, M, N, and J are affiliates of the audit client. Consequently, the accountant would not be independent when any close family member of a covered person in the firm was employed in accounting or financial reporting oversight role at the Audit Client A or the affiliates of the audit client, B, C, E, F, G, L, M, N, or J.

Subject to the general standard, a close family member of a covered person could work in any position at D, I, H, O, or K since those entities are not affiliates of the audit client.

Non-Audit Services

Section (c)(4)(i) of the proposed rule provides that an accountant will not be independent when the accountant provides certain non-audit services to an audit client or an affiliate of an audit client.

Accordingly, the accountant would not be independent if the accounting firm provided any prohibited non-audit services to the Audit Client, A, or to any affiliate of the audit client including B, C, E, F, G, L, M, N, and J. Subject to the general standard, the firm would not be precluded from providing non-audit services to D, I, H, O, or K since these entities are not affiliates of the audit client.

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