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

THE CHAIRMAN

December 5, 2000

The Honorable Michael G. Oxley, Chairman
Subcommittee on Finance and Hazardous Materials
U.S. House of Representatives
2233 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Chairman Oxley:

Thank you for your November 3rd letter regarding the possible impact that changes to the Commission's auditor independence regulations may have on middle market accounting firms and accounting firms practicing in alternative practice structures. The rule adopted by the Commission on November 15th specifically addresses the unique situations faced by these firms, and I appreciate having had your thoughtful input on this aspect of our original proposal. A summary of the final rules is attached.

As you know, SEC rules apply only to auditors of financial statements filed by entities registered with the Commission. The five largest accounting firms (the Big 5) audit the vast majority of these statements. A small percentage of non-Big 5 accounting firms, however, audit middle market and small public companies. While these firms are subject to our rules for these specific audits, we do not expect these firms to be significantly affected by the rules.

First, according to our review of data from the AICPA, non-Big 5 firms earn less than 1 percent of their annual revenues from consulting services to SEC audit clients.

Second, seven out of the nine services deemed at odds with an auditor's independence already are restricted under current profession and SEC rules – and have been for more than two decades. Unfortunately, compliance with these prohibitions has been inconsistent in part because the rules reside in different places. As such, we have codified these prohibitions. The remaining two services are internal audit outsourcing and designing and installing certain financial information systems (IT).

Third, some middle market and smaller accounting firms may assist in performing the internal audit function for middle-sized and small public companies. Under the new rules, accounting firms still are able to perform many functions relating to the internal audit function, and we have exempted from the scope of the rules all internal audit services provided to companies with less than $200 million in total assets, under certain conditions.

Fourth, our final rule would permit the auditor to perform information system design and implementation services, under certain conditions. Given the resource and

manpower demands of designing and implementing financial IT systems, however, mid-tier and smaller accounting firms rarely perform this work. In fact, Grant Thornton, a middle market firm, recently announced that it is selling its electronic business consulting practice. Mr. Dom Esposito, Grant Thonton's chief executive, was quoted in the October 26 Washington Post as saying that in deciding to sell the practice, "We were not driven by what's going on at the SEC" but by the fact that the consulting practice was serving large corporations while most of the firm's clients were medium-sized businesses. Another middle market firm has informed the staff that most of the information technology that it performs is for non-audit clients and that the amount of such consulting is immaterial to the firm.

Finally, and most significantly, the rules do not prohibit these firms from providing general business and planning advice or tax compliance services to their audit clients. As I stated recently before the annual meeting of the National Association of State Boards of Accountancy, "We have heard a number of concerns expressed, especially by smaller firms, about whether they will be restricted from offering the types of general business and tax advice they have been providing over the years to many of their clients.... The proposed rule does *not* restrict tax compliance and planning services, nor does it restrict general business advice. In fact, the rule specifically states that auditors should be able to provide advice on internal controls and perform specific internal audit projects."

While the Commission's rules extend only to audits of Commission registrants, some have suggested that any rules passed by the SEC also would be applied in whole to auditors of non-public companies. While we do not believe this will be the case, we are keenly sensitive to these concerns, as shown by the exemption for internal audit services provided to companies with less than $200 million in total assets and by our decision that under certain conditions information technology consulting services will not impair an auditor's independence.

Each state or territory has its own board of accountancy that is responsible for licensing and regulation. We are fully confident that each board will exercise its own judgment with respect to audits of non-public companies, based on local conditions, needs and concerns. Even if a board were to adopt our final rules, however, we believe that, in view of the changes we made from the proposals, it would not adversely affect accounting firms' serving non-public clients.

As I hope I have made clear, our rules in both scope and application should not negatively affect this country's middle market and small accounting firms. The release explicitly states that the Commission expects state boards to continue their practice of discerning whether or when rules applicable to audits of public companies are appropriate or inappropriate for non-public audits. I already have met with individual state boards of accountancy, and plan to meet with more of them, so that together we can ensure that no harm is done to small firms.

The rules also address "alternative firm structures" in two ways. First, in certain situations, an accounting firm's independence might be impaired if an entity connected with the accounting firm provides services to or has relationships with an audit client of the firm, and the service or relationship would impair the auditor's independence if the firm directly provided the service or had the relationship. In other words, an accounting firm may not do indirectly through an associated entity what it may not do directly. Second, disclosure would be required if more than fifty percent of the hours expended on an audit are performed by persons who are not the auditor's full-time, permanent employees. This disclosure is considered necessary so that investors will know that the firm signing the audit report did not perform a majority of the audit. We now stand ready to assist in any way accounting firms and registrants as they implement the new rules.

Finally, on a more personal note, I want to thank you for your public statement of November 15th on this subject commending me and the other Commissioners for "this reasoned compromise" and expressing your satisfaction with this result. In this, as with many other difficult issues we faced during the 106th Congress, your counsel and support have been invaluable to the Commission and to me personally.

I hope this letter has addressed your concerns. If you have any further questions, please do not hesitate to let me know or to have your staff contact John Morrissey, the Commission's Deputy Chief Accountant, who may be reached at (202) 942-4400.

Sincerely,

Arthur Levitt
Chairman

Attachment