

MEMORANDUM

January 19, 2000

TO: Chairman Levitt

FROM: Lynn E. Turner
Chief Accountant 

RE: Auditor Independence Initiatives

This memorandum responds to correspondence from Congressman John D. Dingell regarding the independent consultant's report of violations by PricewaterhouseCoopers LLP of the Commission's, the profession's, and the firm's auditor independence regulations. In Congressman Dingell's letter, he asks what the Commission and the Independence Standards Board ("ISB") are doing to address auditor independence issues.

As you know, the Commission has taken several steps, and more efforts are underway, to gain added assurances that firms are complying with existing independence regulations. The Commission has brought and continues to pursue enforcement and disciplinary actions and has engaged in rulemaking to increase disclosure of Board activities in this area. In addition, the staff is encouraging improvements in self-regulatory programs, seeking better educational programs related to auditor independence and, through our oversight of the ISB, continuing to seek improvements in existing regulations.

Practically since its inception, the Commission has viewed the independence of auditors as crucial to the credibility of financial reporting and, in turn, the capital formation process. Investors in an impersonal securities market must depend on auditors to assess whether the financial information provided by public companies is comprehensive and reliable. The public's sense of confidence in "the numbers" depends in large part on reasonable investors perceiving auditors to be independent professionals who have neither mutual nor conflicting interests with their audit clients and who exercise objective and impartial judgment on all issues brought to their attention.

Enforcement

Because of this belief in the importance of independence issues, the Commission has not hesitated to bring enforcement and disciplinary actions when warranted. On January 14, 1999, the Commission, in an investigation that remains ongoing, censured PwC for violations of the auditor independence rules and improper professional conduct. Pursuant to the settlement reached with the Commission, PwC agreed to, among other things, complete an internal review supervised by an independent consultant appointed by

the Commission. Congressman Dingell's letter refers to the findings in the consultant's report.

The internal review conducted by PwC has revealed the most serious concentration of violations of the independence regulations to date, but it is not the only enforcement action the Commission has taken in this area. For example, the Commission recently brought an action against an auditing firm whose independence from an SEC audit client was impaired because the firm, among other things, provided legal services to the client and a partner in the firm, acting as trustee over investments by family members of a person affiliated with the client, invested trust funds in client-issued securities. The Commission also has initiated actions in cases where the client had loaned funds to the auditor, where an affiliate of the firm had assumed management of the client, and where the auditor owned client securities. The staff will continue to recommend appropriate actions against firms and individuals who violate established auditor independence regulations.

Professional Oversight

In November 1998, I wrote to the SEC Practice Section ("SECPS") of the American Institute of Certified Public Accountants' Division for CPA Firms and encouraged the SECPS and its member firms to reassess whether the quality controls and training programs of firms were adequate to ensure compliance with auditor independence requirements. A copy of my letter is attached. In response, the SECPS upgraded its membership requirements in the area of auditor independence. In the correspondence noted below, however, the staff indicated that the new requirements essentially embodied procedures that many firms already were following and that additional action was necessary.

When the severity of the independence violations at PwC became apparent, I wrote to the Public Oversight Board ("POB") and, again, to the SECPS. These letters stated my disappointment that PwC's quality controls and the profession's self-evaluative programs had not uncovered and addressed these violations, and questioned whether similar violations might be occurring at other firms.

In my letter to the SECPS, I again expressed concern that SECPS member firms may not have sufficient worldwide quality controls to assure compliance with auditor independence regulations. I stated that prompt action is necessary to identify and remedy deficiencies in existing controls, and noted that a failure to do so could undermine public confidence in the current self-regulatory process. In addition, to guide the SECPS in its standard-setting efforts, my letter outlined the basic elements that should be incorporated into a firm's system of quality controls in order to assure that the firm maintains its independence from SEC audit clients. I subsequently met with representatives of the SECPS to discuss my letter and their ongoing standards setting projects in this area. The letter to the SECPS is attached for your information.

In my letter to the POB, I asked the POB to oversee the actions of the SECPS in the development, installation, and operation of new quality control systems. In addition, I urged the POB to undertake promptly a review of the adequacy of its peer review process as it relates to the testing of firms' compliance with auditor independence regulations. I also strongly recommended that the POB undertake a special review of current compliance with SEC and professional independence regulations by individual SECPS member firms. We have been encouraged by the POB's prompt commitment to perform these reviews. The findings and recommendations arising from these reviews should result in a comprehensive assessment of existing deficiencies both in firms' quality controls and in the peer review process, and lead to appropriate corrective action. My letter to the POB and the POB's response, in which the POB undertakes to perform the requested special reviews, also are attached for your information.

Rulemaking on Audit Committees

The Commission is not relying solely on the accounting profession to evaluate auditor independence issues. In a recent rulemaking initiative, the Commission laid the foundation for audit committees of public companies to be active participants in evaluating the independence of the auditors of their companies' financial statements. As you may recall, the ISB adopted a standard, effective July 15, 1999, that requires auditors to (1) provide each client's audit committee with a letter disclosing certain relationships and services that, in the auditor's judgment, may reasonably be thought to bear on independence, (2) confirm in that letter the firm's independence from the client, and (3) discuss the auditor's independence with the audit committee. In its recent rulemaking on audit committee disclosures, the Commission complemented this ISB standard by requiring that each audit committee disclose, among other things, whether it has received this letter from the auditor and discussed with the auditor the auditor's independence. Taken together, the ISB standard and the Commission's audit committee disclosure requirement should bring independence issues to audit committees' attention and stimulate their participation in identifying and resolving independence issues.

Education and Research

To facilitate audit committees' and other interested parties' understanding of the principles and rules related to auditor independence, the Commission ordered PwC to comply with an undertaking to establish a \$2.5 million fund that is being used to develop educational programs and to conduct additional research in this area. The funds were placed in a separate account soon after the Order was issued in January 1999, with all interest earned on those funds going into the fund. The use of these funds and the development of the educational programs are being overseen by a panel consisting of a former Commission Chief Accountant, a former Chief Accountant for the Commission's Division of Enforcement (who currently is a Professor Emeritus of Accounting at the University of Virginia) and a former Academic Fellow in the Office of the Chief Accountant (who is a Professor of Accounting at Grand Valley State University in Grand Rapids, Michigan). We are encouraged by the plans for the educational program and

expect that part of this program will be a high quality, interactive computer program that will allow businesspersons, accountants, lawyers, and others with an interest in the field to obtain a working knowledge of basic independence principles.

Independence Standards Board

Finally, we are continuing to work with the ISB on appropriate revisions of existing auditor independence regulations. While many of the existing rules reflect basic concepts that continue to provide sound guidance for the profession, other rules were written to apply in a business environment that may no longer exist. One of the ISB's primary tasks is to review, update, and instill a consistent logical approach to auditor independence regulations so that they may be readily applied by practicing auditors.

In January 1999, I referred several issues to the ISB as possible topics for the ISB's agenda. A copy of the referral letter is attached. As a result, the ISB is currently studying several issues, such as the potential impact on a firm's independence caused by its business structure, the provision of legal services to an audit client, and family relationships among individuals in the auditing firm and in the audit client. ISB task forces are examining these and other issues and, in some cases, public comments have been requested in response to discussion memoranda that identify possible threats to an auditor's independence and ways to address those threats. The ISB also has adopted a standard that provides guidance to auditors of mutual funds. Because this guidance conflicts with existing SEC regulations, it will not be effective unless or until the Commission removes or modifies its regulations. The Commission, however, will do so only if it finds that the new ISB standard serves the public interest.

Panel on Audit Effectiveness

As an area of added interest, the POB, at the SEC's request, recently formed a Panel on Audit Effectiveness. The charge to this Panel is to conduct a "top-to-bottom" review of how audits are conducted and to recommend improvements in the current audit process. Members of the Panel include Dennis H. Chookaszian, former Chair and CEO of CNA Insurance Companies; Paul Kolton, former Chairman and CEO of the American Stock Exchange; Bevis Longstreth, Counsel to Debevoise & Plimpton and former SEC Commissioner; Louis Lowenstein, Professor Emeritus of Finance and Law at Columbia University; Zoe-Vonna Palmrose, Auditing Professor at the University of Southern California; Aulana Peters, Partner at Gibson, Dunn & Crutcher and former SEC Commissioner; and Ralph Saul, former President of the American Stock Exchange and CEO of CIGNA Corporation. The Panel is chaired by Shaun F. O'Malley, former Chairman of Price Waterhouse LLP.

Auditor independence has become a prominent topic in the Panel's deliberations. We look forward to receiving the Panel's recommendations and, as appropriate, considering any suggested changes to the auditor independence regulations or to the process by which those regulations are established.

Conclusion

The initiatives to address auditor independence span the Commission's enforcement, rulemaking, and oversight programs. The staff continues to give this area high priority and to devote valuable staff resources to promote the concept of auditor independence, enforce adherence to existing rules, and oversee efforts to revise appropriately the independence regulations.

The staff would be pleased to answer any questions that Congressman Dingell or his staff may have in this area or to provide further information. I may be contacted at (202) 942-4422.

Attachments

- A - Letter dated November 30, 1998 from Lynn E. Turner, Chief Accountant, to Michael Conway, Chairman, SEC Practice Section Executive Committee.
- B - Letter dated December 9, 1999 from Lynn E. Turner, Chief Accountant, to Michael Conway, Chairman, SEC Practice Section Executive Committee.
- C - Letter dated December 9, 1999 from Lynn E. Turner, Chief Accountant, to Charles A. Bowsher, Chairman, Public Oversight Board.
- D - Letter dated December 21, 1999 from Charles A. Bowsher, Chair, to Lynn Turner, Chief Accountant.
- E - Letter dated January 7, 1999 from Lynn Turner, Chief Accountant, to William T. Allen, Chairman, Independence Standards Board.