January 13, 2003

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

Re: File No. S7-49-02
Strengthening the Commission's Requirements Regarding Auditor Independence

Dear Mr. Katz:

I am writing on behalf of the Consumer Federation of America[1] to express our overall support of the Securities and Exchange Commission's proposed rules regarding auditor independence. If some important strengthening amendments, and no weakening amendments, are adopted, these rules could both provide meaningful enhancements to the independence of public company audits and significantly improve the ability of corporate board audit committees to oversee the audit effectively. That in turn should contribute to a return of investor confidence, which has been so badly battered by recent accounting scandals.

I. Background

The sudden implosion of Enron just over a year ago offered compelling evidence of a crisis that had been building for some time. What had become glaringly apparent was that the system of investor protections we have long touted as the best in the world was no longer adequate to fulfill its most basic function -- ensuring that investors get accurate and reliable information about the companies in which they invest. The Enron scandal revealed problems at every level, with the accounting rules that govern corporate disclosures, with the boards that are supposed to represent shareholders' interests, with the securities analysts and credit rating agencies that are supposed to provide early warnings of problems, and more. But no failure was more crucial than the failure of the outside auditors to blow the whistle on financial disclosures they either knew, or should have known, to be misleading.

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[1] The Consumer Federation of America (CFA) is a non-profit association of about 300 pro-consumer groups founded in 1968 to advance the consumer interest through advocacy and education.

Given the central role that the independent audit is supposed to play in safeguarding our markets, and given its spectacular failure to fulfill that function in any number of recent cases, it is highly appropriate that much of the corporate reform legislation that was passed in the wake of the Enron collapse is devoted to restoring integrity to the independent audit. Recognizing that this is a complex and multi-faceted problem, Congress approached this task from several angles. The key elements are strong, independent regulatory oversight of the audits of public companies, a package of reforms to enhance auditor independence, clarification that corporate board audit committees, not management, are responsible for overseeing the audit, and a variety of tools to help audit committees fulfill that responsibility effectively.

II. Summary of General Views on the Proposed Rules

This rule proposal deals with the full range of the legislation's proposals to enhance auditor independence -- the "cooling off" period, the limits on non-audit services, and the rotation of audit partners. It also adds a potentially beneficial compensation-related independence reform not mandated by the legislation. Though some improvements are needed in each of these provisions, and particularly to the proposals pertaining to non-audit services, the rules generally appear to implement the legislation with a high degree to fidelity to the authors' intent.

The proposal also addresses a number of the legislation's provisions to improve the effectiveness of audit committees. With one glaring exception -- the proposal to allow audit committees to "pre-approve" non-audit services through policies and procedures -- these rule proposals again appear to closely follow the intent of the legislation. Here again, however, several strengthening amendments are needed to fulfill the new law's full potential.

On the other hand, the rule proposal includes a provision on fee disclosure that, instead of enhancing the quality of information provided to investors, threatens to muddy the waters, making it more difficult to draw clear distinctions between fees directly related to the audit and fees paid to the auditor for other services. This proposal needs to be extensively revised.

Finally, although the rule proposals themselves show a relatively high degree of fidelity to legislative intent -- and go beyond the legislation's requirements in several important areas -- we are concerned that the release is larded with questions that seem designed to elicit suggestions to weaken the rule's protections and limit its scope. We are particularly disturbed that the release repeatedly seeks comments on the need for special treatment for small companies and small audit firms and broad exemptions for foreign issuers -- changes that were actively pushed, but unequivocally rejected during the legislative process.

Despite the recent focus on the massive failures at major corporations, there is no evidence to suggest that audit failures are exclusively or even primarily a large company problem. For example, just over half the financial statements required to be restated between 1997 and 2001 were from companies with under $100 million in revenues, companies that are more likely to be audited by small firms. Furthermore, neither the Commission nor the accounting profession has ever granted a small firm exemption from the auditor independence rules. It would be worse than ironic if, as part of its efforts to restore investor confidence, the

Commission were to reverse course now.

Suggestions that foreign auditors, foreign issuers, and foreign affiliates of domestic issuers receive broad exemptions are similarly misguided. The benefits that foreign companies receive from listing in this country come with a price, adherence to our system of corporate governance. That is as it should be. Creating a two-tiered corporate governance system that sets different standards for domestic and foreign operations is clearly inimical to investor interests. To the degree that there are certain foreign corporate governance requirements that directly conflict with the requirements under the recently enacted corporate reform law, they should be accommodated either on a case-by-case basis or through very narrowly written exceptions and then only where the level of investor protection afforded by the foreign jurisdiction's requirements are comparable to or exceed those afforded under the U.S. system.

It is essential that the Commission not undermine the legislation's effectiveness by opening up broad new loopholes that were considered and rejected by Congress.

III. Auditor Independence Rules

A. Background

The value of the outside audit derives entirely from its independence. Without a requirement that auditors operate as skeptical outsiders, we might as well allow companies to certify their own financial statements. Unfortunately, as recent experience has so dramatically demonstrated, audits today are all too often independent in name only. This lack of independence starts with the fact that auditors are hired and paid and can be fired by the audit client. The auditor who is too tough in challenging management's questionable accounting risks losing the audit engagement. And because these relationships often last many years, even decades, the auditor that aggressively challenges a company's disclosures puts at risk not just this year's audit fees, but a stream of expected revenues from that client stretching indefinitely into the future. These long relationships also can lead to situations in which many of a company's key management people responsible for financial reporting are hired directly from the audit firm and retain a measure of loyalty to that firm.

Increasingly in recent years, auditors have also had lucrative consulting contracts on the line, contracts that may bring in many times the revenue as the audit itself. While some have argued that this increases the audit firm's independence by reducing its financial dependence on the audit, any reasonable person must recognize that, in the real world, the audit firm that antagonizes the client to the point of being fired from the audit is unlikely to retain the lucrative consulting contracts that go with it. So, instead of reducing the firm's financial dependence on the audit, providing non-audit services to audit clients has the opposite effect, by placing the firm in the position of having more at stake financially if it loses that client.

As a result, right up to the point when an audit firm finds itself in court defending against accusations of fraud, the financial incentives for auditors favor turning a blind eye to overly

"aggressive" accounting, at least with big, important clients.[2] That's how you keep the audit client. That's how you hold on to the consulting contracts. That's how you wind up with an offer to come on board as chief financial officer. And, keeping an important audit client happy is also likely to be how you win promotion and success within the audit firm.

Witness after witness in congressional hearings stressed the importance of changing these financial incentives as an essential component of post-Enron reforms. They recommended sweeping changes, to prohibit auditors from offering any non-audit services to audit clients, to require the periodic rotation of audit firms, or to make some outsider (the exchanges or insurance companies) responsible for hiring auditors, and to close the revolving door between audit firms and the companies they audit.

The legislation that was adopted was fairly modest by comparison. For example, rather than enacting a broad ban on non-audit services, the legislation instead sought to revive the consulting limits from the original 2000 SEC rule proposal that identified a list of services viewed as creating particularly egregious conflicts of interest. When those rules were proposed, accountants lobbied successfully to water them down, arguing that concerns about consulting conflicts had been exaggerated and that no evidence existed of an audit failure resulting from such conflicts. With those arguments now totally discredited, Congress sought to restore the full sweep of the original rule proposal, but did not attempt to impose a broader ban. The bill's revolving door provision is also modest, covering relatively few management positions and imposing a very short cooling off period. And, instead of requiring audit firm rotation, the bill essentially codifies the existing standard that requires audit partner rotation and shortens the rotation term from seven years to five.

Given the fairly limited response from Congress on this central issue, it is absolutely essential that the SEC not water down the auditor independence reforms and highly desirable that the Commission complete the job that Congress left only partly done. In most regards, the proposed auditor independence rule meets that first goal, by closely following not just the legislative language, but also the legislative intent. In several areas it goes beyond the legislation's mandates. We applaud the Commission for its faithful interpretation of the legislation and urge it to go even further in expanding on Congress's somewhat limited independence reforms.

A more detailed analysis of the proposed rules follows.

B. Limits on Non-audit Services

The Enron collapse inevitably renewed the debate over appropriate limits on non-audit services provided by auditors to audit clients which had been the subject of the hotly contested 2000 SEC rule proposal. At that time, the accounting industry was very successful in watering down the proposed rules, by:

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[2] For the smaller audit firms that tend to audit them, small companies may still be "big, important clients."

- removing certain services, such as internal audits and financial system design and implementation, from the list of prohibited services;
- opening up a number of exceptions and loopholes in the definitions of various prohibited services; and
- making the principles governing determinations of auditor independence unenforceable through litigation by moving them from the text of the rule to the preliminary note.

We strongly concur with the Commission's interpretation that, in reviving the original list of banned services, Congress did not intend the rules to contain broad categorical exceptions. This view was communicated to us directly by the Senate staffers primarily responsible for drafting the legislation. It is clearly the appropriate approach for the Commission to take.

We also strongly support the Commission's interpretation that the prohibited services should be judged against three broad principles described in the Senate report language. Put succinctly, these principles dictate that an auditor cannot audit his or her own work, perform management functions, or act as an advocate for the client, because to do so would impair the auditor's independence. In fact, not just the services listed in the legislation and in these rules, but any non-audit service provided to an audit client should be judged against these principles, both by the Commission itself in determining what is permissible and by audit committees in determining what services to approve.

In general, the Commission has done a good job of rewriting the definitions of prohibited services to accomplish these two goals. We are concerned, however, by the repeated use of the phrase "reasonably likely" throughout the definitions. For example, the prohibition on bookkeeping services applies to any service, "where it is not *reasonably likely* that the results of these services will be subject to audit procedures during the audit if the client's financial statements." The same language is used in the definition of appraisal or valuation services, fairness opinions, and contribution-in-kind reports and in the definition of actuarial services.

Such determinations require a subjective judgment on the part of the auditor and the audit client about the likelihood that a conflict will arise. Given the poor past performance of some auditors and their clients in policing such conflicts, the rules should instead provide clear, bright line distinctions. Where no such absolute distinction exists, the rules should err on the side of caution. Otherwise, auditors and their clients are likely to continually test the limits of what is permissible, including by litigating restrictions they oppose. The Commission does not have the resources, either human or financial, to devote to such disputes. It should therefore write its rules to avoid that outcome by making the prohibition on these services absolute.

We are also very concerned that the rule proposal seems to seek to justify an exemption to the internal audit prohibition for small companies. In arguing that such an exemption might be called for, the rule proposal seems to assume that small companies that do not need or cannot afford full-time internal auditors could only affordably purchase such services from their external auditor.

No reason is given to justify the assumption that the company's external auditor would be able to provide the services more cheaply than another outside audit firm. The implication is either that the internal audit is somehow being subsidized by the external audit, which would pose grave independence concerns, or that the functions are so closely allied that they can more affordably be provided together. If the latter is the case, however, it only serves to illustrate how likely conflicts are to arise if these two functions are performed by the same firm and how important it therefor is to keep them separate.

As for the likelihood that such companies would not be able to find any external source for these services if they were prohibited from receiving them from their auditor, the Commission has offered no evidence that this is the case. Free market logic tells us that if there is a need in the market for a particular service, and the potential to make a profit offering that service, a provider of the service will quickly spring up to fill that need. If that logic proves faulty, the Public Company Accounting Oversight Board (PCAOB) would have the authority to grant exemptions on a case-by-case basis. Thus, no broad exemption for small companies is either needed or warranted.

The legislative report language and the Commission's analysis both make clear that the heart of these restrictions lie not in the list of prohibited services but in the principles on which they those restrictions are based. What is important is not that auditors be prohibited from providing bookkeeping services, for example, but that they be prohibited from providing *any* service that puts them in the position of auditing their own work or serving in a management position. Similarly, what is important is not simply that auditors refrain from providing legal services to audit clients, but that they refrain providing *any* service that places them in a position of serving as an advocate for that client.

No list of services can hope to be definitive. Rather than defining the universe of what is prohibited, therefore, the list of services should simply serve to enumerate the services that the Commission has thus far found clearly violate the core principles governing auditor independence.[3] As such, listing the services that are prohibited should not relieve auditors and audit clients of identifying and avoiding other services that involve similar conflicts. Nor should it be the Commission's last word on the subject.

Instead, we strongly urge the Commission to formally codify the four principles in the Preliminary Note to Regulation S-X as part of the rule language itself. This would give these principles the force of law, rather than relegating them to mere guidance as they are under current rules. Furthermore, the SEC and the PCAOB should continually work together to determine whether other services that pose similar conflicts are being offered and, if so, add them to the list of prohibited services.

C. "Cooling Off" Period

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[3] These should include the fourth principle from the 2000 rule proposal, having a mutual or conflicting interest with the audit client.

Another of the problems the new law seeks to address is the "revolving door" that sometimes exists between auditors and their audit clients. This can contribute to an environment in which auditors view themselves as part of the corporate family, not as the skeptical outsiders the public audit function demands. They may be more reluctant to challenge former colleagues than they would be if there were no such prior history. And the ability to dangle the prospect of a lucrative, high prestige job with the company also gives managers a tool for persuading a recalcitrant audit team leader to be more "open-minded" about the company's questionable accounting. None of this is consistent with the total independence that public audits demand.

To address this problem, the legislation prohibits an audit firm from serving as auditor for an issuer if the "chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit." The Commission generally appears to have done a good job of faithfully interpreting this provision of the legislation, by applying its restrictions to all members of the audit engagement team and to all positions at the audit client with direct responsibility for oversight over those who prepare the financial statements and related information included in filings with the Commission.

We strongly encourage the Commission to expand the cooling off period to at least two years, measured in terms of the client's fiscal year. This would help to ensure a true separation between the auditor and the audit firm before the individual could accept a management position at a former audit client without forcing a change of auditors. It would also significantly reduce the likelihood that a member of the audit team would be in active negotiations for a management position at the audit client while participating in the audit.

Given the already quite limited nature of the cooling off period, the Commission should emphatically reject any suggestions to further curtail its reach. In particular, it should not create any sort of small company exemption (for all the reasons described earlier in these comments).

D. Audit Partner Rotation

During the debate that led to the new law's enactment, many leading experts advised Congress to require companies to periodically change auditors in order to reduce the risk auditors face when they challenge management over its "aggressive" accounting and thus stiffen their backbones. Instead, Congress adopted a largely symbolic measure, shortening the term for rotation of audit partners from seven to five years. The Commission has given added heft to this provision, by expanding its reach to all members of the audit engagement team and by requiring a five-year "cooling off" period before the individual can return to work on the audit. We strongly support these changes.

We are confused, however, by the rule proposal's inclusion of a discussion of forensic auditing in this context. Regardless one's views on the merits of this proposal, this is clearly not the context in which to raise the issue. The issue is complex, implying as it does that the routine external audit cannot fulfill its mandated role of rooting out financial fraud. We continue to hold out hope that the new auditor oversight board will raise audit standards to clearly require

independent auditors to perform certain "forensic" auditing procedures as part of the routine audit. As such, we believe it is premature to raise this issue. Should the question be raised in the future, the complexity of the issues involved demand a far fuller examination than it is given in this rule proposal.

E. Compensation

We strongly support the new prohibition on the compensation of audit team leaders for the sale of non-audit services to audit clients. Turning auditors into salespeople who go hat in hand to company management to push the firm's other services so clearly comprises their independence it boggles the mind that any audit firm would even contemplate such a system. It is evidence of the total disregard for professionalism and independence that has helped to bring the accounting profession into such low public regard. The Commission is to be congratulated for taking steps to end this practice.

We urge the Commission to build on this promising start to expand the prohibition's reach to all audit engagement team members (including, in particular, managers and senior accountants who work on the audit) and to all those management personnel in a position to influence the audit. Only in this way can the audit firms create a corporate climate in which the audit is clearly segregated from the sale of non-audit services and protected from the conflicts that may attend such a role.

The Commission appears to have done an excellent job of defining compensation very broadly. Experience in the broker-dealer field has taught us, however, that even the broadest definition can be evaded. For example, some broker-dealers that touted their abandonment of differential compensation for sale of in-house products continued quietly to impose a quota on branch offices and individuals for such sales. Expanding the reach of the compensation ban as advocated above would help to alleviate this concern. Even if this expanded approach is adopted, however, the Commission and the PCAOB will need to be on guard for similar evasions so that the compensation ban is not fatally undermined.

F. Summary of CFA's Suggested Strengthening Amendments with regard to Auditor Independence

<u>Limits on Non-audit Services</u>

- Codify the four principles for determining independence in the Preliminary Note to Regulation S-X, and make them enforceable, by moving them from the preamble into the rule language itself.

- Make prohibitions on services absolute by eliminating "reasonably likely" language in definitions of prohibited services.

- Do not adopt a small company exemption from the internal audit prohibition, as the rule proposal seems to suggest.

"Cooling Off" Period

! Expand the cooling off period to at least two years.

Audit Partner Rotation

! Do not adopt the premature proposal to require forensic audits and instead encourage the new auditor oversight board to raise audit standards so that the routine external audit can effectively perform its mandated function of rooting out financial fraud.

Compensation

! Expand the prohibition on sales-related compensation to all audit engagement team members, including in particular managers and senior accountants who work on the audit.

III. Measures to Strengthen Audit Committee Oversight of the Audit

The corporate reform legislation supported its fairly modest package of auditor independence reforms with meatier proposals to beef up the role of audit committees in supervising the audit. In doing so, the new law's authors sought to increase the independence and expertise of audit committees. They also made clear audit committees' ultimate responsibility both for selecting and retaining the auditor, maintaining the independence of the audit, and supervising the audit itself. And they included provisions designed to give audit committees the information and tools they need to fulfill their responsibilities effectively.

This rule proposal implements the requirement that audit committees pre-approve both the audit engagement and any decision to retain the auditor to perform non-audit services. It also defines the information auditors are required to communicate to audit committees. Other aspects of the audit committee provisions are dealt with in other SEC proposals.

Experience following the Enron collapse made it clear just how essential these reforms are. Instead of waking up to their responsibilities, some audit committees' first reaction was to pass the buck, as quickly and completely as possible. At WorldCom, for example, the audit committee included language in its April 2002 proxy statement that is shocking in its total abdication of responsibility. It states:

> "The members of the audit committee are not professionally engaged in the practice of auditing or accounting and are not experts in the fields of auditing or accounting, including in respect of auditor independence. Members of the audit committee rely *without independent verification* on the information provided to them and on the representations made by management and the independent auditors. Accordingly, the audit committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and financial reporting principles or appropriate internal controls and procedures designed to assure compliance with

accounting standards and applicable laws and regulations. Furthermore, the audit committee's considerations and discussions referred to above do not assure that the audit of our financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that our auditors are in fact 'independent.'" (Emphasis added.)[4]

Given what the WorldCom audit committee tells us it *didn't* attempt to do, it is hard to imagine what it did do to fulfill "its oversight responsibility regarding the quality and integrity of our accounting, auditing and financial reporting practices."[5] Furthermore, this language is not unique. While we have not attempted to perform an exhaustive search, we stumbled across virtually identical language in Qwest's post-Enron proxy statement,[6] and contemporary press reports also made note of the phenomenon.

In our view, this evidence of audit committee buck-passing clearly demonstrates the need for the Commission to make it absolutely explicit in its rules that audit committees are directly responsible for fulfilling these oversight functions. Unfortunately, while the language on pre-approval of audit services appears straightforward, the language on pre-approval of non-audit services falls far short of this standard. The proposal on communication between auditors and audit committees also contains serious short-comings.

A. Pre-approval of all non-audit services

As noted above, the corporate reform legislation did not include a broad ban on the provision on non-audit services by auditors to audit clients. Instead, the new law relies on audit committees to police this relationship, in part by approving in advance any decision to retain the auditor to perform non-audit services. The rule proposal seriously undermines this requirement by allowing pre-approval through policies and procedures.[7]

As the Senate Banking Committee noted in its report on the legislation that formed the primary basis for the new law:

" ... the protection of investors warrants a requirement that a public company's audit

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[4] Report of the Audit Committee, dated March 6, 2002 and signed by Chairman Max E. Bobbitt, James C. Allen, Judith Aroon, and Francesco Galesi and included in the WorldCom proxy statement filed with the Commission April 22, 2002. (http://www.sec.gov/Archives/edgar/data/723527/000091205702015985/a2077247zdef14a.txt)

[5] Ibid.

[6] (http://www.sec.gov/Archives/edgar/data/1037949/000095013402003493/d95121-def14a.txt)

[7] While the release specifies that these policies and procedures would be "detailed," there is not even this minimal requirement in the rule language itself.

committee *know about and approve in advance* the services that the auditor will provide to such company."[8] (Emphasis added.)

This report language also specifies that legislation is intended to require that "each non-audit service be specifically identified in order to be approved by the audit committee" and that audit committee members "vote" to approve non-audit services. A requirement for prior knowledge and a vote is clearly inconsistent with approval through policies and procedures.

Further evidence that this approach is in conflict with legislative intent is provided by the legislative history. The requirement for pre-approval of non-audit services was among those most heavily targeted by the accounting firms for weakening amendments or elimination. It's inclusion was among five reasons cited in an AICPA action alert circulating last June for opposing the Sarbanes bill, which was then headed toward mark-up. Despite aggressive lobbying by accountants, the provision was retained intact both in committee and on the Senate floor. The industry lobby was still hard at it during conference committee negotiations, with at least one accounting firm still shopping around an amendment intended to give audit committees "more flexibility" to approve non-audit services through policies and procedures. That amendment was also rejected.

In short, Congress repeatedly rejected efforts to weaken this provision by scaling back the pre-approval requirement. Instead, it stuck firmly to an approach that required specific knowledge of any non-audit services proposed to be offered by the auditor and an advance committee vote of approval. The SEC proposal would give the accountants by rule what they could not obtain through legislation. In doing so, it would make it easier for audit committees to continue to give short shrift to their responsibilities in this area. This portion of the rule must be eliminated.

The Commission should take no other actions to provide exceptions or exemptions to the pre-approval requirement. The bill's provisions allowing decisions to be delegated to a single committee member or group of members assures that audit committees will have all the flexibility they need to provide timely decisions when questions arise that must be addressed between audit committee meetings. The Commission should go further, by making it clear that, in evaluating non-audit services, audit committees are responsible for: 1) ensuring that such services do not conflict with any of the current rule's guiding principles for determining auditor independence and 2) ensuring that the aggregate revenue from non-audit services does not make the auditor so financially dependent on the audit client as to raise questions of independence.

B. Communication with Audit Committees

To fulfill their oversight responsibilities, audit committees must be able to put accounting decisions in context. To assist audit committees in understanding the assumptions underlying the financial statements, the legislation requires that auditors report to committees on: critical accounting policies and practices used; alternatives under Generally Accepted Accounting

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[8] Report of the Committee on Banking, Housing, and Urban Affairs on the Public Company Accounting Reform and Investor Protection Act of 2002.

Principles that have been discussed with management, the ramifications of using those alternatives, and the accountant's preferred treatment; other material written communications between the accounting firm and management of the issuer. In defining the information that must be disclosed, the proposed rule appears to faithfully follow the prescriptions of the legislation.

We believe the rules should be clearer in requiring "real time" communication of any significant disagreements between auditors and management. As the report language on the underlying Senate bill makes clear, a primary purpose of the provision is to allow audit committees to intervene to protect the integrity of the audit where differences between auditors and management arise. For this provision to be meaningful, therefore, it must ensure that audit committees get information about any potentially significant disputes as soon as such disputes arise so that they can be resolved without delaying the filing of financial statements or other mandated disclosures.

We also strongly urge the Commission to require that these disclosures be made in writing. Discussions of critical accounting policies and practices and alternatives will often involve highly complex issues that may require some study before they are fully understood by members of the audit committee. To ensure that committee members have an opportunity to really grasp critical policies, reports on these issues should be required to be provided in writing. (This will also provide verifiable proof that required disclosures were made.) Where appropriate, the written reports should be followed by an oral presentation that includes time for discussion and questions. This is particularly important where there is a dispute between the auditors and management.

Finally, although the rule closely tracks the legislation's requirements in defining what information should be disclosed, we believe the bill should serve as a floor, not a ceiling. The SEC should consider what additional disclosures would be particularly useful to audit committees. It is essential, for example, that audit committees be informed if there are any numbers the auditor believes should be reported differently, if there is any information missing from the financial statement that the auditor believes should be disclosed, and where the auditor rates the company's accounting on a range from conservative to highly aggressive. To the degree that these issues and other similar issues are not covered by the rule proposal, we encourage the Commission to add them.

C. Summary of CFA's Suggested Strengthening Amendments with regard to Measures to Strengthen Audit Committee Oversight of the Audit

<u>Pre-approval of All Non-audit Services</u>

- Eliminate the provision of the rule that would allow pre-approval of non-audit services through policies and procedures, as this is in direct conflict with legislative intent.

- Clarify that, in evaluating non-audit services, audit committees are responsible for ensuring 1) that such services do not conflict with the rule's four principles for

determining auditor independence and 2) that the aggregate revenue from non-audit services does not make the auditor so financially dependent on the audit client as to raise questions of independence.

Communication with Audit Committees

- Require that disclosures be made in writing, to be followed up where appropriate with oral presentations including time for discussion and questions.

- Clarify that "real time" communication, particularly of any disagreements, is required to comply with the rule.

- Consider expanding the disclosure requirements to include other information that would aid audit committees to put disclosures in context.

IV. Fee Disclosure

Before the fee disclosures mandated by the 2000 SEC independence rule gave them the lie, the major accounting firms that opposed the rules had argued that the extent to which auditors were providing non-audit services to audit clients had been greatly exaggerated. In fact, the fee disclosures clearly demonstrated that the problem was far greater than had previously been reported. While it may be necessary to update the fee disclosures, the Commission should ensure that, in doing so, it does not undermine the progress made in the previous rule. The current rule proposal does not pass this test. Instead, it recreates the misleading disclosure system used by the AICPA before the 2000 rule was adopted.

We strongly object both: 1) to the proposal to add fees for additional services, including attest fees not directly involved in the public audit, to the audit services fee category and 2) to the proposal to label other fees for other non-audit accounting services as "audit-related" fees. Both are misleading. Furthermore, the breakdown into multiple categories is overly complex. The overall effect will be to muddy the essential distinction the disclosures are designed to elucidate -- how much the audit client pays for the audit and how much it pays for other services.

The Commission should scrap this proposal and start again. In doing so, we strongly recommend that the Commission retain the current rule definition of audit fees. Those fees that, under the rule proposal, would be added to the audit fee category should instead be combined in a separate category with the types of services that the current rule proposal would group together in the "audit-related fee" category. That misleading label must be dropped, however, in favor of label along the lines of "Other Accounting and Attest Fees." Other fees, including fees for tax services, should simply be aggregated in a third category labeled as "All Other Fees." If companies want to provide more detailed narrative information to accompany the mandatory disclosure, nothing would prevent them from doing so. But the clarity of the basic fee breakdown would be preserved by such an approach.

- Completely rewrite fee disclosure provision to retain existing definition of audit fees and to simplify other categories.

V. Conclusion

CFA supports the auditor independence rule proposal with the strengthening amendments enumerated above. We strongly urge the Commission not to undermine this important investor protection initiative with weakening amendments sought unsuccessfully by the accounting firms during the legislative process. The Commission's bungled selection process for the auditor oversight board dealt a severe blow to investor confidence in the agency's willingness and ability to enforce the new corporate reform law effectively. Approving the strongest possible set of auditor independence rules would help to mend the agency's badly dented reputation. With a few exceptions noted above, the staff has made a good start, by faithfully interpreting the legislation. We urge the Commission to follow up, by repairing the rule's few weaknesses and by ignoring industry pleadings to limit the scope of its reforms.

Respectfully submitted,

Barbara Roper
Director of Investor Protection