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Chairman William Donaldson
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

It has come to our attention that some in the accounting profession are attempting to systematically undermine the recently adopted SEC rules requiring audit committees to pre-approve non-audit services. We are writing to urge you to conduct an investigation to determine how widespread this abuse is and to call a halt to any such practices where you find them. Furthermore, to ensure that the integrity of the pre-approval process is maintained, we urge you to rescind those provisions of the rules that are being used to undermine this central reform of the Sarbanes-Oxley Act and to take additional steps to shore up the pre-approval process.

The accounting firms sought and won several major concessions from the agency during the auditor independence rulemaking. For example:

- The SEC permitted pre-approval of non-audit services through policies and procedures and then "clarified" in the final rule release that both explicit approval and approval through policies and procedures are "equally acceptable."

- Despite having made a strong case in the proposing release that certain types of tax advisory services violate basic principles of auditor independence, the SEC in the final rule release removed language suggesting audit committees take these principles into consideration in deciding whether to hire the auditor to perform tax services and inserted language reiterating the Commission's "long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence."

! The SEC adopted a new fee disclosure rule that expands the audit fee category to include services that are not specifically part of the audit, creates a new category of other accounting services (that may or may not be related to the audit) that are nonetheless identified as "audit-related," and, as a result, significantly reduces the number of services included in the "all other" fees category.

As the enclosed policy document prepared for its audit clients makes clear, Ernst & Young is now relying on those concessions to advocate an approach to pre-approval of non-audit services that makes a mockery of Congress's intent that this process serve to ensure the independence of the audit. Given the vehemence of Big Four firm opposition to meaningful auditor independence reforms and their virtual unanimity in arguing for weakening amendments to the auditor independence rules, we are concerned that the other firms are likely advocating an equally misleading view to their clients of audit committee responsibilities.

In drafting the corporate reform bill, Senate authors concluded that "the issue of auditor independence is so fundamental to the problems currently being experienced in our financial markets that statutory standards are needed to assure the independence of the auditor from the audit client."[1] To deal with the conflicts related to auditor provision of non-audit services, bill authors included a list of services auditors were expressly prohibited from providing to non-audit clients because they violated one or more of three "simple principles" – that "an accounting firm, in order to be independent of its audit client, should not audit its own work ... should not function as management or an employee of the audit client ... [and] should not act as an advocate of the audit client."[2]

The bill's authors also recognized, however, that no such list will ever be all-inclusive. The audit committee pre-approval requirement was therefore added to supplement the list of prohibited non-audit services. The clear intent was that audit committees would review each proposed non-prohibited non-audit service to determine whether it threatened auditor independence and that, in doing so, they would take into account whether the service in question violated any of the "simple principles" that formed the basis for the list of prohibited services. In short, the legislation makes clear that audit committees have a responsibility to maintain the independence of the audit that goes beyond strict adherence to the list of prohibited services.

The Ernst & Young memorandum creates a very different, and we believe fundamentally misleading, view of audit committees' responsibilities.

! **It encourages rubber stamping of whole categories of services.**

While the SEC allowed the use of policies and procedures to approve non-audit services, the final rule noted that such policies and procedures had to be detailed as to the particular

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

[2] Ibid.

service being approved. In contrast, the Ernst & Young document advises audit committees to use a very broad and expansive approach to approving non-audit services through policies and procedures. In fact, the main point of the document is that the vast majority of non-audit services can be approved without specific review by the audit committee. It states, for example, that "most companies should be comfortable in adopting policies and procedures that allow the audit committee annually to pre-approve categories of audit and audit-related services, as well as most tax services and certain other services."

- **It repeatedly dismisses the possibility of independence concerns related to any but the prohibited services.**

The document states, for example, that "in considering these matters, audit committees can find assurance in the fact that there is a precise listing of proscribed services." It adds that "audit and audit-related services require a minimal level of consideration relating to pre-approval because they have not been thought to raise independence concerns." It further states about audit related services that they "generally improve audit quality and do not impair independence" and that, they are "by definition, not the types of 'consulting' services that have given rise to concern about non-audit services in recent years."

In fact, however, the audit-related category includes a number of services that do not necessarily bear any relation to the audit, except, of course, that provision of those services by the auditor might require them to audit their own work. For example, an auditor may assist a company they audit in performing due diligence for an acquisition. That due diligence may include an assessment of the future prospects of the target company, analysis of its cash flows, review of the likely realization of assets on the balance sheet, and an assessment of the quality of the management of the target company. After the acquisition is made, however, if problems or business issues develop with the acquired company that call into question advice or counsel provided by the auditor, the auditor may have a serious conflict in auditing the results of the acquired company that are included in the consolidated operations and balance sheet of the audit client.

The Ernst & Young document is similarly dismissive of independence concerns related to tax services, even though tax services were singled out by Congress as requiring audit committee pre-approval. "Most tax services, such as tax return preparation and *most types of tax planning*, generally have been viewed as routine and non-controversial," it states. (Emphasis added.) In fact, however, tax planning services are extremely controversial, and were even before recent developments at Sprint highlighted the serious concerns in this area. With investor advocates and any number of corporate leaders suggesting that permissible tax planning services should be dramatically curtailed, it is at best disingenuous of Ernst & Young to downplay such concerns.

- **It suggests that the SEC has concluded that basic principles of auditor independence cannot effectively be applied to these decisions.**

In one of its most misleading passages, the document states that commentators "noted that these principles were too vague to be useful to audit committees in determining whether to

pre-approve tax services." It fails, of course, to mention that these were the self-interested comments of the audit firms, or that a number of non-industry commentators had suggested just the opposite and had recommended that the principles be codified as part of the rule. The document's discussion of this topic is obviously designed to convey the impression that the concern about vagueness was the reason behind the SEC's decision to drop the reference from the final rule. The implication is that the SEC shared the audit firms' view that these principles had no place in the pre-approval process. As the audit firms well know, however, then SEC Chairman Arthur Levitt wrote to audit committees as early as January of 2001 to urge them to pre-approve non-audit services and to take these principles (among other factors) into account as a part of their decision-making process.

- **It encourages companies to exclude most non-audit services from the non-audit services category for the purpose of calculating whether fees for these services create an unacceptable conflict.**

The new fee disclosure requirements adopted by the SEC were widely opposed by investor advocates on the grounds that they serve to mask conflicts of interest. They do this primarily by grouping fees for services that are not specifically part of the audit in the audit fee category and by grouping fees for services that are not related to the audit in the audit-related fee category. The Ernst & Young document uses this new disclosure system to its advantage in encouraging a policy for assessing whether fees for non-audit services create an unacceptable conflict. Specifically, it advocates grouping all "audit," "audit-related," and "tax" services together and weighing them against the few services that are left in the "all other" category. This approach dramatically and inappropriately minimizes the appearance of a conflict. A meaningful assessment would instead group audit services with only those services that can be shown to be directly related to the audit and would then weigh them against fees for everything else.

The audit committee that faithfully followed the approach advocated by Ernst & Young in this document would give the kind of specific review and approval anticipated by Congress for all non-audit service only to tax services involving large complex transactions, to tax services for individual company executive that are paid for by the company, and to a handful of non-recurring services that fall into the "all other" category of services for the purposes of fee disclosure. Furthermore, the audit committee would review those services without regard to the basic principles of auditor independence. Instead, it would consider a variety of factors – such as "familiarity with the Company's business, people, culture, accounting systems," etc. – that favor retention of the auditor to perform non-audit services. The idea that the pre-approval process would have any value in assuring the independence of the audit under such an approach would be a joke, if recent experience hadn't shown just how painful a lack of auditor independence can be for average retail investors.

Although it may not have realized it at the time, the Commission handed the audit firms a roadmap for evading the audit committee pre-approval requirement when it issued its auditor independence rules. It did so, first and foremost, by allowing pre-approval through policies and procedures, a major concession that audit firms had been unable to win from Congress despite a massive lobbying effort. That central disastrous decision was made worse by the agency's

backing down from its original strong stance regarding auditor independence concerns related to tax services and by its adopting a new fee disclosure system that masks, rather than exposes, conflicts of interest.

The Commission must now step in to restore this important auditor independence reform. To that end, we urge the Commission to:

- rescind the rule provision allowing pre-approval of non-audit services through policies and procedures and clarify that the approach recommended by Ernst & Young is unacceptable;

- formally codify as part of Regulation S-X the basic principles for determining auditor independence;

- clarify that audit committees are expected to review all proposed non-audit services with an eye toward determining whether they violate these basic principles;

- add tax planning services and tax services for company executives to the list of non-audit services auditors are prohibited from providing; and

- revise the audit fee disclosure rules to, at a minimum, remove fees for services not directly related to the audit from the audit fee category and rename the audit-related fee category to more accurately reflect its content.

The major audit firms have an abysmal record on auditor independence. They have engaged in practices that entail massive conflicts of interest, and they have fought vehemently to preserve that business model when it has come under attack by regulators and Congress. It should come as no surprise to anyone who is at all familiar with the Big Four's record in this area that at least one of those firms, and probably more, are now using loopholes in the recently adopted auditor independence rules to eviscerate the requirement for audit committee pre-approval of non-audit services. We urge you to step in quickly and forcefully – as you did in response to Mr. Purcell's comments following announcement of the analyst settlement – to call a halt to any an all efforts to undermine this central reform of the Sarbanes-Oxley Act.

Thank you for considering our views.

Respectfully submitted,

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