



THE CHAIRMAN

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

October 6, 2000

The Honorable Michael Crapo
United States Senate
111 Senate Russell Office Building
Washington, D.C. 20510

Dear Senator Crapo:

During last week's hearing on the SEC's rule proposal modernizing the rules governing auditor independence, I indicated I would provide to you a more comprehensive explanation of why I believe Commission action in this important area would have a minimal effect on small accounting firms in your state and across the country. You also recently wrote me a letter on this same issue, to which I'm happy to respond.

As you know, SEC rules apply only to auditors of financial statements filed by entities registered with the Commission. Big 5 firms audit the vast majority of these statements. A small percentage of non-Big 5 firm accounting firms, however, audit smaller public companies. While these firms would be subject to our rules for these specific audits, we do not expect their audits of public companies to be significantly affected by the proposed rule.

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, eight out of the ten 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 proposed codifying these prohibitions. We expect, however, that such codification will have very little impact on small firms' non-audit revenues. The remaining two services are internal audit outsourcing and designing and installing certain financial information systems.

Third, while many smaller accounting firms assist in performing the internal audit function for small public companies, the rule proposal restricts only the complete outsourcing of the internal audit function to the external auditor. Accounting firms, thus, would still be able to perform many functions relating to the internal audit. Fourth, given the resource and manpower demands of designing and implementing financial IT systems, smaller accounting firms rarely perform this work. And most significantly, the rule proposal does not prohibit these firms from providing general business and planning advice or tax compliance to their audit clients.

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In fact, some have expressed the view that these rules may increase opportunities for the smaller firms who provide services to SEC registrants. At one of the SEC's public hearings on the proposed rule, Larry Gelfond, a member of the Colorado State Board of Accountants and a partner in a smaller accounting firm stated, "I look at this, frankly, as an opportunity, particularly in the internal audit functions to step in, and given our experience, to work with management and with their respective independent auditor, let's say a Big Five firm... this is an area that we can frankly look at as a new revenue generator."

While the Commission's rule proposal extends only to audits of Commission registrants, some in the profession have argued that any rule will "trickle down" 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.

Each state or territory has its own board of accountancy that is responsible for licensing and regulation. These boards have the power, the authority and the discretion to adopt or not adopt any aspect of a Commission rule. 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. This is especially important since most members of state boards are from small firms. State board members from small firms are in the position to ensure that the interests of small practitioners and small businesses are fully considered and protected.

Indeed, differences between the states' independence rules, the AICPA's rules and the Commission's rules have existed for many years. For example, our rules differ in, among other things, the amount of accounting work an auditor can perform for its audit clients, which family members are subject to the independence rules, whether the firm may provide certain legal services to an audit client, and whether the auditor may be indemnified by the client for certain legal liabilities and costs.

As the SEC and the state boards have long recognized, these differences are fully appropriate for audits of non-public companies. Small, non-public companies often need extensive help with accounting, internal controls, and general business strategies. Lenders to and investors in small, non-public companies generally have more direct access to management and to the company's financial records.

Smaller accounting firms are more focused on providing sound business or tax advice than a broad array of exotic services. Consider many of the services small accounting firms offer to their non-public clients today:

- Maintaining depreciation records
- Performing routine end-of-reporting-period adjustments
- Making journal entries necessary to convert cash basis records to the accrual basis of accounting for reporting purposes
- Preparing financial statements and note disclosure from the actual books and records of their clients
- Preparing required tax returns and advising on tax issues
- Advising on payroll taxes, employment laws, workmen's compensation, insurance, sales and use taxes

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- Preparing personal tax returns for owners and employees of their audit clients
- Advising on various economic decisions, such as “purchase vs. leasing”
- Helping locate qualified personnel for staffing
- Helping to identify the most appropriate software and hardware for their clients.

Many state boards allow all of this work to be done for non-public clients. And, small accounting firms will continue to perform this work for their non-public clients in the future.

As I stated last month 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.”

You asked how many organizations representing small business, state accountancy boards and state regulators have provided written comments during the comment period and what percentage were supportive of the rulemaking. As you may know, the Commission received over 2,000 comment letters. We have not completed reading through those comment letters, but it’s clear they reflect a broad array of views.

For instance, the National Conference of CPA Practitioners is the only national organization that represents only practicing CPAs. It has 1,200 firm members which service 500,000 small and medium sized businesses. They wrote me a letter stating that they fully support our position on independence.

I have seen letters from a number of small accounting firms and some state boards expressing concern about the Commission’s rulemaking. Yet, many of these letters rest on the assumption that the SEC’s rule proposal would prohibit the broad range of consulting services auditors provide to their clients. That assumption simply is not true.

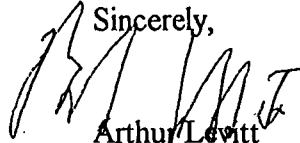
As I hope I’ve made clear, our rule proposal in both scope and application would not negatively affect this country’s small accounting firms. But, I pledge to you that we will continue to listen to views of the small accounting firms very carefully. With the consent of my fellow Commissioners, I will ask the staff to state explicitly in the release that we expect 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. In the meantime, I plan to meet and visit with individual state boards of accountancy so, together, we can ensure that no harm is done to small firms.

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I look forward to continuing to work with you on this most important issue. If you have any questions or comments, please don't hesitate to call.

Sincerely,

A handwritten signature in black ink, appearing to read 'Arthur Levitt', written over the printed name.

Arthur Levitt
Chairman