Date

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Général

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Mr. Jonathan G. Katz
Secretary
US Securities and Exchange Commission
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USA

Email: rule-comments@sec.gov

Dear Mr. Katz,

Re: File n° S7-49-02 – SEC Proposed Rule Strengthening the Commission's Requirements Regarding Auditor Independence

I. General

1. FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) welcomes the opportunity to provide comments on the Proposed Rule on Strengthening the Commission's Requirements Regarding Auditor Independence. FEE is the representative body for the accountancy profession in Europe. We have 41 Member Bodies in 29 countries – as listed in the annex to our letter of 20 December – and represent some 500.000 accountants of which about 45% work in public practice. FEE is a member of the European Commission's Committee on Auditing. Through our position paper "Statutory Audit Independence and Objectivity – Common Core of Principles" we have contributed to the European Commission's Recommendation of 16 May 2002 on "Statutory Auditors' Independence in the EU: A Set of Fundamental Principles" (referred to as European Commission's Recommendation on Independence).

2. FEE has a direct interest in the SEC rules since the provisions of the Sarbanes-Oxley Act also address foreign registrants, their affiliates and foreign affiliates of US registered public accounting firms. As a general policy, we support international convergence of standards to enhance global confidence in auditing. We strongly support IFRS and ISA and firmly believe that capital markets require principles-based global solutions, and not unilaterally imposed rules-based requirements. The SEC should, therefore, prepare its independence rules with this aim in view. For multinational audit clients the world needs to converge towards global independence principles.

3. FEE supports the overall objective of the Sarbanes-Oxley Act to restore investor confidence in the functioning of the capital market. However, the Act is very much related to the US legal environment and can be seen as a reaction to mainly US financial reporting problems. It addresses mainly US problems of auditor independence. For European companies and their auditors, many of the Sarbanes-Oxley Act measures, especially as regards their details, are, in our opinion, unnecessary, disproportionate, burdensome, or even impossible to apply. FEE strongly supports the European Commission's Recommendation on Independence, which is fully compatible with the global IFAC Code of Ethics, Section 8 (November 2001) as well as with the IOSCO Statement on Principles of Auditor Independence and the Role of Corporate Governance

in Monitoring an Auditor's Independence. The work of the EC Committee on Auditing, resulting in the European Commission's Recommendation on Independence started long before the current issue arose in the US. Because it is principles-based, the European Commission's Recommendation on Independence would have covered any independence problems that might be seen to arise in the recent corporate scandals. FEE strongly believes that a fundamental ethical issue cannot be adequately dealt with solely through rules, prohibitions and/or legislation. The European Commission's Recommendation on Independence starts from the same objectives and provides a set of safeguards to appropriately protect investors in EU companies and should be recognised as having at least equivalent effect to the SEC proposed rule on auditor independence.

4. The percentage of trading volume in shares of EU registrants at the NYSE compared to that at domestic EU stock exchanges is relatively small. The vast majority of foreign registrants' shares are traded on domestic EU markets. However, the full weight of the Sarbanes-Oxley Act is imposed on these companies and their auditors. The European Commission's Recommendation on Independence and the proposed rule cover the largely same issues of concern. FEE fully supports the European Commission in the dialogue with the SEC about appropriate exemptions and recognition of equivalence of European systems and strongly supports an exemption for all EU auditors from the SEC proposed rule on audit independence.

Principles-based Approach

5. FEE supports a principles-based approach to financial reporting, independence and other standards, rather than detailed rules. Our profession is committed to respecting the fundamental principles established by the Code of Ethics of IFAC. Also the Technical Committee of IOSCO recognises in its Statement of Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence the benefits of a threats and safeguards approach on the basis of a framework of principles and refers to the IFAC Code of Ethics. FEE has contributed to the European Commission's Recommendation on Independence by publishing a comprehensive position paper "Statutory Audit Independence and Objectivity", adopting a principles-based approach. Fundamental principles must be observed by the auditor. The auditor must conscientiously consider whether the engagement involves threats which would, either in fact or in appearance, impede the observance of the fundamental principles. Where such threats exist, the auditor should put safeguards in place that eliminate the threats or reduce them to insignificant levels. Where it is not possible to reduce or mitigate the threats, the ultimate safeguard is a specific prohibition. For example, the European Commission's Recommendation on Independence includes specific prohibitions on bookkeeping services for listed companies and on certain IT and valuation services. This approach prohibits relationships and situations, including the provision of non-audit services, where they compromise auditors' objectivity or give the appearance of doing so.

6. By focusing on the underlying aim rather than detailed prohibitions, the principles-based approach combines flexibility with rigour in a way that is unattainable with a rule-based approach. In particular, it:

   - allows for the almost infinite variations in circumstances that arise in practice;
   - can cope with the rapid changes in the modern business environment;
   - prevents the use of legalistic devices to avoid compliance;
   - requires auditors to consider actively, and to be ready to demonstrate the efficacy of, arrangements for safeguarding independence.

7. In the rapidly evolving modern global economy, it is impractical to comprehensively list all possible threats to independence. In fact, such an approach is open to the danger of ignoring threats not specifically mentioned or detailed in the rules. The events of the last year have, if anything, reinforced this view. The ethical guidance based on the conceptual framework approach includes examples of threats that might arise and appropriate safeguards to deal with them. But these are clearly stated to be illustrative and not exhaustive. If an auditor were to appear before a disciplinary tribunal charged with a breach of ethical requirements, it would not be a sufficient

defence to demonstrate that particular examples of threats and safeguards in the ethical code had been addressed. He would need to be able to demonstrate that, in the particular circumstances under consideration, the fundamental principles had in fact been observed – a far more rigorous test of compliance. The framework approach is also the best way for an audit committee to exercise judgement in relation to non-audit services as this approach allows it to consider the relevant threats and safeguards in the particular circumstances under consideration.

Confusion of Principles and Rules

8. In the proposed rule, the SEC recognises three basic principles in respect of the provision of non-audit services:

   a) an auditor cannot audit his or her own work (self-review threat or risk)
   b) an auditor cannot perform management functions or function as an employee of the audit client (self-interest and/or self-review threat or risk)
   c) an auditor cannot act as an advocate for the client (advocacy threat or risk)

   As regards the first of these SEC principles, may we respectfully propose that the line of thought would be better and more effectively expressed in terms of a self-review threat. FEE has defined the self-review threat as:

   "The apparent difficulty of maintaining objectivity in conducting what is effectively a self-review, if any product or judgement of a previous statutory audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching statutory audit conclusions."

   In our opinion, self-review as an approach much better reflects the facts and common sense - a range of threats exists but can often be eliminated or controlled by appropriate safeguards.

   We also point out that using the self-review approach would better promote long term global convergence, specifically with the IFAC and EU codes.

9. The proposed rule states that the scope of the prohibited services should be judged against the above basic principles. FEE fully supports a principles based approach to identifying threats to independence, as set out by FEE in its Common Core of Principles, in the European Commission's Recommendation on Independence and in the IFAC Code of Ethics. However, FEE is concerned about the apparent lack of readily visible linkage between these principles and the nine proposed prohibitions of non-audit services. This is because the approach in the proposed rule remains rules-based. It does not take into account materiality, subjectivity and the nature of the services provided. The three principles are nowhere to be seen in the proposed rules. There is, therefore, a permanent conflict with the basic principles because there is an implicit assumption that the principles are absolute. There is no consideration of the degree and range of threats that might arise in practice, neither is there any recognition that safeguards can exist to eliminate or mitigate threats to independence. In practice, audit committees and auditors should generally be left to consider whether non-audit services conflict with the underlying principles.

Materiality and Scope of Application

10. In our opinion the proposed rule takes an excessively wide view of what an auditor's own work comprises. If an auditor performs work of a mechanical or routine nature for a client which does not involve a significant degree of subjectivity and whereby the decisions remain with the client, in our view, this does not compromise the auditor's objectivity. Such work could be safely carried out, subject to specific safeguards where necessary.

11. The concept of materiality is hardly acknowledged in the proposed rule. If a matter is clearly insignificant to all parties, it is assumed any threat to independence cannot be significant. However, materiality needs to be considered both in quantitative and qualitative terms. For example, there may be non-audit services which generate insignificant fees for the audit firm but represent, or may be perceived to represent, a significant threat to the individual auditors' independence and objectivity, i.e. there may be factors other than the amount involved.

12. FEE is of the opinion that it is unnecessary for the proposed rule to impact on individuals in audit firms that are not in a position to exercise significant influence on the audit opinion, for example because their work is supervised or because of the immateriality of their role in relation to the company's accounts or to the audit. This is in particular the case in the wide range of individuals when the proposed rotation and cooling off rules apply. All the requirements should be subject to an assessment of whether a reasonable and informed investor would consider that there was any likelihood that the issue could have any influence on the audit team's judgement.

Small Firms

13. In terms of objectives, we consider that it is difficult to justify exemptions for audit firms or clients purely based on size. The European Commission's Recommendation on Independence is applicable to all statutory audits of limited liability companies in the EU. As indicated below, it differentiates in some instances based on the fact whether the client can be classified as a public interest entity, where the perceptions of threats to independence carries greater weight. Some additional services may be provided to non-public interest entities. All SEC registrants are public interest entities, therefore there is no basis for a distinction in your rules. However, small audit firms are significantly affected by those rules, which makes it vital for the SEC to limit prohibitions and restrictions to those areas where it is absolutely necessary to safeguard against an unacceptable compromise to independence.

Final Rule Making

14. We draw your attention to our letter of 20 December 2002 where we, in the name of all of our 41 Member Bodies, asked for the deferral of rule making for foreign registrants and their auditors and urged the SEC not to address issues in rule making that go further than the requirements of the Sarbanes-Oxley Act. Please find a copy of the letter attached. We also conveyed our concerns in this letter about tax services and internal rotation. Below, we provide more detailed comments on these and other aspects.

II. Discussion of Proposed Rules

A. Conflicts of Interest Resulting from Employment Relationships

The European Commission's Recommendation on Independence introduces a requirement for a two-year cooling-off period for key audit partners leaving the audit firm to join the audit client for a key management position. A key audit partner is defined as "an audit partner of the Engagement Team (including the Engagement Partner) who is at group level responsible for reporting on significant matters, such as on significant subsidiaries or divisions of the audit client, or on significant risk factors that relate to the statutory audit of that client".

The SEC requirement in the proposed rule would however apply to individuals who participated in any capacity in the audit. We do not believe that it is necessary to introduce the requirement for other staff than the key audit partners where they are not in a position to exercise significant influence on the audit opinion since their work is subject to oversight or because of immateriality of their role in relation to the group accounts or to the audit.

B. Services Outside the Scope of the Practice of Auditors

1. Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client

The European Commission's Recommendation on Independence concludes that while management always has the responsibility for the presentation of the financial statements, it is uncommon for a set of financial statements to appear where the statutory auditor has had no hand whatsoever in presentation or drafting. The auditor's assistance should be limited to carrying out mechanical or routine tasks and to providing advisory information on alternative standards and methodologies. However, in relation to public interest companies, such assistance should not go beyond the statutory audit mandate. In emergency cases, a statutory auditor may participate in the preparation process, but should not take part in any final decisions.

The auditor should also consider additional safeguards that would allow him to minimise the level of risk to independence. Where appropriate, the auditor should seek to discuss the situation with the audit committee and ensure that the services provided and the reasons for this are summarised in the financial statements. Also in the involvement in the preparation of the financial statements of immaterial subsidiaries, the self-review threat is not considered significant when the assistance is solely of a technical or mechanical nature.

We regret therefore that the SEC proposes to remove such exceptions. In our view, as set out above, this is not a question of auditing own work and therefore would not pose any significant threat to auditor independence.

2. Financial Information Systems Design and Implementation

The self-review risk is too high to permit an auditor, audit firm or audit network to be involved in the design and implementation of financial information technology systems to generate information forming part of the client's financial statements unless certain safeguards – including that management is taking all the decisions – are met. Therefore, it will depend on the circumstances whether in testing or selecting of hardware and software systems, the auditor's independence is impaired. Statutory audit work includes the testing of those hardware and software systems that are used by the client to generate the financial information which is to be disclosed in the financial statements. For example, there is little risk in the case of a smaller company client, which is not a public interest company, where the auditor is asked to tailor a standard accounting system to meet the needs of that client's business.

The independence of the auditor is also not impaired when the auditor proposes a correction of a mistake in the financial information system detected during the audit. Similarly, the involvement of the auditor in a review of alternative systems would not impair independence if, taking account of this review, the client's management decides which system to install. In such a case independence will only be compromised if the auditor has a significant financial interest or a significant business relationship with any of the systems' suppliers.

In the above cases, none of the three basic principles identified by the SEC would be breached.

3. Appraisal or Valuation Services, Fairness Opinions, or Contribution in Kind Reports

FEE believes that it is not necessarily the case that independence is impaired where a valuation is material to the financial statements. Under the European Commission's Recommendation on Independence and the IFAC's principles-based Code of Ethics, valuations are prohibited where the service is material to the financial statements being audited and where the valuation involves a significant degree of subjectivity. This approach recognises that if there is no scope for judgement the threat to independence from self-review does not exist. Whilst we welcome the inclusion of the "reasonable likelihood that the results will not be subject to audit procedures" clause in the proposed

rule it makes no allowance for whether the opinion derives from the auditor's own judgement or pre-determined calculations. It is the case that many valuations performed by auditors in the EU fall into the latter category. Accordingly, no significant threat to independence is considered to exist where an opinion expressed is material to the financial statements but where no subjectivity is involved in the statement being made by the auditor. Clarification should therefore be provided in the rules that services which give no scope for opinion as well as those which are immaterial to the financial statements would not be in conflict with the non-audit services principles.

The issue of tax related valuations is dealt with below.

We consider that the provision of valuation or appraisal services that are unrelated to the financial statements would not pose any significant threat to auditor independence as it clearly does not relate to the financial statements and therefore does not conflict with the principle that you should not audit your own work. It is important that auditors not be subject to any unnecessary constraints. Moreover, the audit committee or governance body should generally be able to agree the most suitable provider of services.

As explained above, there are instances where valuation services can be provided without impairing auditor independence. Further examples are where the engagement is to review an opinion on the valuation work performed by others or to collect and verify data to be used by others. We note that you do not propose to prevent auditors from providing such services but this is by no means clear from the proposed rule itself.

An example of a valuation required by law is Belgium where shares that are issued for a consideration other than cash in the course of an increase in the subscribed capital is the subject of a report by the statutory auditor. We assume that you do not intend for the services to be prohibited by the rules and would like you to clarify that these services will be permitted.

With regard to certain routine valuations, the degree of subjectivity inherent to the item concerned may be insignificant. The result of a valuation performed by an informed third party, even if not identical, is unlikely to be materially different. The provision of such valuation service might therefore not compromise an auditor's independence, even if the value itself could be regarded as material to the financial statements, provided that the management of the audit client has at least approved and taken responsibility for all significant matters of judgement.

The SEC's rules should allow auditors to perform valuations for EU issuers where there is no risk to auditor independence. A blanket restriction forbidding the provision of this service would prevent the client from choosing the auditor to carry out the work where they are best placed to do it economically and effectively. The European Commission's Recommendation on Independence's principles-based approach is equally as effective for the protection of investors and other stakeholders and is appropriate to European legal frameworks.

We are therefore strongly of the opinion that EU auditors should continue to be able to provide valuation services where they would not be in a position of auditing their own work through utilisation of appropriate safeguards.

4. Actuarial Services

We refer to our comments above under 3.

5. Internal Audit Outsourcing

Participation in a client's internal audit by the auditor may give rise to a self-review threat. As indicated in the European Commission's Recommendation on Independence, this threat can be mitigated by putting appropriate safeguards in place. These safeguards need to ensure that the overall responsibility is with management, including the decision-making. The introduction of such

requirements might ease the problems likely to be encountered by SMEs. Internal audit is an important element of an entity's internal control system. In companies, particularly small and medium sized ones, which cannot afford an internal audit department or where such a department lacks certain facilities (e.g. access to specialists in information technology or treasury management), participation by the auditor in the internal audit may strengthen management control capacities. The proposed SEC rule provides that an auditor is not independent when the auditor performs internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client and that existing SEC independence exemptions for small businesses will be eliminated.

As stated in the European Commission's Recommendation on Independence, self-review threats can arise if, for example, there is not a clear separation between the management and control of the internal audit and the internal audit activities themselves, or if the auditor's evaluation of the client's internal control system determines the kind and volume of his subsequent statutory audit procedures. To avoid such threats, the auditor must be able to show that he is not involved in management and control of the internal audit. Furthermore, in his capacity as the statutory auditor of the client's financial statements the auditor must be able to demonstrate that he has taken appropriate steps to have the results of the internal audit work reviewed and has not placed undue reliance on these results in establishing the nature, timing and extent of his audit work. In order to ensure that the firm's audit work meets required auditing standards and that the auditor's independence is not compromised, an appropriate review of these matters should be performed by an audit partner who has not been involved in either the audit or any of the internal audit engagements which may impact the financial statements.

Furthermore, in companies where the internal audit department reports to a governance body rather than to management itself, the internal audit function performs a role that is complementary to the statutory audit function. It can therefore be seen as a separate element of the corporate governance framework. If the auditor is asked to perform internal audit work in these circumstances, he must still be able to demonstrate that he has adequately assessed any threats to his independence, and has applied any necessary safeguards.

6. Management Functions

FEE fully supports the basic principle that an auditor cannot perform management functions since auditors should not be involved in management decision-making.

As far as the assessment of internal accounting and risk management controls is concerned, we refer to our comments on internal audit outsourcing under 5. If the management of a client has to produce a statement on the effectiveness of internal controls and the auditor has to provide a related attestation statement, there might be a perceived conflict of interest if the external auditor is also engaged in the internal audit process. Therefore, the external auditor should not participate in these circumstances in the internal audit.

7. Human Resources

Recruitment of senior or key financial or administration staff may give rise to self-interest, trust or intimidation threats and the auditor needs to assess carefully these threats to independence. The decision as to who should be engaged should always be taken by the client. In this respect, the European Commission's Recommendation on Independence states that in providing a shortlist of candidates for a public interest company for senior or key financial or administrative staff, the independence risk would be considered too high. However, other services, including recruitment/shortlist other type of personnel or non-executives; reviewing professional qualifications; preparing shortlist on criteria specified by the client; etc. could be provided when appropriate safeguards are in place. If the auditor cannot give the assistance requested without directly or indirectly participating in the client's decision to the appointment, he should decline to provide it.

8. Broker: Dealer, Investment Adviser, or Investment Banking Services

Having too close a business relationship with the client, for example through providing broker-dealer or investment advice or other investment banking services such as underwriting gives rise to self-interest threats, which are in practice too great to be overridden by possible safeguards. Using a principles-based approach, FEE would reach the same conclusion i.e. that a prohibition is the only appropriate safeguard.

9. Legal Services

FEE fully supports the basic principle that an auditor cannot serve in an advocacy role for the clients. However, legal services do not always include an element of advocacy. Following a principles-based approach, it is not necessary to prohibit all legal services. The auditor can perform legal services in particular circumstances where proper safeguards are in place to reduce the advocacy risk to insignificant levels or to mitigate it.

There is no definition at global level as to what is and what is not a legal service. This is primarily due to the existence of wide variations between countries.

The questions raised by the SEC demonstrate that the SEC appears to have noted that, for historical and cultural reasons, other countries may have an understanding of the role of legal advice which differs from that in the US. Hence, the question as to whether the provision of legal services to or acting in an advocacy role for an audit client impairs an auditor's independence can only be assessed by examining the legal framework within which that auditor operates or legal advice is provided. From a European point of view, the provision of legal advice does not a priori impair the independence of the statutory auditor for example because the auditor does not assume management functions or is not exposed to a significant self-review threat by a need to re-evaluate the advice as part of the audit.

Moreover, if a service is permitted in the US, it should not be prohibited in a non-US country as a result of the application of SEC rules simply because, due to local custom, it falls into another definition of a service that is prohibited by the SEC rules.

Furthermore, if an auditor is able to perform a service that could be classified as a legal service (e.g. advising on the application of Company Law) but without violating any provisions of national law (e.g. the service is not "reserved" to members of the legal profession) and without impairing his independence as an auditor, then there should be no prohibition of that service, neither should the auditor be prevented from receiving compensation on such services.

FEE supports the European Commission's Recommendation on Independence which prohibits the auditor from acting for a client in the resolution of litigation which involves matters that would reasonably be expected to have a material impact on the client's financial statements and a significant degree of subjectivity inherent to the case concerned.

10. Expert Services

The provision of expert services to an audit client does not necessarily mean that there is a significant threat to independence. In particular, the provision of expert services would not usually create a significant threat where it involves matters which are not expected by a reasonable and informed third party to have any material impact on the financial statements. It is wrong to presume that all expert opinions in legal, administrative or regulatory proceeding involve advocacy.

In considering whether the provision of expert services creates a significant self-review and/or advocacy threat, auditors need to evaluate the significance of the threat. To that end auditors need to consider factors such as:

- materiality of the amounts involved
- degree of subjectivity inherent in the matter concerned and
- nature of the engagement.

Even where the auditor takes a relatively active role, there can be specific situations, which are generally not regarded as compromising auditors' independence. Such a situation would include defending a particular accounting treatment accepted by the auditor, which is subject to an investigation by the Commission's Division of Enforcement.

In many countries, the nature of expert services (in particular expert witness work) differs significantly from the US environment.

FEE believes an auditor should not be generally prohibited from serving as a non-testifying expert for an audit client in connection with a proceeding as it is unlikely that the threat will be significant in such cases.

FEE believes that the definition of prohibited expert services is not appropriate. A prescriptive list of services provides no insight into the relevant threats and safeguards which auditors need to evaluate as it fails to consider the significance of any threat created. Such lists are inflexible and therefore cannot accommodate the many circumstances encountered in practice. As noted above, the provision of expert services to an audit client does not necessarily mean that there is a significant threat to the auditors' independence. Auditors, therefore, need to analyse the specific situation and their particular involvement in the provision of expert services. A principles-based approach provides a far more rigorous test of compliance as it requires auditors to demonstrate that, in the particular circumstances under consideration, the fundamental principles had in fact been observed; not merely that every example in an ethical code or set of independence rules had been addressed.

FEE believes that the distinction between advocacy and providing appropriate assistance to an audit committee is insufficiently precise. As noted above, the provision of expert services would not usually create a significant threat where it involves matters which are not expected to have any material impact on the financial statements. FEE fully supports the principles-based approach as endorsed by the European Commission's Recommendation on Independence, IFAC and IOSCO. This provides a framework for analysing threats and safeguards which auditors can use to determine appropriate courses of action.

11. Tax Services

Section 201 of the Act states that a registered public accounting firm may engage in any non-audit services, including tax services, that is not described in any paragraphs (1) through (9) of subsection (g) for an audit client, if the activity is approved in advance by the audit committee of the issuer.

This clearance for providing tax services to audit clients is emphasised by the wording of the introduction of section B "Services outside the scope of the practice of auditors". It is clear that Congress did not wish to ban all expert services because the Act specifically provided for an auditor to be able to perform certain services, including tax services, if the audit committee approves them in advance. In addition, Senator Oxley recently stated the following: "Any fair reading of the record of the debate in our committee, on the floor in the house as well as in the Sarbanes Committee and on the floor of the Senate, would indicate, quite the contrary, that indeed we did deal with that issue and basically determined that tax issues were part and parcel of the traditional audit function and that, frankly, there was no evidence in our hearings on Enron or WorldCom or Adelphia or any of the other companies that would indicate that somehow the tax function somehow was untoward to lead to the fraud that was uncovered".

In contrast to this position, chapter II.B.11 differentiates between different categories of tax services and states that the representation before the tax court and the formulation of tax strategies designed to minimise a company's tax obligations imply an impairment of the auditor's independence. In our

letter of 20 December 2002, we expressed our concerns regarding tax services in that the proposed rule and commentary go substantially beyond the Act. In that letter, we requested the SEC not to address tax services at all in the rules and commentary on the rules.

FEE agrees that tax services comprise a broad range of services, including the preparation of tax returns, tax compliance, tax planning, tax recovery, provision of formal taxation opinions and assistance in the resolution of tax disputes.

However, with respect to the three basic principles mentioned in the rule:

(1) the auditor cannot audit his or her own work
(2) the auditor cannot function as a part of management
(3) the auditor cannot serve in an advocacy role for the clients.

none of these services necessarily create threats to independence. The threat to independence is significant only where such work is material to the accounts audited and involves subjective judgement. This will often not be the case as computations are ultimately subject to review by the tax authorities and must comply with their rules. This assessment also applies to the representation of an audit client before the court and to the formulation of tax strategies which would neither impair nor appear to reasonable investors to impair an auditor's independence.

We support the SEC's statement that tax services are unique due to the existence of detailed tax laws that must be consistently applied and because the IRS has discretion to audit any tax return. There is implicit recognition in this statement that "safeguards" can exist to minimise the threat that the provision of a tax service could have on an auditor's independence. Therefore, it is not meaningful to categorise tax services into permitted and prohibited activities.

C. Partner Rotation

In our letter of 20 December 2002, we indicated that it is crucial that the global solution of IFAC in its Code of Ethics section 8 and the approach of the European Commission's Recommendation on Independence on internal partner rotation is accepted as equivalent – without extension of the period or the range of audit personnel involved.

Frequency of rotation

Rotation of partners can serve as a safeguard for auditor independence, but it can also be a threat to audit quality.

An audit partner, in determining the resources needed for an audit engagement, in allocating the resources to the various audit objectives, and in evaluating the information from the tests performed, needs to have a thorough understanding of the client's business, internal controls, and risk environment. Long professional experience, supported by academic studies, shows that an auditor runs a more serious risk of committing mistakes in these respects when the client is new than when the assessments can be based on feedback from previous years' audits. Some European countries have even introduced minimum terms of up to 6 years for audit assignments.

On the other hand, an audit partner who has held that position for many years may have developed personal relationships to the directors or the management of the audit client. Although, given the heavy risk for disciplinary consequences and litigation, it is unlikely that an auditor would consciously let such relationships influence the audit work, his/her professional judgement may be subconsciously affected to an extent that will be detrimental to the audit. Furthermore, if many years of audits have proven the internal control and the accounts to be flawless an audit partner may be less alert to audit risks.

The quality and independence implications therefore will have to be carefully balanced when determining the frequency of any compulsory partner rotation. Very probably, the resultant frequency will vary between different markets, depending on legal environment, business culture and traditions, and the availability of other safeguards for auditor independence than rotation. In the European Commission's Recommendation on Independence, based on the conditions prevailing in the European environment, the frequency has been determined to seven years. FEE would strongly recommend that this rule be accepted as a safeguard equivalent to the five-year rule that may be appropriate for US purposes.

Persons to include in the rotation requirement

In the Act the rotation requirements are applicable to the lead audit partner and the concurring review partner. This is logical, since those are the individuals whose professional judgement determine the outcome of the audit and who run the risk of committing, consciously or subconsciously, errors that may lead to a materially misleading audit report. The European Commission's Recommendation on Independence extends the requirement to other key audit partners. All of the other members of the audit team are responsible to the lead audit partner. In FEE's opinion it is unlikely that any of them would be in a position where misdirected loyalty or over familiarity with the client could affect the audit in a way contrary to the intentions of the lead audit partner without being detected by the quality control programme.

As indicated in the Proposed Rule, the need for continuity of appropriate expertise will necessitate a staggering of the rotation of partners. It is essential that, when a lead audit partner is rotated out, a successor with such expertise is available. Widening the group of individuals beyond what is set out in the Act will make that planning more difficult, and consequently compromise audit quality.

Forensic audits

FEE would strongly advise against using forensic audits as a general safeguard for the independence of the ordinary auditors. The arguments used in the proposed rule are hardly relevant to auditor independence. The concerns expressed would be better addressed by auditing standards. Moreover, the terminology "forensic" is unhelpful since it normally relates to fraud detection services. Furthermore, forensic audits would lead to disproportionate burdens to the business community.

Continuous evaluation of threats to independence

FEE would like to underline that the European Commission's Recommendation on Independence is based on the condition that threats to auditor independence are continuously evaluated. Therefore, if an audit or concurring partner, or any member of the audit team, *de facto* develops unduly strong relationships to the client, or shows signs of letting over familiarity with client systems weaken his or her professional judgement, safeguards have to be found regardless of any fixed rotation rules. An obvious safeguard could be to remove that individual out of the audit team.

D. Audit Committee Administration of the Engagement

It needs to be recognised that other jurisdictions than the US may have different corporate governance systems established in law. In Europe, the auditor is appointed by the general meeting of shareholders. In addition, we have as alternative systems to the one tier system, the two tiers system and the Italian system of collegio sindacale. Audit committees are not found in all these structures but other organs with similar functions could be identified. Therefore, for foreign jurisdictions, the audit committee function should be referred to rather than the audit committee itself. In Europe these legal requirements conflicting with the Sarbanes-Oxley Act may make it difficult for companies to comply with the audit committee pre-approval requirements for allowed non-audit services. The European

Commission's Recommendation on Independence, however, recognises the importance of the involvement of the client's governance body.

In Europe, the High Level Group of Company Law Experts[1] has at the end of last year published its reports on company law and corporate governance. It recognises that the audit committee (non-executive directors or supervisory board) should monitor non-audit services provided by the audit firm.

Taking into account the above legal constraints in Europe, we want to observe that if pre-clearance by the audit committee or a comparable organ were to be introduced, it should be sufficient that the audit committee lays down a purchasing policy. The audit committee's task would then be the monitoring of the implementation of the purchase policy.

E. Compensation

We agree that when audit partners would be compensated directly for non-audit services provided to the audit client, there is a clear self-interest threat. We could therefore support the thrust of the proposed rule.

However, taking this rule further would suggest that audit partners cannot be independent or objective if their remuneration or profit share is dependent on the audit fees received from the SEC registrant. Ultimately, all partners' income depends on the profitability of the firm, and this could be construed to mean that no partner could be independent or objective. It would be helpful if the SEC could elaborate on the overall principle it is seeking to apply here – that members of the audit team should not benefit directly from the provision of non-audit services to audit clients.

In addition, it should be clarified that the rule only may apply to direct compensation received from the same audit client. Audit firms may have worldwide or regional pools for participating auditors which include fees charged for non-audit services. These pools usually are funded by a great number of non-audit engagements with various clients. The auditor of a specific client has no relation at all with these clients. Therefore, the independence of the auditor as to his specific audit client is not impaired. For this reason, we urge that the proposed rule should not apply to auditor's compensation received from a pool.

H. Expanded Disclosure Principal Accountants Fees

The European Commission's Recommendation on Independence requires the disclosure of fee income by four categories:

- statutory audit services
- further assurance services
- tax advisory services
- other non-audit services

We support the idea that an auditor should be able to demonstrate that his independence has not been compromised by providing non-audit services to an audit client for which the remuneration he receives is significant.

While we support the proposed requirements to disclose the fee categories audit fees, tax fees, and all other fees, we do not consider the category "audit related fees" as appropriate because – although the SEC has included some examples of services, which the SEC considers to be audit related – it is unclear, which kinds of services this category will include. One of the characteristics of audit related services is their close nature to audit services. For example, it is not clear whether the assessment of

[1] Report of the High Level Group of Company Law Experts on a modern regulatory framework for company law in Europe (http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm)

the reporting entity's internal control system in the course of an audit of financial statements, will be subsumed under the category audit related services (SEC) or under audit (ISA).

We are of the opinion that the European Commission's Recommendation on Independence categorisation as above is a more appropriate classification.

I. Transition Period

FEE strongly believes that transitional arrangements cannot be a substitute for recognition of the equivalence of EU and national law, or different approaches to the same issue.

III. Conclusion

Our above comments enforce the views explained in our letter of 20 December that there should be deferral of rulemaking in respect of foreign registrants and that rulemaking should not go further than the requirements of the Sarbanes-Oxley Act. We strongly support an exemption for all EU auditors from the SEC proposed rule on audit independence since the European Commission's Recommendation on Independence should be recognised as being equivalent to the SEC proposed rule.

We would be pleased to discuss this letter with you.

Yours sincerely,

David Devlin
President

Encl. FEE Submission to the SEC of 20 December 2002