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Report on the Independence Quality Control Systems of the Four Reviewed Firms December 19, 2002

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**Transition Oversight Staff's
Report on the Independence Quality Control Systems
of the Four Reviewed Firms**

December 19, 2002

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Report on the Independence Quality Control Systems of the Four Reviewed Firms

To the Securities and Exchange Commission, Mr. Donald J. Kirk (the Independent Reporter), Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP:

We have reviewed the design, implementation, and operating effectiveness of the systems, procedures, and internal controls (the Systems and Controls) developed by Deloitte & Touche LLP (D&T), Ernst & Young LLP (E&Y), KPMG LLP (KPMG), and PricewaterhouseCoopers LLP (PwC) (the Firms) to provide them with reasonable assurance of compliance with the independence rules of the Securities and Exchange Commission (SEC), the American Institute of Certified Public Accountants (AICPA), the Independence Standards Board (ISB), and the SEC Practice Section (SECPS) of the AICPA (collectively, the Independence Rules). The reviews of the design, implementation, and operating effectiveness (the Reviews) covered the design and implementation of each Firm's Systems and Controls as of June 30, 2001, and their operating effectiveness during the six months ended December 31, 2001 (the Review Period). The purpose of the Reviews was not to report violations of the Independence Rules or to provide a basis for an evaluation of the integrity and objectivity of the Firms and their partners and staff in the course of performing attest services for the Firms' clients.

This report is organized as follows:

1. a description of the context in which the Reviews took place,
2. a description of the standards against which each Firm's Systems and Controls were reviewed and the elements of each Firm's Systems and Controls that are related to those standards,
3. a description of the scope and methodology of the Reviews and the work performed,
4. an evaluation of whether the design, implementation, and operating effectiveness of the Firms' Systems and Controls provided each of the Firms with reasonable assurance of its compliance with the Independence Rules, and
5. appendices that:
 - a. describe deficiencies that were found in a Firm's Systems and Controls,
 - b. identify recommendations to the SEC and the SECPS based on the results of the Reviews,
 - c. describe "Best Practices" identified during the Reviews,
 - d. describe the elements of each Firm's Systems and Controls,
 - e. provide data about each Firm's U.S. practice, including lines of business, and the approximate number of partners and other professionals covered by the Independence Rules, and
 - f. contain each Firm's response to the deficiencies that were found in the Firm's Systems and Controls.

The Context in Which the Reviews Took Place

In June 2000 the SEC announced that it and the Firms had agreed to a “Term Sheet for Independence Look-Back Testing Program” (Term Sheet), which called for the Firms to participate in “look-back” testing of their compliance with certain independence requirements. Under that program, the Firms received safe-harbor protection from enforcement action by the SEC for all but the most serious “financial interest” violations specified by the program. The Term Sheet required the Firms to retain independent counsel to oversee the reviews, and to disclose violations to the SEC and to the audit committees of the Firms’ clients that were affected by the violations. The purposes of the look-back reviews were to examine the investments held by certain of the Firms’ partners and professional staff and by the Firms themselves over a specified period (nine to twelve months) and to determine whether those individuals, their immediate family members, or the Firms held prohibited financial interests in audit clients and affiliates of audit clients of the Firm. Those reviews were completed and their results were reported to the SEC by July 16, 2001.

The Term Sheet also stated the following:

- Systems and Controls. Firms would continue to implement the systems, procedures, and internal controls relating to independence set forth by the Commission’s Chief Accountant, in letters to Michael Conway, Chairman of the SEC Practice Section Executive Committee, dated December 9, 1999 and May 1, 2000, with implementation to be completed no later than January 1, 2001.
 - Firms would submit to review and oversight by the POB [Public Oversight Board] of the effectiveness of the design and implementation of these systems, procedures, and internal controls, and to testing by the peer reviewers or the POB of their effectiveness. If the testing is performed by a peer reviewer, the POB shall have oversight of the peer review. Firms would agree to cooperate with the POB in such review and oversight. The POB would issue public written reports with respect to (i) the design effectiveness and implementation of these systems, procedures, and internal controls as of January 1, 2001 and (ii) the testing and evaluation of their operating effectiveness during the six-month period ending June 30, 2001. Such reports will not disclose violations.

On March 31, 2002 the POB terminated its existence. On April 12, 2002 a Memorandum of Understanding (MOU) was agreed to by the SECPS Executive Committee, the AICPA, the staff of the SEC, and the staff of the former POB, which on April 1, 2002 began functioning as the Transition Oversight Staff (TOS). The MOU described the agreement that the Firms, the SEC staff, the TOS, and the Independent Reporter reached relating to the Reviews by the TOS of the Systems and Controls, the oversight and reporting on the TOS’s Reviews by the Independent Reporter, and the SEC staff’s access to documents relating to the Reviews. (The full text of the MOU is on the TOS website at www.oversightstaff.org.) Key aspects of the MOU with respect to the Reviews, are as follows:

1. The TOS will have the responsibility for conducting and reporting on the Reviews.
2. The Reviews will be conducted in accordance with work programs developed by the TOS.
3. The Reviews will cover design and implementation of the Systems and Controls as of June 30, 2001 and their operating effectiveness during the six months ended December 31, 2001.
4. The standards governing the Reviews will be the Independence Rules and the independence quality control provisions of the SEC's rules, Statement on Quality Control Standards No. 2, the ISB, and the SECPS membership requirements.
5. The TOS will assign at least two senior TOS employees or consultants, referred to as the "Assigned Team," to each Review to perform tests of the design and implementation of the Systems and Controls.
6. The TOS will engage independence experts, including experts from the reviewed Firm's peer reviewers, to perform tests of operating effectiveness pursuant to the TOS's work programs. The TOS will define, supervise, and assume responsibility for the work performed by the independence experts.
7. The TOS will assign specific employees or consultants, referred to as "Element Experts," to each of the elements of the Systems and Controls to ensure consistency of approaches across the Firms as to the nature and extent of the work to be performed and the fairness of the evaluation of the specific elements of the Systems and Controls. (Individuals who served on an Assigned Team also served as Element Experts.)
8. The TOS will issue one report, which will include the matters listed in the first paragraph of this report.
9. Donald J. Kirk will serve as the Independent Reporter to oversee the TOS's activities in connection with the Reviews and will issue a report as to whether the process followed by the TOS in conducting the Reviews was properly designed and performed and whether the results of the Reviews have been appropriately assessed and reported by the TOS.

The design, implementation, and operating effectiveness of a Firm's Systems and Controls are the responsibility of the Firm. Our responsibility is to evaluate and report on whether the Systems and Controls developed by each Firm for compliance with the Independence Rules, taken as a whole, were effectively designed and implemented as of June 30, 2001 and operated effectively during the six months ended December 31, 2001 to provide the Firm with reasonable assurance of complying with the Independence Rules during that period.

Standards for and Elements of Independence Quality Control Systems

A Firm's Systems and Controls encompass the organizational structure, policies, procedures, and internal controls specified by the Statements on Quality Control Standards issued by the AICPA, the membership requirements of the SECPS, ISB Standard No. 3, *Employment with Audit Clients*, and SEC Rule 2-01(d)(4) of Regulation S-X and established by the Firm to provide it with reasonable assurance of complying with the Independence Rules. For purposes of the Reviews, we identified the essential features of those Systems and Controls, and classified them into ten elements:

1. written independence policies and procedures,
2. automated tracking system and restricted entity list,
3. independence training,

4. internal monitoring of independence Systems and Controls,
5. senior management and others responsible for independence Systems and Controls,
6. “tone at the top” and culture relating to independence,
7. prompt reporting of personnel employment negotiations,
8. reporting by personnel of apparent independence violations,
9. disciplinary policies, and
10. independence quality controls of the Firms relating to foreign associated firms, as set forth in the SECPS membership requirements.

In addition, because of heightened concerns arising from certain publicly-reported alleged violations of the Independence Rules that came to our attention during the course of our Reviews, we developed an eleventh element – Systems and Controls relating to business relationships and alliances, commissions, and contingent fees – and expanded our planned tests of the design, implementation, and operating effectiveness of Systems and Controls that addressed the Independence Rules applicable to that element.

Scope, Methodology, and Work Performed

The Reviews took place between May and December 2002. In accordance with the MOU, the Reviews were conducted by senior TOS employees and consultants, and by independence experts engaged by the TOS from the reviewed Firms’ peer reviewers. The consultants used in the Reviews consisted of a partner in an accounting firm not undergoing a Review who has information technology systems expertise, seven retired partners of three of the four Firms whose Systems and Controls were reviewed, and an educator who at various times from 1962 through 1993 had been an employee of or consultant to two of those Firms and who is the co-author of several editions of a book with partners of one of those Firms. No consultant was used as a member of an Assigned Team on the Review of a Firm with which he had a former affiliation. In their capacity as Element Experts and in order to achieve the objectives of employing Element Experts described above, certain consultants by necessity participated in the Reviews of Firms where they had a former affiliation; however, the work of the Element Experts and their evaluations were overseen by the Assigned Team, who had overall responsibility for the evaluations made and conclusions reached with respect to the Firm to whose Review they were assigned.

The Executive Director of the TOS is a retired partner of one of the Firms. Prior to assuming his position with the TOS he served in the same capacity with the POB from 1989 to that Board’s termination in 2002. As specified in the MOU, the Reviews were overseen by the Independent Reporter, who has no financial ties to any of the Firms, having resigned from one of them almost 30 years ago when he joined the Financial Accounting Standards Board. The MOU specified that the costs of the Reviews would be borne by the four Firms.

The Independent Reporter (a) participated in all TOS meetings that involved planning for the Reviews, including staffing decisions, and training of the reviewers; (b) observed, on a test basis, the on-site performance of the Reviews and participated in meetings with personnel at each of the Firms; (c) reviewed the TOS’s work programs and the working papers underlying the planning and performance of and reporting on the Reviews; (d) observed the TOS’s process of compiling and evaluating its findings and preparing its report; and (e) was present at the final meetings of the TOS and the senior management of each Firm to discuss this report. The conclusions of the Independent Reporter can be found in his accompanying report.

The Reviews were conducted in accordance with the MOU and included procedures to plan and perform the Reviews that are summarized below. The Reviews would not necessarily disclose all weaknesses in the design, implementation, and operating effectiveness of a Firm's Systems and Controls, since they were based on selective tests. Also, projection of any evaluation of a Firm's Systems and Controls to future periods is subject to the risk that the Systems and Controls may become inadequate because of changes in conditions, or that the degree of compliance with the Systems and Controls may deteriorate.

To plan the Reviews, the TOS obtained an understanding of each Firm's Systems and Controls as of June 30, 2001. Based on that understanding, the TOS developed work programs for each of the eleven elements of Systems and Controls. The work programs specified the information to be obtained and the nature and extent of the tests to be performed to evaluate the effectiveness of the design of each Firm's Systems and Controls, to determine whether they were implemented, and to evaluate their operating effectiveness.

The effectiveness of the design of a Firm's Systems and Controls relates to whether those Systems and Controls, if they were implemented and operated effectively, would achieve the objective of providing the Firm with reasonable assurance of compliance with the Independence Rules. The TOS obtained information about the design of each Firm's Systems and Controls relating to each element through inquiry, observation, and reading documents prepared by the Firm. The TOS evaluated design effectiveness by considering whether the design of the Systems and Controls would accomplish that objective.

Implementation of a Firm's Systems and Controls relates to whether they were placed in operation, that is, whether the Firm was using them. Effective operation of a Firm's Systems and Controls relates to how they were applied, whether they were applied consistently and continuously throughout the period, and by whom they were applied. The TOS tested for implementation and operating effectiveness concurrently, by assessing whether the Firm's Systems and Controls for each element operated consistently and continuously throughout the period in the way they were intended to operate. The TOS's tests involved inquiry, observation, inspection of records and reports, and, when appropriate, reperformance of procedures performed by the reviewed Firm. Before concluding the Review of each Firm's Systems and Controls, the TOS reassessed the adequacy of the scope of the Review and conducted an exit interview with Firm management to discuss its findings and recommendations.

While our evaluation of the operating effectiveness of the Firms' Systems and Controls is limited to the six months ended December 31, 2001, our work programs at times required us to consider certain changes made by the Firms in 2002 in one or more of their Systems and Controls. For example, in the process of evaluating the extent to which a Firm identified the need for and appropriately developed new or changed independence policies and procedures on a timely, complete, and accurate basis in response to new or changed Independence Rules, we considered changes in those policies and procedures and the Firm's related training materials resulting from changes in the Independence Rules that became effective in 2002. We believe that our consideration of those kinds of changes in the Firms' Systems and Controls was necessary to generate evidence that is relevant to our evaluation of the operating effectiveness of the Firms' Systems and Controls during the six months ended December 31, 2001.

Basis for Evaluating the Firms' Systems and Controls

Specific requirements for quality control systems over auditor independence – referred to in this report as Systems and Controls – are a recent phenomenon. The requirements that were introduced starting in 2000 mandated sophisticated Systems and Controls, particularly for electronically tracking the investments of partners and managers and identifying those investments that might impair independence. Before the introduction of those requirements, there was considerable diversity among the Firms regarding their Systems and Controls. Some Firms were more advanced than others in certain of the elements that comprised their Systems and Controls. As a result, the Firms had to expend varying amounts of effort and resources to meet the new requirements.

Our Reviews indicate that D&T, E&Y, KPMG, and PwC each have committed significant financial and personnel resources to develop, maintain, and enhance Systems and Controls consisting of the eleven elements described earlier in this report, for the purpose of providing each Firm with reasonable assurance that both the Firm itself and its partners and other professionals are in compliance with the Independence Rules.

As noted in Appendix D, the eleven elements of a Firm's Systems and Controls are interrelated and complement, as well as supplement, each other. For example, a Firm's restricted entity list and automated tracking system, which consume a major share of the resources a Firm dedicates to compliance with the Independence Rules, by themselves provide some assurance that professionals have not purchased prohibited investments. That level of assurance is significantly increased if the tracking system is accompanied by a Firm culture that elevates the importance of independence to the highest level, if there are clearly written policies that cover prohibited investments and the use of the Firm's tracking system, if professionals are well-trained in those policies, if the investments of partners and managers are subject to audits that test whether they complied with Firm policies, and if violations that are discovered by those audits result in meaningful disciplinary sanctions. Because the elements of a Firm's Systems and Controls are interrelated and complementary, our evaluation addresses whether each Firm's Systems and Controls, taken as a whole, provide reasonable assurance that the Firm and its partners and other professionals are in compliance with the Independence Rules.

Our evaluation of the effectiveness of each Firm's Systems and Controls, taken as a whole, in providing it with reasonable assurance of complying with the Independence Rules was necessarily subjective. In making that evaluation, we considered deficiencies in a Firm's Systems and Controls, both individually and in the aggregate, to determine whether they rose to a level that would have warranted a modification of the opinion expressed below with respect to any of the Firms. In making that determination, we considered the following factors:

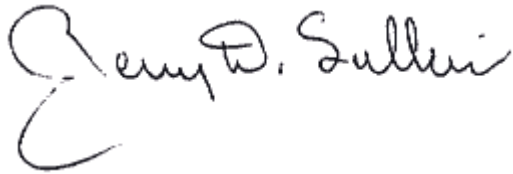
- whether a deficiency in a Firm's Systems and Controls involved a control that would directly prevent or detect specific activities and relationships that are violations of the Independence Rules
- whether a deficiency in a Firm's Systems and Controls actually failed to prevent or detect violations of the Independence Rules
- the number of violations of the Independence Rules that actually resulted or could result from a deficiency in a Firm's Systems and Controls
- the length of time that any violations resulting from a deficiency in a Firm's Systems and Controls remained uncorrected

whether violations resulting from a deficiency in a Firm's Systems and Controls were dealt with appropriately, including, when required, being communicated to the appropriate parties
whether a deficiency in a Firm's Systems and Controls resulted from the failure of senior management or others responsible for independence to take appropriate action
whether a deficiency in a Firm's Systems and Controls persisted beyond a limited period of time related to transitioning to the implementation of new, more restrictive Independence Rules
the total number of deficiencies in a Firm's Systems and Controls
whether a deficiency in a Firm's Systems and Controls was mitigated by complementary controls, compensating controls, and other factors

Evaluation of the Firms' Systems and Controls

After considering the matters and factors identified in the "Basis for Evaluating the Firms' Systems and Controls" section of this report, we believe that the deficiencies set forth in Appendix A of this report, while requiring prompt corrective action, do not, either individually or in the aggregate, warrant a modification of our opinion with respect to any of the Firms.

In our opinion, the Systems and Controls, taken as a whole, developed for compliance with the Independence Rules by D&T, E&Y, KPMG, and PwC were effectively designed and implemented as of June 30, 2001 and operated effectively during the six months ended December 31, 2001 to provide each Firm with reasonable assurance of complying with the Independence Rules during that period.

A handwritten signature in cursive script that reads "Jerry D. Sullivan". The signature is written in dark ink and is positioned above the typed name and title.

Jerry D. Sullivan
Executive Director
Transition Oversight Staff

December 19, 2002

Appendix A: Deficiencies in Systems and Controls

This Appendix describes deficiencies that were found in the Firms' Systems and Controls that warrant prompt corrective action by the managements of the respective Firms to enhance the design or operating effectiveness of the Firms' Systems and Controls. These deficiencies have been communicated to the respective Firms, and their responses comprise Appendix F.

Deloitte & Touche LLP

Our Review identified the following deficiencies that warrant prompt corrective action.

1. Deloitte Consulting LP (DC) (an entity associated with D&T for purposes of the Independence Rules) developed a computerized independence training program in 1999 that was intended to identify electronically both DC client service personnel who had completed the training program successfully and those who had not. A software change made at some point in 2000 resulted in inconsistent and incomplete recording of training completed by DC client service personnel. As a result, there is no record of whether certain DC client service personnel had completed training.

Although D&T and DC are unable to provide assurance that all DC client service personnel received independence training, DC has provided evidence of steps it took to inform all of its principals and managers about the Independence Rules and D&T's policies. For example, during the autumn of 2001 DC issued a series of electronic messages to its professionals that focused on the need to comply with the Independence Rules and D&T's policies generally, and specifically on contingent fees and business alliances, matters that could create independence issues for D&T. In addition, DC has risk managers who are knowledgeable about compliance with the Independence Rules and who review proposed contracts for various risks, one of which is the risk of violating the Independence Rules. Nevertheless, the Systems and Controls of D&T and DC did not provide reliable evidence that all DC client service personnel had completed independence training by December 31, 2001.

2. Neither D&T nor DC had a written policy (but the TOS was told that they had a practice) that required notification to the lead client service partner (LCSP) responsible for a restricted entity of all (a) nonaudit services proposed to be provided to the entity either by D&T or DC, and the related fee arrangements, and (b) proposed business relationships with the client either by D&T or DC, to ascertain whether the proposed services, fee arrangements, and business relationships violated the Independence Rules and D&T's policies. In addition, D&T did not have a written policy requiring the LCSP to document his or her evaluation of the independence implications of nonaudit services, fees, and business relationships. As a result, D&T did not have documentation to permit monitoring the LCSP's discharge of his or her responsibility to evaluate the relevant independence implications of services provided by D&T or DC to restricted entities.
3. D&T's policies required that a retired partner or principal consult with the Firm before taking a position with a restricted entity. However, the Firm's policies encouraged, but did not also require, a former partner or principal who was not a retiree, but who had an

unsettled financial interest in either D&T or DC, to consult with the national independence office when he or she accepted a position with a restricted entity.

4. D&T's policies relating to possible employment of a professional by a client were not updated to include all of the procedures required by ISB Standard No. 3, *Employment with Audit Clients*. The policies did not require a professional to report discussions or conversations with the client related to employment, which may occur earlier in time than an offer is made or employment is sought. Furthermore, the policies did not require (a) the review of the professional's work on the engagement if he or she declined the client's employment offer and (b) consideration of the potential need to modify the audit plan and to execute a separate review of the next annual audit.
5. D&T's quality control policies and procedures for independence required that independence representations be obtained for newly hired experienced professionals and professionals transferring between offices. During the course of our review, we noted instances where some of these representations were not obtained or were not obtained in a timely manner. In all instances, subsequent representations were obtained, and no violations of the independence requirements were noted.
6. In December 2000 the SEC issued significant new rules related to independence, including several more restrictive requirements relating to direct financial interests of covered persons. These aspects of the new rules were effective in May 2001. D&T's quality control policies and procedures for independence are communicated to its professionals in a variety of ways, and reinforced through its training programs. Although D&T issued updated policies regarding the items in the revised independence rules that were more restrictive than previous policies, in the form of a memorandum to all professionals, D&T did not update its related training programs in a timely manner.
7. D&T's policies required the imposition of discipline for violations by professionals of the Independence Rules or Firm policies. During the Review Period, D&T documented formal disciplinary actions taken against certain professionals for violations that occurred prior to the Review Period. However, no formal disciplinary actions have been imposed on professionals who were found to have violations during the Review Period.

Ernst & Young LLP

Our Review identified the following deficiencies that warrant prompt corrective action.

1. New, more restrictive SEC independence rules relating to the settlement of capital and retirement interests of former firm professionals who join firm audit clients as officers or directors became effective in May 2001. E&Y amended its policies and notified both active and retired partners of these rule changes on a timely basis. In making the transition to the new rules, however, a limited number of situations occurred in which balances owed to former partners were not liquidated, or their retirement obligations were not settled, before they joined SEC audit clients as officers or directors. Some of those instances were not communicated in writing to those clients pursuant to ISB Standard No. 1, *Independence Discussions with Audit Committees*.
2. The SECPS membership requirements stipulate that a firm should develop, as part of its policies, guidelines for actions to be taken against professionals for independence violations, and that the policies should describe the potential sanctions to be levied against those who do not comply with the firm's policies and procedures or professional independence requirements. E&Y's sanctioning guidelines dealing with independence violations by professionals were informal and, although they were distributed to managing partners and others for their use in applying sanctions, the guidelines were not communicated to all professionals.
3. The Firm's policy relating to possible employment of a professional by a client did not explicitly require the professional to report conversations or discussions with the client, as required by ISB Standard No. 3, *Employment with Audit Clients*. The policy required that a professional notify the Firm if the professional is offered employment with a client, which may be later than a conversation or discussion. The policy complies in all other respects with ISB Standard No. 3, however, and states that professionals may not seek employment with a proscribed entity while participating in an engagement requiring independence.

KPMG LLP

Our Review identified the following deficiency that warrants prompt corrective action.

1. The SECPS membership requirements specify that a firm's monitoring system include procedures to ensure that information received from its U.S. partners and managers about their investments is complete and accurate. Those procedures involve auditing, on a sample basis, selected information such as partners' and managers' brokerage statements. During the Review Period, the Firm focused its audits on the completeness and accuracy of investment information provided by 30 partners and managers with previous violations. While the various quality control standards do not specify the number of audits that should be conducted, we believe that more than 30 audits are warranted for a firm of KPMG's size.

In the six months subsequent to the Review Period, the Firm commenced 165 audits covering either investments of partners and managers or the timeliness of entries in the Firm's tracking system by other Firm professionals. The Firm also commenced expanded audits (covering loans, credit cards, and insurance) of twelve partners. We believe that a greater number of expanded audits is warranted for a firm of KPMG's size.

In addition, documentation of the work performed in the Firm's audits of partners and managers should be improved by expanding audit programs to cover all procedures actually performed and more adequately documenting the performance of those procedures and related judgments and conclusions, as well as reasons for not completing any audit step. Additional audit procedures should be performed to identify whether there are prohibited financial interests underlying investments in partnerships and insurance products.

In its letter of response included in Appendix F, KPMG indicates that the 300 expanded audits it performed pursuant to the Look-Back Testing Program, covering the period July 1, 1999 to March 31, 2000, meet the requirements of Appendix L of the SECPS membership requirements; we do not agree. Audits under the Look-Back Testing Program were performed pursuant to a June 2000 agreement with the SEC and covered a period that predated the effective date of the Appendix L SECPS membership requirement.

PricewaterhouseCoopers LLP

Our Review identified the following deficiencies that warrant prompt corrective action.

1. The Firm has over 100 individuals, including partners, who devote a substantial portion of their time to responsibilities related to the eleven elements of the Firm's Systems and Controls, including systems development work on the automated tracking system. As described in this report, the eleven elements of a Firm's Systems and Controls are interrelated and complement, as well as supplement, each other, thereby requiring close coordination among those responsible for components of the Firm's Systems and Controls. We believe that the day-to-day coordination and oversight of individuals with responsibilities for the components of the Firm's Systems and Controls were insufficient and contributed to some of the other deficiencies set forth below. This deficiency could be corrected by the Firm's risk management leader assigning a senior level partner on a full-time basis with the requisite authority and responsibility to perform these functions.
2. The Firm's audit engagement teams have primary responsibility for identifying as restricted those securities issued by audit clients and their affiliates that are on the master securities list, by reviewing and updating that list with respect to their clients five times a year (during each of the three quarterly reviews, during planning, and during the year-end audit). However, there has been no comprehensive review by the Firm's national independence office of engagement teams' identification of securities issued by audit clients and their affiliates as restricted. As a result, we identified certain securities that should have been marked restricted, but were not. The majority of these securities were debt securities; debt securities represent a small percentage of the total securities held by the Firm's partners and managers. No independence violations involving covered persons were observed with respect to the unmarked restricted securities that we identified during our Review. Nevertheless, the absence of a comprehensive review of the engagement teams' identification of restricted securities increases the risk that the Firm's professionals could acquire securities that are proscribed under the Independence Rules.
3. Mandatory monitored training on independence matters related to scope of services, business relationships, and fee arrangements was not developed and available until April 2002. Previously, training had been offered on these independence matters to some professionals based on the relevance of such matters to their line of service, level, and job responsibilities. However, such training was not monitored and was only delivered to a limited number of professionals. Lack of mandatory monitored training before April 2002 on scope of services, business relationships, and fee arrangements is somewhat mitigated by the Firm's extensive consultation resources (both at the national level and the line-of-service level) and the comprehensive control policies and procedures for each line of service.
4. The Firm has developed comprehensive and clearly written independence policies. However, such policies were contained in a number of documents, none of which represented a complete collection of the Firm's current policies. As a result, we found that the policies taken as a whole were difficult to navigate and some individual policies were difficult to access if one did not know where to look. Some of the policies were on the Firm's independence website, while others were in databases maintained by the Firm's various lines of service, some of which were not linked to the independence

website. In addition, the Firm's independence policies and guidance contained certain obsolete materials that were not eliminated when professionals were informed about new or amended Independence Rules. The failure to eliminate the obsolete material increased the risk that individuals might make inappropriate decisions with respect to compliance with the Independence Rules.

5. The Firm's policy relating to possible employment of a professional by a client requires a professional to immediately notify the Firm when the professional is offered or seeks employment with the client during an audit of the client and to immediately remove himself or herself from the engagement. The Firm's policy differs from ISB Standard No. 3, *Employment with Audit Clients*, which requires Firm professionals promptly to report conversations between themselves and an audit client respecting employment, without regard to whether the professional is offered or seeks employment and without regard to whether the conversations occurred during the performance of an audit of that client. Otherwise, the Firm's policy complies with ISB Standard No. 3.

Appendix B: Recommendations to the SEC and the SECPS

As indicated in the body of this report, the elements of a Firm's Systems and Controls are based on the organizational structure, policies, procedures, and internal controls specified by Statements on Quality Control Standards issued by the AICPA, the membership requirements of the SECPS, ISB Standard No. 3, and SEC Rule 2-01(d) of Regulation S-X. In several instances, we found that the SEC's independence rules and the standards for independence quality control systems contained in the SECPS membership requirements may not have been sufficiently specific and definitive to support their consistent application among the Firms, as a result of which there were wide variations in practice. This Appendix discusses those matters and presents recommendations to standard setters.

Recommendations to the SEC

1. The SEC's independence rules define a "covered person" to include any "partner, principal, or shareholder from an 'office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit." It is unclear, however, whether that means the office to which the partner is assigned, the office where the partner does most of his or her work on the audit, or the office where most of the work on the audit is performed, and we observed diversity among the Firms in that regard. We recommend that the SEC clarify that aspect of the definition of a covered person.
2. Rule 2-01 of Regulation S-X states that parents and subsidiaries of an audit client are "affiliates" of the audit client, regardless of materiality. However, the SEC also retained a portion of the Codification of Financial Reporting Policies that suggests that a materiality threshold may be used with respect to nonclient parents and subsidiaries. We observed that some Firms use a materiality threshold for parents and subsidiaries. We recommend that the SEC clarify whether a materiality threshold applies with respect to parents and subsidiaries of audit clients.

Recommendations to the SECPS

1. With respect to independence training:

The SECPS membership requirements specify that professionals performing services for clients complete training on the Independence Rules near the time of their initial employment and periodically thereafter. The SEC's independence rules relating to quality control systems refer to annual or ongoing training programs. The Firms' interpretation of "periodic" and "ongoing" has led to wide divergence in the frequency of independence training provided to professionals.

We recommend that the membership requirement be amended to interpret "periodic" and "ongoing" as no less frequently than annually. We further recommend that the annual training cover at least the following:

- New or revised Independence Rules or other changes in the firm’s independence policies or guidance
 - Recent SEC enforcement actions and litigation involving auditor independence
 - Recent firm consultations involving independence matters that may provide useful guidance to other professionals
 - Problem areas involving compliance with the Independence Rules that have been identified by the firm’s Systems and Controls and by the firm’s inspection program
 - Disciplinary actions taken by the firm relating to independence
2. With respect to internal monitoring of Systems and Controls:

The SECPS membership requirements specify that a firm’s monitoring system “should include procedures to provide reasonable assurance that *(i) investments of the member firm and its benefit plans are in compliance with the member firm’s policies* and *(ii) information received from its partners and managers is complete and accurate*. The monitoring system will generally include auditing, on a sample basis, selected information such as brokerage statements, *or alternative procedures that accomplish the same objective.*” (Italicized text indicates requirements added on October 10, 2001 with an effective date of January 1, 2002.) The requirements do not specify the basis for determining the number of partners and managers to be audited, the period to be covered by the audits, the timeliness of the audits, the matters to be covered in the audits, the information (beyond brokerage statements) to be obtained as sources of evidence in the audits, or the appropriate documentation of the work performed. In addition, the requirements do not specify that the investments of a firm’s foundation(s) should be in compliance with the firm’s policies and that they should be audited at least annually. As a result, the Firms’ practices varied with respect to these matters.

We recommend that the monitoring requirement be amended as follows:

- Each of the four largest firms should audit a minimum of 160 to 180 partners and managers annually. (The recommended number was derived from the AICPA Audit Guide, *Audit Sampling*, Appendix A, Table A.2, “Statistical Sample Sizes for Test of Controls – 10 Percent Risk of Assessing Control Risk Too Low,” using an expected deviation rate [noncompliance with the SEC independence rules] of 2.5 percent and a tolerable error rate of 5 percent.) Consideration by each firm of various risk factors should affect the specific partners and managers selected for audit.
- The period covered by the audits should be a minimum of 90 days.
- The matters to be covered in the audits should include banking relationships (both loans and deposits), brokerage relationships, credit card relationships, and insurance products, as well as investments.
- The information initially requested of the professional being audited should include copies of relevant portions of the most recent federal income tax return, brokerage statements, and, if applicable, bank statements, loan documents, credit card statements, and evidence underlying insurance policies.
- The information requested from the professional being audited ordinarily should be received within 60 days of the end of the period selected for audit. Audits ordinarily should be completed within 120 days of the end of the period selected

for audit. The results should be summarized, analyzed, and reported for disciplinary consideration ordinarily within 150 days of the end of the period selected for audit.

- All of a firm's investments, including but not limited to those of its subsidiaries, pension plans, foundations, and captive insurance companies, should be in compliance with the firm's independence policies and audited on a sample basis at least once a year.
- Appropriate audit documentation and related retention requirements should be specified.

3. With respect to disciplinary policies:

The membership requirements with respect to disciplinary actions to be taken against professionals for violations of the Independence Rules should explicitly obligate each firm to describe and communicate to all professionals the range of sanctions to be levied for specific types of violations and repeat offenses. The requirements should specify that all identified violations related to independence, including those of firm policies that are more restrictive than the Independence Rules, should be reported to the individual or group responsible for applying sanctions. Violations to be considered for disciplinary action should include instances of noncompliance with the Independence Rules or firm policy at the engagement level. The application of sanctions should be timely, taking into consideration the time needed to complete the audit process, evaluate violations, and provide due process to the individual involved.

4. With respect to consultations:

The SECPS membership requirements state that consultation policies “should address the documentation of consultations that involve significant accounting and auditing matters. If consultation occurs on a significant accounting or auditing matter, the auditor should follow the guidance in Statement on Auditing Standards No. 96, *Audit Documentation*, and document the matter, the action taken to address the matter, and the basis for the final conclusion reached. Both the lead audit engagement partner and the appropriate member(s) of the consultation network should be provided with the documentation in accordance with firm policies.”

The Firms' policies differ regarding whether all the parties to a consultation must approve the documentation, thereby signifying their understanding of the facts and their agreement with the conclusions reached.

We recommend that the membership requirements be amended to:

- Explicitly cover consultations on independence matters.
- Require that the parties to significant consultations approve the documentation and that the documentation of any engagement-related consultation be included in the engagement's working papers.

5. With respect to unit investment trusts, hedge funds, and variable annuities:

Under the SEC's independence rules, products such as unit investment trusts, hedge funds, and variable annuities in some circumstances may need to be assessed for investment restrictions by looking through the products to the underlying investments. We observed diversity among the Firms with respect to the monitoring of such products on their restricted entity lists and in policy requirements to include those products in individual investment portfolios, as well as diversity with respect to the information being monitored (i.e., the product sponsor, the product itself, or the underlying investments).

We recommend that further guidance be provided with respect to these products, including a determination of whether to treat the underlying investments as potentially restricted, the attributes to be monitored, and, possibly, prohibitions against investing in such products if it is determined that there is no practical means for either the holder or the Firm to monitor on a timely basis activity in the underlying investments (e.g., changes in relative value, new investments, and issuers of underlying investments becoming clients of the Firm).

Appendix C: Best Practices Identified During the Reviews

This Appendix describes “Best Practices” that the TOS identified during the Reviews that it suggests the Firms consider adopting. The TOS recognizes that the Firms need to evaluate the costs and benefits, which often are intangible and difficult to quantify, of adopting these suggestions.

Element 1: Written Independence Policies and Procedures

1. Update the principal independence policy document at the same time that policies are updated in other documents; at a minimum, insert a reference to the updating policy document in the principal policy document. Date the changed paragraphs in the principal independence policy document to help ensure that users have the latest policy dealing with a matter.
2. Require that if two or more of the Firm’s professionals jointly acquire a financial interest in a closely held investment, regardless of its form, the investors execute a formal buy-out purchase agreement that permits the prompt elimination of a potential independence problem if one of the investors is later employed by a restricted entity.
3. Provide guidance on dealing with mortgage brokers to indicate that particular care should be taken to not originate or refinance a mortgage loan with a broker that is a restricted entity even if it is known that the loan will be immediately sold to a nonclient. In addition, provide guidance to indicate that when dealing with a nonproscribed broker, reasonable inquiries should be made regarding the loan’s originator (i.e., the party making the loan).
4. Require that professionals notify the Firm’s national independence office, through the automatic tracking system or otherwise, of relatives who are employed by or are directors of a restricted entity. The information provided should enable the national independence office and others to assess whether, as a result of having an accounting role or a financial reporting oversight role, the relative is in an audit sensitive position or in a position to influence the financial reporting of the entity, and whether the potential exists for the relative to move into such a position. Information provided should also include the professional’s knowledge, if any, about the relative’s financial interest in the restricted entity. The information submitted should be shared with the partner in charge of the audit engagement, the partner in charge of the business unit, and the area senior technical partner for their use in helping to ensure adherence to the Independence Rules.
5. Prohibit investments by partners and other professionals in unit investment trusts and other investment vehicles that could hold securities issued by restricted entities because of the difficulty in tracking whether those vehicles have investments in restricted entities.
6. Include in the Firm’s independence policy detailed guidance (which may take the form of a matrix) to assist professionals in analyzing investor and investee relationships relating to auditor independence. Include in this guidance situations in which there are (a) both material and immaterial indirect financial interests involving clients, and nonclients that may be restricted entities because of a relationship with a client, and (b) relationships between clients and nonclients involving majority control of one entity by the other,

involving the presumed ability of one entity to exercise significant influence over the other, and no ability of either entity to exercise significant influence over the other.

Element 2: Automated Tracking System and Related Entity List

1. Maintain a “reverse restricted entity” list that identifies nonclient entities with which the Firm has a borrowing or other business relationship that would alert the Firm to not provide attest services to the entities or their affiliates.
2. Include in engagement audit programs a procedure requiring each professional working on an attest engagement to confirm in writing his or her independence of the client and its related entities. Also, during the first audit cycle after a new SEC audit client is accepted, obtain a written independence confirmation from each professional providing services of any type to the client before the professional begins work on an engagement.

Element 3: Independence Training

1. Develop and present mandatory monitored training course modules, including examinations, dealing in depth with independence requirements in specific areas of activity (e.g., a module for firm administrative personnel and outside investment managers dealing with firm investments and a module for tax and certain service line professionals dealing with contingent and other fee arrangements).
2. Monitor training course examination results by individual question to determine the need for improvements in independence training materials.
3. Use hypothetical examples and case materials to enhance understanding of the Independence Rules and the ability of professionals to utilize the Firm’s independence policy document.

Element 4: Internal Monitoring of Independence Systems and Controls

1. In addition to the professionals selected at random for audits of their financial interests, select some or all members of the Firm’s senior management and candidates for senior management positions, including those on or being considered for the board and management committee.

Element 5: Senior Management and Others Responsible for Independence Systems and Controls

1. Accumulate all significant independence consultations on a centralized database that is available to the professionals providing independence consultation to Firm personnel.

Element 7: Prompt Reporting of Personnel Employment Negotiations

1. Include in engagement audit programs a procedure to determine whether any former Firm personnel have joined the client in audit sensitive positions or in positions to influence the financial reporting of the entity. Perform this procedure each quarter, during planning, and at completion of the audit.

Element 8: Reporting by Personnel of Apparent Independence Violations

1. Distribute from the Firm's national independence office a report to all professionals summarizing the results of the annual independence confirmation process and the audits of professionals' financial interests.

Element 9: Disciplinary Policies

1. Track and include as a factor in assessing disciplinary sanctions the number of times that a professional purchases restricted securities.
2. Impose discipline not only for violations of independence policies related to individuals but also for violations of engagement-related independence policies for which engagement team personnel have monitoring responsibility, including failure to notify the Firm's national independence office on a timely basis of entities and securities to be added to restricted lists.
3. Provide reports to professionals on the number and types of sanctions imposed for various types of independence violations, to serve as a deterrent to noncompliance with the Independence Rules and Firm policies.

Element 11: Business Relationships and Alliances, Commissions, and Contingent Fees

1. Require all engagements and engagement letters or contracts for (a) tax services with fee arrangements involving other than fixed amounts or rates, (b) all management consulting services, and (c) all corporate finance services to be approved in advance by a quality standards/risk management group for the applicable function to help ensure that the scope of services and billing arrangements proposed are appropriate under the Independence Rules and the Firm's policies. As part of that procedure, require the partner or principal who is to be responsible for the proposed nonaudit services engagement to submit to the risk management group a copy of the executed engagement letter or contract with his or her certification that there are no side agreements, arrangements, or other understandings, either written or oral, that in any way modify that document. In addition, establish a procedure to determine that all of these engagements have received the required approvals before opening engagement billing records that enable personnel to charge time and expenses.
2. Require notification to the partner in charge of an audit engagement for an SEC audit client of all (a) nonaudit services proposed to be provided to the client, and the related fee arrangements, and (b) proposed business relationships with the client to help ensure that

the proposed services, fee arrangements, and business relationships conform with the Independence Rules and the Firm's policies. Require, as part of that policy, that the partner in charge of the audit engagement document his or her consideration of, and conclusion with respect to, the appropriateness of such matters.

In addition, include in engagement audit programs a procedure to consider the independence implications of all nonaudit services and related fee arrangements, and business relationships with the client. Perform this procedure each quarter, during planning, and at completion of the audit.

Also include in the annual internal inspection programs, procedures to evaluate nonaudit services provided to audit clients, and related fee arrangements, for consistency with the Independence Rules, the SECPS membership requirements, and the Firm's policies. For each engagement selected for review, obtain all engagement letters for nonaudit services and determine whether the services provided and related fee arrangements were permitted under those rules, requirements, and Firm policies. In this review consider (a) whether there was timely notification to the partner in charge of the audit and others, as required, regarding the services provided, (b) the propriety of any contingent, value added, discretionary payment, commission, and referral fee arrangements, and (c) whether approval requirements for such services and fee arrangements were met.

Appendix D: Description of the Elements of Each Firm's Systems and Controls and Related Findings

A Firm's Systems and Controls encompass the organizational structure, policies, procedures, and internal controls established to provide it with reasonable assurance of complying with the Independence Rules. The Systems and Controls identified for purposes of the Reviews are based on the Statements on Quality Control Standards issued by the AICPA, the membership requirements of the SECPS, ISB Standard No. 3, *Employment with Audit Clients*, and SEC Rule 2-01(d)(4) of Regulation S-X. For purposes of the Reviews, the following eleven features have been identified as elements of Systems and Controls:

1. written independence policies and procedures,
2. automated tracking system and restricted entity list,
3. independence training,
4. internal monitoring of independence Systems and Controls,
5. senior management and others responsible for independence Systems and Controls,
6. "tone at the top" and culture relating to independence,
7. prompt reporting of personnel employment negotiations,
8. reporting by personnel of apparent independence violations,
9. disciplinary policies,
10. independence quality controls of the Firms relating to foreign associated firms, as set forth in the SECPS membership requirements, and
11. business relationships and alliances, commissions, and contingent fees.

While the eleven elements of a Firm's Systems and Controls are conceptually separate and distinct, operationally they are interrelated. As one example of the interrelationships among the elements, a Firm's policies (Element 1) should address the responsibilities that individuals have to enter investments into the automated tracking system (Element 2). Individuals need to be trained on meeting those responsibilities (Element 3), and the investments that they actually hold should be subject to audit (Element 4). Violations of the Independence Rules should be self-reported (Element 8) or may be detected by the audits and reported to senior management and others responsible for independence Systems and Controls (Element 5), and then be subject to discipline in accordance with the Firm's disciplinary policies (Element 9). The effectiveness of all of the various Systems and Controls depends on the "tone at the top" and the Firm's culture relating to independence (Element 6).

Readers of this report are encouraged to keep the interrelationships among the elements in mind when considering the descriptions and findings reported below with respect to each individual element.

Element 1: Written Independence Policies and Procedures

SEC Rule 2-01(d)(4) of Regulation S-X states that a Firm's quality control system includes written independence policies and procedures. The SECPS membership requirements (Appendix L, *Independence Quality Controls*) are more expansive and state the following:

1. Each member firm shall establish written independence policies covering relationships with "restricted entities," for example, relationships between the restricted entity and the member firm (including, where applicable, its foreign

associated firms), its benefit plans, and its professionals. These policies shall be written in language, to the extent possible, that is clear, concise, and tailored to each member firm's independence policies and procedures, given the complexity of the member firm's practice. These relationships would include investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements. For purpose of this membership requirement, "restricted entities" shall include all audit clients of the member firm, and to the extent applicable its foreign associated firms, that are SEC registrants and other entities that the member firm is required to be independent of under the applicable SEC requirements. . . . (footnotes omitted)

2. The member firm's independence policies shall be provided or otherwise made available to all professionals, as defined in paragraph 1(a). Substantive changes to the member firm's policies shall be provided or otherwise made available on a timely basis.

Each of the Firms has developed comprehensive, clearly written independence policies and procedures that cover the Firm, the Firm's benefit plans and foundations, all professionals, and relatives of professionals as specified by the Independence Rules. Those policies and procedures, which in certain instances are more restrictive than those specified by the Independence Rules, generally cover all aspects of independence, including: when the Firm needs to be independent; that independence is required of the Firm with respect to audit clients and affiliates of audit clients; the various sources of the Independence Rules; to whom the Independence Rules apply; the Independence Rules that apply when professionals become directors, officers, or employees of clients; actions required when engagement team members begin employment negotiations with a client and when client officers, directors, or employees join the Firm as an owner or employee; financial interests and relationships involving clients; business relationships with clients; proscribed or restricted services; fee arrangements; prohibitions against indemnification agreements; adversary, and in some cases mutual, positions created by litigation involving a client and the Firm; reporting responsibilities under ISB Standard No. 1; and responsibilities that professionals have with respect to family members.

The Firms' policies and procedures also require: professionals to review a list of restricted entities before they, their spouses or spousal equivalents, or their dependents engage in certain transactions and, in the case of partners and managers, to enter relevant data into an automated tracking system to enable an electronic match; certifications near the time of initial employment and at least annually thereafter that each professional has read, understood, and complied with the Firm's independence policies; and reporting by professionals of apparent independence violations and the corrective action taken or proposed.

Each Firm makes its independence policies and procedures available electronically to each professional in the Firm on a timely basis. Changes to those policies and procedures that are required by changes in the Independence Rules also are made and communicated electronically on a timely basis. Each Firm also has procedures in place at the engagement level to address the consideration of independence matters during the course of the engagement and the completeness of ISB Standard No. 1 communications. The policies and procedures, either as part of the Firm's independence policies or in other Firm policies or guidance, include the Firm's independence training requirements, the names of partners and others responsible for independence consultation and compliance, and policies and procedures for resolving disputes over independence matters. They also typically explain the consequences to the individual that

may result from independence violations. Each Firm also has global policies that address relationships between its foreign associated firms and its audit clients and affiliates of its audit clients, and has provided or otherwise made those policies available, along with its restricted entity list, to its foreign associated firms, including the partners and managers of those firms.

D&T, E&Y, and KPMG maintain their principal independence policies in a single publication. (More detailed guidance on independence matters related to restricted or proscribed services, business relations, and fee arrangements – which augments the basic independence policies – often exists in separate policy publications of the particular relevant lines of service.) The independence policies of PwC are contained in a number of documents, none of which represented a complete collection of the Firm’s current policies. Some of PwC’s policies were on the Firm’s independence website, while others were in databases maintained by the Firm’s various lines of service, of which only some are linked to the independence website. In addition, PwC’s independence policies and guidance contained certain obsolete materials that were not eliminated when professionals were informed about new or amended Independence Rules.

Element 2: Automated Tracking System and Restricted Entity List

Until recently, quality control standards related to independence were not specific, requiring only that firms establish policies and procedures to provide reasonable assurance that firm professionals maintain independence (in fact and in appearance) in all required circumstances.¹ In 1999, as part of its membership requirements, the SECPS established more specific independence quality control requirements for member firms.² Some of those requirements differ by firm size and have the effect of being applicable only to the Firms. Among other requirements, each of the Firms was required by December 31, 2000 to:

- Maintain a database that includes all audit clients of the Firm that are SEC registrants (Restricted Entity List or REL)
- Have established an automated system to identify investment holdings of partners and managers that might impair independence (Tracking System)
- Have issued policies and procedures requiring that each professional certify near the time of initial employment and at least annually thereafter that he or she (1) has read the Firm’s independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and dependents, and (3) has complied with the requirements of the Firm’s independence rules since the prior certification (Certifications)

In November 2000 the SEC amended Rule 2-01 of Regulation S-X to include similar quality control systems requirements.

¹ AICPA Statements on Quality Standards, Section 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*.

² AICPA SECPS Reference Manual, Appendix L – *Independence Quality Controls*.

Effect of Technology

Until shortly before the Review Period, only E&Y had a Tracking System, and the Firms' Restricted Entity Lists varied as to their completeness, accuracy, and timeliness. The Firms' RELs and Certification processes generally were manual. Over time there were improvements, but the 1999 changes to the SECPS membership requirements resulted in the other Firms making major improvements in their independence systems, particularly with respect to Tracking Systems.

Use of technology has been a key factor in the Firms' improving their abilities to assure compliance with the Independence Rules. Each of the Firms has committed significant personnel and financial resources to establish and maintain sophisticated Tracking Systems and related RELs and Certification processes that exceed the basic requirements.

This section of the report describes the three interrelated portions of Element 2 of the Firms' Systems and Controls. They are functionally integrated in that partners and managers (1) search the REL before making an investment, (2) post investments to their individual portfolios in the Tracking System, and (3) periodically certify the contents of their portfolios and their compliance with the Independence Rules. The Certifications are generated from information on the Tracking System and submitted electronically by partners and managers.

Technological integration also extends to virtually all other aspects of independence quality controls as well. For example, human resources data is accessed to help ensure that all appropriate professionals have access to Firm policies and receive independence training and requests for Certifications. The Tracking Systems enable individuals to report violations and the Firms to identify prohibited investments by professionals.

Restricted Entity Lists

The Firms' RELs include not only those audit clients and their affiliates required to be thereon but also many other entities. That results from the Firms' policies exceeding the minimum requirements of the Independence Rules, as noted in the description of Element 1 in this report and explained further below. Also, the Firms are subject to other professional independence rules as well as those of the SEC. For example, there are investment limitations on publicly traded securities issued by client governmental units and not-for-profit entities that are exempt from registration with the SEC.

Exhibit A compares the types of entities on each Firm's REL. The first two types of audit clients noted – that is, those that are U.S. or foreign registrants (and certain of their affiliates) – are the entities required to be included by the SECPS and SEC rules (the minimum REL requirements).

The Firms' RELs have many similarities with respect to the inclusion of entities beyond the minimum requirements. For example, all Firms list governmental issuers, governmental financing authorities and not-for-profit entities. D&T, E&Y, and PwC include public and nonpublic banks and other financial institutions, as well as broker-dealers, to identify entities with which lending and brokerage relationships are prohibited or limited. KPMG includes public, but not nonpublic, banks and broker-dealers on its list.

Each of the Firms lists public audit clients of its international offices that are not SEC registrants and that trade only outside the United States. (KPMG limits this to Canada in its REL, but maintains in a separate list other international clients that trade only outside the United States.) The SEC rules relating to quality controls are not applicable to offices of the Firms outside the United States until December 31, 2002. Each of the Firms is in the process of installing Tracking Systems and other elements of independence quality control internationally.

The RELs are entity-name oriented. As explained later, and by way of contrast, the securities master files in the Tracking Systems identify individual securities as well as entity names and use unique identifiers such as CUSIP numbers.³

The challenge to the Firms is maintaining the accuracy, completeness, and timeliness of the RELs, starting with entry of newly-accepted public audit clients and existing audit clients that first become SEC registrants. The Firms place primary responsibility for notification of REL changes on their engagement teams. The national independence offices of the Firms maintain the RELs and research personnel in those offices corroborate to the extent practicable the information supplied by engagement teams. Except for PwC, the Firms' national independence offices systematically search for potential changes in RELs that may not be reported or are overlooked by engagement teams.

The Firms focus on placing new public audit clients on the REL before commencing any audit services. As indicated in Exhibit C, client acceptance and engagement team notification generally trigger entry on the list. D&T, E&Y, and PwC have controls over the client acceptance process that help ensure that engagement teams supply the relevant information to their national independence offices for initial entry of a newly-restricted entity onto the REL. In addition to controls over the client acceptance process, E&Y and KPMG also rely on the research of their national independence offices to help ensure that all additions are identified or corroborated on a timely basis. D&T's national independence office also performs research on engagement-team submitted information to validate its completeness and accuracy.

The Firms use a variety of sources to either anticipate or corroborate REL additions. For example, the Firms' national independence offices search public data bases of Form 8-Ks for auditor changes reported by public companies.⁴ The Firms use various external sources to help identify auditor changes and initial public offerings by their clients. They also look to client acceptance files and data bases of all clients; E&Y also reviews lists of clients assigned to SEC review partners. Depending on the volume of changes, the Firms generally perform these searches at least weekly.

More challenging is the identification of nonaudit affiliates of public audit clients in which investments also are proscribed. The REL should include all affiliates⁵ with public securities. Again, the Firms look primarily to the engagement teams for this identification. Several external data sources contain useful (though not necessarily complete) information that helps the national independence offices identify affiliates of public audit clients.

³ CUSIP numbers are unique nine-digit identifiers for securities determined by the Committee on Uniform Security Identification Procedures of the American Bankers Association.

⁴ Form 8-K, *Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*: Item 4, "Changes in Registrant's Certifying Accountant." Registrants must report changes in auditors on Form 8-K within five business days.

⁵ Generally includes parents and subsidiaries, material equity investees, entities with significant influence over the client, nonclient sister mutual funds, and nonclient sponsors of client benefit plans.

Similarly, engagement teams are responsible for reporting other changes, such as acquisitions and name changes. Here again, research personnel in national independence offices pursue, in varying degrees, separate external identification or corroboration of this information to help ensure the integrity of the RELs.

Deletions of lost clients from RELs generally are not pursued with the same vigor by national independence offices. (The worst that can happen if a lost client is not deleted from the REL is that a professional refrains from making an investment that is not proscribed.)

Each Firm updates its REL at least weekly and posts notices of the changes on its intranet site. Changes also are announced in other daily or weekly Firm news communications emailed to all professionals.

None of the Firms' policies permit investments by partners in any audit client. KPMG extends this proscription to managers as well, and E&Y extends it to managers and all professional staff. D&T and PwC do allow managers to hold certain investments in restricted entities, as long as they provide no professional services to the client and are not located in an office that participates in a significant portion of the audit. As a result, the RELs of D&T and PwC identify the names of offices of those Firms that participate in a significant portion of audits of individual restricted entities.

Automated Tracking Systems

The Firms require that partners and managers review the REL before making investments or entering into other financial interest transactions that could affect independence, including investments by or on behalf of spouses and dependents. Partners and managers then must enter all investments and certain other transactions in their individual portfolios in the Firms' Tracking Systems. They do not enter quantities owned, such as the number of shares.

E&Y has an approximately thirty-year history of tracking securities owned by its professionals. Originally, securities owned were matched manually with the REL. In 1989 the Firm began adding CUSIP number information to its REL and began electronically matching the securities owned to the REL. As indicated in Exhibit B, E&Y tracks the most information. For example, it is the only Firm that tracks lending, depository, and family relationships information. The other Firms implemented their Tracking Systems during 1999 or 2000.

Exhibit B illustrates that all the Firms track more than investments, the minimum required to be tracked by the SECPS membership rules. Tracking other information helps facilitate independence compliance in those other areas. Whether additional information is tracked or not, the other interrelated elements of Systems and Controls also assist in providing reasonable assurance of compliance with the Independence Rules.

In addition to RELs, the Firms maintain master files or databases of publicly available securities, using data purchased from third parties, to enable partners and managers to identify the exact security they acquire and to enable consistent postings to the Tracking Systems. RELs concentrate on the names of the Firm's audit clients and certain affiliates of those clients. Tracking System master files catalog publicly available securities issued by all registrants (clients and nonclients alike), generally by reference to the CUSIP numbers of those securities,

but sometimes by ticker symbols. Individual registrants may have hundreds or even thousands of CUSIP numbers for various debt and equity securities.

Thus, the REL enables ready identification of the names of entities in which investments are proscribed. The more expansive securities master file enables the professional to identify a specific security acquired by ticker symbol or CUSIP number and enter it in the Tracking System. (Use of ticker symbols and CUSIP numbers in securities master files not only helps ensure that investments are entered properly and consistently, but also facilitates the Firms' ability to meet the SECPS membership requirement that they identify investment holdings of partners and managers that might impair independence.) Securities issued by restricted entities are prominently labeled as proscribed in securities master files. KPMG maintains one file, which serves both as the REL and the securities master file.

E&Y, KPMG, and PwC receive periodic updates to the securities master files from third parties, generally weekly. D&T refreshes its master file as it updates the REL or when partners and managers post securities that cannot be identified. That is, if a partner or manager acquires a security that is not on the master file because it was issued after initial compilation of the file, he or she nonetheless posts the acquisition. The national independence office then researches the security and adds it to the master file.

Maintenance of both an REL and a securities master file requires that the Firms reconcile restricted entity information on both lists. Generally, the Firms reconcile additions to both lists and periodically determine that securities issued by restricted entities are identified as proscribed.

While the securities master files of all the Firms include ticker symbol or CUSIP data for restricted and nonrestricted equity securities, the Firms vary in their practices regarding bonds and other debt securities. The volume of CUSIP numbers for debt securities is much greater than that for stocks. The experience of the Firms, however, is that most of the securities posted to portfolios are stocks. KPMG and PwC maintain complete listings of debt security CUSIP numbers in their securities master files. The securities master files of D&T and E&Y generally include restricted debt securities and only nonrestricted debt securities that are "user-added"—that is, CUSIP numbers are added only for those debt securities acquired and posted by partners and managers in their portfolios in the Tracking System, after information about the entity and the security has been validated by the national independence office.

SECPS membership rules require that each professional report on a timely basis apparent policy violations and the corrective action taken or proposed to be taken.⁶ The Tracking Systems all have features that assist professionals to self-report violations and corrective actions. The national independence offices follow up on reported violations until corrective action is confirmed as having been taken by the partner or manager.

Certifications

As indicated in Exhibit D, each of the Firms requires that its partners and managers furnish detailed statements regarding their compliance with Firm policy and the Independence Rules. These Certifications are required at least annually, and some Firms also require them on the occasion of other events, such as upon promotion to manager. To promote timely Tracking

⁶ Timely dispositions of securities of newly-restricted entities are not required to be reported.

System postings by professionals, E&Y also has initiated a quarterly process of confirming the completeness and accuracy of investment information reported in the Tracking System.

In varying degrees, the Firms also obtain Certifications from professionals other than partners and managers, as well as from certain nonprofessional personnel. For example, all employees are expected to comply with basic standards regarding client confidentiality and insider trading, and acknowledgement of these expectations may be included in the Certifications.

The periodic Certification process is electronic at each of the Firms, and partners and staff are notified by email to complete the Certification form on the Firms' independence websites. The Firms follow up on those who do not complete the Certification process within a prescribed period of time (generally one month).

Partners and managers are asked to confirm that they have read and understand the Firm's independence policies and have complied with them. Also, they confirm their specific compliance with individual aspects of the Independence Rules, including such matters as:

- the completeness and accuracy of all information they have entered in the Tracking System, including investments of spouses and dependents
- depository relationships
- loans or other borrowings
- brokerage relationships
- insurance policies (beginning in 2002 for E&Y)
- family relationships

The Certification forms of each of the Firms are comprehensive. E&Y and KPMG require the respondent to review stated assertions of specific compliance with the Independence Rules and to provide a representation covering each of them. In addition to the overall representation, D&T and PwC use a "Yes/No" response format for specific independence questions.

As indicated in Exhibit D, other matters confirmed by some of the Firms include:

- timely filing of income tax returns and payment of taxes
- current validity of CPA license
- positions with outside organizations
- health status
- confidentiality
- conflicts of interests

Respondents also use the Certification process to report exceptions or possible independence violations.

In addition to its annual Certification process, PwC's standard audit program includes a procedure requiring each professional working on an attest engagement to confirm in writing his or her independence of the client and its related entities. Also, during the first audit cycle after a new SEC audit client is accepted by the Firm, a written independence confirmation must be obtained from each professional providing services of any type to the client before the professional begins work on an engagement.

Exhibit A
Comparison of Firms' Restricted Entity Lists

		D&T	E&Y	KPMG	PwC
	Audit clients required by SECPS membership and SEC rules (a):				
1	U.S. registrants	✓	✓	✓	✓
2	Foreign registrants	✓	✓	✓	✓
	Other non-registrant audit and attest clients (b):				
3	Banks and other financial institutions (c)	✓	✓		✓
4	Broker/dealers (c)	✓	✓		✓
5	Governmental issuers (d)	✓	✓	✓	✓
6	Governmental financing authorities (d)	✓	✓	✓	✓
7	Hospitals, universities, other not-for-profits (d)	✓	✓	✓	✓
8	General partners (e)	✓	✓		✓
9	Certain syndicated unregistered limited partnerships (e)	✓			✓
10	Entities that trade only outside the U.S.	✓	✓	✓ (f)	✓
11	Lotteries (g)	✓			

✓ Included in Restricted Entity List

(a) The SECPS membership rules require that the Restricted Entity List generally include audit clients that are:

1. Registrants under the Securities Act of 1933 or the Securities Exchange Act of 1934
2. Registrants that file periodic reports under the Investment Company Act of 1940 or the Securities Exchange Act of 1934
3. Banks and other lending institutions that file periodic reports under the Securities Exchange Act of 1934 with a bank regulatory agency other than the SEC
4. Non-registrant sponsors and managers of investment funds whose financial statements appear in fund proxy statements
5. Foreign private issuers that have securities registered or have filed a registration statement with the SEC

The list also should identify affiliates of the above entities unless they have no securities available for public sale. Generally, that includes parents and subsidiaries, material equity investees, entities with significant influence over the client, and nonclient sister mutual funds, nonclient sponsors of client benefit plans.

- (b) The Firms include on their restricted entity lists the names of a variety of other clients, beyond the minimum required by and SECPS membership rules. These represent other entities for whom independence must be maintained to conform with Firm policies or AICPA or other professional requirements.
- (c) These are nonpublic institutions included on the list to assist with compliance with professional limitations on loans, depository and brokerage relationships. Public banks and public broker/dealers would be in categories 1 and 2 above.
- (d) These entities are issuers of public securities that are not required to be registered with the SEC.
- (e) These names are maintained to identify and prevent investment in a non-client limited partnership syndicated by a general partner or limited partnership that is an attest client.
- (f) Canada only. The Firm maintains a separate list of other international clients that trade only outside the United States.
- (g) These are included to assist with compliance with contracts with client lottery sponsors that preclude participation by Firm employees.

Exhibit B
Comparison of Firms' Tracking Systems

		D&T	E&Y	KPMG	PwC
	Minimum required to be tracked by SECPS membership and SEC rules:				
1	Investments	Partners and managers (a)	Partners and managers (a) (b)	Partners and managers (a) (b)	Partners and managers (a)
	Other information tracked (c):				
2	Loans		Partners		
3	Grandfathered loans		Managers and staff (d)		
4	Depository relationships		Partners		
5	Brokerage relationships	Partners and managers	Partners		
6	Sec. 529 plans	Partners and managers (beginning in 2002)	Partner and managers	Partners and managers (beginning in 2002)	Partner and managers
7	Insurance products (e)				
8	Family relationships		Partners, managers, and staff (f)		
9	Firm investments	Pension fund manager and each sub-manager; Firm's treasurer; captive insurance companies; Firm's 401(k) and profit sharing plan options (beginning in 2002)	Firm, benefit plans, and foundation	Firm, benefit plans and foundation. Firm loans are also recorded.	Firm, benefit plans, captive insurance companies, and (beginning in 2002) foundations
	Non-independence information tracked:				
10	CPA license information	Partners, managers, and staff (g)	Partners		Partners and managers (beginning in 2002)

- (a) Includes spouses and dependents. Underlying investments in variable annuities and unit investment trusts are not required by the Firms to be tracked.
- (b) Firm requires that all investments be tracked, including those in private or non-public entities.
- (c) The Firms track other items for which independence must be maintained, although only investments are required to be tracked. Tracking assists the Firm and professionals in identifying potential threats to independence.
- (d) "Staff" includes all client-serving personnel and some interns.
- (e) None of the Firms tracks insurance products.
- (f) All client-serving personnel report family relationships where the relative is employed by or is a director of a proscribed entity.
- (g) D&T maintains a separate database in its intranet into which all CPAs are required to enter their CPA licensing information.

Exhibit C
Other Comparisons: Tracking Systems and RELs

		D&T	E&Y	KPMG	PwC
1	Trigger date for entry on Restricted Entry List	Notification by engagement team, a required element of client acceptance	Form 8-K filed and client acceptance complete	Client acceptance, but before commencing services and signing engagement letter	Notification by engagement team, before fieldwork begins or engagement letter signed
2	Tracking System access	Firm's intranet web site and (beginning in 2002) the internet	Firm's intranet web site and (beginning in 2002) the internet	Firm's intranet web site and the internet	Firm's intranet web site and the internet
3	Investment transactions must be entered in Tracking System within-	10 calendar days	10 business days	14 calendar days	5 business days
4	Disposal period for restricted securities (a)	As soon as practicable, without delay	5 business days	5 business days	5 business days
5	"Reverse restricted entity" list in Restricted Entity List or Tracking System (b)	Yes	No (c)	Yes	No
6	"Permitted" lists in Restricted Entity List, Tracking System, or internal independence guidance (d)	Yes (e)	Limited list of lenders (beginning in 2002)	Yes (e)	Yes (f)

- (a) For example, individuals previously owning shares in a new client are issued instructions to dispose of the newly-restricted security.
- (b) "Reverse restricted" lists identify nonclient entities with which the Firm has lending or other business relationships that would prevent the Firm from providing attest services to those clients.
- (c) A list is maintained in "back end" administrative files only.
- (d) "Permitted" or "safe" lists identify nonclient entities with which Firm personnel may have financial interests.
- (e) Includes certain mutual funds as "safe havens" in the reverse restricted entity list and a short list of currently unrestricted broker/dealers.
- (f) Includes certain "safe" mutual funds.

Exhibit D
Comparison of Certification Processes

		D&T	E&Y	KPMG	PwC
	<i>Certifications are obtained from:</i>				
1	Newly-hired professionals, at time of hire	✓	✓	✓	✓
2	Newly-hired nonprofessionals, at time of hire (a)	✓		✓	✓
3	Partners and managers, at least annually	September 30 (b)	March 31 (c)	March 31 (d)	May 31
4	Other professionals	September 30 (b)	March 31	March 31 (d)	May 31
5	Nonprofessionals	September 30 (b)	No	No	May 31 (a)
6	New partners, at admission	✓	✓	✓	✓
7	New managers, upon promotion	✓	(e)	✓ (beginning in 2002)	✓
8	Managers, upon relocation to another office	✓	(f)	(f)	No

- (a) Generally limited to matters such as confidentiality and insider trading (and, at D&T, lotteries).
- (b) Beginning in June 2002 Firm personnel began providing certifications on a cycle basis based on their birth month.
- (c) In addition, partners and managers confirm quarterly at June 30, September 30, and December 31 the completeness and accuracy of security information reported in the Tracking System.
- (d) Beginning in 2002 Firm personnel will begin providing certifications on a cycle basis based on date of most recent promotion and other factors.
- (e) Not confirmed because the Firm independence requirements for managers and other professionals are the same. Thus, there is no change in independence status upon promotion.
- (f) Not obtained because there is no change in independence status. Managers at the Firm may not invest in any audit client.

Element 3: Independence Training

The SECPS membership requirements specify that each firm's independence training program provide reasonable assurance that partners and other professionals understand the firm's independence policies; that partners and other professionals complete their training near the time of employment and periodically thereafter; that the content, extent, and timing of the training be included in the firm's policies; and that the content include the relevant rules regarding investments, loans, brokerage accounts, business relationships, employment relationships, proscribed services, and fee arrangements. SEC Rule 2-01(d)(4) specifies that an independence quality control system include an annual or ongoing training program.

Each of the Firms has developed training courses on independence matters, all of which are delivered or deliverable in electronic form, that all partners and other professionals are required to take. Each Firm has tracking, monitoring, and follow-up procedures designed to assure that all professionals required to take a course have done so. (These are referred to in this section as monitored courses.) The content of these courses generally tracks each Firm's independence policies. Each Firm also includes independence training as part of other training courses that are neither required nor monitored, which are directed to only some professionals. While training that is not monitored, as well as communications informing professionals and others of independence developments and engagement-based documents and requirements that deal with specific independence requirements, are important in helping partners and other professionals understand and comply with the Firm's independence policies, only monitored training is discussed in this section.

Organization, People, and Processes

Each Firm has identified professional personnel to follow independence developments and to develop or oversee training materials dealing with them. The course development and oversight includes determining the objectives of training, the need for new or changed training materials, who should be trained, and the content and delivery of training. Determining who should be trained is done in various ways (see below) by those responsible for managing independence compliance. Because each Firm is organized differently and many independence compliance personnel have multiple duties, the number of personnel involved is difficult to ascertain.

At D&T there are three professionals, including a partner, in the national independence office who oversee training development. In conjunction with policy development efforts, these people identify potential training issues. The monitored courses are web-based and were implemented, with oversight by the national independence office, either by Deloitte Consulting LP (DC) or by an outside software development firm. An earlier classroom-based course was developed jointly by the Firm's national independence office and its education division.

At E&Y there are three professionals, including a national office partner who is responsible for independence matters on a substantially full-time basis, who oversee independence training. The primary effort in designating course content and overseeing development of courses is performed by a principal in the Firm. The monitored course is web-based (there is also an identical CDROM-based course); delivery was implemented by a captive software development organization. Implementation and testing was overseen by Firm personnel.

At KPMG there are two professionals, a partner and manager, in the national independence office who are specifically assigned to maintain training materials. In conjunction with national independence office personnel in the policy development function, they determine training requirements. The monitored course is CDROM-based. Course delivery was implemented by an outside software development firm, based on content provided by the national independence office.

At PwC, the development of training materials is a joint effort of the national independence office and Learning and Education (L&E). A partner in L&E is responsible for overseeing course development; others in the national independence office and L&E assist in this process on a project basis. The monitored courses are web-based and were developed and implemented internally.

For D&T, E&Y, and KPMG, the monitored courses were designed for and delivered to all professionals, and certain other designated employees. PwC excluded those who were not partners or managers from the course on scope of services that was made available in April; all consulting personnel were also excluded. D&T presently has two monitored courses, both web-based. The initial web-based course was designed by DC with national independence office oversight for delivery by DC to its client service personnel. Using that course as a model, D&T employed an outside software design company to develop a second monitored, web-based course, which is required for all other client service employees. (The previous D&T classroom-based course noted above was given to all professionals before being replaced by the web-based course.)

Course Comprehensiveness and Timeliness

With the exception of PwC, each Firm attempted to cover in a single course all relevant Independence Rules. PwC has chosen to use a targeted approach to training. It delivered a monitored course in late 1999 on personal independence matters that was updated for the revised Independence Rules and provided to new personnel, and a second monitored course in the spring of 2002 on scope of services, business relationships, and fee arrangements. The monitored course of each Firm was sufficiently comprehensive with respect to its selected topics. Each Firm also had other courses that dealt with various aspects of independence, but most of these were not designed to be comprehensive and none of them was monitored.

Timing varied as to when the monitored courses were initiated and the preponderance of training occurred, with E&Y and KPMG having introduced the monitored course during the Review Period. The timing of the delivery of the PwC courses is noted above. D&T introduced its courses in 2000. Each of the four Firms required new hires to complete its independence course. None of the Firms has offered one specific independence course to all professionals since the initial roll-out, although the Firms have offered targeted training.

KPMG has adopted an annual training requirement, to be effective in the last quarter of 2002. As a result of a recent settlement with the SEC, PwC has also adopted an annual training cycle for all professionals, but this requirement had not been implemented by the time of our Review. D&T and E&Y have not adopted guidelines or policies with respect to the requirement for periodic training.

The Firms varied as to the timeliness of updates of course materials. Significant rule changes effected in early 2001 were dealt with by E&Y and KPMG on a timely basis. The PwC personal independence course also made changes on a timely basis for topics covered by that course. The changes in the Independence Rules pertaining to business relationships and fees were dealt with in the spring of 2002 when PwC introduced its course on scope of services. The D&T and DC course materials did not cover the changes and referred to superseded policies. (It should be noted, however, that D&T did not adopt the new SEC rules that were less restrictive.)

Competency Testing

D&T, KPMG, and PwC have graded examinations in their monitored courses. D&T and PwC use randomly selected questions, so that anyone required to retake the examination because of a failing grade receives a new series of questions. D&T and PwC grade examinations on-line, and KPMG grades within the CDROM-course itself, with examination results being recorded and maintained on-line. E&Y does not have a graded examination.

Firm Administrative Personnel

E&Y, KPMG, and PwC require administrative personnel engaging in activities that could affect independence (e.g., making investments and loans on behalf of the Firm) to take the monitored training courses. D&T does not.

The Firms requiring these individuals to take independence training did not have a monitored course dealing specifically with independence issues as they pertain to Firm administration. KPMG also has developed two courses dealing specifically with Firm administration and delivered them to both internal Firm administrative employees engaged in such activities and to outside investment managers working for the Firm. PwC also has developed such a course, but it had not been delivered at the time of our Review.

Identifying Professionals to be Trained

Each Firm uses payroll or human resource records as the primary source for forming a training roll, and modifies those records by selecting specified coded job classifications. With respect to monitored courses, the national independence offices at E&Y and KPMG make and manage the selection. D&T maintains two training rolls, one for DC and another for all other professionals. DC maintains and manages the roll for the course taken by its professionals, while the national independence office of D&T does this for the other monitored course (and did so for the previous classroom-based course). Based on selections made by the national independence office, PwC included all professionals on the training roll for the course on personal independence requirements. Only partners or managers were included in the course on scope of services because they make the decisions on services provided by the Firm.

Processes varied regarding the selection of certain individuals, such as Firm administrative personnel, for required training. The Systems Team in the national independence office of KPMG has adopted a formal process that is reviewed on an ongoing basis. PwC has established different participation criteria for each course, for example, determining that only partners and managers will receive the course on scope of services. E&Y included Firm administrative

personnel at the time of the roll-out. DC and the D&T national independence office each made specific determinations at the time of their initial roll-outs. Each Firm also has procedures to update the training rolls because of promotions and new hires within specified groups.

Tracking Training Completion

Each of the Firms has developed software to track completion of required training and to follow up on noncompletion. At D&T, tracking for the course for professionals other than consultants is performed by a manager in its national independence office. DC was supposed to have its tracking overseen by an administrative principal in its national office (see further discussion below). Tracking of course completion is done at E&Y by a principal and her assistant in the national independence office; at KPMG by personnel at the Independence Help Desk; and at PwC by the line-of-service independence leaders and their staff, with oversight by Learning and Education.

The timing of and follow-up on course completion and noncompletion reports at the Firms has varied, based principally on when their courses were introduced. Responses to our inquiries indicated that, during the roll-out period, D&T, KPMG, and PwC monitored and followed up on course completion weekly. E&Y did not have a formal monitoring schedule, but usually followed up on a weekly basis. Since the roll-out, KPMG has maintained a weekly monitoring and follow-up schedule; D&T, E&Y, and PwC follow up monthly.

DC appears to have ceased monitoring course completion by its professionals at an undetermined date in 2000. In addition, it appears that a software change at some point resulted in inconsistent and incomplete recording of training-course completion. As a result, as of August 2002 there is no record of approximately 32% of DC client service personnel (about 8% of total D&T professionals and DC client service personnel) having completed training.

Each Firm has follow-up notifications by email that, if needed, involve partner level management personnel. This process is automated at E&Y and PwC, whereas at D&T and KPMG manual interface is required to produce and send the email, using software designed for that purpose. (During the Review Period, however, at E&Y a principal created a letter, pulled the noncompletion file, and entered the names into the email system.) The timing of follow-up by each Firm varies considerably; newly employed professionals are allowed 30 to 120 days from date of hire to complete the required course, although reminders may be sent after 60 days.

Element 4: Internal Monitoring of Independence Systems and Controls

The requirements for this element that were in effect during the six months ended December 31, 2001 are found in SEC Rule 2-01(d)(4)(v) of Regulation S-X and in the membership requirements of the SECPS. The SEC rule includes as a feature of a quality control system “an annual internal inspection and testing program to monitor adherence to independence requirements.” Appendix L, *Independence Quality Controls*, of the SECPS membership requirements that were in effect during the Review Period specified that:

Each member firm shall have a monitoring system under the supervision of the senior-level partner . . . to determine that adequate corrective steps are taken and documented on all apparent violations reported by

professionals within the U.S. member firm. The monitoring system should include procedures to ensure that information received from its U.S. partners and managers is complete and accurate as to the requirements described in paragraph 5(b). An example of such a procedure may include auditing, on a sample basis, selected information such as brokerage statements, etc.

and that:

Each professional shall certify near the time of initial employment and at least annually thereafter that he or she (1) has read the firm's independence policies, (2) understands their applicability to his or her activities and those of his or her spouse and close relatives, and (3) has complied with the requirements of the firm's independence policies since the prior Certification.

On October 10, 2001 the SECPS adopted amendments to Appendix L that became effective January 1, 2002. The amendments included the following italicized modifications relating to investments of the member firm and the auditing of selected information:

The monitoring system should include procedures to provide reasonable assurance that (i) investments of the member firm and its benefit plans are in compliance with the member firm's policies and (ii) information received from its partners and managers is complete and accurate. The monitoring system will generally include auditing, on a sample basis, selected information such as brokerage statements, or alternative procedures that accomplish the same objective. . . .

Monitoring Procedures to Provide Reasonable Assurance of Compliance with the Financial Interest Rules

The quality control requirements noted above do not specify the matters to be covered in the audits, the information (beyond brokerage statements) to be obtained as sources of evidence in the audits, the basis for determining the number of partners and managers to be audited, the period to be covered by the audits, or the timeliness of the audits. There is a wide variation among the Firms with respect to each of these matters. As a consequence, we have recommended that the SECPS membership requirements be amended in this area (see Appendix B to this report).

Matters Covered in the Audits of Individuals

PwC tests the information submitted by its partners, managers, and other professionals in their annual Certifications to determine its completeness and accuracy. Consequently, PwC tests not only compliance by professionals with the SEC rules and the Firm's policies relating to investments in securities reported in the Firm's Tracking Systems, but also compliance relating to other financial interests (loans, broker-dealer accounts, credit cards, insurance products, and investment company holdings). (Hereafter, audits of information relating to financial interests in addition to investments in securities are referred to as "Enhanced Audits," and audits of

information relating only to financial interests in securities are referred to as “Regular Audits.”) PwC is the only Firm that conducted Enhanced Audits covering the Review Period.

The number and comprehensiveness of audits have varied considerably across the four Firms, as indicated in the following table. (Note that the table presents periods covered by audits, not the periods when audits were commenced or completed.)

Period Covered by Audits	D&T	E&Y	KPMG	PwC
July 1 through September 30, 2001	None	50 Regular Audits	30 Regular Audits for the nine months ended September 30, 2001	152 Enhanced Audits
October 1, 2001 through December 31, 2001	55 Regular Audits	None	None	150 Enhanced Audits
January 1 through March 31, 2002	(A) 50 Regular Audits for the five months ended February 28, 2002; and (B) 50 Regular Audits for the quarter ended March 31, 2002	75 Enhanced Audits	(A) 30 Regular Audits covering January 2002; (B) 88 audits limited to testing the disposition of newly restricted securities; (C) 47 audits limited to testing the timeliness of entry of investments for March 2002 by experienced, newly hired, or recently promoted partners and managers; and (D) 12 Enhanced Audits covering the 12 months ended March 31, 2002	150 Enhanced Audits

As indicated in the following table, there also is diversity in the matters that are covered in the audits conducted and the evidence inspected.

<u>Matters Covered and Evidence Requested:</u>	D&T	E&Y	KPMG	PwC
Federal income tax returns (joint or separate) and returns of dependents	No	Yes	Yes, selected schedules if Enhanced Audit	Yes
Forms 1098 and 1099	No	Yes	No	Yes
Broker and other statements indicating all financial instruments held	Yes	Yes	Yes	Yes
Information regarding all broker-dealers and any margin loans	Yes	Yes	Yes	Yes
Statements of money market accounts	Yes	Yes	Yes	Yes
Statements of trusts either as trustee or as beneficiary and financial instruments held	Not explicitly requested	Yes	Not explicitly requested	Yes
Statement of nonfirm retirement accounts and financial instruments held therein	Yes	Yes	Yes	Yes
Depository relationships	No	Yes, if a covered person	Yes, if Enhanced Audit	Yes, for any account greater than \$100,000
Real estate loans	No	Yes	Yes, if Enhanced Audit	Yes
Loans from financial institutions, excluding car loans or leases	No	Yes	Yes, if Enhanced Audit	Yes
Credits and charge cards	No	Yes, if proscribed must indicate if carried forward balance is ever > \$5K and if a covered person	Yes, if Enhanced Audit	Yes

List of all other investments not otherwise included on brokerage statements	Yes, must provide information describing direct investments in debt or equity securities	Yes, must provide information for all investments	Yes, must provide a listing of such investments	Yes, must provide copies of stock certificates
Copies of insurance policies	No	No	Yes, if Enhanced Audit	No

Basis for Selecting Individuals to Be Audited and Period Covered

D&T randomly selects partners and managers from all lines of service to audit the completeness and accuracy of the information they have entered in the Firm’s Tracking System. Seventy percent of those selected are partners and principals. A limited number of judgmental selections are also made. Responses to inquiries indicated that in the future the Firm intends to audit the quarterly activity and investments of 105 partners and 45 managers.

From the population of client-serving professionals, E&Y randomly selects a total number of individuals to be audited from all lines of business (weighted toward partners and managers) that exceeds the number that would have been selected if the Firm had used statistical tables to arrive at its specified confidence level. E&Y makes no selections for the quarter ended December 31 to avoid auditing during the busy season for its professionals.

KPMG’s selections to date have been directed at auditing the completeness and accuracy of the information entered into the Firm’s Tracking System by partners and managers from all lines of business for specific objectives. For example, KPMG conducted Regular Audits, covering investment activity and holdings as of and for the nine months ended September 30, 2001, of a sample of partners and managers who were subjected to disciplinary action as a result of issues identified in the Firm’s March 31, 2001 Certification process. Other samples of partners and managers were selected for specific purposes and for periods less than a quarter. KPMG performed 12 Enhanced Audits in August 2002. During our discussions with the Firm, KPMG indicated that it intends to audit 160 to 180 professionals annually, and has scheduled 85 enhanced reviews to be completed during the remainder of 2002.

PwC uses a statistical sampling approach to make random selections from the populations of partners, managers, and other professional employees in all lines of service to achieve its chosen statistical confidence level. The approach results in greater coverage of partners and managers, who report their securities portfolios in the Firm’s Tracking System. The selection is supplemented by some judgmental selections, such as members of senior management and newly-elected members of the Firm’s governing board. PwC selects samples to test the completeness and accuracy of financial interest activity and holdings for each quarter.

Audits of the Investments of Member Firms and Their Benefit Plans

As noted above, the SECPS membership requirements were amended in October 2001, with an effective date of January 1, 2002, to require that the monitoring system of the Firms include procedures to provide reasonable assurance that the Firms' investments and their benefit plans are in compliance with the their policies. Therefore, during the Review Period the Firms were not obligated to have such procedures in place. By June 30, 2002 each of the Firms had entered Firm investments into its Tracking System.

E&Y conducted annual procedures to determine that the Firm's investments and those of its foundation and pension plans are not in restricted entities and that its borrowings are not from restricted entities. The procedures involved comparing listings of investments and loans to the Firm's restricted entities list and determining that there were no investments in or borrowings from restricted entities, and that all investments were in the Tracking System. The procedures employed with respect to borrowings have not included review of source documents from lenders.

KPMG currently conducts monthly audits of source documents relating to the Firm's investments and those of its captive insurance company and pension plans. These audits determine that the reporting of investments in the Tracking System is accurate and that the investments are not in securities of restricted entities. KPMG's audits include review of Firm-established concentration tests to assure that KPMG could not be deemed in control of an intermediary, such as a commingled fund, and thereby have a direct investment in the securities held in the fund under the SEC's independence rules. The Firm's policies and procedures were developed and implemented over a period of time that started during the Review Period. KPMG's audits also cover the Firm's borrowing relationships.

D&T conducted an audit of its Firm investments and borrowings under the Look-Back Testing Program prior to the Review Period. While D&T has not performed audits, it has engaged a third party to perform daily procedures to validate that restricted securities are not purchased or held by the investment managers of its employees' pension plans. PwC has not conducted an audit of its Firm investments and borrowings.

Annual Internal Inspection Programs

The *Statements on Quality Control Standards* have long recognized the importance of an internal inspection function as part of monitoring of compliance with professional standards. Each of the Firms has well-developed policies and procedures for conducting comprehensive inspections of compliance with the Firm's policies and procedures to help ensure compliance with the Independence Rules.

Inspection of compliance with independence policies occurs at four levels: the national office level, the audit engagement level, the office level, and the international level.

National Office Level

KPMG and PwC conduct procedures at the national office level to test the completeness and timeliness of additions to their restricted entity lists. These procedures are in addition to those

performed by personnel assigned to the independence function and consist of searches of external databases for new client additions and initial public offerings.

KPMG and PwC also test the independence Certification process. PwC's inspectors test the completeness of the population of professionals that was circularized by randomly selecting from the payroll records a sample of professionals at all levels and in all lines of service, and tracing those professionals to the completed Certifications. The inspectors also determine whether any reported matters are included in the "reported matters" database. In addition, PwC inspectors randomly select a sample of partners and other professionals who reported exceptions to evaluate the timeliness and resolution of those exceptions.

KPMG inspectors also select a sample of independence Certifications with possible reported exceptions to test the effectiveness of the Firm's resolution process.

PwC inspectors monitor to determine that the Firm does not have prohibited relationships with SEC audit clients, in part by randomly selecting entities on the Firm's approved list of business alliances and reviewing the underlying agreements. KPMG also does this, but outside of the inspection process.

Inspection of Selected Audit Engagements

Each Firm has developed engagement review questionnaires that are tailored to the Firm's specific policies and procedures, including those related to independence, to assure consistency of the inspection of selected engagements. The responses to these questionnaires are later summarized and actions are taken to eliminate systemic deficiencies and to deal with detected independence violations.

The annual inspection process entails a major effort. The number of offices visited by inspectors of each Firm in 2002 averaged approximately 25 and the number of engagements inspected averaged 230.

Each of the Firms' engagement review questionnaires covers the following engagement-related independence issues to the extent applicable:

- listing of the client and affiliates on the restricted entity list
- whether appropriate actions were taken if Firm personnel reported employment negotiations or employment with an audit client
- whether consultation advice was sought on independence issues and, if so, the adequacy of the advice provided
- existence, completeness, and timeliness of ISB Standard No. 1 letters
- independence representations from other firms or from associated firms
- collection of prior year's fees before commencing succeeding year's audit

PwC requires professionals assigned to each audit engagement to confirm their independence annually before commencing work on the engagement. In addition, the Firm requires documentation five times a year that the engagement team has reviewed the completeness of the lists of client-related entities and related CUSIP numbers and updated the lists as necessary.

The inspection of audit engagements at E&Y, KPMG, and PwC cover the areas of nonaudit services, proscribed services, fee arrangements, and business relationships; however, there are variations in how each Firm approaches those areas. D&T deals with these issues in its functional area reviews at each office (see discussion below) and in the inspection of audit engagements covers the areas of internal audit services, management consulting services, and proscribed services.

E&Y inspectors select one nonaudit service engagement performed for each SEC audit client selected for inspection and reads the report or file memorandum and the proposal and engagement letter to determine the propriety of the services under the SECPS membership requirements and the SEC independence rules. E&Y inspectors also evaluate the propriety of fee arrangements when the Firm assists in an acquisition or divestiture.

In its inspection of each audit engagement selected for review, KPMG evaluates all nonaudit services for consistency with the Independence Rules and the SECPS membership requirements. In each case, the inspector obtains the engagement letters and considers whether the services were in accordance with those requirements and Firm policies, concerning:

- notification to the lead audit partner and others as required for services being provided for the first time to the client
- contingent, value added, discretionary payment, commission, and referral fee arrangements
- approval requirements for various types of alternative fee arrangements

In the inspection of each audit engagement where the Firm provides internal audit services to the client, the D&T inspector determines if there is evidence that such services were conducted in a manner that impairs the Firm's independence. Additionally, in its inspection of each SEC audit engagement, the D&T inspector obtained a general familiarity with management consulting engagements for the client by selecting one such engagement and performing procedures to ascertain whether the Firm complied with the relevant Independence Rules.

D&T and PwC do not require inspectors to review engagement letters relating to nonaudit services and fee arrangements.

E&Y inspectors ascertain through inquiry whether there was a business alliance or proposed cooperative arrangement with the audit client and, if so, determine whether the required Firm approvals were obtained. PwC's questionnaire requires the inspectors to consider whether there was compliance with the SEC and AICPA rules concerning nonaudit services, contingent fees, commissions, and business arrangements and alliances.

KPMG inspectors check whether the selected audit is on the Firm's list of entities with which it has financial relationships. The inspectors are on notice that if an audit client is on that list, an independence issue may exist, and they are required to evaluate that possibility.

Inspection of Independence Function at the Office Level

In addition to the inspection procedures on individual audit engagements discussed above, D&T deals with the areas of nonaudit services, proscribed services, fee arrangements, and business relationships in its office functional program. That program calls for the inspection team to:

1. Ascertain the procedures that are employed at the office level to determine whether there are any prohibited relationships that affect independence.
2. Ascertain the procedures that are employed at the office level to determine whether fee arrangements (such as contingent fees, commissions, or referral fees) affect the Firm's ability to comply with the Independence Rules.
3. Inquire and document whether any of the following situations existed during the period subject to review:
 - a. situations in which the Firm has entered into a cooperative arrangement (e.g., prime or subcontractor relationship) or other direct or indirect business relationships with a restricted entity, other than in the normal course of the client's business,
 - b. contingent fees charged to a restricted entity, and
 - c. commissions received from a restricted entity or in relation to a restricted entity's products or services.

As noted in the preceding section, each of the Firms deals with these issues during the review of individual audit engagements.

Each of the Firms conducted focus group interview sessions with two classes of professionals — managers (one group of five or six) and staff (a second group of similar number). During 2002, at the specific request of the TOS, the interview leaders for each of the Firms used TOS-prepared questions relating to the independence area (e.g., one question related to familiarity with the Firm's policies concerning employment negotiations) to assure consistency of coverage across all offices and Firms. One hundred sixty-two sessions were held at the four Firms.

Inspection of Multi-National Engagements⁷

The following summarizes the Firms' policies with respect to assuring the independence of other auditors participating in an audit of a multi-national U.S. SEC audit client. Each of the Firms has procedures to help ensure the independence of participating foreign associated firms in accordance with the *Standards for Performing and Reporting on Peer Reviews*, "Appendix C – Work Performed by Other Auditors":

- D&T: Annually, each member firm of the international firm is required by policy to report to the global office that the firm's independence partner has carried out sufficient procedures to ensure that the member firm and its professionals have complied with the independence policies of the international firm. Foreign associated firms annually obtain confirmations from professionals that they are in compliance with the international firm's independence policies, which include AICPA and SEC policies. The foreign associated firms annually confirm to the international firm that they are in compliance with the latter's independence policies. The international firm

⁷ See also Element 10: Foreign Associated Firms.

has a practice review program that requires all practices to be subject to a review at least once in a three-year period. The practice review manual requires review of compliance with the independence policies at both an assurance practice level and at a client level. Each member firm receives an international restricted entity list. There are two classifications of entities on the list, SEC restricted and other. All SEC registrants and their affiliates are SEC restricted under the Firm's international policy.

- E&Y: Both the Firm's U.S. and global inspection programs cover engagement teams' compliance with the Firm's policies with respect to assuring the independence of foreign associated firms participating in an audit of a multinational U.S. SEC audit client. Foreign associated firms annually obtain confirmations from professionals that they are in compliance with EY International's (EYI) independence policies, which include AICPA and SEC policies, and annually confirm to EYI that the foreign associated firms are in compliance with those minimum EYI policies. The EYI inspection program tests compliance with policies at the engagement and country practice levels. Among other things, at the engagement level, inspectors check that each client is on the independence list and evaluate consultations on independence issues. At the office level, inspectors cover, among other things whether policies conform to minimum EYI policies, the completeness of the independence list, the annual confirmations to EYI by the practices and by professionals in each country's practice, proscribed services, business relationships, and offers of employment.
- KPMG: The Firm's international inspection program tests compliance with the Firm's independence policies and the Independence Rules on engagements selected for inspection. The international inspection program addresses:
 - Receipt of annual independence Certifications from partners and staff
 - Appropriate listing of publicly-held audit clients on the Firm's international listing
 - Staff awareness of independence policies (determined through interviews)
 - Deployment of appropriate controls to ensure that prohibited services are not rendered to SEC audit clients
- PwC: Both the Firm's U.S. and global inspection programs cover engagement teams' compliance with the Firm's policies with respect to assuring the independence of foreign associated firms participating in an audit of a multi-national U.S. SEC audit client. The U.S. program determines whether an appropriately worded written confirmation of independence was obtained annually from each non-U.S. PwC firm prior to that firm's commencing its portion of the engagement.

PwC's international inspection program covers such matters as (a) whether annual written confirmations of compliance with the Firm's independence policies have been obtained from all professionals and whether any exceptions identified have been dealt with appropriately, (b) whether engagement partners and managers assigned to SEC engagements are aware of the restrictions on professional services that can be provided, (c) whether the client appears on the Firm's independence database, and (d) whether nonaudit services were conducted and billed in conformity with relevant professional standards and Firm guidelines so as to avoid independence issues.

While PwC considers the Firm's independence on an engagement-by-engagement basis, the Firm also obtains an annual independence confirmation from each of its foreign associated firms indicating that the it was in compliance with the Firm's independence policy in that (a) it did not have any SEC-proscribed financial interests in treasury investments, pension plans, or other similar plans, and (b) it was in compliance with the Firm's policy regarding bookkeeping and payroll services.

Element 5: Senior Management and Others Responsible for Independence Systems and Controls

The SECPS membership requirements specify that:

Each member firm shall designate a senior-level partner responsible for: (1) overseeing the adequate functioning of the independence policies of and the consultation process within the member firm; (2) providing or otherwise making the Restricted Entity List readily available to all professionals; (3) keeping the Restricted Entity List updated on at least a monthly basis; and (4) communicating additions to the Restricted Entity List on a timely basis (generally monthly).

This element of independence quality control thus relates to the organization and staffing of the independence function; the management of the Firm's restricted entity list; the administration of the consultation process; the notification to senior independence partners of alleged or apparent independence violations and their monitoring of those matters; the reporting by senior independence partners to top management of current independence issues, Firm education needs, violations, and discipline; and the communication by top management of independence matters to Firm professionals. Each Firm has different mechanisms to accomplish these objectives, although the coordination and oversight exercised by PwC over certain of its Systems and Controls were deemed by us to be insufficient.

Communication channels exist between the independence leader and the top management of each Firm. At each of the Firms, periodic reports on independence matters are made to the governing boards. The independence leader of PwC is a member of that Firm's management committee, and reports directly to the CEO.

Each Firm updates its restricted entity list at least weekly, which is significantly more often than required by the SECPS membership requirements. Controls are in place to assure that both changes to the contents of the Tracking Systems and the systems themselves are made by authorized personnel.

Changes in a Firm's independence guidance caused by changes in the Independence Rules or by Firm policies are developed by professionals in the national independence offices and authorized by the appropriate person in the national independence office and often by a higher level of management. Each Firm's national independence office is involved with the content of the Firm's independence training to assure that it focuses on the most important matters and that it is consistent with Firm policies and the Independence Rules.

Although the title of the partner to whom notices of alleged or apparent independence violations are sent varies by Firm, generally the notices are routed to a partner in the national independence office or a partner whose responsibilities include independence matters. The possible violation is

documented, analyzed, and, if applicable, resolved promptly. The seriousness and the complexity of the independence matter influence whether the independence leader is personally involved. Actual violations are generally summarized, reported periodically to the independence leader, and sometimes to others within a Firm.

The nature and extent of the documentation of independence consultations varies, and generally depends on the complexity and the seriousness of the independence matter being considered. The documentation of complex or serious independence matters normally summarizes the facts, identifies the applicable Independence Rules, and draws appropriate conclusions. Each of the Firms has mechanisms to deal with a range of questions, commonly those involving responses to annual independence Certifications by professionals. KPMG has a centralized database of consultations that generally is accessible to professionals in the national independence office. KPMG's national independence office has prepared summaries of consultations that it believes are broadly applicable and posts them on the national independence office's website. Each Firm has appropriate guidelines that specify the independence matters that require consultation and identify who should be consulted.

Although the Firms do not have explicit policies that require following the advice of independence consultants, Firm cultures, combined with tests made in each Firm's inspection program and disciplinary actions from not following advice of the independence consultants, reasonably assure compliance with that advice. Recommendations for strengthening the consultation process are included in Appendix B.

Element 6: "Tone at the Top" and Culture Relating to Independence

The SECPS membership requirements indicate that the importance of compliance with independence standards and related quality control standards should be reinforced by management of the firm, thereby setting the appropriate "tone at the top" and instilling its importance into the professional values and culture of the firm.

Interviews conducted at each Firm with the chief executive officer (CEO) and other members of senior management, including leaders for each major line of business (e.g., tax and audit), as part of evaluating the Firm's culture and "tone at the top" indicated that each Firm's senior management has adopted strategies and procedures to communicate the importance of independence to all professional personnel. Each of them demonstrated an understanding of the independence requirements, their involvement in developing their Firm's response to the need for independence, maintaining a culture of independence, and communicating the importance of independence in all areas of professional practice.

Each of the CEOs was knowledgeable about processes in place to maintain and monitor compliance with the Independence Rules and Firm policy, including their Firm's independence Tracking System, Certification process, and training. Each discussed procedures in place to assure training of newly admitted partners and newly hired managers, and their compliance with the Independence Rules and Firm policy, particularly in the context of the recent hiring of former Andersen LLP professionals. Each CEO gave examples of personal voice mail and email communications concerning the importance of independence and various aspects of the Firm's compliance requirements. A wide variety of examples were given, but among those cited (and selectively reviewed by the TOS reviewers) were a voice mail reminder to all professionals concerning the importance of timely completion of the annual independence Certification,

inclusion of videotape messages as part of independence training and email messages to specific practice groups on specific issues such as contingent fees and alliances.

The Firms' CEOs noted the dedication of substantial resources to maintaining a culture of independence and their commitment to continuing to supply those resources. They each cited frequent presentations by senior independence personnel to the Firms' management committees on a wide variety of independence matters. Similarly, they discussed the significant effort and resource commitment associated with rolling out enhanced independence requirements to the international components of their Firms.

Element 7: Prompt Reporting of Personnel Employment Negotiations

ISB Standard No. 3, *Employment with Audit Clients*, and the SEC's independence rules are the primary source of the requirements related to this element. SEC Rule 2-01(d)(4)(vii) states that a firm's quality control system for independence should include:

Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement.

ISB Standard No. 3 contains more specific guidance on a program of safeguards and procedures that firms should implement to effectively eliminate the risk of impairment of independence when a former firm professional joins an audit client. Such a program and procedures should enable a firm to comply with the SEC rule.

Each of the Firms has written policies and procedures in this area; however, they differ in substance and specificity in some respects. Perhaps the most important differences are with respect to which personnel are required to report to the Firm and when and to whom in the Firm they should report. KPMG requires professionals to report "conversations" between themselves and an audit client regarding possible employment (consistent with ISB Standard No. 3). E&Y's policy states that "professionals do not seek employment with a proscribed entity while participating in an engagement requiring independence," and requires professionals to report if they are "offered employment while participating in the engagement." D&T and PwC require professionals to report if they are offered or seek employment with a client during the performance of an engagement requiring independence. The policies of the last three Firms are specific with respect to whom the report should be made, while KPMG's policies are not.

Each of the Firms requires the immediate removal of the reporting professional from the audit engagement when the person currently is on the engagement, and the prompt liquidation or settlement of all capital and retirement balances when that is necessary.

KPMG and PwC require a prompt review of the work the professional performed related to the engagement, and they require this review regardless of whether the professional accepts employment with the client. D&T requires a prompt review of the work performed by a partner or manager only when the partner or manager accepts employment with the client. The partner exercises judgment based on several factors in determining whether and the extent to which the work of a staff person who accepts employment with the client needs to be reviewed. E&Y's

policies recognize that the nature and extent of the review procedures to be undertaken will vary depending on the position of the person who is leaving the Firm (e.g., the partner in charge of the audit versus a junior staff person) and the timing of the decision to leave the Firm. KPMG states that the review should be performed by another appropriately designated partner if the person leaving the Firm is a partner. KPMG is silent, however, on who should perform the review when the person leaving is not a partner. The other three Firms provide extensive guidance on who should perform the review.

E&Y, KPMG, and PwC require the ongoing engagement team to give active consideration to the need to modify the audit plan to adjust for the risk of circumvention of the audit approach or testing strategy by a former member of the engagement team who has gone to work for the client. D&T's policies do not address this area.

While E&Y, KPMG, and PwC state in their policies that the Firm should take appropriate steps to help ensure that the existing engagement team members have the stature and objectivity to deal effectively with the former Firm professional and his or her work when the former Firm professional has significant interaction with the engagement team, the steps to be taken are not set forth in detail because they appropriately will vary depending on the circumstances. E&Y's and PwC's policies are more specific than KPMG's policies with respect to who should determine the steps to be taken in the specific situation. D&T requires appropriate specified personnel to review the appropriateness of the partners assigned to the engagement when a partner who was on the engagement or in a leadership position in the Firm joins a client. The specified personnel also are to consider the need for involvement of other partners with appropriate experience and stature to ensure an appropriate level of skepticism is maintained.

E&Y, KPMG, and PwC require a separate review of the next annual audit by someone who is uninvolved in the audit when a former Firm professional joins a client within one year of disassociating from the Firm and the professional has significant interaction with the engagement team. D&T's policies do not address this matter.

All four Firms have advised retired partners to notify the Firm before accepting officer or director positions with a client, and all have alerted engagement partners to monitor their clients for situations in which retired or former partners have joined the client and to report such matters to designated personnel in the Firm. PwC's audit program requires engagement teams to determine whether any former Firm personnel have joined the client in audit-sensitive positions or in positions where they can influence the entity's financial reporting. Engagement teams are required to perform this procedure five times each year – during each quarterly review, when planning the audit, and at the completion of the audit.

Element 8: Reporting by Personnel of Apparent Independence Violations

The Independence Requirements for this element are found primarily in the membership requirements of the SECPS (Appendix L, *Independence Quality Controls*). They include:

Each member firm's independence policies and procedures should specifically require the following:

Each professional shall report apparent violations of policies involving himself or herself and his or her spouse and dependents and the corrective action taken or proposed to be taken on a timely basis when identified. . . .

Each member firm shall have a monitoring system under the supervision of the senior-level partner . . . to determine that adequate corrective steps are taken and documented on all apparent violations reported by professionals within the member firm. . . .

Each of the Firms has policies that state that personnel are required to report apparent independence violations involving themselves or their spouses or dependents when they are identified. Each of the Firms also has policies that state that personnel who report apparent independence violations are required to identify the corrective actions they have taken or propose to take. At KPMG, the national independence office determines the corrective action to be taken and advises the individual and the Business Unit Professional Practice Partner. From July 1, 2001 through December 31, 2001 the Business Unit Professional Practice Partner was responsible for following up and ensuring that the appropriate corrective action had been taken. In addition, the national independence office followed up and required evidence of corrective action when it involved the disposition of a security. At PwC, the national independence office requires the individual to take corrective action immediately, to report when the action was taken, and in some cases, to provide documentation of the corrective action. D&T does not specify the medium to be used, although it requires the individual to describe the apparent violation and the corrective action taken or proposed to be taken. At E&Y, the individual is required to confirm the corrective action that has been taken, or the national independence office follows up to assure that it has been taken.

Each of the Firms' policies identifies the senior-level partner (or the national independence office he leads) to whom apparent independence violations are to be reported for the purpose of determining the appropriateness of the corrective actions, the need to consider disciplinary actions, and the need to consider any actions with respect to the clients involved.

At each of the Firms, the senior-level partner periodically reports to senior management on a variety of independence matters, including violations and discipline. The senior-level partner in each Firm exercises judgment in determining which violations are so significant that they should be reported to senior management immediately. At KPMG, the national independence office distributes a summary report on the annual Certification process to all Firm personnel. In addition, violations that involve an audit engagement are required to be reported to the audit engagement partner. At PwC, the Firm's audit program requires the engagement team to check with the national independence office for any independence matters of which it is aware for inclusion in the ISB Standard No. 1 letter.

Each of the Firms follows up to confirm that reported apparent independence violations have been resolved and that any proposed corrective actions are appropriate and have been carried out and are documented. The nature and extent of the follow up depend upon such factors as the nature of the violation, the level of the person involved, and the severity of the violation.

For example, at E&Y the national independence office exercises judgment based on such factors as the rank of the individual involved, the nature of the violation, whether it appears to be inadvertent, whether there are multiple violations or it is an isolated matter, and whether the person involved is a covered person, and if so, what type of covered person. Violations

involving covered persons are given priority. At KPMG violations involving investments are followed up by the national independence office to ensure that the required corrective action has been taken. The individual involved is required to confirm and provide evidence that the corrective action has been taken. The national independence office or the applicable Business Unit Professional Practice Partner is responsible for reviewing other violations and uses professional judgment in determining whether and what follow up is necessary. At PwC, when investments are involved, the corrective action, including the date it occurred, is reported on an electronic form that is submitted to the national independence office. The national independence office exercises judgment in determining the appropriate follow up on other types of violations. At D&T, if the violation involves investments, the professional is required personally to enter the disposition in the Firm's Tracking System.

Each of the Firms maintains a record of reported apparent independence violations and actions taken to determine whether a violation has occurred and whether any necessary corrective actions have been taken on a timely basis.

Element 9: Disciplinary Policies

The independence quality control standards of the SECPS require member firms to include guidelines in their independence policies for actions to be taken against professionals for independence violations. Firms are directed to foster an environment where the seriousness and importance of compliance is evidenced in many forms, such as by the action taken in the case of noncompliance with such policies.

The independence policies of D&T, KPMG, and PwC describe their disciplinary mechanisms and policies, and thus comply with the independence quality control standards. The written independence policies of E&Y do not include the required description of the guidelines for actions to be taken against professionals for independence violations.

The sanctioning guidelines established by KPMG and PwC categorize infractions and assign increasingly severe penalties according to their seriousness. Factors considered in evaluating the seriousness of an infraction include whether the individual is a covered person, has violated the Firm's independence policies or the Independence Rules, has a history of violations, and whether the violation was inadvertent or intentional. PwC analyzes infractions using computer models that assign points to infractions based on a number of factors, including those described above, and score each infraction. D&T and E&Y do not use this approach to determine independence sanctions. At D&T, senior executives of the Firm determine the appropriate discipline. At E&Y, the Vice Chair, Professional Practice or the National Director of Independence provides guidance and examples of sanctions for consideration by the supervisors of individuals with independence violations, and it is those supervisors, in consultation with the Vice Chair, Professional Practice or the National Director of Independence, who determine the sanction to be applied. Each of the Firms' disciplinary processes involves the exercise of judgment to some degree in analyzing infractions and applying sanctions. Each Firm believes that its methodology results in a consistent application of sanctions because, in the case of D&T, E&Y, and KPMG, sanctions are determined by the same individuals over time using their matrices or other guidance, while for PwC the consistency is achieved by its computerized model. The types of sanctions imposed by each of the Firms are similar, and include written admonitions, reduction of performance ratings, monetary penalties, and dismissal from the Firm. Only KPMG communicates a summary of the deficiencies identified in its annual independence Certification process to its personnel.

The Reviews identified differences with respect to the timeliness of each Firm's analysis of violations and the application of disciplinary sanctions. E&Y and KPMG apply sanctions promptly after they are identified. PwC generally takes a longer period of time to analyze infractions and discipline personnel, principally because their disciplinary system is quite comprehensive and considers relevant history. D&T has not completed its analysis of, or issued any sanctions for, independence violations identified subsequent to the completion in July 2001 of the Look-Back Testing Program.

The diversity that exists in the disciplinary processes and practices of the four Firms demonstrates that the independence quality control standards are not sufficiently specific in this area. Recommendations for strengthening these standards are included in Appendix B.

Element 10: Foreign Associated Firms⁸

The SECPS membership requirements provide that member firms that are members of, correspondents with, or similarly associated with international firms or international associations of firms should seek adoption of policies and procedures by the international organization or individual foreign associated firms that are consistent with the objectives set forth in Appendix K of those requirements.

The objectives described in Appendix K are summarized as follows:

- (a) Policies and procedures should address the performance of procedures with respect to certain SEC filings by SEC registrants that are clients of foreign associated firms by a person or persons knowledgeable in accounting, auditing and independence standards generally accepted in the U.S., independence requirements of the SEC and ISB, and SEC rules and regulations in areas where such rules and regulations are pertinent (the "filing reviewer").
- (b) Policies and procedures should address the review of a sample of audit engagements performed by foreign associated firms for clients that are SEC registrants. (Such reviews may be performed as a part of an annual inspection program of the international organization or the individual foreign associated firms.)
- (c) Policies and procedures to resolve disagreements between the filing or inspection reviewer and the partner in charge of the audit engagement.

Each of the Firms has established policies and procedures to provide reasonable assurance of compliance with the Appendix K objectives. These policies and procedures require that all SEC filings by foreign registrants (including registration statements and annual Form 20-F filings) be reviewed by a filing reviewer. The Firms have designated audit partners to perform these filing reviews who are knowledgeable about the requirements of generally accepted accounting principles and generally accepted auditing standards in the U.S., including SEC and ISB independence requirements. They have developed various forms and checklists for use by filing reviewers and engagement teams to document compliance with the filing review procedures.

The procedures performed by the filing reviewers regarding independence include discussing with the partner in charge of the audit engagement (1) the engagement teams' familiarity with

⁸ See also "Inspection of Multi-National Engagements" in Element 4: Internal Monitoring of Independence Systems and Controls.

the understanding of U.S. independence standards, including independence requirements of the SEC and the ISB; (2) the significant differences between the independence standards of the foreign associated firm's country of domicile and those applicable in the U.S.; and (3) any significant independence matters that come to the attention of the filing reviewer and how such matters were addressed and resolved by the audit partner in charge of the engagement. The Firms' policies also include procedures for resolving any differences of opinion between the filing reviewer and partner in charge of the audit engagement.

In order to monitor the timely completion of these reviews, each of the Firms has developed a master list of foreign SEC audit clients. These lists generally include the names of the clients, audit engagement partners, and assigned filing reviewers.

Further monitoring of the filing reviews is done through the Firm's international inspection program. In general, the inspection policies and procedures in place in the Firms' international organizations are similar to those employed in the U.S. Included in the engagements selected for review under the international inspection programs are engagements of foreign SEC registrants. The inspection questionnaires include questions related to independence and completion of the filing review procedures.

The Firms also have adopted policies and procedures to provide reasonable assurance that their foreign associated firms, their personnel, and their spouses and dependents comply with independence requirements when participating in audits of segments of U.S. SEC audit clients.

Element 11: Business Relationships and Alliances, Commissions, and Contingent Fees

The Firms' business relationships and alliances with other entities and nonstandard fee arrangements (including commissions and contingent fees) (collectively, Arrangements) present independence complexities and recently have received the attention of regulators and legislators. The Reviews included analyses of the Systems and Controls that each Firm has implemented with respect to Arrangements. The Firms' Systems and Controls with respect to these matters fall generally into the following five areas:

- policies and training programs concerning Arrangements
- review and approval of proposed Arrangements
- involvement of the partner responsible for audit services in decisions on proposed Arrangements
- tests during the inspection programs for compliance of Arrangements with Firm policies
- other controls

Policies and Training Programs Concerning Arrangements

The policies of each of the Firms address and provide suitably comprehensive guidance on Arrangements. This guidance is provided in the Firms' independence policies, their line-of-service policies, or a combination of them. There is some diversity in the content of the Firms' training programs in this area, however. D&T, E&Y, and KPMG address Arrangements in their mandatory, monitored independence training program and, in some cases, in programs presented to service-line groups where such matters are likely to be encountered. PwC did not add Arrangements to its mandatory, monitored training programs until April 2002, but provided

certain targeted training before that. Although, as discussed in Appendix A, Deloitte Consulting (DC) is unable to demonstrate that all of its personnel received training on Arrangements, DC did issue a series of electronic messages to its professionals that focused specifically on compliance with the Independence Rules and D&T policies on contingent fees and business alliances, either of which could create independence issues for D&T.

Review and Approval of Proposed Arrangements

Alliances, Joint Ventures, and Other Business Relationships

Each of the Firms sometimes enters into alliances, joint ventures, or other business relationships (collectively, Business Relationships) with other organizations. In some cases these Business Relationships could affect the Firm's independence with respect to the other organization, thereby preventing the Firm from providing audit or other attest services to the other organization. Each of the Firms has a required process for review and approval of proposed Business Relationships. The characteristics of the Firms' processes are summarized in the following table.

Process Established for Considering Whether to Enter into a Business Relationship	D&T(a)	E&Y	KPMG	PwC
The Firm has established a centralized process requiring review and approval of a Business Relationship before it is entered into	√	√	√	√
The process requires:				
○ A written submission describing the proposed Business Relationship	√	√	√	√
○ Investigation of the background of the other party to the Business Relationship, including its significant officers and directors	√	√	√	√
○ Review of the proposed Business Relationship by the:				
▪ Operating management of the line of business and/or the Firm's national office	√	√	√	√
▪ National independence office and/or office of general counsel	√	√	√	√
○ Review of the Business Relationship agreement by the national independence office and/or office of general counsel	√	√	√	√
Documentation of approval of a Business Relationship is retained	√	√	√	√
If the proposed Business Relationship is with an audit client, the lead audit partner is involved in the review of the proposal before the proposed Business Relationship is consummated	√(b)	√	√	√
If the Business Relationship involves an audit client, it is subject to review under the Firm's audit inspection program	√	√	√	√

√ The Firm's procedures include this requirement.

(a) Includes Deloitte Consulting.

(b) The partner responsible for managing the service relationship for an audit client (lead service partner), who is generally an audit partner, is notified and is responsible for reviewing the proposal.

Nonstandard Fees

Each of the Firms has policies that require approval of most nonstandard fees for audit clients and provide guidance with respect to the content of engagement letters as summarized in the following table.

Policies for Nonstandard Fees with Audit Clients	D&T(a)	E&Y	KPMG	PwC
The Firm's policies establish a centralized process for review and approval of nonstandard fees before they are entered into	√	√	√	√
The review process includes the engagement letter	√	√	√	√
The Firm's policies with respect to nonstandard fees do not permit fees with audit clients that are prohibited by the Independence Rules, such as contingent fees, commissions, referral fees, and finder's fees	√	√	√	√
The Firm's policies provide suitable guidance on nonstandard fees and specifically require consultation with individuals knowledgeable about the Independence Rules before using various forms of value-based fees	√	√	√	√
The lead audit partner is involved in the evaluation of the proposal on a timely basis before it is entered into	√(b)	√	√	√
Nonstandard fees, including documentation (e.g., approved engagement letters and memoranda concerning significant issues), are subject to review under one of the Firm's inspection programs	√(c)	√	√	√(c)

√ The Firm's policies and procedures include this requirement for all lines of business likely to have these types of fees.

(a) Includes Deloitte Consulting.

(b) The partner responsible for managing the service relationship for an audit client (lead service partner), who is generally an audit partner, is notified and responsible for evaluating the effect of the proposal.

(c) The Firm's inspection program leaves the extent of review of engagement letters and other documentation to the judgment of the reviewer based on responses to inquiries concerning nonaudit services and nonstandard fees.

Involvement of the Partner Responsible for Audit Services in Decisions on Proposed Arrangements

Both KPMG and PwC have a policy under which the lead audit partner has the ultimate responsibility for ensuring that the Firm's continued independence with respect to the client is not impaired as a result of an Arrangement. The TOS has been informed by D&T and E&Y that those Firms have a practice under which the lead service partner in the case of D&T and the lead audit partner in the case of E&Y has the ultimate responsibility for ensuring that the Firm's continued independence with respect to the client is not impaired as a result of an Arrangement. D&T (with respect to fees for tax services), KPMG, and PwC have written policies that require others in the Firm who plan to propose Arrangements to an audit client to advise these partners of those plans, so that their independence ramifications can be evaluated. D&T (with respect to other matters) advised the TOS that it is customary practice that the lead service partner be informed of any Arrangement before it is proposed. E&Y's lead audit partner reviews and concurs in tax service engagements involving value-added and findings-based fees.

Tests During the Inspection Programs for Compliance of Arrangements with Firm Policies

The TOS reviewed the procedures performed in the Firms' inspection programs as part of the Review, and identified inspection procedures designed to test compliance with the Firms' independence policies pertaining to Arrangements. The procedures in the Firms' audit quality inspection programs are discussed in Element 4: Internal Monitoring of Independence Systems and Controls, and are summarized in the following table, together with the procedures in the Firms' other line-of-service inspection programs.

Annual Audit Quality Inspection Program	D&T	E&Y	KPMG	PwC
Procedures require reviewers to make inquiries about Arrangements and their appropriateness during inspections at the engagement, office, or national levels	√	√	√	√
Engagement letters for nonaudit services are reviewed for audit engagements selected for review to determine whether the service and fee terms are appropriate	No(a)	√(b)	√(b)	No(a)
Quality Review Inspection Programs in Nonaudit Lines of Business that Include Procedures for the Review of Nonstandard Fees and Engagement Letters				
Tax services	√	√	√	√
Consulting services	√ D&T; NSP-DC	N/A	N/A	NSP
Financial advisory services	NSP	NSP	√	√
Valuation services	NSP	√	N/A	N/A

√ The Firm performs this procedure in the indicated inspection program.

N/A The Firm did not have this line of service during the Review Period.

NSP The Firm does not have a separate inspection program for this line of service; however, nonstandard fees and engagement letters for engagements in this line of service performed for audit clients are subject to review in the Firm's audit inspection program.

(a) The Firm's inspection program leaves the extent of review of engagement letters to the judgment of the reviewer based on responses to inquiries concerning nonaudit services and nonstandard fees.

(b) E&Y requires the review of the letter for one selected nonaudit service engagement for each audit engagement reviewed; KPMG requires the review of letters for all nonaudit services engagements for each audit engagement reviewed.

Other Controls

Some of the Firms have controls over Arrangements in addition to those described above. PwC's standard audit programs require all engagement teams to consider whether any nonaudit services provided to the client or Business Relationships between PwC and the client have created an independence issue. KPMG's standard audit checklist requires each engagement team to verify that the client is not listed on the Firm's Financial Relationship List and, if it is listed, to investigate whether an independence issue exists.

Appendix E: Description of the Firms' U.S. Practices

The following table summarizes information about the Firms' U.S. practices on the dates indicated based on information submitted by each Firm to the SECPS of the AICPA.

Summary Description of the Firms' U. S. Practices (1)				
	D&T	E&Y	KPMG	PwC
"As of" Date of Firm-Supplied Data	June 2, 2001	June 29, 2001	June 30, 2001	June 30, 2001
Number of Partners or Equivalent	1,779	1,934	1,451	2,784
Number of CPAs	6,228	7,218	5,761	8,391
Number of Professionals	17,000	15,805	12,349	36,238
Number of Personnel	22,300	22,526	18,176	43,134
Number of SEC audit Clients	2,877	2,923	1,808	3,025
Gross Fees Expressed as a Percentage of the Total: (2)				
Accounting and Auditing	33%	57%	44%	35%
Tax	22%	38%	38%	20%
Management Consulting	45%	5%	18%	45%
	100%	100%	100%	100%
Number of Offices in the United States	97	83	57	145
<p>(1) The information included in this Summary Description may be materially affected in 2002 as a result of the acquisition of SEC audit clients and personnel previously reported by Andersen LLP. PwC's consulting practice is included in the data provided in the table. (PwC divested its consulting practice in October 2002.) Deloitte Consulting LP is included in D&T's "Gross Fees Expressed as a Percentage of the Total." The data for numbers of partners or equivalent, CPAs, professionals, and personnel shown for D&T are for Deloitte & Touche LLP only. As of June 2, 2001 Deloitte Consulting LP, which is not a member of the SECPS, had approximately 500 principals and 5,700 client service personnel.</p> <p>(2) The gross fees percentages lack comparability because of the fiscal year 2000 disposition by E&Y of its consulting practice and the fiscal year 2001 disposition by KPMG of its consulting practice.</p>				

Appendix F: Firm Responses to Deficiencies in Systems and Controls

This Appendix contains the response of each of the Firms to the deficiencies in the Firm's Systems and Controls that are noted in this report.



December 16, 2002

Mr. Jerry D. Sullivan
Executive Director
Transition Oversight Staff
One Station Place
Stamford, CT 06902

Dear Mr. Sullivan:

This letter is our response to the comments issued in connection with our Firm's independence quality control systems review for the six months ended December 31, 2001. All of the necessary changes to our quality control policies and procedures in response to such comments will be closely monitored.

1. We have obtained documentation of the successful completion of training for approximately 90% of the Deloitte Consulting LP client service personnel for which we did not have a record of having completed independence training as of August 2002. We are continuing our efforts to obtain documentation of the completion of training for the remaining 10% of such DC client service personnel.
2. We will amend the Firm's written policies to include requirements for the lead client service partner (LCSP) responsible for a restricted entity to: (a) be notified of all (i) nonaudit services proposed to be provided to the entity and the related fee arrangements, and (ii) proposed business relationships with the entity, and (b) document his or her evaluation of the independence implications of proposed nonaudit services, fees, and business relationships.
3. We will amend the Firm's written policies to require (rather than encourage) a former partner or principal who is not a retiree, but who has an unsettled financial interest in the Firm, to consult with National Office (Independence) before he or she accepts a position with a Restricted Entity.
4. We will amend the Firm's written policies such that they explicitly include all of the procedures required by ISB Standard No. 3, Employment with Audit Clients.
5. We have reemphasized to the appropriate office management the need to obtain independence representations from newly hired experienced employees and professionals transferring between offices.
6. We will update our independence training programs to reflect the Firm's current policies, including the 2001 changes to the SEC's other financial interests independence requirements.

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Mr. Jerry D. Sullivan
December 16, 2002

7. We are in the process of reviewing violations by professionals of the Independence Rules or Firm policies during the six months ended December 31, 2001 and have commenced the imposition of disciplinary actions for such matters.

Sincerely,

Deloitte & Touche LLP

December 16, 2002

Transition Oversight Staff

Following is Ernst & Young LLP's response to the comments of the Transition Oversight Staff (TOS) about the Firm's Systems and Controls included in Appendix A to the Report on the Independence Quality Control Systems of Four Reviewed Firms.

Response to TOS Comment 1. The TOS notes that new, more restrictive SEC independence rules relating to the settlement of capital and retirement interests of former Firm professionals who join Firm audit clients as officers or directors became effective in early 2001. We adopted policies and procedures on a timely basis to achieve compliance with Rule 2-01(C)(2)(iii) of Regulation S-X and to monitor the settlement of accounts with the Firm. However, we experienced some transition issues that resulted in a few situations where the settlement of accounts with the Firm was not accomplished prior to the date when a partner joined a client as an officer or director. In each of these cases the settlement was in process, and we had safeguards in place in the interim period. In two situations where the ISB Standard No. 1 letter did not cover this matter, supplemental ISB Standard No. 1 letters have since been issued. In addition, the Firm has strengthened and will continue to strengthen its monitoring procedures to ensure timely settlement in the future.

Response to TOS Comment 2. The TOS notes that the Firm's sanctioning guidelines dealing with independence violations by professionals were informal and, although they were distributed to managing partners and others for their use in applying sanctions, the guidelines were not communicated to all professionals. As the TOS is aware, violations involving covered persons have been rare at E&Y. In the few situations where a serious independence violation has occurred, we have taken strong, swift, and visible action.

Our actions have been consistent with our formal Independence Policy Statement that advises our professionals that, "Violations of professional and/or regulatory standards or rules that are other than inadvertent and that are not timely corrected can have severe consequences to the professional." As the TOS noted, our informal policies that describe a range of possible actions to take in response to violations have not been distributed to all professionals but rather have been distributed only to management for its use. In part, we do not wish to communicate a policy that indicates milder sanctions might be appropriate for less serious infractions. We prefer that our professionals understand the threat of very strong sanctions for any violation depending on the facts and circumstances, and believe that such an approach enhances full compliance with all aspects of our policies.

Notwithstanding our view, we will undertake to develop and communicate more formal disciplinary policies and guidelines and sanctioning procedures. In this connection, we note that in Appendix B of this report, the TOS has made recommendations to the SECPS with respect to membership requirements regarding disciplinary policies. We will work with the SECPS Executive Committee to consider timely revisions to the membership requirements, and will adopt policies and practices consistent with those revisions prior to the proposed effective date.

Response to Comment 3. The TOS notes that the Firm's policy relating to possible employment of a professional by a client did not explicitly require the professional to report conversations or discussions with the client, as required by ISB Standard No. 3, *Employment with Audit Clients*. As indicated in the description of Element 9 in Appendix D of this report, we do not allow our professionals to seek employment while participating in an engagement requiring independence, and if they are approached, i.e., offered employment, they must notify the Firm and remove themselves from the engagement. The ISB Standard No. 3 threshold is when employment negotiations commence, whereas our requirements kick in before employment negotiations commence and apply even in situations where employment negotiations actually never occur.

Based on our experience with notifications by professionals and consultations with our National Office Professional Practice personnel at the initial conversation or discussion stage, we believe that our people understand these requirements and are sensitive to these issues, despite the fact that our policy does not use the literal wording in ISB Standard No. 3.

Notwithstanding our view, given the TOS's determination that ISB Standard No. 3 wording should be literally used (as evidenced by this same comment being issued to three of the four Firms subject to review), we will revise our policy accordingly, while maintaining our more rigorous policies and procedures and continuing to emphasize to our people the importance of compliance in this area.

Very truly yours,

Ernst + Young LLP



280 Park Avenue
New York, NY 10017

Telephone 212 909 5400
Fax 212 909 5699

December 19, 2002

Transition Oversight Staff
Stamford, Connecticut

Gentlemen,

This letter represents our response to the comment included in Appendix A of your report entitled "*Report on the Independence Quality Control Systems of the Four Reviewed Firms*" issued in connection with your review of the design, implementation, and operating effectiveness of the independence systems, procedures and internal controls developed by KPMG LLP and implemented as of June 30, 2001 and operating during the six months ended December 31, 2001.

Independence Compliance Auditing

We believe in considering this comment the TOS should have given more weight to the extensive auditing we conducted during 2001, under the supervision of outside counsel, in connection with the Look-Back Testing Program. We acknowledge this is a matter of professional judgment. KPMG's policy is to perform an appropriate number of independence related compliance audits on an annual basis, which we believe is contemplated by the SECPS and SEC requirements. In connection with the Look-Back Testing Program, KPMG performed 336 expanded audits (covering loans, credit cards, and other financial interests and relationships as well as investments) during the period from January 1, 2001 through July 15, 2001.

In summary, during the eighteen months ended June 30, 2002, we performed 543 audits. In our view, the audits conducted during the period were sufficient to meet the audit requirements. Had we believed they were not, additional audits would have been conducted.

We agree that documentation of audit work performed could be improved and have already taken appropriate steps to enhance the documentation of our 2002 audits.

KPMG LLP

KPMG LLP
New York, NY



Transition Oversight Staff
One Station Place
Stamford, CT 06902

December 16, 2002

Dear Sirs:

We appreciate this opportunity to respond to comments contained in your report titled, "Report on the Independence Quality Control Systems of the Four Reviewed Firms" (hereinafter, referred to as the "Report"). We recognize that you undertook a challenging assignment in a very complex arena that has been subject to a dynamically changing regulatory landscape and commend you for your efforts.

From an overall viewpoint, we believe that the matters raised in Appendix A of the Report, to a certain degree, represent differing judgments or preferences in areas of organization and system design and function. You can be assured that we are taking your comments and observations seriously with a goal of improving our firm's systems and processes surrounding our independence functions.

The first comment relating to our firm focuses around perceived sufficiency of coordination and oversight over certain elements of our system and a recommendation for an additional senior oversight partner. As you have already been informed, we had previously been considering certain changes to the structure and organization of our independence functions and we will take into account your suggestions as we implement our changes. By way of background and as you are aware, two independence partners retired on July 1, 2002 just as your review began. Consequently, at that time, the independence office was transitioning the responsibilities of the two retiring partners and adding another senior partner. Moreover, also as you know, two senior partners were unexpectedly out of the office during much of your review period and the independence group was supporting the global rollout of the updated independence system. As a consequence, the independence office was shifting responsibilities

during the time of your onsite review, as well as responding to your questions, all of which may have contributed to your perception in this area. While we believe our group worked well together as a team to address situations and change in this dynamic environment, to reiterate, we will consider your suggestion in our restructuring.

In response to the second comment, PwC has been in the process of implementing its global independence system that is required by January 1, 2003. In this process and at the time you were conducting your review, PwC added additional data feeds to the master securities file to include securities generally available only outside the United States. PwC had also just released a revised format for displaying the independence and securities list to assist the engagement teams in performing their required audit steps and for the independence office to perform additional analytical procedures on the data. Although comprehensive reviews were performed, we will consider performing additional analytical procedures in the independence office and reemphasizing engagement team responsibilities.

As to the third comment, our approach to independence training has been to provide individuals with training on personal independence matters at one time or upon initial employment. We then develop relevant independence training as an overall curriculum that is provided to targeted groups such as new managers or lines of service personnel focusing on points in their career where their responsibilities change or specific areas within their practice. Within this curriculum, we provided training on scope of services, business relationships, and fee arrangements within the training of targeted groups when relevant to the individual's role and responsibility. Generally, this independence training was a part of a one or multi day training program. In addition, in April 2002 and consistent with our curriculum, we issued a comprehensive scope of service course targeted to partners and managers. Further, all continuing education courses are tracked and monitored for attendance and completion within our Learning and Education group. Overall, our training approach focuses on developing the understanding needed to perform an individual's responsibilities as well as training everyone on the fundamentals. As we further refine our curriculum, we will consider your observations relating to broadening targeted groups of professionals for additional training.

Comment four discusses how independence policies are accessed and updated. We will use an analogy to illustrate the access point discussed here. Basically, the first part of the comment relates to whether it is better to have a single library that everyone comes to and then tries to find what is relevant to them or to have a library that contains the general framework with additional libraries that contain guidance applicable to and focused on a particular field of study. PwC followed the multi library approach for its independence policies because it works best for our organization with various lines of services, products offered and locations. Specifically, this approach placed the guidance used by individual service lines where it was most relevant. PwC then backs this system with extensive consultation resources so that people can consult and discuss the various rules and regulations.

In response to your suggestions, we will consider the need for additional electronic links to service line policies.

The second part of comment four discusses that we did communicate changes in independence policy on a timely basis to each professional. These updates took the form of a series of Independence Technical Advisories (ITAs). Our independence policy informs individuals to read the ITAs in addition to the policy document. Further, for the most part, any obsolete guidance was more stringent. Therefore, following the guidance would not have resulted in a compliance failure. To the extent the new guidance was more stringent, PwC had continuous processes to emphasize the new guidance to the practice. However, as you know, we have implemented your suggestions by adding links to the guidance within the policies at the same time as ITA's are issued.

As to comment five, PwC believes that the firm policy addressed this situation; however, agrees that the wording of the policy could be enhanced and has revised our policy accordingly.

* * * * *

We will also analyze the best practices enumerated within the Report and implement any best practices not currently in place taking into account relevant cost/benefit considerations.

Once again, we appreciate the opportunity to provide you with our response to the matters raised in Appendix A to the Report with respect to our firm.

Very truly yours,

PricewaterhouseCoopers LLP