AMERICAN ACADEMY *of* ACTUARIES

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January 6, 2003

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

Re: ***Proposed Rules Regarding Auditor Independence, S7-49-02***

Dear Mr. Katz:

The American Academy of Actuaries (the "Academy") submits these comments on the proposed rules on auditor independence implementing Sections 201-208 of the Sarbanes-Oxley Act of 2002 (the "Act"). Our comments, which appear at greater length below, may be summarized as follows:

Timing of Determinations: To avoid second-guessing of good faith decisions by audit committees, the proposed rules should clearly state that where the audit committee pre-approves a non-audit service by an accountant on the grounds that it is not "reasonably likely to be subject to audit" based upon the facts as known at the time, the accountant is not subsequently disqualified on independence grounds should the accountant later determine to review such non-audit services as part of audit or review procedures.

Transition: To provide for orderly transition and minimize unnecessary expense and duplication of work, the changes in accountant independence standards in proposed Rules 2-01(c)(4)(iii) and (iv) should not take effect for a period of six months with respect to non-audit services rendered to issuers having fiscal years ending March 31, 2003 or earlier, provided that the prior service met with then-required independence rules.

Actuarial Services: The definition of "actuarial services" in proposed Rule 2-01(c)(4)(iv) should be limited, as in the present rule, to a determination of insurance company policy reserves and related accounts, because other non-audit services provided by actuaries in accounting firms fall within the scope of other proscribed non-audit services as defined in the proposed rules.

Expert Services: Actuaries who work for accounting firms should be able to serve as fact witnesses and non-testifying experts for clients in connection with litigation, administrative or

regulatory proceedings, whether the testimony relates to authorized non-audit services or matters within the scope of their audit or review services.

Rotation: Because few accounting firms have depth in connection with partner-level actuarial services, forced automatic rotation of such persons will, as a practical matter, work a hardship on issuers and accounting firms without necessarily achieving a corresponding benefit relating to independence. The Academy further believes that (1) rotation of partners is sufficient, and that senior managers and other non-partner professionals should not be required to rotate; and (2) the five-year "time out" requirement for rotated partners is unnecessarily long, and that a shorter time period such as two years would be sufficient to achieve the SEC's objectives.

I. Statement of Interest

The Academy is a professional association with nearly 15,000 members established in 1965 to provide a common membership organization for actuaries of all specialties practicing in the United States. Approximately 85% of U.S. actuaries are members of the Academy. The Academy serves as the actuarial profession's primary vehicle for public policy outreach, communications and professionalism.[1]

As architects of financial security, actuaries play a key role in maintaining the financial health of the nation's private and governmental pension systems, determining plan contributions by selecting and applying a complex series of economic and demographic assumptions and, in some instances, assisting with plan design and administration. Actuaries also play a crucial role in monitoring the financial management of the nation's insurance companies, identifying and quantifying the risks those companies face and measuring appropriate reserves to meet the companies' obligations. Additionally, an increasing number of actuaries are bringing their sophisticated understanding of risk management and finance to banks, securities firms and other financial service providers, as well as other issuers who assume contingent financial risk.

Many actuaries are affiliated with auditing firms, and actuaries work closely with auditors, accountants and senior financial officers. Consequently, the Academy anticipates that the proposed rules will have a major impact on a significant segment of its membership.

II. Timing of Determinations

Several of the proposed rules identify as a bar to accountant independence the provision of a non-audit service by an accountant where that service is "reasonably likely" to be the subject of

[1] The Academy has four sister organizations: the American Society of Pension Actuaries; the Casualty Actuarial Society; the Conference of Consulting Actuaries; and the Society of Actuaries. All of these organizations look to the Academy as the organization with primary responsibility for fostering actuarial professionalism and addressing public policy issues of interest to the profession as a whole.

subsequent audit procedures. We can readily envision a fact scenario where there may be a non-audit service that both the accountant and the audit committee (as part of the pre-approval process in accordance with proposed rule 2-01(c)(7)(ii)) may - based on the facts as then known to them - reasonably conclude is not likely to result in subsequent audit procedures, but those facts could change causing the accountant to alter his or her view as to the need to engage in audit procedures with respect to such services. As we read the rule, the good faith of the determination by the accountant and the audit committee at the time the non-audit service is rendered does not bar the subsequent disqualification of the accountant, a result that we believe to be inappropriate and one that creates potential unwarranted additional expense or unintended hardship.

For example, assume that an issuer – with prior approval by the audit committee – retains its accountant to perform a valuation of a subsidiary pension plan, an item that is not then material to either the subsidiary's financial statements or the parent reporting company's financial statements. No one reasonably anticipates that the valuation would be likely subject to audit procedures. Later that year, however, market conditions change and the issuer determines to sell its subsidiary, requiring management to change the accounting treatment for that subsidiary, and making audit procedures reasonably likely with respect to that accounting change. At this point the valuation of the subsidiary pension plan may be material, and may require the accountant to review its own work-product. In that event, either the auditor is disqualified, or the issuer must obtain a new valuation with respect to its subsidiary pension plan in order to avoid disqualification of the accountant. Such a result should not be required by the SEC rule.

It may in some circumstances be impractical for an issuer to obtain an alternative valuation in a timely fashion and at relatively modest cost. A new actuary may not be familiar with the plan or the basis for the underlying assumptions, requiring substantial additional time and expense to validate the assumptions or to verify the prior actuary's work-product. Moreover, this process may not be able to be completed in a sufficient timely fashion to accommodate audit or review deadlines. In that event, the issuer would be forced to obtain a substitute accountant.

To remedy this dilemma, the SEC should clarify that the determination of independence should be based on an objective determination of the facts known at the time the accountant is engaged and the non-audit service is rendered. The accountant acting in good faith who renders non-audit services - consistent with the pre-approval process in proposed Rule 2-01(c)(7)(ii) - should not be penalized and disqualified if all parties acted in good faith at the time the decision was made. Moreover, the issuer should not be forced to change accountants by arbitrary rules when all parties act in good faith. Therefore, the SEC should accept as sufficient protection against abuse by accountants of independence determinations, decisions of audit committees acting in good faith based upon facts known at the time it authorizes an accountant to provide non-audit services.

III. Transition

Several of the proposed rules would prohibit non-audit services that the SEC's current Rules clearly permit based on certain articulated exceptions. The proposed effective date for the new rules is January 26, 2003, and no specific transition rule is now proposed. This suggests that a service that was provided by an auditor in good faith reliance on existing requirements of the SEC, the Independence Standards Board ("ISB"), or the accounting profession could be the basis for subsequent disqualification of the accountant without providing the issuer with a reasonable opportunity to cure the deficiency. Of particular concern are audits or quarterly reviews for companies having fiscal years ending before March 31, 2003 - a date that provides issuers with very little time to secure either an alternative source for the non-audit services rendered by the accountant or a substitute accountant.

When the SEC proposed its current rules in November 2000, it provided a ten-week overall transition period, with certain rules having a longer transition period. Each exception was subject to the requirement that independence not be impaired under pre-existing SEC rules, the standards of the ISB or the accounting profession generally.

The Academy requests that a similar transition period be provided for the changes to proposed Rules 2-01(c)(4)(iii) and (iv). We believe that a transition period of six months should be provided with respect to non-audit services rendered for companies having fiscal years ending prior to March 31, 2003, provided that the prior service performed by auditors met all existing independence requirements

IV. Definition of "Actuarial Services"

The SEC's current Rules define "actuarial services" as advice involving the determination of insurance company policy reserves and related accounts. The Academy recommends that a comparable definition of "actuarial services" be incorporated into Section 2-01(c)(4)(iv) of the proposed rules.

As noted in our interest statement, actuaries perform important services outside of the insurance sphere. Nevertheless, the Academy understands that the effect on accountant independence of other actuarial services that might be provided by an accounting firm is addressed within the context of other proposed rules, including proposed Rules 2-01(c)(4)(iii) (valuation) and 2-01(c)(4)(vi) (management function). This renders unnecessary and redundant a rule broadly defining actuarial services so as to reach the full panoply of actuarial services that might be performed by an accounting firm.

We think that the SEC should glean from the Act's identification of actuarial services as requiring special independence concerns, a concern about the particular nature of the function of

those services rather than a particular concern that a person who is an actuary performs them. For this reason, we suggest that the SEC define the meaning of the term "actuarial services" proscribed by the statute as those services that are not otherwise swept into other prohibitions. In this regard, the only such services that we perceive may not fall within the sweep of other rules are certain types of insurance-related services. Accordingly, the Academy urges the SEC to adopt the present rule definition of actuarial services as relating to advice "involving the determination of insurance company policy reserves and related accounts."

V. Expert Services

The proposed rules would prohibit accountants from providing "expert services" to clients. In response to the SEC's specific request for comment on the scope of the proposed rule, the Academy comments on those circumstances in which providing audit clients expert services in legal, administrative or regulatory proceedings should not be deemed to impair independence. The Academy believes that the proposed SEC rule should be clarified so as not to preclude an accountant from serving as a fact witness because those are not expert services, as that term is commonly understood. The Academy further believes that the SEC should permit an accountant to serve as a non-testifying expert because the cost of substitute services could be substantial, and there is no overriding policy issue requiring the issuer to obtain substitute services. The pre-approval for such services by the audit committee should provide sufficient protection against possible abuse.

The Academy believes that an actuary practicing within an accounting firm must be able to serve as a fact witness with respect to either non-audit services or audit services previously provided to the issuer in a legal, administrative or regulatory proceeding without compromising independence. These are not true "expert services" as that term is commonly understood and such testimony may required by the issuer because the actuary may have personal knowledge of facts that could be relevant to the proceeding - facts that an outside actuary would not necessarily possess. A person serving as a fact witness does not serve - and is not generally perceived to serve - as an advocate for the party calling him or her.

The Academy also believes that, without compromising independence, an actuary practicing within an audit firm should be able to serve as a non-testifying expert under those circumstances where such opinions are not ordinarily discoverable in a proceeding (*see* Fed. R. Civ. P. 26(b)(4)(B)). In this event, the actuary would not be serving or perceived to be serving as an advocate in any public proceeding, but would merely be making his or her expertise and familiarity with the client's financial circumstances available to the client when the cost of alternative comparable services could be substantial.

VI. Partner Rotation

The Academy is concerned that the partner rotation requirements set forth in proposed Rule 2-01(c)(6) may be unduly burdensome when applied to actuaries practicing in accounting firms.

The Academy does not perceive any need for the SEC's proposed rule to go beyond the express terms of Section 203 of the Act and extend to all partners or similar persons on an engagement, rather than the lead and reviewing partner. In the Academy's experience, multiple partners are part of an audit or review engagement when the business activities of the issuer are sufficiently diverse to require additional partner-level expertise in an engagement. Even at larger accounting firms, such expertise is not widely available. Thus, automatic rotation of such persons will add to the cost to the issuer and could diminish the quality of the audit without a comparable benefit to the engagement.

Such a difficulty is particularly highlighted in the case of partner level actuaries working at accounting firms. The Academy understands that only a handful of accounting firms have actuaries on their staffs, and even those who do so have relatively few such persons qualified to perform partner level roles. Automatic forced rotation of such partners may as a practical matter preclude that accountant firm from continuing to provide actuarial services as part of its audit procedures of similar quality to their clients, and may require the accountant to look outside the accounting firm for such services. We believe that such a result may cause additional expense while contributing little, if anything, to the overall independence of the accountant.

As to other issues on which the SEC invites comment, the Academy believes that a rotation rule should be limited to partners, and that senior managers and other non-partner professionals should not be required to rotate. The natural career progression of non-partner level personnel results as a practical matter in few such persons remaining part of audit engagements for five successive years. Moreover, partners who will be rotated are the persons responsible for overseeing and supervising the audit or review engagement.

Finally, on the issue of the length of partner rotation, the Academy believes that, regardless of the scope of the rotation requirement, the five-year "time out" requirement is unnecessarily long, and that a shorter time period would be sufficient to achieve the Act's objectives. It is important to remove the rotated partner from an engagement for sufficient time that he or she is not involved in review of the beginning or ending period for which he or she had responsibility under previous reviews. Excluding the rotated partner for a two-year hiatus from participating in audit planning or review engagements is a sufficient period to achieve the legislative goal of requiring other responsible persons to independently evaluate the accounting firm's audit and review procedures, an issuer's financial statements and internal control processes, while permitting accounting firms greater flexibility in personnel management and assignment decisions.

VII. Conclusion

The Academy appreciates the opportunity to comment on these important proposed rules. Please contact us through the Academy's Executive Director, Richard C. Lawson, or General Counsel, Lauren M. Bloom, at (202) 223-8196, if you require any additional information.

Sincerely,

Robert A. Anker
President