

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

IN REPLY REFER TO: 1600E

RAO Letter 28
DA 99-2674
Adopted: December 1, 1999
Released: December 1, 1999

Responsible Accounting Officer:

Re: Auditor Independence and Objectivity

I. Introduction

The Commission relies on outside auditors to verify carrier compliance with a variety of Commission rules. For this to be effective, the Commission needs to be confident that the auditors are acting independently and that the opinions expressed by the auditors are objective and unbiased. This Responsible Accounting Officer (RAO) letter discusses the importance of independence and objectivity in the performance of audit work required by the Commission and adopts, as modified for Commission purposes, *Standard No. 1* of the Independence Standards Board¹, which requires auditors to disclose and discuss potential independence problems.

II. Background

In the *Joint Cost Order*, adopted in 1988, the Commission required large local exchange carriers to obtain independent audits to verify that their systems for allocating costs between regulated and nonregulated activities accurately reflected the procedures set forth in their cost allocation manuals and application of the Commission's rules.² The Commission expressed concern in the *Joint Cost Order* that independence problems might arise, but the Commission declined to choose the independent auditors for the carriers, instead relying on the auditors' standards of professional conduct to mitigate its concerns.³ The Commission stated that it would review the auditors' work and "take appropriate corrective action if [it had] reason to believe that a particular firm has not performed its task in an objective and competent manner."⁴ Since that initial requirement was adopted in 1988, the Commission has added many other instances in which independent audits

¹ See INDEPENDENCE DISCUSSIONS WITH AUDIT COMMITTEES, *Independence Standards Board Standard No. 1* (Independence Standards Bd. 1999)(*Standard No. 1*).

² See Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, *Report and Order*, CC Docket No. 86-111, 2 FCC Rcd 1298, 1330-31, ¶¶ 254-56 (1987) (*Joint Cost Order*), *recon.*, 2 FCC Rcd 6283 (1987), *further recon.*, 3 FCC Rcd 6701 (1988), *aff'd sub nom. Southwestern Bell Corp. v. FCC*, 896 F.2d 1378 (D.C. Cir. 1990). The audit requirement is codified at 47 C.F.R. § 64.904(a).

³ *Id.* at 1332, ¶ 270.

⁴ *Id.* at 1333, ¶ 274.

are relied upon to assure compliance with its rules.⁵

Auditors are governed by standards of professional conduct that require them to remain objective toward and independent of the audited company. Those standards emphasize independence and objectivity in both fact and appearance, reflecting the practical view that, even if independent in fact, auditors should avoid even the appearance of bias so that those who rely on the results of their audits can be confident in their work.

Consulting and advocacy by accounting firms has increased substantially in recent years.⁶ In many instances, carriers use the same accounting firms to advocate positions on issues before the Commission that they engage to perform independent audits. Advocacy or support on behalf of a carrier concerning issues before the Commission, particularly with respect to auditing or accounting matters, could raise concerns and questions about the independence and objectivity of the auditors.

III. Discussion

To address the independence implications for the new consulting and advocacy services provided by auditors, the Securities and Exchange Commission and the American Institute of Certified Public Accountants recently established the Independence Standards Board (ISB). The initial standard of the ISB, *Standard No. 1—Independence Discussions with Audit Committees*, requires the following:

At least annually, independent auditors shall:

- a) disclose to the audit committee (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
- b) confirm in writing that in its professional judgment it is independent of the company within the meaning of the Securities Acts; and
- c) discuss the auditor's independence with the audit committee.

We believe that *Standard No. 1* can be adapted to address in part the Commission's concern about auditor independence. The Commission's concern that audits be performed with

⁵ The areas in which the Commission relies on independent auditors include the following: 1) carrier compliance with our cost allocation and affiliate transactions rules, *see* 47 C.F.R. 64.904(a); 2) Universal Service Administrative Company's Schools & Libraries Division and Rural Health Care Division to help ensure against fraud, waste, and abuse, *see* Changes to the Board of Directors of the National Exchange Carrier Association, Inc., *et al.*, *Report and Order* in CC Docket No. 97-21, *Second Order on Reconsideration* in CC Docket No. 96-45, 12 FCC Rcd 18400, 18439-40, ¶¶ 75-76 (1997); 3) section 272 biennial audits, *see* 47 U.S.C. § 272(d)(1); and 4) merger reviews to test compliance with conditions such as improved access to unbundling for CLECs, *see, e.g.*, Applications of Ameritech Corp. Transferor, and SBC Communications Inc., Transferee, *Memorandum Opinion and Order*, FCC 99-279, ¶¶ 410-12 (rel. Oct. 8, 1999).

⁶ *See, e.g.*, Barry C. Melancon, *A New Initiative for Accreditations*, JOURNAL OF ACCOUNTANCY, Feb. 1999, at 4.

independence and objectivity mirror the concern of audit committees that are responsible for engaging independent auditors for corporations. Therefore we establish the following standard based on ISB's *Standard No. 1*. For independent audits performed pursuant to Part 32 and Sections 64.901 *et seq.* of the Commission's rules⁷, the auditor shall at least annually:

- a) disclose to the Accounting Safeguards Division (ASD) of the Common Carrier Bureau in writing all relationships between the auditor and its related entities and the carrier and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
- b) confirm in writing to ASD that in its professional judgment it is independent of the carrier; and
- c) discuss the auditor's independence with ASD.

Creation of the Independence Standards Board is an encouraging sign of the profession's desire to preserve the independence and objectivity of auditors. Although adoption of *Standard No. 1* alone may not be enough to satisfy the Commission's concerns, it should lead to a frank and open dialogue that will benefit both the Commission and the auditors.

Because items in this RAO letter pertain to the collection of information, Office of Management and Budget (OMB) approval of the proposed collection is required by the Paperwork Reduction Act of 1995.⁸ Under the Paperwork Reduction Act, members of the public are not required to respond to a collection of information sponsored by the Federal government, and the government may not conduct or sponsor a collection, unless the information collection contains a currently valid OMB control number. Accordingly, independent auditors will not be required to comply with this RAO until OMB has given such approval. ASD will notify the public when OMB has approved the proposed information collection.

This letter is issued pursuant to authority delegated under Section 0.291 of the Commission's rules, 47 C.F.R. § 0.291. Applications for review under Section 1.115 of the Commission's rules, 47 C.F.R. § 1.115, must be filed within 30 days of the date of this letter. *See* 47 C.F.R. § 1.4(b)(2).

If you have any questions please contact Hugh Boyle at 418-0820.

Sincerely,

Kenneth P. Moran, Chief
Accounting Safeguards Division
Common Carrier Bureau

⁷ These engagements include audits, attest examinations, agreed-upon procedures engagements, and any other engagement required of independent auditors.

⁸ *See* 44 U.S.C. § 3507 (1995).