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Frequently Asked Questions Regarding SEC Rules on Auditor Independence

In August 2003, the Office of the Chief Accountant of the SEC released answers to frequently asked questions regarding the rules on auditor independence that were imposed in January 2003. This memorandum addresses certain of the matters covered in the August release. For more information regarding the rules on auditor independence, see our memorandum entitled "SEC Adopts Rules Strengthening Its Requirements Regarding Auditor Independence."

Audit Committee Pre-Approval

An issuer's audit committee is responsible for the appointment, compensation and oversight of the work of the independent auditor of the issuer. As part of this responsibility, the audit committee is required to pre-approve the audit and non-audit services performed by the independent auditor in order to assure that the provision of these services does not impair the auditor's independence. To streamline this process, the audit committee may establish policies and procedures to pre-approve certain services that may be provided by the independent auditor without obtaining specific pre-approval from the audit committee.

May an audit committee serve as the audit committee for wholly-owned subsidiaries that are also issuers and that don't have their own audit committee?

Yes. It is appropriate for the audit committee of a parent company to, in effect, serve as the audit committee of the parent company and its wholly-owned subsidiaries. In this situation, the subsidiary's disclosure should include the subsidiary's pre-approval policies and procedures for the pre-approval of audit and non-audit services provided by its auditor and, also should include the parent company's pre-approval policies and procedures.

Foreign subsidiaries may have statutory audits performed by statutory auditors not affiliated with the parent company's "principal" auditors. Do the parent's pre-approval requirements run to the statutory auditors for the foreign subsidiaries or should its pre-approval requirements run just to the principal audit firm?

The SEC's rules relating to listed company audit committees require audit committees to approve all audit services provided to the company, whether provided by the principal auditor or other firms. Therefore, the parent company's pre-approval requirements also run to the statutory auditors for its foreign subsidiaries. However, failure of the parent's audit committee to pre-approve audit services to be provided by another firm would not affect the independence of the principal auditor.

May the audit committee use monetary limits as the basis for establishing its pre-approval policies and procedures?

The audit committee must follow three requirements in its use of pre-approval of audit and non-audit services through policies and procedures. First, the policies and procedures must be detailed as to the **particular** services to be provided. Second, the audit committee must be informed about **each** service. Third, the policies and procedures cannot result in the delegation of the audit committee's authority to management. Pre-approval policies and procedures that do not comply with all three of these requirements are in contravention of the SEC's rules. Therefore, monetary limits cannot be the only basis for the pre-approval policies and procedures. The establishment of monetary limits would not, alone, constitute policies that are detailed as to the particular services to be provided and would not, alone, ensure that the audit committee would be informed about each service.

Can the audit committee's pre-approval policies and procedures provide for broad, categorical approvals (e.g., tax compliance services)?

No. The SEC's rules require that the pre-approval policies be detailed as to the particular services to be provided. Use of broad, categorical approvals would not meet the requirement that the policies must be detailed as to the particular services to be provided.

How detailed do the pre-approval policies need to be?

The determination of the appropriate level of detail for the pre-approval policies will differ depending upon the facts and circumstances of the issuer. However, a key requirement is that the policies cannot result in a delegation of the audit committee's responsibility to management. If a member of management is called upon to make a judgment as to whether a proposed service fits within the pre-approved services, then the pre-approval policy would not be sufficiently detailed as to the particular services to be provided. Similarly, pre-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. For example, if the audit committee is presented with a schedule or cover sheet describing services to be pre-approved, that schedule or cover sheet must be accompanied by detailed back-up documentation regarding the specific services to be provided.

Audit Committee Communications

Each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements is required to report to the issuer's audit committee, prior to the filing of the financial statements with the SEC:

- all critical accounting policies and practices used by the issuer;
- all alternative accounting treatments of financial information within GAAP related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management of the issuer or registered investment company.

These communications are not required to be in writing, but the SEC indicated that it expects these communications would be documented by the auditor and the audit committee.

What is the effective date for the rules regarding communications with audit committees?

Because there are no specific transition provisions in the SEC's final release, the communication requirements under the rules are effective for audit reports filed on or after May 6, 2003, the effective date of the new rules.

Would the requirement to communicate with audit committees apply to situations where the auditor is merely providing a consent to the inclusion of a past audit report in a filing (e.g., related to a 1933 Act registration statement)? If so, what information should be communicated to the audit committee?

Yes. In the situation where the auditor provides a consent to the inclusion of a past audit report, the audit report is still deemed to be "filed". As a result, the auditor would be required to communicate the relevant information to the audit committee. Since the auditor would have communicated the relevant information when the audit report was originally filed, this communication at the time of the consent may properly be restricted to updating the audit committee. However, if in the process of applying audit procedures required by AU §711 ("Filings under Federal Securities Statutes"), matters come to the auditor's attention that would or could have affected the financial statements or the auditor's report that was previously filed, all relevant information should be communicated to the audit committee.

The rules require that auditors communicate to the audit committee alternative applications of GAAP relating to material items that have been discussed with management. Does this require that auditors discuss with audit committees transactions where there are alternative applications of GAAP that occurred subsequent to the balance sheet date that are not reflected in the financial statements (including the related notes) subject to audit?

Because the rules require the auditor to communicate alternative applications of GAAP that are material and that the communications occur before the audit opinion is filed with the SEC, the rules relate to items that are material to the financial statements on which the auditor is expressing an opinion. Therefore, any transactions that have occurred subsequent to the balance sheet date and which are not required to be reflected in the financial statements or the related notes are not required to be communicated to the audit committee until the period in which those transactions affect the financial statements. It should be noted, however, that the text of the SEC release announcing the rules indicates that over time these communications should occur on a "real time" basis. Auditors are therefore strongly advised to consider communicating the matters to audit committees at the first opportunity after the matters arise.

If an issuer switches auditing firms and makes a filing that contains the report of both a successor audit firm and a predecessor audit firm, each of the audit firms will be required to provide a consent. Must each of the audit firms provide the communications with the audit committee?

No. When there is a predecessor-successor auditor relationship, only the successor auditor is required to communicate with the audit committee. Prior to providing its consent, however, the predecessor audit firm is required to perform the audit procedures specified in AU §711.

If a significant portion of an issuer's consolidated financial statements were audited by a firm other than the principal accountant and the principal accountant decides to make reference to the other accountant (and consequently both the audit opinions of the principal accountant and the other accountant are filed), is the other accountant required to make the specified communications with the issuer's audit committee?

Yes. The SEC's rules require that the auditor communicate with the audit committee before the audit report is filed with the SEC. Because, in this situation, the other auditor's report will be filed, the other auditor also is required to provide the required communications with the audit committee.

Fee Disclosures

The SEC believes that issuers should disclosure the scope of services provided by their independent public accountants in order to allow investors to be better able to evaluate the independence of the accountant. The proxy disclosure rules previously required that an issuer disclose the professional fees it paid to its principal independent accountant in the most recent fiscal year. The new rules change both the types of fees that must be detailed and the years of service that must be covered.

What fee disclosure category is appropriate for professional fees in connection with an audit of the financial statements of a carve-out entity in anticipation of a subsequent divestiture?

The SEC release announcing the final rules on auditor independence establishes a new category, "Audit-Related Fees," which enables registrants to present the audit fee relationship with the principal accountant in a more transparent fashion. In general, "Audit-Related Fees" are assurance and related services (*e.g.*, due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services related to financial reporting that are not required by statute or regulation and consultation concerning financial accounting and reporting standards. Fees for the above services would be disclosed under "Audit-Related Fees."

Would fees paid to the audit firm for operational audit services be included in "Audit-Related Fees"?

No. "Audit-Related Fees" are fees for assurance and related services by the principal accountant that are traditionally performed by the principal accountant and which are "reasonably related to the performance of the **audit or review of the registrant's financial statements**." Operational audits would not be related to the audit or review of the financial statements and, therefore, the fees for these services should be included in "All Other Fees." As required by the rules, the registrant would need to include a narrative description of the services included in the "All Other Fees" category.

The SEC's new independence rules require companies to disclose fees paid to the principal auditor in four categories ("audit", "audit-related", "tax", and "all other") for the two most recent years. Previously, companies were required to disclose fees paid to the principal auditor in three categories and only for the most recent year. When are the new fee disclosure requirements effective?

The release text indicates that the new disclosure requirements are effective for periodic annual filings and proxy or information statement filings for the first fiscal year **ending after December 15, 2003**. Thus, the new disclosure requirements are not mandatory until the calendar-year 2003 periodic annual filings are made in 2004. However, the SEC has encouraged issuers to adopt these disclosure provisions earlier. Thus, companies may, but are not required, to provide the new disclosures for proxies and other periodic annual filings that are made prior to the effective date for the new disclosures.

"Cooling Off" Period

Under the SEC's previous rules, an accounting firm is not deemed to be independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of the accounting firm accepts employment with the client and he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. This requirement remains unchanged.

The new rules impose a one-year "cooling off" period that provides that when the lead partner, the concurring partner, or any other member of the audit engagement team who provides more than ten

hours of audit, review or attest services for the issuer accepts a position with the issuer in a "financial reporting oversight role" within the one-year period preceding the commencement of the current audit engagement, the accounting firm is not independent with respect to that issuer. The rule applies to employment relationships entered into between members of the audit engagement team and the "issuer," subject to certain exceptions.

For purposes of applying this provision, is the term "issuer" restricted to the legal entity (typically the parent company) that issues the securities?

No. The rule prohibits a member of the audit engagement team from commencing employment in a "financial reporting oversight role" with the issuer if the auditor is to remain independent. The SEC's rules define a financial reporting oversight roles as "a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them . . ." Since the issuer is required to prepare consolidated financial statements to include in filings with the SEC, a financial reporting oversight role can extend to both the issuer and its subsidiaries. In determining whether an individual is in a financial reporting oversight role with the issuer, you should consider the role the individual is playing, his or her involvement in the financial reporting process of the issuer, and the impact of his or her role on the consolidated financial statements.

If a company wishes to file a registration statement for an IPO and includes three years of audited financial statements in the filing, do the "cooling off" rules apply to all audited periods included in the filing or just to the periods after the company becomes an issuer?

The SEC's rules on auditor independence require that the auditor be independent in each period for which an audit report will be issued. Thus, just as is the case for prohibited non-audit services, accounting firms will need to consider their relationship with the client both prior to and after the time that the client becomes an issuer. Since the registration statement will contain an audit report for three years, the "cooling off" rules, likewise, would apply to all years. In applying the cooling off period rules for time periods prior to the filing, the day after the audit report is dated (rather than the day after the periodic report is filed with the SEC) is deemed to constitute the commencement of audit procedures.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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