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SEC Adopts Rules Strengthening Its Requirements Regarding Auditor Independence

The SEC has adopted new rules to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. The new rules:

- revise the SEC's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence;
- require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements;
- prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement;
- prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that client had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures;
- require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and
- require additional disclosure to investors regarding the audit and non-audit services provided by, and fees paid to, the auditor of an issuer's financial statements.

In addition, under the new rules, an accountant would not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

The rules apply to both U.S. and foreign audit firms. They are effective as of May 6, 2003, although transition rules apply to some provisions, as discussed below.

I. Background

The Sarbanes-Oxley Act of 2002 (the "Act") required the SEC to adopt rules under which certain non-audit services would be prohibited, conflict of interest standards would be strengthened, auditor partner rotation and second partner review requirements would be strengthened, and the relationship between the independent auditor and the audit committee would be clarified and enhanced.

The rules focus on key aspects of auditor independence:

- the provision of certain non-audit services and the unique ability of the audit committee to insulate the auditor from the pressures that may be exerted by management,

- the potential conflict of interest that can be created when a former member of the audit engagement team accepts a key management position with the audit client, and

- the need for effective communications between the auditor and audit committee.

II. Discussion of the New Rules

A. Conflicts of Interest Resulting from Employment Relationships

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 "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 the following exceptions:

- other than the lead and concurring partner, an individual must provide more than ten hours of service during the annual audit period as a member of the engagement team to be deemed to have participated in an audit capacity;

- individuals employed by the issuer as a result of a business combination may remain employed by the issuer, provided that the employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of this conflict;

- individuals may be employed by the issuer due to an emergency or unusual situation (which, among other things, may be applicable to issuers in certain foreign jurisdictions where it may be extremely difficult or costly to comply with the rules), provided that the audit committee determines that doing so is in the best interests of investors. The SEC anticipates that this exception will be invoked very rarely.

The Act specifies that the "cooling off" period must be one year. For purposes of the rules, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report (*e.g.*, Form 10-K, 10-KSB, 20-F or 40-F) is filed with the

SEC. The audit engagement period for the current year is deemed to conclude the day the current year's periodic annual report is filed with the SEC. Therefore, under the new rules, the prohibition would require that the accounting firm complete one full annual audit cycle subsequent to the individual's participation on the audit engagement team.

The rules define "financial reporting oversight role" as a role in which an individual has direct responsibility or oversight of those who prepare the issuer's financial statements and related information (*e.g.*, MD&A), which will be included in an issuer's report filed with the SEC.

Due to the unique structure of investment companies, where the normal operating activities, including activities related to the preparation of financial statements, are provided by outside service providers, the rules provide that an accounting firm would not be independent if a former audit engagement team member is employed in a financial reporting oversight role with not only the registered investment company, but also with any entity in the same investment company complex that is responsible for the financial reporting or operations of the registered investment company or any other registered investment company in the same investment company complex. The rules prohibit employment in positions at an investment company complex that would allow a former audit engagement team member to bring undue influence over the audit process of an investment company.

Effective Date and Transition

In order to provide for orderly transition and because the SEC believes that it would be unfair to expect those who began employment before the effective date of the new rules to be asked to sever those employment relationships, the "cooling off" period rules are effective for employment relationships with issuers that commence after May 6, 2003, the effective date of the auditor independence rules.

B. Service Outside the Scope of the Practice of Auditors

Section 201(a) of the Act amended Section 10A of the Securities Exchange Act of 1934 to provide that it shall be unlawful for a registered public accounting firm that performs an audit of an issuer's financial statements (and any person associated with such a firm) to provide to that issuer, contemporaneously with the audit, any non-audit service, including specified services set forth in the Act. There is an exception, however, for any non-audit service, including tax services, that is not specified as a prohibited service, but only if the service has been pre-approved by the issuer's audit committee.

The non-audit services specified in the Act and the rules relating to them are discussed below. According to the SEC, the rules are based on three basic principles, violations of which would impair the auditor's independence. Under these principles, a company's auditors should not:

- audit their own work;
- function as part of management or as an employee of their client; and
- act as an advocate for their client.

The prohibited services contained in these rules only apply to non-audit services provided by independent accountants to their audit clients. These rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client. Under the Act, the responsibility falls on the audit committee to pre-approve all audit and non-audit services provided by the accountant.

Effective Date and Transition

Because audit clients may need a period of time to exit existing contracts, the rules provide that until May 6, 2004 the provision of these non-audit services will not impair an accountant's independence, provided those services are pursuant to contracts in existence on May 6, 2003.

(1) Bookkeeping or other services related to the audit client's accounting records or financial statements.

Under the new rules, an auditor's independence is impaired if the auditor provides bookkeeping services to an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. The rules use the existing definition of bookkeeping or other services, which focuses on the provision of services involving:

- maintaining or preparing the audit client's accounting records;
- preparing the audit client's financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC; or
- preparing or originating source data underlying the audit client's financial statements.

Previous rules permitted auditors to provide bookkeeping services under limited circumstances. These exceptions have been eliminated.

Consistent with previous rules, the independence of accountants that prepare statutory financial statements that are not filed with the SEC for foreign companies would be impaired if those statements form the basis of the financial statements that are filed with the SEC. Under these circumstances, an auditor or accounting firm that has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant financial statements that were prepared to comply with U.S. generally accepted accounting principles ("GAAP").

(2) Financial information systems design and implementation.

Under the new rules, an accounting firm is prohibited from providing any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. Under the rules, an accountant is not independent of an audit client if the accountant:

- directly or indirectly, operates, or supervises the operation of, the audit client's information system or manages the audit client's local area network; and
- designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is "significant" to the audit client's financial statements or other financial information systems taken as a whole.

According to the adopting release, "significant" to the financial statements taken as a whole refers to information that is reasonably likely to be material to the financial statements of the audit client.

Consistent with previous rules, the new rules do not preclude an audit firm from:

- working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records, so long as those services are pre-approved by the audit committee;

- evaluating the internal controls of a system as it is being designed, implemented or operated either as part of an audit or attest service and making recommendations to management; or

- making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.

(3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.

Under the new rules, an accountant is not independent of an audit client if the accountant provides any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction.

The rules do not prohibit an accounting firm from providing appraisal or valuation services for non-financial reporting purposes (*e.g.*, transfer pricing studies, cost segregation studies and other tax-only valuations). The rules also do not limit an accounting firm from utilizing its own valuation specialist to review the work done by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements.

(4) Actuarial services.

Under the rules, an accountant is not independent of an audit client if the accountant provides any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

The rules permit an accountant to:

- assist a client in understanding the methods, models, assumptions and inputs used in computing an amount; and

- utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

The new rules prohibiting actuarial services are significantly broader than the previous rules, which generally barred auditors only from providing actuarial services related to insurance company policy reserves and related accounts.

(5) Internal audit outsourcing services.

The new rules prohibit the accountant from providing internal audit outsourcing services to an audit client. This prohibition includes any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

The prohibition on "outsourcing" would not preclude, among other things:

- the auditor from evaluating the company's internal controls and, as a result, recommending improvements to the controls;
- the client from engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function; or
- the accountant from performing operational internal audits unrelated to the internal accounting controls, financial systems or financial statements.

Previous SEC independence rules contained an exception for small businesses, identified as those with assets totaling less than $200 million. However, the new rules contain no similar exception because, regardless of the entity's size, the Act appears to view the auditor as being in a position of auditing his or her own work if these services are provided.

(6) Management functions.

Under the new rules, an accountant is not independent of an audit client if the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any decision-making, supervisory, or ongoing monitoring function for the audit client. This is consistent with previous independence rules.

The SEC noted in its adopting release that so long as the auditor does not act as an employee or perform management functions, the auditor could provide services in connection with the assessment of internal accounting and risk management controls as well as make recommendations for improvements without impairing his or her independence. Accordingly, the rules continue to allow auditors to assess the effectiveness of internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls. However, designing and implementing internal accounting and risk management controls would be considered to impair the auditor's independence because the auditor is placed in the role of management.

(7) Human resources.

Under the new rules, an accountant is not independent of an audit client if the accountant:

- searches for or seeking out prospective candidates for managerial, executive, or director positions;
- engages in psychological testing, or other formal testing or evaluation programs;
- undertakes reference checks of prospective candidates for an executive or director position;

- acts as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or
- recommends, or advises the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative or control positions).

The rules in this area are substantially consistent with previous independence rules.

(8) Broker-dealer, investment adviser, or investment banking services.

Under the new rules, an auditor is deemed to lack independence when acting as a broker-dealer (registered or unregistered), promoter or underwriter on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

The new rules are substantially the same as the SEC's previous rules relating to the provision of these types of services to audit clients. However, the new rules expand the current independence rules by adding prohibitions on serving as an unregistered broker-dealer.

The new rules are not meant to change the SEC's previous position that an audit firm's broker-dealer division can cover an industry (including industry surveys and analyses) which includes an audit client when performing analyst functions. However, analysis of a specific audit client's stock places the auditor in the position of acting as an advocate for the client and would cause the auditor to lack independence.

(9) Legal services.

Under the new rules, an accountant is not independent of an audit client if the accountant provides any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

The SEC acknowledged in its adopting release that there may be implications for some foreign issuers from this rule. For example, some jurisdictions only permit tax work to be performed by a person licensed to practice law. An accounting firm providing such services, therefore, would be deemed to be providing legal services. As a general matter, the rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. In determining whether or not a service would impair the accountant's independence solely because the service is labeled a legal service in a foreign jurisdiction, the SEC will consider whether the provision of the service would be prohibited in the United States as well as in the foreign jurisdiction. In the adopting release, the SEC said it encouraged accounting firms and foreign regulators to consult with the staff to address these issues.

(10) Expert services unrelated to the audit.

Under the new rules, an accountant is not independent of an audit client if the accountant provides expert opinions or other expert services for an audit client (or a legal representative of an audit client) for the purpose of advocating that audit client's interests in litigation or regulatory, or administrative investigations or proceedings. However, under this rule, an accountant's independence will not be deemed to be impaired if:

- in an investigation or proceeding, an accountant provides factual accounts or testimony describing work it performed; or

- an accountant explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

The prohibition on the provision of expert services would include providing consultation and other services to an audit client's legal counsel in connection with litigation, administrative or regulatory proceedings. The prohibition on providing "expert" services covers services that are intended to result in the accounting firm's specialized knowledge, experience and expertise being used to support the audit client's positions in various adversarial proceedings. Therefore, under the rules, an auditor's independence would be impaired if the auditor were engaged by the audit client's legal counsel to provide expert witness or other services, including accounting advice, opinions or forensic accounting services, in connection with the client's participation in a legal, administrative, or regulatory proceeding.

The rules do not, however, preclude

- an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact finding engagements; or

- an accountant from assisting the audit committee in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety.

These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client. If, subsequent to the completion of such an engagement, a proceeding or investigation is initiated, the accountant may allow its work product to be utilized by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, but may provide factual accounts or testimony about the work performed.

In the adopting release, the SEC recognized that auditors have obligations under Section 10A of the Exchange Act and generally accepted auditing standards ("GAAS") to search for fraud that is material to an issuer's financial statements and to make sure the audit committee and others are informed of their findings. Auditors should conduct these procedures whether they become aware of a potential illegal act as a result of audit, review or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system. In these situations, the SEC stated that it believed that the auditor may conduct the procedures, with the approval of the audit committee, and provide the reports that the auditor deems appropriate. Should litigation arise or an investigation commence during the time period that the auditors are conducting these procedures, the completion of these procedures would not be deemed to be prohibited expert services so long as the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

(11) Tax services.

Tax services are not included among the non-audit services prohibited by the Act. In the adopting release, the SEC reiterated its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence. Accordingly, accountants may continue to provide tax services such as tax compliance, tax planning and tax advice to audit clients, subject to the normal audit committee pre-approval requirements. Additionally, the rules require issuers to disclose the amount of fees paid to the accounting firm for tax services.

The SEC cautioned, however, that classifying a service as a "tax service" does not mean that the service may not be within one of the categories of prohibited services or may not result in an impairment of independence under the rules. The accounting firm and the issuer's audit committee should consider, for example, whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service.

C. Partner Rotation

Section 203 of the Act requires rotation of the lead (or coordinating) audit partners having primary responsibility for the audit and the audit partner responsible for reviewing the audit on a five-year basis in order for a registered public accounting firm (as defined in the Act) to continue to provide audit services for an issuer.

The new rules require:

- the lead and concurring "audit partners" to rotate after five years and, upon rotation, be subject to a five-year "time out" period; and
- "audit partners," other than the lead and concurring partner, to rotate after no more than seven years and to be subject to a two-year "time out."

In the adopting release, the SEC noted that the partner rotation requirements must strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants. In its view, a proper balance is one that weighs the responsibility for decisions on accounting and financial reporting issues impacting the financial statements with the level of the relationship with senior management of the client.

For purposes of this rule, the SEC has defined the term "audit partner" to mean the lead and concurring partners, as well as partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee. In particular, in addition to the lead and concurring partners, "audit partners" would include:

- all partners who serve the client at the issuer or parent level, other than specialty partners;
- other audit engagement team partners who provide more than ten hours of audit, review or attest services in connection with the preparation of the annual or interim financial statements; and
- the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the client's consolidated assets or revenues.

The term "audit partner" does not include specialty partners or partners assigned to "national office" duties who may be consulted on specific accounting issues related to a client. Accordingly, these individuals are not subject to the rotation requirement.

Small Business/Small Firm Considerations

Consistent with previous rules, the new rules provide an exemption from the auditor rotation requirements for firms with fewer than five audit clients that are issuers and fewer than ten partners. However, in order for these firms to qualify for the exemption from partner rotation, the Public Company Accounting Oversight Board must conduct a review of all of the firm's engagements subject to the rule at least once every three years.

Investment Companies

Lead and concurring partners on investment company audit engagements will be required to rotate after a total of five consecutive years in either role. At a minimum, all audit partners that audit investment companies will be required to rotate after a total of seven years of consecutive service on any of the investment companies in the same investment company complex and observe the applicable five or two year "time out" period. Consequently, the rules will not allow audit partners to satisfy the partner rotation requirements by rotating between investment companies in the same investment company complex.

Effective Date and Transition

In order to allow firms to establish an orderly transition of their audit engagement teams, the SEC has established transition provisions related to the partner rotation requirements, as follows:

- Lead partner – the rotation requirements applicable to the lead partner are effective for the first fiscal year ending after May 6, 2003, the effective date of the new rules. In determining when the lead partner must rotate, time served in the capacity of lead partner prior to May 6, 2003 is included in determining the number of years served.

- Concurring partner – in order to facilitate the process of staggering the rotation of the lead and concurring partners, the rotation requirements for the concurring partner are effective as of the end of the second fiscal year after May 6, 2003. Time served in the capacity of concurring partner prior to May 6, 2003 is included in determining the number of years served.

- Other "audit partners" – the rotation requirements are effective as of the beginning of the first fiscal year commencing after May 6, 2003. However, in determining the number of years served, that first fiscal year will constitute the first year of service for these partners.

- All partners with foreign accounting firms who are subject to rotation requirements – the rotation requirements are effective as of the beginning of the first fiscal year commencing after May 6, 2003. In determining the number of years served, that first fiscal year will constitute the first year of service for these partners.

D. Audit Committee Administration of the Engagement

The rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attestation engagements required under the securities laws. The rules require that before the accountant is engaged by the audit client to render the service, the engagement must be:

- approved by the audit client's audit committee; or

- entered into pursuant to pre-approval policies and procedures established by the audit committee, provided the policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and the policies and procedures do not include delegation of the audit committee's responsibilities to management.

As provided in the Act, the rules recognize audit services to be broader than those services required to perform an audit pursuant to GAAS. For example, the Act identified services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services. The rules identify various other types of services as audit services, including:

- statutory audits required by some domestic and foreign jurisdictions;

- services performed to fulfill the accountant's responsibility under GAAS; and

- review of complex accounting issues through consultation with "national office" or other technical reviewers to reach an audit judgment.

The rules require that the audit committee pre-approve all of these services.

The audit committee has the sole authority to pre-approve the engagement of the company's independent accountant to perform all services. The audit committee can establish policies and procedure for pre-approval, provided they are detailed as to the particular service and designed to safeguard the continued independence of the auditor. In accordance with the Act, one or more audit committee members who are independent directors are permitted to pre-approve the service. Decisions made by the designated audit committee members must be reported to the full audit committee at each of its scheduled meetings.

Consistent with the Act, the rules also include a *de minimis* exception solely related to the provision of non-audit services for an issuer. This exception waives the pre-approval requirements for non-audit services provided that all such services:

- do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided;

- were not recognized as non-audit services at the time of the engagement; and

- are promptly brought to the attention of audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives.

Finally, the audit committee's policies for pre-approvals of services must be disclosed by issuers in their annual reports and proxy statements.

The rules limit an investment company's audit committee pre-approval responsibility to those services provided directly to the investment company and those services provided to an entity in the investment company complex where the nature of the services provided have a direct impact on the operations or financial reporting of the investment company. The rules allow an investment company's audit committee to assess and determine before the work is conducted the impact that the services might reasonably have on the investment company accountant's independence as it relates to the audits of the investment company's financial statements. In addition, the rules clarify that only the service providers that provide ongoing services to the investment company must have their non-audit services pre-approved. Thus, the rules limit the number of instances where pre-approval would be sought from multiple audit committees in the investment company complex. In addition, the rules require that the accountant disclose to the audit committee all services provided to the investment company complex, including the fees associated with those services.

Effective Date and Transition

These rules apply to all audit, review, and attest services and non-audit services that are entered into after May 6, 2003, the effective date of the rules. For arrangements for non-audit services entered into prior to that date — regardless of whether or not they were pre-approved by the audit committee — the accounting firm will have until May 6, 2004 to complete these services.

E. Compensation

The rules amend existing auditor independence rules to address the practice of auditors being compensated by their firms for selling non-audit services to their audit clients. The rules provide that an accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner, other than specialty partners, earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any services other than audit, review, or attest services.

Audit partners include the lead and concurring partners and other partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee.

The adopting release clarified that from the SEC's perspective compensation concerns exist where the audit partner's compensation is based on the act of selling non-audit services. The rule was designed to reinforce the position that accountants at the partner level should be viewed as skilled professionals and not as conduits for the sale of non-audit services to the audit partner's individual clients. While the rule focuses on the need for independence of the most senior members of the engagement team, it does not preclude an audit partner from sharing in the profits of the audit practice and those of the overall firm.

The rules attempt to mitigate the concerns that an audit partner might be viewed as compromising audit judgments in order not to jeopardize the potential for selling non-audit services. These rules do not specifically address compensation of other audit engagement team members for directly selling non-audit services. Accordingly, the rules allow other engagement team partners to be compensated for selling services with their discipline.

In the adopting release, the SEC suggested that in deciding whether to pre-approve a non-audit service, an audit committee may want to consider the impact that compensation to audit engagement members based on the sale of non-audit services may have on the individual's or the firm's independence.

The rules provide an exemption for accounting firms with ten or fewer partners and five or fewer audit clients that are issuers.

Effective Date and Transition

The compensation rules will be effective in the fiscal periods of the accounting firm that commence after May 6, 2003.

F. Communication with Audit Committees

Section 204 of the Act directed the SEC to issue rules requiring timely reporting of specific information by auditors to audit committees. The rules amend Regulation S-X to require each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements to report to the issuer's or registered investment company's audit committee, prior to the filing of such financial statements with the SEC:

- all critical accounting policies and practices used by the issuer or registered investment company;

- 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;

- other material written communications between the accounting firm and management of the issuer or registered investment company; and

- for a registered investment company, all non-audit services provided to any entity in the investment company complex that were not pre-approved by the registered investment company's audit committee.

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. The categories of required communications are discussed in more detail below.

(1) Critical accounting policies.

The rules require communication by auditors to audit committees of all critical accounting policies and practices.

In December 2001, the SEC issued cautionary advice regarding disclosure of those accounting policies that management believes are most critical to the preparation of the issuer's financial statements. The cautionary advice indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. As part of that cautionary advice, the SEC stated that:

- audit committees should review the selection, application and disclosure of critical accounting policies prior to finalizing and filing annual reports;

- consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods; and

- proactive discussions between the audit committee and senior management and auditor about critical accounting policies are appropriate.

In May 2002, the SEC proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies. The May 2002 proposed rules covered accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation.

The SEC suggests that auditors should consider referring to the December 2001 cautionary guidance as well as the May 2002 proposed rules as guides to determining the types of matters that should be communicated to the audit committee under the new rules. The rules do not require that those discussions follow a specific form or manner, but the SEC expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why certain estimates or policies are or are not considered critical and how current and anticipated future events impact those determinations. In addition, the SEC said that it anticipates that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the auditors that were not included.

(2) Alternative accounting treatments.

The rules require communication by auditors to audit committees of all alternative accounting treatments within GAAP for policies and practices 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. The rules are intended to cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

In the adopting release, the SEC stated that it believes that communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the auditors should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not the preferred method in the auditor's opinion, the SEC stated that it expects that the reasons why the auditor's preferred method was not selected by management also would be discussed.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS, and would include the impact of management's judgments and accounting estimates, as well as the auditor's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies should include the range of alternatives available under GAAP that were discussed by management and the auditors along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change should also be communicated. If the accounting policy selected is not the auditor's preferred policy, then the SEC expects the discussions to include the reasons why the auditor considered one policy to be preferred but that policy was not selected by management.

The SEC does not consider the separate discussion of critical accounting policies and estimates to be a substitute for communications regarding general accounting policies because the discussion about critical accounting policies and estimates might not encompass any new or changed general accounting policies and estimates. Likewise, the discussion of general accounting policies and practices is not intended to dilute the communications related to critical accounting policies and practices, since the issues affecting critical accounting policies and practices, such as sensitivities of assumptions and others, may be tailored specifically to events in the current year, and the selection of general accounting policies and practices should consider a broad range of transactions over time.

(3) Other material written communications.

The rules attempt to clarify the substance of information that must be provided by auditors to audit committees to facilitate auditor and management oversight by those committees.

The Act specifically cites the management letter and schedules of unadjusted differences as examples of material written communications to be provided to audit committees. Examples of additional written communications that the SEC expects would be considered material to an issuer include:

- management representation letters;
- reports on observations and recommendations on internal controls;
- schedules of material adjustments and reclassifications proposed, and a listing of adjustments and reclassifications not recorded, if any;
- engagement letters; and
- independence letters.

These examples are not exhaustive, and the SEC encouraged auditors to critically consider what additional written communications should be provided to audit committees.

(4) Timing of communications.

The rules specify that the communications between the auditor and the audit committee must occur prior to the filing of the audit report with the SEC pursuant to applicable securities laws. As a result, these discussions will occur, at a minimum, during the annual audit, but could occur as frequently as quarterly or more often on a real-time basis.

(5) Investment companies.

The rules require the accountant to communicate to the audit committee of an investment company annually, and if the annual communication is not within 90 days prior to the filing, provide an update in the 90 day period prior to the filing, of any changes to the previously reported information. The rules, in effect, require an accountant of an investment company complex where the individual funds have different fiscal year ends to communicate the required information no more frequently than four times during a calendar year.

G. Expanded Disclosure

(1) Principal accountants' fees.

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.

Under the new rules, the disclosure of professional fees paid for audit and non-audit services must be broken into the following categories:

- Audit fees, which include fees paid to the principal accountant for services necessary to perform an audit or review in accordance with GAAS, and may also include services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attestation services, consents and assistance with and review of documents filed with the SEC. Also included are fees for services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements. The adopting release specified that all services performed to comply with GAAS should be classified as "audit services." This could include services such as tax services and accounting consultations, to the extent that these services are necessary to comply with GAAS.

- Audit-related fees, which include assurance and related services that are traditionally performed by the independent accountant, such as employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation and consultation concerning financial accounting and reporting standards.

- Tax fees, which include all services performed by professional staff in the independent accountant's tax division, except those related to the audit and included in audit fees. Tax fees would include fees for tax compliance, tax planning and tax advice. Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities.

- All other fees, which include fees for financial information systems implementation and design.

The rules require disclosure of these fees for each of the two most recent fiscal years, rather than just the most recent fiscal year as previously required, so that investors have comparative information. In addition, other than for audit fees, issuers are required to describe, in qualitative terms, the type of the services provided that are categorized as audit-related fees and all other fees. The rules also include disclosure requirements related to audit committee pre-approval policies and procedures for audit and non-audit services provided by an independent public accountant, as well as the percentage of fees that were pre-approved pursuant to the de minimis exception. This information must be provided by category.

The requirement to disclose the percentage of audit services that are not provided by permanent, full-time employees of the independent public accounting firm, if more than 50%, remains unchanged from existing rules.

(2) Audit committee actions.

The rules require that issuers filing proxy statements disclose any policies and procedures developed by the audit committee of the board of directors concerning pre-approval of the independent accountant to perform both audit and non-audit services.

The disclosure should set out in detail the audit committee's policies and procedures for engaging the independent accountant to perform services other than audit, review and attestation services. The SEC stated that it expects issuers to provide clear, concise and understandable descriptions of the policies and procedures. Alternatively, a copy of those policies and procedures can be included with the proxy statement delivered to investors and filed with the SEC. Either method should allow shareholders to obtain a complete and accurate understanding of the audit committee's policies and procedures.

The SEC expects the disclosed policies and procedures to address auditor independence oversight functions in a prudent and responsible manner. Additionally, these procedures should describe, if applicable, the specific processes in place that permit and monitor activities meeting the *de minimis* exception. The disclosure should also discuss what percentage of the fees reported in each of the "audit-related fees," "tax fees," and "all other fees" categories were pre-approved by the audit committee pursuant to the policies and procedures instituted by the audit committee.

(3) Location of disclosure.

Under the rules, the new disclosure will be required to be included in a company's annual report, as well as in a company's proxy statement on Schedule 14A or information statement on Schedule 14C. Because the information is to be included in Part III of annual reports on Forms 10-K and 10-KSB, domestic companies are be able to incorporate the required disclosures from the proxy or information statement into the annual report. Issuers that do not issue proxy statements are required to include appropriate disclosures in their annual filing included in Form 10-K, Form 10-KSB, 20-F, Form 40-F and Form N-CSR as appropriate. Asset-backed issuers and unit investment trusts are exempt from these disclosure requirements.

(4) Investment Companies.

The rules require an investment company to disclose separately those audit and non-audit fees for services provided directly to the investment company and those non-audit fees for services provided to all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee. Like an operating company, the investment company is required to disclose the percentage of fees for each category of fees that were pre-approved pursuant to the *de minimis* exception. The rules require disclosure of the total non-audit fees paid to the accountant, regardless of whether those fees were pre-approved by the investment company's audit committee, by the investment company, its adviser, and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the fund. The rules also require the investment company to disclose if the audit committee has considered whether the provision of non-audit services provided to the investment company's adviser and its related parties that were not subject to the investment company audit committee's pre-approval is compatible with maintaining the principal accountant's independence.

(5) Effective Date

The disclosure provisions are effective for periodic annual filings for the first fiscal year ending after December 15, 2003. In the adopting release, the SEC encouraged issuers that have not previously issued their periodic annual filings to adopt these disclosure provisions earlier.

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This memorandum provides only a general overview of the SEC's rules regarding auditor independence. It 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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