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SEC ADOPTS AUDITOR INDEPENDENCE RULES

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On January 28, 2003, the SEC adopted final rules consistent with the direction of Section 208(a) of the Sarbanes-Oxley Act of 2002 (the "Act") to enhance the independence of outside auditors and require additional disclosures to investors about the services provided by independent auditors. *(Click here to link to our E*Zine regarding the SEC's proposed rules.)* The new rules concern the following:

Non-Audit Services

Section 201 of the Act prohibits an accounting firm from providing certain non-audit services to an audit client. The rules adopted by the SEC define the prohibited services as follows:

- The rules prohibit an accountant from auditing the **bookkeeping** or similar work performed by his or her accounting firm, unless it is reasonable to conclude that the results of these services will not be subject to the audit.

- An accounting firm is prohibited from providing any service related to the audit client's **financial information systems**, unless it is reasonable to conclude that the results of these services will not be subject to the audit. These rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as such services are pre-approved by the audit committee. Likewise, this prohibition does not preclude the accountant from 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.

- The rules prohibit an accountant from providing **appraisal or valuation services, fairness opinions, or contribution-in-kind reports,** unless it is reasonable to conclude that the results of these services will not be subject to the audit.

- The rules prohibit an accountant from providing to an audit client any **actuarial services** 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 ser-

vices will not be subject to the audit. However, the accountant may assist the client in understanding the methods, models, assumptions and inputs used in computing an amount.

- The rules prohibit an accountant from providing any **internal audit outsourcing service** 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 the audit. It is understood that during the conduct of the audit or when providing attest services related to internal controls, the auditor will evaluate the company's internal controls and, as a result, may make recommendations to the audit client for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, is not a prohibited service.

- An accountant is prohibited from **acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory or ongoing monitoring function for an audit client**. An accountant's independence will be impaired with respect to an audit client if the accountant (i) seeks out prospective candidates for managerial, executive or director positions; (ii) acts as negotiator on the audit client's behalf; (iii) undertakes reference checks of prospective candidates; (iv) engages in psychological testing or other testing or evaluation programs; or (v) recommends or advises the audit client to hire a specific candidate for a specific job.

- An accountant is prohibited from acting as a **broker-dealer, promoter, underwriter or investment adviser** on behalf of an audit client.

- An accountant is prohibited from providing **legal services** to an audit client.

- An accountant is prohibited from providing **expert opinions or other expert services** to an audit client, or a legal representative of the audit client, for the purpose of advocating the audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. An accountant's independence will not be impaired, however, by an accountant providing factual accounts or testimony or explaining the positions taken or conclusions reached during the performance of any service by the accountant.

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An accountant may continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements. There are, however, some circumstances where providing certain tax services to an audit client would impair the independence of the accountant, such as representing the audit client in tax court or other situations involving public advocacy.

Non-audit services performed by accounting firms for non-audit clients are *not* affected. Until May 6, 2004, the provision of a prohibited service will not impair an accountant's independence *provided* the service is rendered pursuant to a contract in existence on May 6, 2003.

Conflicts of Interest Resulting from Employment Relationships

The rules prohibit an accounting firm from auditing the financial statements of a public company if:

- a former employee of the accounting firm is in an accounting role or financial oversight role at the company, unless the individual (i) does not influence the accounting firm's operations or financial policies; (ii) has no capital balances in the accounting firm; and (iii) has no financial arrangement with the accounting firm;

- 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 audit procedures for the year that included employment by the issuer of the former member of the audit engagement team; or

- if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on that partner procuring engagements with the audit client to provide any services other than audit, review or attest services.

An accountant's independence will not be deemed to be impaired by employment relationships that commenced prior to May 6, 2003 and by compensation earned or received during the accounting firm's fiscal year that includes May 6, 2003.

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The rules provide certain exceptions whereby a person who is involved with the audit will not be considered part of the audit engagement team.

Partner Rotation

The new rules on partner rotation apply to "audit partners," which includes the (i) lead and concurring partners, (ii) other audit engagement team partners who provide more than 10 hours of audit, review or attest services in connection with the annual or interim consolidated financial statements of the issuer, and (iii) the lead partner on subsidiaries of the audit client whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the audit client.

The rules prohibit the lead and concurring partners from providing audit services to the client for more than *five* consecutive years. After five years, the proposed rules require a *five-year* "cooling-off" period during which the lead and concurring partners are prohibited from providing services. Partners subject to the rotation requirements, other than the lead and concurring partner, must rotate after no more than *seven* consecutive years and are subject to a *two-year* cooling-off period. Consequently, a partner could serve as the lead partner on a significant subsidiary or as an "audit partner" at the parent or issuer level for a period of time (*e.g.*, two years) prior to becoming the lead or concurring partner on the engagement and still be able to serve in that lead or concurring role for five years.

The new requirements applicable to the lead partner will go into effect as of the first fiscal year that begins after May 6, 2003. In determining when the lead partner must rotate, time spent as the lead partner prior to May 6, 2003 will be included. Rotation requirements for the concurring partner will be deferred until the second fiscal year that begins after May 6, 2003, which results in a minimum one-year lag between rotation by a lead partner and a concurring partner for any audit client. With respect to partners subject to the rotation requirements, other than the lead and concurring partner, the seven-year rotation period begins effective as of the first fiscal year that begins after May 6, 2003, but time prior to that fiscal year will not be counted in determining the seven years of audit participation, deferring any rotation until 2010 at the earliest.

Accounting firms may stagger the rotation of the partners to ensure continuity. Partners assigned to "national office" duties who may provide regular consultation to audit clients on specific accounting issues would *not* be subject to the rotation requirements.

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Auditor Communication with Audit Committee

The rules require the auditor to timely report (orally or in writing) to the company's audit committee:

- all critical accounting policies and practices used by the company;
- all material alternative GAAP accounting treatments of financial information discussed with management (including ramifications and the auditor's preferred treatment); and
- other material written communications between the auditor and management.

The rules provide the following examples of written communications that the SEC expects will be considered material to an issuer: (i) management representation letter; (ii) reports on observations and recommendations on internal controls; (iii) schedule of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any; (iv) engagement letter; and (v) independence letter.

The rule requires that communications between the auditor and the audit committee occur prior to the filing of the audit report with the SEC and, as a result, such discussions will occur (at a minimum) during the annual audit. However, the SEC expects that the required communications will occur as frequently as quarterly or more often on a real-time basis.

Audit Committee Pre-Approval of Services Provided by the Auditor

The rules require that the audit committee pre-approve all audit, review, and attest engagements. The rules also require that either:

- the audit committee expressly approve, in advance, the particular engagement for non-audit services; or
- any engagement for non-audit services be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee, and the audit committee is informed on a timely basis of each such service.

The Act allows the audit committee to delegate to one or more of its members the responsibility for such pre-approvals, with a follow-up report to the full audit committee. The pre-approval requirement can be

waived under certain conditions, including a de minimis exception where the aggregate amount of all non-audit services provided constitutes no more than 5% of the total amount of revenues paid by the audit client to the accounting firm during the fiscal year.

Disclosures to Investors of Services Provided by the Auditor

The Act requires disclosure in periodic reports of non-audit services approved by the audit committee. The new rules require that the audit client provide, in its annual report on Form 10-K or proxy statement, the following fees paid to the auditor: (1) audit fees, (2) audit-related fees, (3) tax fees, and (4) other fees. To the extent that the audit committee has applied the de minimis exception mentioned above, the issuer must disclose the percentage of total fees paid to the independent accountant.

"Audit-Related Fees" include the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review, including services such as employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with acquisitions, internal control reviews, and consultation concerning financial accounting and reporting standards. The aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, consultation and planning are captured in the "Tax Fees" category. The aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than audit-related fees and tax fees, are included in the "All Other Fees" category.

The disclosure of fees paid for audit and non-audit services is required for the last two fiscal years, as compared to the one fiscal year period required under current proxy statement disclosure rules. Companies will also be required to *describe* in subcategories the services categorized as "Audit-Related Fees," "Tax Fees" and "All Other Fees."

The rules also require that public companies disclose in detail, in their annual report on Form 10-K or proxy statement, any policies and procedures developed by the audit committee concerning pre-approval of the independent accountant to perform both audit and non-audit services.

Small Business/Small Firm Considerations

The SEC recognized that some of the provisions of the new rules may impose an undue burden on certain smaller accounting firms. Accordingly, the rules provide that firms with fewer than five audit clients and fewer than ten partners may be exempt from the partner rotation and compensation provisions, provided each of the engagements is subject to a special review by the Public Company Accounting Oversight Board at least every three years.

The new rules under Section 208(a) of the Act become effective on May 6, 2003. *(Click here to link to the full text of the new rules.)*

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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