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SEC PROPOSES AUDITOR INDEPENDENCE RULES

By Margaret F. Murphy and Monique Cenac

On December 2, 2002, the SEC released proposed rules under Section 208(a) of the Sarbanes-Oxley Act of 2002 (the "Act") to enhance the independence of auditors. As directed in the Act, the SEC's proposed rules include:

- revising the SEC's regulations related to the non-audit services that would impair an accounting firm's independence;
- defining the circumstances whereby an issuer's audit committee can and should pre-approve all audit and allowable non-audit services provided to the issuer by the auditor of an issuer's financial statements;
- prohibiting partners from serving on an issuer's audit engagement team for more than five consecutive years;
- prohibiting an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; and
- requiring 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.

In addition to the provisions required by the Act, the SEC's proposal includes the following:

- defining an accounting firm as not being independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based on any service provided or sold to that client, other than audit, review, and attest services; and
- requiring disclosure of additional information to investors as to audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.

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Conflicts of Interest Resulting from Employment Relationships

The proposed rules would 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;
- an employee of the audit client who oversees financial reporting had been a member of the accounting firm's audit engagement team within the one-year period preceding the commencement of the audit procedures for the current audit; or
- at any point during an engagement period, any member of the audit team directly or indirectly receives compensation based on the performance or sale of any services to the audit client, other than audit, review, or attest services.

Non-Audit Services

Section 201(a) of the Act prohibits an auditor from providing contemporaneously the following non-audit services to an audit client:

- bookkeeping;
- financial information systems design and implementation services;
- appraisal or valuation services and fairness opinions;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources services;
- broker-dealer, investment adviser or investment banking services; and
- legal and expert services unrelated to the audit.

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The proposed rules provide a definition of each of the prohibited services and, in some cases, a list of examples, and remove the categorical exemptions contained in the existing rules.

Under the SEC's proposal, non-audit services should be judged against the four general principles that an accounting firm cannot audit its own work, perform management functions of the audit client, act as an advocate of the audit client, or promote the audit client's stock or other financial interests. Non-audit services that conflict with any of these principles would be prohibited, whether or not specifically enumerated. Non-audit services performed by accounting firms for non-audit clients would not be affected.

Partner Rotation

The proposed rules prohibit all partners (not just the lead and reviewing partner) who are directly involved in the audit, review, and attest engagements of the issuer 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 partner is prohibited from providing services. Tax partners who perform significant services related to the audit engagement would also be subject to the rotation requirements. 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. Under the proposed rules, accounting firms may stagger the rotation of the partners to ensure continuity.

Audit Committee Administration of the Engagement

The proposed rules require that the audit committee pre-approve all audit, review, and attest engagements. The proposals 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 of its members the responsibility for such pre-approvals. However, under the Act, this pre-approval requirement is waived with respect to the provision of

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non-audit services by the accounting firm, provided:

- 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 in which the services are provided;
- such non-audit services were not recognized by the audit client at the time of the engagement to be non-audit services; and
- the non-audit services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit.

Auditor Communication with Audit Committees

The proposed 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 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 proposed rules also require that the 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 would occur more frequently.

Expanded Disclosure

Fees for Audit and Non-Audit Services

The proposed rules revise the disclosure required in proxy statements as to fees paid for audit and non-audit services to add two new categories, "Audit-Related Fees" and "Tax Fees," and eliminate the category entitled "Financial Information Systems Design and Implementation Fees." Audit-related fees would include assurance and related services that are traditionally performed by the independent accountant, including services

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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. Fees paid for services performed by professional staff in the independent accountant's tax division, including tax compliance, consultation and planning, would be captured in the "Tax Fees" category. Fees paid for financial information systems implementation and design services would be included in the current "All Other Fees" category.

The SEC's proposed rules also expand the types of fees to be included in the "Audit Fees" category. In addition to fees for audit and review services, "Audit Fees" will also include fees for services that only independent accountants can generally provide, including comfort letters, statutory audits and assistance with and review of documents filed with the SEC.

As proposed, the disclosure of fees paid for audit and non-audit services would be 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" and "All Other Fees."

Audit Committee Actions

The proposed rules require that registrants filing proxy statements disclose in detail any policies and procedures developed by the audit committee concerning pre-approval of the independent accountant to perform both audit and non-audit services. Alternatively, registrants could include a copy of these policies and procedures in their proxy statement delivered to shareholders and filed with the SEC.

The Act requires the SEC to issue final rules regarding auditor independence by January 26, 2003. The SEC is considering transition periods for instituting some of the auditor independence rules, including the audit partner rotation and audit fees disclosure proposals. Comments on the proposed rules should be delivered to the SEC no later than January 13, 2002. [\(Click here to link to the full text of the SEC's proposal.\)](#)

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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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