

SEC PROPOSES RULES REGARDING RETENTION OF RECORDS RELEVANT TO AUDITS AND REVIEWS

By Dionne M. Rousseau and Richard B. Montgomery IV

On November 21, 2002, the SEC released a proposed rule under Section 802 of the Sarbanes-Oxley Act of 2002 (the "Act") that would amend Regulation S-X to require accountants who audit or review an issuer's financial statements to retain certain records relevant to that audit or review for five years from the end of the fiscal year in which the audit or review was concluded.

Documents to be Retained

The proposed rule would require that auditors retain workpapers and other documents that form the basis of the audit or review of an issuer's financial statements, and memoranda, correspondence, communications, and other documents and records (including electronic records) that:

- are created, sent or received in connection with the audit or review; and
- contain conclusions, opinions, analyses, or financial data related to the audit or review.

Under the proposed rule, auditors must retain materials that satisfy both of these criteria. Non-substantive materials that are not part of the workpapers, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions or analyses, would not meet the second of these criteria and would not have to be retained.

Period of Retention

The period for retention of these materials would be five years after the end of the fiscal period in which an accountant concludes an audit or review of an issuer's financial statements. The retention period is based on the period in which the audit or review is concluded and not on the fiscal period covered by the financial statements. For example, if a company has a calendar fiscal year-end and an audit of its fiscal year 2002 financial statements is completed in March 2003, the retention period would end January 1, 2009.

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In its release, the SEC points out that Section 103 of the Act directs the Public Company Accounting Oversight Board (the “Board”) to require auditors to retain for seven years audit workpapers and other materials that support the auditor’s conclusions in any audit report. The SEC states in its release that there may be fewer documents retained pursuant to Section 103 of the Act, which focuses more on workpapers that support the auditor’s conclusions, than under Section 802 of the Act, which includes not only workpapers but also the documents that meet the criteria described above and those that “cast doubt” on the auditor’s conclusions, as described below.

“Workpapers” Defined

The proposed rule would require the retention of more than what traditionally has been thought of as an auditor’s “workpapers.” By defining “workpapers,” the SEC would clarify the distinction between workpapers and additional materials that would also be required to be retained under the proposed rule. The SEC believes that the term “workpapers” is understood to refer to the documents required to be retained by generally accepted auditing standards. The proposed rule would, therefore, define “workpapers” as “documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the Commission or by the Public Company Accounting Oversight Board.” Under this definition, the Board, subject to SEC oversight, would have the ability to review and change the nature and scope of the required documentation of procedures, evidence, and conclusions related to audits and reviews of financial statements.

Differences of Opinion

The proposed rule would require that in addition to materials that support an auditor’s conclusions about the financial statements, those materials that may “cast doubt” on those conclusions must be retained as well. To illustrate, the proposed rule would contain an example requiring retention of “documentation of differences of opinion concerning accounting and auditing issues.” The proposed rule is intended to ensure retention of those records that reflect differing professional judgments and views, both within the accounting firm and between the firm and the company, and how those differences were resolved. Examples contained in the release include:

- a memorandum by an accounting firm’s national office that is critical of the accounting used by an audit client; and

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- documentation related to an auditor's communications with an audit committee when the company has chosen disclosures or accounting methods not preferred by the auditor.

Comment Period

Comments on the proposed rule should be delivered to the SEC no later than December 27, 2002. ([Click here to link to the full text of the SEC's proposal.](#))

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STOCK OPTION INCOME TO BE REPORTED SEPARATELY ON FORM W-2 IN 2003

By Amos J. Oelking III

In recent Announcement 2002-108, the IRS reminded employers that income from the exercise of nonstatutory (*i.e.*, non-qualified) stock options must be identified and reported separately on Form W-2 beginning in 2003.

When an employee (or former employee who is required to receive a Form W-2) exercises non-qualified stock options, employers are required to report the excess of the fair market value of the stock received over the amount paid for the stock (the "stock option income") in boxes 1, 3 and 5 of Form W-2. The Announcement alerts employers that when an employee or former employee exercises non-qualified stock options, employers will also be required to report the stock option income in box 12 using "Code V - Income from the exercise of nonstatutory stock options." This separate reporting of stock option income is optional for 2002 Forms W-2.

The IRS intends to publish the 2003 Form W-2 and instructions in the near future.

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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