Acknowledgement: This document is excerpted from materials prepared by Fried, Frank, Harris, Shriver & Jacobson.

April 10, 2003

SEC Adopts Final Rules Regarding Auditor Independence & Other Matters Implementing Title II of the Sarbanes-Oxley Act of 2002

On January 28, 2003, the Securities and Exchange Commission adopted final rules regarding auditor independence and other matters implementing Title II of the Sarbanes-Oxley Act of 2002. These rules:

- revise the SEC's existing regulations related to eight categories of non-audit services that, if provided to an audit client, would impair an accounting firm's independence, add "expert services" as a ninth restricted category, and clarify the SEC's view that accounting firms can provide tax services to their audit clients;

- 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, either on a case-by-case basis or pursuant to pre-established policies and procedures;

- prohibit the lead and concurring partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years, with a five-year "time-out" period, and prohibit certain other "audit partners" from performing audit services for more than seven consecutive years, with a two-year "time-out" period;

- prohibit an accounting firm from auditing an issuer's financial statements if any individual with a "financial reporting oversight role" at that issuer (subject to specified exceptions) was a member of the accounting firm's audit engagement team within a "cooling off" period (which is the one-year period preceding the date that audit procedures commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer);

- require that the auditor of an issuer's financial statements report to the issuer's audit committee all "critical accounting policies" used by the issuer, all alternative

Copyright (c) 2003 by the American Institute of Certified Public Accountants, Inc. License is hereby granted for reuse or reprint of this matter for purposes other than resale or commercial exploitation, provided AICPA copyright statement and acknowledgment of any modification is displayed in any circumstance of reuse or reprint.

treatments within GAAP for policies and procedures related to material items discussed with management, and other material written communications between the auditor and the issuer's management;

- require disclosures to investors in proxy statements and annual reports of information related to audit fees, audit-related fees, tax fees and all other fees billed during the prior two fiscal years by the principal auditor of the issuer's financial statements, as well as the audit committee's pre-approval policies; and

- provide that an accountant will not be deemed independent from an audit client if an "audit partner" receives compensation based on selling engagements to that client for services other than audit, review and attest services.

In addition to applying to audits of domestic issuers, the rules apply to audits of foreign subsidiaries and affiliates of U.S. issuers, as well as of foreign private issuers, by U.S. and foreign accounting firms.[1]

The effective date of the rules is May 6, 2003 (the "Effective Date"), which is 90 days after February 5, 2005, the date the rules were published in the Federal Register. Transition and grandfathering provisions, however, delay the impact of certain of the rules.

A. Scope of Services Provided by Auditors

The rules limit and clarify the scope of non-audit services that independent accountants can provide to their audit clients. [2] The rules only apply to non-audit services provided by independent accountants to their audit clients. The Adopting Release states that the rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client.

The SEC's rules with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot audit his or her own work, (2) an auditor cannot function in the role of management, and (3) an auditor cannot serve in an advocacy role for his or her client.

[1] In a number of instances there are separate rules dealing with investment companies. This memorandum does not address the special application of the auditor independence rules to investment companies.

[2] Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested to. Subject to certain limited exceptions, audit client includes affiliates of the audit client. See SEC Rule 2-01(f)(4) and (6) for definitions of *affiliate of the audit client* and *audit client*, respectively.

Consistent with the Sarbanes-Oxley Act, the rules prohibit the following non-audit services, subject to various exceptions and qualifications as described below:[3]

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services; and
- expert services.

The Sarbanes-Oxley Act also prohibits any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

While most of these categories of services (other than expert services) were prohibited under the prior independence rule amendments adopted in 2000, a number of exceptions to those prohibitions have been eliminated.

These revised scope of service rules do not apply to engagements that are contracted for before May 6, 2003 so long as they are completed by May 6, 2004.

1. Bookkeeping or Other Services Related to Accounting Records or Financial Statements of the Audit Client

Under the rules, all bookkeeping services provided by an auditor to an audit client would cause the auditor to lack independence, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures.[4] The rules state that

---

3 In order to understand the precise scope of the restrictions on non-audit services, it is important to review both the rules and the relevant portion of the Adopting Release. In some instances, there are important clarifications of the SEC's intentions in the release that are not obvious from, or incorporated in, the rule itself.

4 With respect to the prohibitions on (1) bookkeeping, (2) financial information systems design and implementation, (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports, (4) actuarial services and (5) internal audit outsourcing, the rules generally state that the service may not be provided "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." As such, the SEC stated that there is a rebuttable presumption that services in these five categories

bookkeeping includes: (1) maintaining or preparing the audit client's accounting records, (2) preparing financial statements that are filed with the SEC or the information that forms the basis of financial statements filed with the SEC, or (3) preparing or originating source data underlying the audit client's financial statements. While the prior rules included such a prohibition, the new rules eliminate exceptions for emergency situations and services provided in foreign jurisdictions.

The SEC noted that accountants sometimes are asked to prepare statutory financial statements for foreign companies that are not filed with the SEC. Consistent with the SEC's previous rules, the SEC said that an accountant's independence would be impaired where the accountant prepared the statutory financial statements if those statements formed the basis of the financial statements that are filed with the SEC.

2. Financial Information Systems Design and Implementation

The rules prohibit an accounting firm from providing any service related to an audit client's financial information systems design and implementation, 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 auditor may not directly or indirectly operate or supervise the operation of the audit client's information system or manage the audit client's local area network. The principle underlying this prohibition is that designing, implementing, or operating systems affecting the financial statements could place the accountant in a management role, or result in the accountant's auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by the accountant.

The rules also prohibit the accountant from designing or implementing a hardware or software system that aggregates source data or generates information that is "significant" to the financial statements or other financial information systems taken as a whole. The SEC noted that information would be "significant" if it is reasonably likely to be material to the financial statements of an audit client. The SEC noted that because materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm by necessity would need to evaluate the general nature of the information, as well as the system output during the period of the audit engagement, before proceeding with the engagement. In addition, by way of example, the SEC stated that an accountant would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning or similar system since the system would serve as the basis for the audit client's financial reporting system.

The SEC noted that the 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 those services are pre-approved by the audit committee.

---

are subject to audit procedures. A footnote in the Adopting Release identifies, as an example of a situation where it would be reasonable to conclude that the results would not be subject to audit procedures, a situation where an accounting firm provides a prohibited service to an affiliate of the client but the accounting firm is not the auditor of the entity or entities that controls the accounting firm's audit client or its affiliate.

The SEC also emphasized that these restrictions are not intended to prevent accountants from continuing to evaluate 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. Similarly, the SEC stated that an accountant would not be precluded from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system for an audit client by another service provider. Accountants have long performed these types of services.

3. Appraisal or Valuation Services, Fairness Opinions, or Contribution-in-Kind Reports

The rules prohibit an accountant from providing "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." The Adopting Release states that 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 prior rules contained similar restrictions on these services, but were accompanied by a series of exceptions that for the most part have been eliminated. For example, under the prior rules, accountants could assist an audit client in the valuation of pension and other post-employment benefit or similar liabilities, so long as the client determined and accepted responsibility for the underlying assumptions and data.

The SEC's Adopting Release clarified that the rules do not prohibit an accounting firm from providing such services for non-financial reporting purposes (*e.g.*, transfer pricing studies, cost segregation studies, and other tax-only valuations). Also, the release clarifies that the rules do not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed 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.

The SEC noted that laws and regulations in certain foreign countries require auditors in connection with designated transactions of their audit clients to provide "contribution-in-kind reports" that express an opinion on the fairness of the transaction, the value of a security, or the adequacy of the consideration to shareholders. The SEC stated that it has previously afforded relief from proscriptions against appraisal and valuation services where, among other things, the auditor and issuer demonstrated to the SEC's satisfaction that the auditor was not providing an opinion on the fairness of a given transaction. The SEC stated that it will continue to take this *ad hoc* approach and

consider requests for exemptive relief from foreign auditors. The SEC also stated that it would continue to work with foreign regulatory agencies on the issue.

4. Actuarial Services

The rules prohibit an accountant from providing to an audit client "any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, 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." Prior SEC rules only restricted actuarial services involving the determination of insurance company reserves.

The Adopting Release states that the accountant may 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 its management with the actuarial advice that is subject to audit.

5. Internal Audit Outsourcing

The rules prohibit the accountant from providing "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 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."

The prior rules permitted audit firms to provide internal audit services in a variety of circumstances. For example, firms could provide such services for clients with less than $200 million in total assets, or internal audit services in an amount constituting less than 40% of the total hours expended on the client's internal audit activities in a fiscal year, provided that certain safeguards were observed, for example, the audit client's management accepted responsibility for the results of the services. These exceptions have been eliminated and replaced by a broader ban on internal audit outsourcing, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures.

The SEC's Adopting Release noted that during the conduct of an audit in accordance with GAAS or when providing attest services related to internal controls, making recommendations for improvements to internal controls is a part of the accountant's responsibilities under GAAS or other applicable attestation standards and, therefore, will not be considered to constitute an internal audit outsourcing engagement.

Similarly, the Adopting Release states that the prohibition on "outsourcing" does not preclude a client's engaging an accountant to perform nonrecurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function. For example, the SEC noted that a company may engage an accountant,

subject to the audit committee pre-approval requirements, to conduct "agreed-upon procedures" engagements related to the company's internal controls, since management accepts responsibility for the scope and assertions in those engagements.

6. Management Functions

The rules prohibit the accountant 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 the audit client." This formulation is virtually identical to the previous restriction on management functions.

The SEC's Adopting Release elaborates that services provided in connection with an assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an accountant's independence under this provision. The SEC also noted that auditors may recommend improvements in the internal accounting and risk management controls of an audit client (which is a permissible service, if pre-approved by the audit committee). The SEC contrasted these services with designing or implementing internal accounting and risk management controls. For example, management could engage a third-party service provider to design and implement an inventory control system. In the course of that engagement, the third-party service provider might ask the accountant to make recommendations on internal control and accounting system components that have been included in the system being designed. Providing such recommendations to the third-party service provider would not place the independent accountant in the role of management.

In addition, the Adopting Release states that the outside auditor may be engaged by a company, subject to the audit committee pre-approval requirements, to conduct an agreed-upon procedures engagement related to the company's internal controls or to provide attest services related to the company's internal controls without impairing his or her independence.

7. Human Resources

The rules provide that an accountant's independence is impaired with respect to an audit client when the accountant:

- searches for or seeks 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 negotiator on the audit client's behalf, such as determining position, status, 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).

These restrictions are virtually identical to the previous restrictions on the performance of human resources functions.

8. Broker-Dealer, Investment Adviser or Investment Banking Services

The rules provide that an accountant's independence is impaired when an accountant is "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."

These provisions are virtually identical to the prior rules except that the prohibition has been extended to "unregistered" broker-dealers. Of course, acting as an unregistered broker-dealer could result in a separate violation of the broker-dealer registration requirements.

The SEC noted that the rules are not meant to change its previous position that an audit firm's broker-dealer division can cover an industry 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 and would cause the auditor to lack independence.

9. Legal Services

Under the rules, an accountant is prohibited from "providing 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."

Under the prior rules the prohibition on legal services only applied where the service provider was required to be permitted to practice before the courts in a U.S. jurisdiction. Thus, the amendment has the broad effect of extending the prohibition to regulated foreign legal services. The SEC noted that, in some jurisdictions, only lawyers can perform tax work, and that, as a general matter, the SEC rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. The SEC also said it was "making clear that foreign accounting firms can provide tax services, as appropriate, despite their local definitions and local licensing requirements." The SEC encouraged foreign accounting firms and regulators to consult with the SEC staff to address these issues.

10. Expert Services

The rules prohibit an accountant from "providing an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation." This prohibition was not included in the regulations adopted in 2000, although prior staff positions had restricted certain expert witness activities by audit firms. Additionally, under the rules, an accountant's independence would be impaired if the audit client's legal counsel, in order to acquire the requisite expertise, engaged the accountant to provide such services in connection with litigation, or any regulatory or administrative proceeding or investigation.

The SEC acknowledged that virtually all services provided by an accountant theoretically could be characterized as "expert" services. It emphasized, however, that the restrictions in the rules only cover those services that involve advocacy in proceedings and investigations and do not apply to other permitted non-audit services, such as tax services. The SEC also noted that the rules do not preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact finding engagements. These types of permitted engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit committee. If a procedure or investigation is commenced during such an engagement, the accountant may complete the engagement, provided he or she maintains control over his or her work and that work does not become subject to the influence of the issuer's legal counsel. Also, should a proceeding or investigation not be initiated until *after* the engagement is completed, 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 SEC noted that an auditor's independence would be impaired if its assistance to the audit committee included defending, or helping to defend, the audit committee or the company generally in a shareholder class action or derivative lawsuit, other than as a fact witness.

The Adopting Release further explains that the rules would not prohibit an accountant from assisting an audit committee in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety. For example, if the audit committee were concerned about the accuracy of the inventory accounts at a subsidiary, it could engage the auditor to conduct a thorough inspection and analysis of those accounts, the physical inventory at the subsidiary, and related matters without impairing the auditor's independence.

11. Tax Services

One issue that engendered considerable discussion during the rulemaking process was the extent to which the SEC would continue to allow accounting firms to provide tax services to their audit clients. In this regard, the Sarbanes-Oxley Act specifically identified "tax services" as permissible for accounting firms to provide SEC audit clients, subject to audit committee pre-approval, but the SEC's Proposing Release contained some language that appeared to suggest that tax services would impair independence if

they either fell within one or more of the nine categories of restricted non-audit services under the Sarbanes-Oxley Act or raised concerns under the three "basic principles" of auditor independence identified in the release.

In response to the concerns raised by the Proposing Release, the SEC's Adopting Release states definitively that "an accounting firm can provide tax services to its audit clients without impairing the firm's independence." Accordingly, the SEC emphasized that "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."

The SEC noted, however, that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence. In particular, the SEC notes that accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, the SEC warns that audit committees should "scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations."

B. Audit Committee Administration of the Engagement

The rules provide that an auditor will not be deemed independent in respect of an engagement to render a service unless:

- the engagement is specifically pre-approved by the issuer's audit committee or one or more of its members who are independent directors and are designated to perform this role; or

- (1) the engagement is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer, which policies and procedures are detailed as to the particular service, (2) the audit committee is informed on a timely basis of each engagement, and (3) such policies and procedures do not include delegation of the audit committee's responsibilities to management.

The audit committee must pre-approve all services. The audit committee may establish policies and procedures for pre-approval provided they are detailed as to the particular service and designed to safeguard the independence of the auditor. The Sarbanes-Oxley Act allows the audit committee to pre-approve a service at any time in advance of the activity, and the SEC's Adopting Release states that "we expect audit committees will establish policies for the maximum period in advance of the activity the approval may be granted."

The rules also include a *de minimis* exception mandated by the Sarbanes-Oxley Act 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;

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

- the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee to whom authority to grant such approvals was delegated.

These rules apply to all audit (including review and attest) services and non-audit services that are contracted for on or after the May 6, 2003. In the Adopting Release, the SEC noted that for arrangements for non-audit services entered into prior to May 6, 2003 — regardless of whether or not they were pre-approved by the audit committee — the accounting firm will have 12 months from that date to complete these services. For example, the SEC stated that an engagement to provide non-audit services entered into in December 2002 is not subject to these rules but must be completed by May 6, 2004

C. Partner Rotation

The rules provide that the lead and concurring partners must rotate after five years and, upon rotation, are subject to a five-year "time-out" period. In addition, other "audit partners" must rotate after no more than seven years on an engagement and are subject to a two-year "time-out" period. As proposed, all audit engagement team partners would have been subject to the five-year rotation and "time-out" provisions. In response to comments, the SEC modified the proposed standard by (i) limiting the rotational obligations to a new defined category of "audit partners" and (ii) differentiating between the lead and concurring partners and other "audit partners." Any accounting firm with less than five audit clients that are issuers and less than ten partners is exempt from the partner rotation rule as long as the Public Company Accounting Oversight Board conducts a review at least once every three years that would focus on the overall quality of audits performed and specifically, the independence and competence of key persons on the firm's audit engagement teams.

"Audit partners" are 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, other than a partner who consults regarding technical or industry-specific issues, transactions or events. "Audit partners" include the following:

- the lead partner;

- the concurring or review partner;

- other audit engagement team partners who provide more than ten hours of audit, review or attest services in connection with the annual or interim consolidated financial statements of the issuer; and

- other audit engagement team partners who serve as the lead partner in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the issuer's consolidated assets or revenues.

Partners assigned to "national office" duties (which can include technical accounting and auditing functions — whether at a local or national level — as well as centralized quality control functions) and other "specialty" partners who may be consulted on specific accounting issues related to a client are not considered "audit partners" for purposes of these requirements, even though they may periodically consult on client matters.

The SEC noted that an audit partner who first works in a position other than the lead or concurring partner and subsequently becomes the lead or concurring partner can serve the client in an "audit partner" capacity for seven consecutive years so long as the partner does not serve as the lead or concurring partner on the issuer for more than five years. This change from the SEC's original proposal is intended to facilitate a smooth transition from a rotating lead or concurring partner to a knowledgeable successor. For example, a person serving as the lead partner on a significant subsidiary for a period of four years who then becomes the lead partner on the issuer would be able to serve in that capacity for three additional years before reaching a total of seven years as an audit partner on that client.

The SEC noted that the partner rotation requirements set forth in the proposed rules were of particular concern to the international community. Commentators noted that the proposed requirements could have a particularly adverse impact in foreign countries, especially in emerging countries, where there may be a more limited pool of accountants and experts conversant in U.S. GAAP and U.S. GAAS. Other commentators indicated that the proposed rotation requirements would cause firms to rotate hundreds of partners in scores of countries. These commentators argued that the resulting widespread rotation would affect audit quality adversely, and would be hard, if not impossible, to implement effectively. The SEC did not provide any special relief for foreign accounting firms in this area, although the general changes made to the proposed rules and the addition of the new category of "audit partners" address to some extent foreign concerns.

D. Employment at Audit Client of Former Employees of Accounting Firms

The new addition augments preexisting rules that require partners and professional employees to sever financial and other ties with their firms prior to accepting certain employment or other managerial positions with a client. The new rules provide that an accounting firm will not be independent in respect of a fiscal year if a member of the audit engagement team takes on a "financial reporting oversight role" with the issuer

without observing a defined "cooling off" period (as described below) before taking up that employment with the issuer.

The new restriction only applies where the former employee of the auditor works at the issuer in a "financial reporting oversight role." The term "financial reporting oversight role" means "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, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position." The SEC rejected comments to narrow the list of positions at the issuer covered by the new restriction to those specifically identified in the relevant provision of the Sarbanes-Oxley Act.

The "cooling off" requirement applies to all members of the audit engagement team except:

- persons, other than the lead partner and concurring partner, who provided ten or fewer hours of audit, review or attest services during the relevant fiscal period;

- individuals employed by the issuer as a result of a business combination between an issuer that is an audit client and the employing entity, provided that the employment was not in contemplation of the business combination and that the audit committee of the successor issuer is aware of the prior employment relationship; and

- individuals that are employed by the issuer due to an emergency or other unusual situation, provided that the audit committee determines that the relationship is in the interest of investors (such as in certain foreign jurisdictions where it may be extremely difficult or costly to comply with these requirements). The SEC Adopting Release states that the SEC expects this exception will be used "very rarely."

Under the rules, the term "audit engagement team" refers to all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client. Included within the audit engagement team would be "audit partners" (as separately defined in the rules) and all other persons who consult with other members of the engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

The proposed restriction extended to employment relationships with an "audit client," but the restriction as adopted applies only to employment relationships entered into between members of the audit engagement team and an "issuer." [5] The SEC noted

[5] The term ''issuer'' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files

that extending the requirement to the "audit client" (which includes all affiliates of the audit client) might be difficult to monitor because of the potentially broad scope of that term under the SEC's current independence rules – particularly in situations where a member of the audit engagement team is employed by an affiliate [6] of the issuer.

In response to comments, the rules clarify the time period of the prohibition. The rules provides that an issuer cannot hire a person who was a member of the audit engagement team "during the one-year period preceding the date that audit procedures commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer." For this purpose, 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, 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 (for example, Form 10-K, 20-F or 40-F) is filed with the SEC.[7]

The SEC noted that the international community had requested that the SEC modify its approach to conflicts of interest resulting from employment relationships. Moreover, the SEC noted that it had become aware that in certain jurisdictions the labor law or jurisprudence would prohibit foreign accounting firms from imposing restrictions

---

or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

6 Affiliates generally include entities in parent/subsidiary and common control relationships with an audit client, other entities included in an investment company complex with an audit client, and can even extend in certain cases to equity method (investee/investor) ownership interests.

7 The SEC provided the following example to illustrate the application of this rule. Assume that Issuer A's Forms 10-K are filed on March 15, 2003, April 5, 2004, March 10, 2005, and March 30, 2006. Issuer A is a calendar-year reporting entity. The audit engagement periods would be deemed to commence and end:

Annual Period	Engagement Period Commences	Engagements Period Ends
2003	March 16, 2003	April 5, 2004
2004	April 6, 2004	March 10, 2005
2005	March 11, 2005	March 30, 2006

If audit engagement person B provided audit, review or attest services for Issuer A at any time during the 2003 engagement period (March 16, 2003 - April 5, 2004), and he or she begins employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. For example, if person B last performed audit, review or attest services for Issuer A on March 24, 2003 and he or she began employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. Likewise, if person B provided audit, review or attest services for Issuer A at any time during the 2004 engagement period (April 6, 2004 - March 10, 2005) and he or she began employment with Issuer A in a financial reporting oversight role prior to March 31, 2006, the accounting firm would be deemed to be not independent with respect to Issuer A.

on the future employment opportunities of their personnel. Although the SEC did not provide any special relief for foreign auditors or foreign issuers, the SEC's revisions to its initial proposals concerning the "cooling off" rules will help foreign auditors. In particular, the prohibition only applies to persons who undertake a financial reporting oversight role at the "issuer" but not at affiliates or subsidiaries – including foreign subsidiaries. There is also the new exception (described above) for individuals employed by an issuer "due to an emergency or other unusual situation" if the audit committee pre-approves the arrangement.

E. Communication with Audit Committees

The rules require that the independent accountants must communicate certain information to an issuer's audit committee. Specifically, each accountant that performs for an audit client that is an issuer any audit required under the securities laws must report, prior to the filing of such audit report with the SEC, to the audit committee:

- all critical accounting policies and practices to be used;
- all alternative treatments within GAAP "for policies and practices related to material items" that have been discussed with management of the issuer, including:
    - the ramifications of the use of such alternative disclosures and treatments; and
    - the treatment preferred by the registered public accounting firm; and
- other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

The SEC has not required that the communication be in writing; however, the SEC noted that it would expect that such communications would be documented by the accountant and the audit committee.

1. Critical Accounting Policies and Practices

The rules require communication by accountants to audit committees of all critical accounting policies and practices. Based on the SEC's December 2001 "cautionary advice," 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 effects of matters that are inherently uncertain.

The SEC did not require that these discussions follow a specific form or manner, but stated that accountants and issuers should read and refer to the December 2001 cautionary guidance to determine the types of matters that should be communicated to the audit committee. The SEC said that it expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the SEC's December 2001 cautionary guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, the SEC stated that it anticipated that the communications regarding critical accounting policies would include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

2. Alternative Accounting Treatments

The rules require communication, either orally or in writing, by accountants to audit committees of all alternative 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 proposed rules had not included the materiality limitations.

The SEC's Adopting Release states that the rules are intended to cover recognition, measurement, and disclosure considerations related to general accounting policies and the accounting for specific transactions. The SEC noted that the communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies and include the impact of management's judgments and accounting estimates, as well as the accountants' 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 accountants along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the accountants should describe the reasons for the change. The SEC stated that communications regarding specific transactions should identify, at a minimum, the underlying facts, any affected financial statement accounts, and the 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 the accountants should explain why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy. Whenever a new accounting policy or treatment selected is not the accountant's preferred policy or treatment, then the SEC expects the discussions to include the reasons why the accountant considered one policy or treatment to be preferable, but management did not select that policy or treatment.

3. Other Material Communications

The rules require that accountants provide the audit committee with copies of material written communications between the accountant and management. The

Adopting Release states that examples of communications that the SEC expects will be considered material to an issuer include:

- management representation letters;
- reports on observations and recommendations on internal controls;
- schedules of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any;
- engagement letters; and
- letters confirming the accountant's independence.

The SEC noted that these examples are not exhaustive and encouraged accountants to consider carefully what additional written communications should be provided to audit committees.

4. Timing of Communications

The rules specify that the communications between the accountant 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 the SEC stated that it expects that the discussions could occur as frequently as quarterly or more often on a real-time basis. The SEC noted that the timing of these communications is intended to occur before any audit report is filed with the SEC pursuant to the securities laws, including prior to the filing of annual reports and proxy statements, registration statements, other periodic or current reports which contain audit reports.

F. Expanded Disclosure

The rules require that an issuer disclose the following information about its "principal accountant" in its Form 10-K and proxy statement (or Form 20-F or Form 40-F used by foreign private issuers and certain Canadian issuers, respectively):

- the aggregate "Audit Fees" billed for each of the last two fiscal years for the audit and quarterly reviews or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements;
- the aggregate "Audit-Related Fees" billed in each of the last two years that are reasonably related to the audit or review (together with a description of the nature of the services comprising the fees disclosed in this category);
- the aggregate "Tax Fees" billed in each of the last two years for tax compliance, tax advice and tax planning (together with a description of the nature of the services comprising the fees disclosed in this category);

- the aggregate amount of "All Other Fees" billed in each of the last two fiscal years (together with a description of the nature of the services comprising the fees disclosed in this category);

- the audit committee's pre-approval policies and procedures;

- the percentage of Audit-Related Fees, Tax Fees and All Other Fees that were approved by the audit committee using a *de minimis* exception; and

- if more than 50%, the percentage of hours expended on the principal accountant's engagement to audit the annual financial statements that were attributable to work performed by non-full time, non-permanent employee.

The "Audit Services" category includes fees for services necessary to perform an audit or review in accordance with GAAS, as well as fees for services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements. This includes services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the SEC.

"Audit-Related Fees" are fees for 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 that are not required by statute or regulation and consultation concerning financial accounting and reporting standards.

The "Tax Fees" category captures fees for all services performed by professional staff in the independent accountant's tax division except those services related to the audit. Typically, such fees would relate to tax compliance, tax planning and tax advice services. 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 or employee benefit plans and requests for rulings or technical advice from taxing authorities.

The category of "All Other Fees" is a residual category for all other non-audit services.

The SEC stated that it expects registrants to provide clear, concise and understandable descriptions of the audit committee pre-approval policies and procedures. Alternatively, registrants could include a copy of those policies and procedures with the information delivered to investors and filed with the SEC.

These disclosure provisions are effective for periodic annual filings for the first fiscal year ending after December 15, 2003.

G. Compensation

The rules provide that an accountant is not independent if, at any point during the audit and professional engagement period, any "audit partner" earns or receives compensation based on the audit partner's procuring engagements with that audit client to provide any services, other than audit, review, or attest services. The SEC believes that such financial incentives could threaten an auditor partner's objectivity and that the appearance of independence is affected by such compensation arrangements. The restriction applies during the "audit and professional engagement period," which begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or auditor notifies the SEC that the client is no longer the auditor's client.[8] The restriction does not apply to specialty partners such as tax and valuation specialists (who are not considered "audit partners" for purposes of the restrictions, even if they are consulted during the audit engagement).

The Adopting Release provides additional guidance to accounting firms relating to the compensation restriction. It states that the rules prohibit accounting firms from establishing an audit partner's compensation or allocation of partnership "units" based on the sale of non-audit services to the partner's audit clients. For purposes of the restriction, the term "sale" is meant to encompass any revenue, fees, or compensation related to non-audit services provided over the period of the evaluation, regardless of the date of the related contract. The rules do not, however, preclude an audit partner from sharing in the profits of the audit practice or those of the overall firm. In addition, an audit partner's evaluation could take into account a number of factors directly or indirectly related to selling services to an audit client. For example, an audit partner could be evaluated on the complexity of his or her engagements, the overall management of the relationship with an audit client including the provision of non-audit services, and/or the attainment of explicit sales goals. In addition, an audit partner could be compensated for selling audit or audit-related services to an audit client or compensated for selling audit or non-audit services to a non-audit client.

These provisions will be effective in the fiscal periods of the accounting firm that commence after May 6, 2003.

H. Effective Date and Transition Dates

The rules are effective May 6, 2003 (90 days after they were published in the Federal Register).

The SEC provided specific transition periods for each of the new independence rules. Provided the following relationships do not impair the accountant's independence under pre-existing requirements of the SEC, the Independence Standards Board, or the accounting profession in the United States (e.g., AICPA *Code of Professional Conduct*), an accountant's independence will not be deemed to be impaired:

---

[8] Any accounting firm with ten or fewer partners and five or fewer audit clients that are "issuers" is exempt from this rule.

- until May 6, 2004, by the provision of non-audit services restricted under the new rules, provided those services are pursuant to contracts in existence on May 6, 2003 (in the unusual instance where additional time is needed to exit an existing contract, the staff in the Office of the Chief Accountant or the Public Company Accounting Oversight Board may be consulted on a case by case basis);

- until May 6, 2003, by the provision of services that have not been pre-approved by an audit committee as required;

- until the first day of the issuer's fiscal year beginning after May 6, 2003, by a lead partner and other audit partner (other than the concurring partner) serving for periods in excess of those permitted by the partner rotation rules;

- until the first day of the issuer's fiscal year beginning after May 6, 2004, by a concurring partner serving for periods in excess of those permitted by the partner rotation rules;

- by a former employee of the accounting firm becoming employed by the issuer if the employment by the issuer commences prior to May 6, 2003; and

- by compensation earned or received by the accountant during the accounting firm's fiscal year that includes May 6, 2003. [9]

The SEC also adopted special transition rules and rules for calculating periods of service related to the partner rotation requirements:

- the rotation requirements applicable to the lead partner are effective for the first fiscal year ending after May 6, 2003. In determining when the lead partner must rotate (time served in the capacity of lead partner prior to May 6, 2003 is included);

- the rotation requirements for the concurring partner are effective as of the end of the second fiscal year after May 6, 2003 (time served prior to May 6, 2003 will be counted in determining when rotation is required); and

- for other "audit partners," the rules are effective as of the beginning of the first fiscal year after May 6, 2003 (in determining the time served, service prior to May 6, 2003 will not be taken into consideration and that first fiscal year will constitute the first year of service for these partners).

[9] The SEC notes that, "We understand that because of the seasonal nature of accounting firms that many firms have fiscal periods that end in the April to September time frame. In recognition of this fact and understanding that individuals may be operating in the current period under an established set of performance goals, the provisions of this paragraph will be effective in the fiscal periods of the accounting firm that commence after the effective date of these rules.

Although the rules were carefully crafted, the SEC was operating under the extremely tight timetable set forth in the Sarbanes-Oxley Act. It is inevitable that some interpretive issues will arise in practice as accounting firms and audit clients seek to comply with the new requirements.