

Client Alert

SEC Adopts Final Rules on Auditor Independence

A. Introduction

On January 22, 2003, the SEC adopted final rules that implement §208(a) of the Sarbanes-Oxley Act of 2002 (SOA) and strengthen the SEC's existing requirements regarding auditor independence.¹ The rules:

- revise the SEC's regulations relating to prohibited non-audit services;
- require an issuer's audit committee to pre-approve all audit and permissible non-audit services provided to the issuer by its independent auditor;
- prohibit certain partners on an issuer's 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;
- prohibit an accounting firm from auditing an issuer's financial statements if members of the issuer's management who are engaged in a financial reporting oversight role had been members of the accounting firm's audit engagement team within the one-year period preceding the audit; and
- require that an issuer's independent auditors report certain matters to the issuer's audit committee, including critical accounting policies used by the issuer.

In addition to the rules implementing SOA §208(a), the SEC also adopted rules prohibiting accounting firms from compensating any audit partner (as defined in the rules) based on any non-audit service provided to an audit client. The SEC's rules also amend disclosure requirements relating to audit and non-audit services provided by an issuer's independent auditors and fees paid for those services.

The rules become effective on May 6, 2003, subject to certain transition periods.

¹ Securities and Exchange Commission Release Nos. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103; FR-68; File No. S7-49-02. A copy of the release is available on the SEC website at <http://www.sec.gov/rules/final/33-8183.htm>. The SEC originally proposed rules with respect to SOA §208(a) on December 2, 2002. See Securities and Exchange Commission Release Nos. 33-8154; 34-46934; 35-27610; IC-25838; IA-2088; FR-64; File No. S7-49-02. A copy of that release is available on the SEC website at <http://www.sec.gov/rules/proposed/33-8154.htm>.

B. Non-Audit Services

Under the SOA and the new SEC rules, it is unlawful for any public accounting firm performing audit services for an issuer to provide contemporaneously any of the following non-audit services (with certain exceptions discussed below):

- 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 unrelated to the audit; and
- any other service that the Public Company Accounting Oversight Board (the “PCAOB”) determines to be impermissible.

The SEC’s rules amend existing auditor independence regulations by eliminating categorical exceptions to the prohibited non-audit services described above and provide exceptions to those prohibited non-audit services by reference to one or more of the following principles: (1) an auditor cannot audit its own work; (2) an auditor cannot function as part of management or as an employee of the audit client; and (3) an auditor cannot act as an advocate of the audit client. The SEC has clarified that while tax services, such as tax compliance, tax planning and tax advice, are generally permitted, other tax services could impair an accounting firm’s independence if they run afoul of these principles, such as representing an audit client regarding a tax matter before a court. The permitted tax services will require audit committee pre-approval.

The PCAOB also may exempt any issuer, accounting firm or transaction from any of the prohibited non-audit services on a case-by-case basis when in the public interest and consistent with the protection of investors, subject to SEC review.

Transition Period: Accounting firms may continue to provide audit clients with the prohibited non-audit services, to the extent permitted by current rules, until May 6, 2004 without impairing their independence, provided the services are performed under contracts in existence on May 6, 2003.

C. Audit Committee Responsibilities for Auditor Engagement

The SEC's rules reflect the principle expressed in the SOA that audit committees should play a critical role in preserving auditor independence. The rules require the audit committee to pre-approve all audit and permissible non-audit services provided by an issuer's auditor. Pursuant to SOA §202, an audit committee may delegate to one of its members the authority to pre-approve both audit and permissible non-audit services. The rules also provide that as an equally acceptable alternative, an audit committee may establish policies and procedures pursuant to which audit and permissible non-audit services could be provided. Those policies and procedures must be detailed as to the particular service and must not include a delegation of the audit committee's authority to management. The audit committee also must be informed of each service to be provided.

The rules require issuers to include in their annual report and proxy statement (or incorporate by reference from their annual report) a detailed description of policies and procedures developed by the audit committee concerning pre-approval of audit and permissible non-audit services.

Although not specifically addressed by the rules, SOA §202 also requires disclosure in periodic reports of non-audit services approved by the audit committee.

Transition Period: Accounting firms may continue to provide audit and permissible non-audit services that have not been pre-approved by the issuer's audit committee until May 6, 2003 without impairing their independence.

D. Audit Partner Rotation

The SEC's rules require rotation of each "audit partner" on a five- or seven-year basis, depending on each partner's involvement in the audit. The term "audit partner" means a partner (or a person in an equivalent position) who is a member of the audit engagement team and maintains regular contact with a company's management and audit committee or has responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements. The term audit partner includes:

- lead and concurring partners;
- any individual who has provided more than ten hours of audit, review or attest service as a member of the audit engagement team of a company;
- and

- the lead partner on audits of a subsidiary of the company whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the company.

Specialty partners and partners who perform “national office” duties² are not subject to the rotation requirement — even if they consult on client matters regularly — because they are not involved in the audit *per se* and do not have the same relationships with the issuer as “line” partners.

Lead and concurring partners must rotate after five years and, upon rotation, are subject to a five- year “time out” period before returning to the issuer’s account. Audit partners other than lead and concurring partners must rotate after seven years and are subject to a two-year time out period before returning to the issuer’s account.

Transition Period: The effective dates for the new rotation requirements will depend on the status of the audit partner and the audit client’s fiscal year as follows:

- rotation requirements for lead partners are effective as of the end of the first fiscal year ending after May 6, 2003, and in determining when the lead partner must rotate time served as lead or concurring partner prior to May 6, 2003 is included;
- rotation requirements for concurring partners are effective as of the end of the second fiscal year ending after May 6, 2003, and in determining when the concurring partner must rotate time served as lead or concurring partner prior to May 6, 2003 is included; and
- rotation requirements for all other audit partners and for all audit partners of foreign accounting firms are effective as of the beginning of the first fiscal year beginning after May 6, 2003, and in determining when the audit partner must rotate time served prior to that first fiscal year will not be included.

E. Conflicts of Interest Resulting From Employment Relationships

Under the SEC’s rules, a public accounting firm is not considered independent if an audit client employs in a financial reporting oversight role any former partner, principal shareholder or professional employee of the accounting firm who was a member of the audit engagement team (subject to a *de minimis* exception) within a one-year cooling-off period.

² National office duties can include both technical accounting and centralized quality control functions.

A person employed in a financial reporting oversight role is anyone who “exercise[s] influence over the contents of the financial statements or anyone who prepares them.” This concept extends coverage of the rule beyond the “chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position” contemplated by SOA §206.

The rule includes specific provisions for determining the start date for the cooling-off period that effectively require the accounting firm to have completed one annual audit of the issuer since the individual employed was a member of the audit engagement team.

Transition Period: An audit client may employ a former audit engagement team member in a financial reporting oversight role without impairing the auditor’s independence so long as the employment commences at the client prior to May 6, 2003.

F. Auditor Communication with Audit Committee

Effective May 6, 2003, the SEC’s rules require each public accounting firm that audits an issuer’s financial statements to report to the issuer’s audit committee, prior to the filing of the financial statements with the SEC:

- all critical accounting policies and practices used by the issuer;
- all alternative GAAP accounting treatments of financial information that have been discussed with management, the ramifications of using such alternative treatments and the treatments preferred by the accounting firm; and
- other material written communications between the accounting firm and management, including management representation letters, reports on internal controls, schedules of unadjusted audit differences, engagement letters and independence letters.

Although the final rules do not require the communications to be in writing, the SEC has stated that it expects that the communications would be documented by the accounting firm and the audit committee.

G. Auditor Compensation

Although not required by SOA, the SEC’s rules also address the practice of auditing firms compensating their employees for selling non-audit services to their audit clients. An accounting firm is not independent if, at any point during the audit and professional

engagement period, any audit partner, other than a specialty partner, earns or receives compensation based on any non-audit service provided or sold to that client.

Transition Period: An audit partner may earn or receive compensation based on the provision of non-audit services during the accounting firm's fiscal year that includes May 6, 2003 without impairing the accounting firm's independence.

H. Disclosure of Fees Paid to Auditors

The new SEC rules amend required proxy statement disclosures regarding fees paid to auditors. Effective May 6, 2003, companies are required to disclose fees paid in the last two fiscal years to the issuer's principal independent accountant in the following categories: (1) audit fees; (2) audit related fees; (3) tax fees; and (4) all other fees. Additionally, other than for the audit fee category, issuers will be required to describe in subcategories the nature of any services provided in the other three categories.

The SEC explained that "audit fees" include fees for services necessary to perform an audit in accordance with GAAS, as well as services that generally only the independent accountant can reasonably provide (*e.g.*, comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the SEC).

The rules also introduced a new term, "audit related fees", which are fees paid for assurance and related services by the accounting firm that are reasonably related to the performance of the audit or review of the company's financial statements and are not audit fees.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the SEC's new rules, please contact any of the following:

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