

Client Alert

SEC Proposes New Rules on Auditor Independence

A. Introduction

On December 2, 2002, the SEC proposed rules that would implement §208(a) of the Sarbanes-Oxley Act of 2002 (SOA) and strengthen the SEC's requirements regarding auditor independence.¹ The proposed rules would:

- revise the SEC's regulations relating to the non-audit services provided to an audit client that would impair an accounting firm's independence;
- define the circumstances in which an issuer's audit committee must pre-approve all audit and permissible non-audit services provided to the issuer by its independent auditor;
- prohibit partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years;
- prohibit an accounting firm from auditing an issuer's financial statements if certain members of the issuer's management had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; and
- require that the 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 required by SOA §208(a), the SEC also proposed rules that would define an accounting firm as not independent if any partner, principal or shareholder of the accounting firm who is a member of the audit engagement team received compensation based on any service provided or sold to that client other than audit, review and attest services. The proposed rules would require expanded disclosure of the audit and non-audit services provided by the issuer's independent auditors and the fees paid for their services.

¹ 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 the Release is available on the SEC website at <http://www.sec.gov/rules/proposed/33-8154.htm>

The SEC has solicited comments on the proposed rules by January 13, 2003. The SEC is required to adopt final rules by January 26, 2003.

B. Non-Audit Services

Under the SOA, it is unlawful for any registered public accounting firm performing audit services for a client to contemporaneously provide the following non-audit services:

- 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 by regulation, is impermissible.

Any non-audit services not described in the preceding list, including tax services, must be pre-approved by the issuer’s audit committee. The PCAOB also may exempt any issuer, accounting firm or transaction from the general prohibition on a case-by-case basis where necessary or appropriate in the public interest and consistent with the protection of investors, and subject to review by the SEC.

In the Release, the SEC states that in view of the legislative intent to eliminate categorical exemptions and to interpret the prohibited services in a manner that would avoid an unnecessarily broad construction, the proposed rules would amend existing auditor independence rules under Rule 2-01 of Regulation S-X to do away with the existing exemptions and to define the prohibited services in relation to the following basic principles expressed in the legislative history: (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.

C. Audit Committee Administration of the Engagement

The proposed rules reflect the belief that an audit committee should play a critical role in preserving auditor independence. Thus, the proposed rules would require the audit committee to pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. The audit committee would have the sole authority to pre-approve the engagement of the company's independent accountant to perform non-audit services. Alternatively, the audit committee could establish policies and procedures pursuant to which non-audit services would be entered into, provided that the policies and procedures are detailed as to the particular service, are designed to protect the auditor's independence and that the audit committee is informed of each service to be provided. Pursuant to SOA §202, the audit committee may delegate to one of its members the authority to pre-approve both audit and non-audit services.

The proposed rules would require issuers to include in any proxy statement a detailed description of policies and procedures developed by the audit committee concerning pre-approval of non-audit services. Alternatively, issuers could include a copy of the policies and procedures with the proxy statement delivered to investors and filed with the SEC. Such disclosures must also be included in the registrant's annual report and may be incorporated by reference to the proxy statement. Issuers that do not prepare proxy statements are required to include appropriate disclosures in Form 10-K, Form 10-KSB, Form 20-F, Form 40-F or proposed Form N-CSR. Although not specifically addressed by the proposed rules, SOA §202 requires disclosure of non-audit services approved by the audit committee in periodic reports.

D. Audit Partner Rotation

The proposed rules would require rotation of each audit engagement team partner, principal or shareholder on a five-year basis in order to continue to provide audit services for an issuer. The proposed rules go further than the requirements of SOA§203 mandating rotation of the lead and reviewing partners and would apply to any audit engagement team partner, principal or shareholder directly involved in the performance of an audit, including the lead partner, the concurring review partner, the client service partner and other "line" partners directly involved in the performance of the audit.

A "tax" partner who provides only tax services would not be subject to the rotation requirement. To the extent that tax services are a necessary part of the accounting firm's ability to complete the audit, however, partners providing those services would

be subject to the rotation requirement. Partners that 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.

E. Conflicts of Interest Resulting From Employment Relationships

The proposed rules would supplement the SEC’s existing rules regarding conflicts of interest for auditors employed by a former audit client. Under the proposed rules, a registered public accounting firm is not considered independent if the audit client employs in a financial reporting oversight role any audit engagement team member who worked on an audit engagement for the client within a one-year cooling-off period. As proposed, the one-year cooling-off period would commence one year prior to the earlier of:

- when the accounting firm began the current fiscal year’s audit of the issuer; or
- when the accounting firm began review procedures necessary to conduct a timely review of the issuer’s quarterly financial information for the current fiscal year.

Under the proposed rules, a person is employed in a financial reporting oversight role if he or she “has direct responsibility for oversight over those who prepare the registrant’s financial statements and related information . . . that are included with filings with the Commission.” 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 SEC is considering whether it should provide an exemption from these auditor independence requirements for companies meeting certain criteria in order to address the potential difficulties that some issuers may have in hiring qualified personnel (*e.g.*, a limited pool of candidates for a position, the size of the company and the audit committee’s role in ensuring the independence of the auditor).

F. Auditor Communication with Audit Committee

The proposed rules would require each registered public accounting firm that audits an issuer’s financial statements to report, prior to the filing of such report with the SEC, to the issuer’s audit committee:

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

- all critical accounting policies³ and practices used by the issuer;
- all alternative accounting treatments of financial information permitted under GAAP that have been discussed with management, the ramifications of using such alternative treatments and disclosures and the treatments preferred by the accounting firm; and
- other material written communications between the accounting firm and the issuer's management.

G. Auditor Compensation

Although not required by SOA, the proposed rules also address the practice of auditing firms compensating their employees acting as auditors for selling non-audit services to their audit clients. Under the proposed rules, any partner, principal or shareholder who is a member of the audit engagement team is not considered independent if, at any point during the audit and professional engagement period, he or she earns or receives compensation based on any service provided or sold to that client other than audit, review and attest services.

Under the proposed rules, compensation would include any form of income or monetary benefit distributed to the partner, principal or shareholder. Compensation would be based on the performance or sale of non-audit services if the partner, principal or shareholder were financially rewarded in any way for the performance or sale of such services.

H. Disclosure of Fees Paid to Auditors

The proposed rules would expand the disclosure currently required in an issuer's proxy statement to require disclosure of 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, issuers will be required to describe in subcategories the nature of any services provided that are categorized as audit-related fees and all other fees.

The proposed rules would expand the existing definition of audit fees to include fees for services necessary to perform an audit, as well as services that generally only the

³ In May 2002, the SEC proposed rules that would define critical accounting policies to mean any accounting estimate recognized in the financial statements (1) that requires a company to make assumptions about matters that are highly uncertain at the time that the accounting estimate is made and (2) for which different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

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).

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The SEC requests that comments on the proposed rules be received no later than January 13, 2003. Comments may be submitted electronically to rule-comments@sec.gov. All comment letters should refer to File No. S7-49-02 (in the subject line if sent electronically).

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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 this proposal, please contact any of the following:

New York

Marc A. Alpert	(212) 408-5491	malpert@chadbourne.com
Philip L. Colbran	(212) 408-1122	pcolbran@chadbourne.com
A. Robert Colby	(212) 408-5571	rcolby@chadbourne.com
Barry S. Eisler	(212) 408-1073	beisler@chadbourne.com
Joseph F. Giannini	(212) 408-1137	jgiannini@chadbourne.com
Morton E. Grosz	(212) 408-5592	mgrosz@chadbourne.com
Charles E. Hord, III	(212) 408-5353	chord@chadbourne.com
Peter K. Ingerman	(212) 408-5422	pingerman@chadbourne.com
Peter R. Kolyer	(212) 408-5564	pkolyer@chadbourne.com
Sey-Hyo Lee	(212) 408-5122	shlee@chadbourne.com
J. Allen Miller	(212) 408-5454	amiller@chadbourne.com
Anne-Marie F. Shelley	(212) 408-5272	ashelley@chadbourne.com
Thomas V. Sjoblom	(212) 408-1018	tsjoblom@chadbourne.com
Edward P. Smith	(212) 408-5371	esmith@chadbourne.com
Kevin C. Smith	(212) 408-1092	ksmith@chadbourne.com
Philip W. Webb	(212) 408-2350	pwebb@chadbourne.com

Washington, D.C.

Thomas V. Sjoblom	(202) 974-5636	tsjoblom@chadbourne.com
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London

William Greason	(44-20) 7337-8010	wgreason@chadbourne.com
Claude S. Serfilippi	(44-20) 7337-8030	cserfilippi@chadbourne.com