SEC ADOPTS AUDITOR INDEPENDENCE, AUDIT COMMITTEE COMMUNICATION AND RECORD RETENTION RULES PURSUANT TO SARBANES-OXLEY

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The Securities and Exchange Commission has issued rules under the Sarbanes-Oxley Act of 2002 (the "Act") to strengthen the independence of auditors of public companies and to ensure that significant communications between auditors and management are provided to the audit committee and retained after the audit.[1] The rules address perceived conflicts of interest affecting auditors' independent judgment in the financial reporting process by restricting the non-audit activities of auditors, requiring more frequent rotation of audit partners, imposing new disclosure requirements regarding the audit process and mandating communications between auditors and audit committees.

EXECUTIVE SUMMARY

The SEC's new independence rules provide that an audit firm cannot serve as a company's independent auditor under the securities laws if:

- the audit firm provides any specified non-audit services to the company or certain of its affiliates during the performance of the audit;
- any "lead, concurring or reviewing" partner on the audit team has served on the company's audit team for more than *five* consecutive years, or any other partner of the audit firm performing more than 10 hours of audit services has worked on the audit team for more than *seven* consecutive years;
- any audit partner of the audit firm earns or receives compensation based on that partner selling the company or certain of its affiliates any non-audit services; or
- any member of the outside audit team has been hired by the company in a "financial reporting oversight role" prior to a one-year cooling off period.

1 SEC Release Nos. 33-8183 and 34-47265 (February 5, 2003) (the "Release").

In addition, under the SEC's new independence rules:

- auditors must report to the audit committee of an issuer (1) all material written communications between the auditor and management, (2) all critical accounting policies and practices to be used and (3) all alternative treatments of material items that have been discussed with management;
- the audit committee of an issuer must "pre-approve" all services provided by its audit firm (or establish and disclose detailed pre-approval policies and procedures that management may implement); and
- companies must disclose detailed information regarding audit and non-audit services provided by, and fees paid to, its audit firm.

These independence rules became effective May 6, 2003, but the SEC has established a complex series of transition provisions for each individual rule. We discuss the transition provisions for each rule separately below.

The rules vary significantly in their application. Some of the rules (e.g., ban on certain non-audit services) apply to statutorily defined "issuers" ***and certain of their affiliates***. This means that, in those cases, if the audit firm is precluded from performing services for a particular company, it is also precluded from performing services for that company's parent or, for example, a private equity firm that controls the company, as well as other portfolio companies under the control of the private equity firm. Many of the disclosure rules apply to ***all companies*** that file reports under the Securities Exchange Act of 1934, including so-called "voluntary filers." Other rules, by comparison, apply only to statutorily defined "issuers" – i.e., companies required by law to file reports under the Exchange Act or which have a registration statement pending before the SEC. We discuss the application of each rule separately below.

In separate rulemaking under the Act, the SEC adopted measures to require that accountants retain certain audit records for seven years after the conclusion of an audit. This rule will apply in respect of all audits of "issuers" completed on or after October 31, 2003.

BAN ON SPECIFIED NON-AUDIT SERVICES

Statutory and Regulatory Background

Section 201 of the Act makes it unlawful for an accounting firm that performs an audit for an issuer (and, to the extent determined by the SEC, any associated persons of that accounting firm) to provide that issuer the following non-audit services:[2]

- 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, providing fairness opinions or preparing 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") prohibits through regulation.

The SEC implemented Section 201 of the Act by amending Rule 2-01(c)(4) of Regulation S-X. Prior to its amendment, Rule 2-01(c)(4) restricted an accounting firm's ability to provide most of these services to its audit clients (other than expert services and other services prohibited by the PCAOB). The prior rules, however, contained significant exceptions that are no longer available under the new rule.

New Rule 2-01(c)(4) of Regulation S-X

Rule 2-01(c)(4), as amended, prohibits the same types of services specified in the Act, without adding or subtracting from the list. The SEC cites three broad principles that underlie

[2] Because Section 201 amends Section 10A of the Exchange Act, willful violations of this provision are felonies, punishable by up to 20 years imprisonment and fines of up to $25 million.

the independence rules and provide guidance for individual circumstances. The SEC believes an auditor will impair its independence if it performs certain services that require it to:

1. audit its own work;
2. perform management functions; or
3. act as an advocate for its audit client.[3]

The SEC uses these broad principles, which are substantially the same as those that have been in the preliminary notes to existing Rule 2-01 of Regulation S-X[4] for years, to define the scope of the prohibited non-audit services. In certain cases, the Release somewhat narrows the scope of prohibited services by referencing the broad principles. For example, the Release explains that while the Act's ban on "expert services" by auditors could be read literally to apply to tax services, the intent of the Act is not to preclude the provision of tax services by auditors.

Prohibited Non-Audit Services

Rule 2-01(c)(4)(i) – Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client. The SEC maintained its existing description of bookkeeping or other services, prohibiting any bookkeeping or other services related to accounting records or financial statements. The SEC, however, replaced specific exemptions with a general provision that permits these services if it is reasonable to conclude that the

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[3] In formulating these three principles, the SEC cited the Senate Report on the Act:

> The list [of prohibited services] is based on simple principles. An accounting firm, in order to be independent of its audit client, ***should not audit its own work***, which would be involved in providing bookkeeping services, financial information systems design, appraisal or valuation services, actuarial services, and internal audit outsourcing services to an audit client. The accounting firm ***should not function as part of management*** or as an employee of the audit client, which would be required if the accounting firm provides human resources services such as recruiting, hiring, and designing compensation packages for the officers, directors, and managers of an audit client. The accounting firm ***should not act as an advocate of the audit client***, which would be involved in providing legal and expert services to an audit client in legal, administrative, or regulatory proceedings, or serving as a broker-dealer, investment adviser, or investment banker to an audit client, which places the auditor in the role of promoting a client's stock or other interests.

[4] "[T]he Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client." See Preliminary Note 2 to Rule 2-01 of Regulation S-X.

results thereof will not be subject to audit procedures during an audit. Prohibited services include:

- maintaining or preparing an audit client's accounting records;
- preparing the audit client's financial statements that are filed with the SEC or the information that forms the basis of such statements; and
- preparing or originating source data underlying the audit client's financial statements.

The rules eliminate the limited circumstances under which prior rules permitted bookkeeping services (e.g., in an emergency or routine services provided in a foreign jurisdiction).[5] In addition, the Release says that auditors may not prepare statutory financial statements for foreign companies if the statutory statements form the basis of financial statements filed with the SEC.

Rule 2-01(c)(4)(ii) – Financial Information Systems Design and Implementation. The SEC substantially maintained its prior description of prohibited financial information systems design and implementation services. The SEC replaced specific exemptions, however, with a general provision that permits services if it is reasonable to conclude that the results of those services will not be subject to audit procedures during an audit. Financial information systems design and implementation services include:

- directly or indirectly operating, or supervising operation of, an audit client's information system or managing an audit client's local area network; or
- designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to an audit client's financial statements or other financial information systems taken as a whole.[6]

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[5] See prior Rule 2-01(c)(4)(i)(B) of Regulation S-X.

[6] The phrase "significant" to the financial statements means information that is reasonably likely to be material to the financial statements. The Release notes that because materiality determinations cannot be made before finalizing financial statements, audit clients and their auditors should evaluate the general nature of the information and system output for "significance" during the engagement. The SEC notes that if an auditor were to design an integrated enterprise resource planning ("ERP") or similar system, its independence would be impaired because the system would form the basis for the client's financial reporting system.

Under its prior rules, the SEC permitted accountants to design or implement a hardware or software system if certain safeguards were in place to ensure management's ultimate responsibility for these systems.[7] The new rule eliminates this exception.

Rule 2-01(c)(4)(iii) – Appraisal or Valuation Services, Providing Fairness Opinions or Preparing Contribution-in-Kind Reports. The SEC substantially maintained its prior description of appraisal or valuation services and fairness opinions. The SEC, however, expanded the prohibition to contribution-in-kind reports and removed an exception that permitted these services if they would not be material to the financial statements. The new rule permits these services only if it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.[8]

The Release clarifies that prohibited appraisal and valuation services include "*any* process of valuing assets, both tangible and intangible, or liabilities."

Rule 2-01(c)(4)(iv) – Actuarial Services. The SEC substantially expanded the scope of its prior restrictions on providing actuarial services. The new rule prohibits ***any*** actuarially-oriented advisory service involving the determination of amounts recorded in financial statements and related accounts (except any services for which it is reasonable to conclude that the results thereof will not be subject to audit procedures during an audit). The rule does permit the auditor, however, to assist a client in understanding the methods, models, assumptions and inputs used in computing an amount recorded in the financial statements.

Prior SEC rules only restricted actuarially-oriented advisory services involving the determination of ***insurance company policy reserves and related accounts***, subject to various exceptions.[9] The new rule applies to determinations of all amounts recorded in financial statements and related accounts. In addition, the prior rule permitted actuarial services if certain safeguards were in place to ensure management's ultimate responsibility.[10] The new rule eliminates this exception.

Rule 2-01(c)(4)(v) – Internal Audit Outsourcing Services. The SEC substantially expanded the scope of its prior restrictions on internal audit outsourcing. The rule eliminated

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[7] See prior Rule 2-01(c)(4)(ii)(B)(1)-(5) of Regulation S-X.

[8] The prior rule prohibited these services "where it is reasonably likely that the results … will be audited by the accountant." The new rule shifts the presumption, so that the accountant and audit client must affirmatively and reasonably conclude that the results will not be subject to audit procedures.

[9] See prior Rule 2-01(c)(4)(iv)(A) of Regulation S-X.

[10] See prior Rule 2-01(c)(4)(iv)(A)(1)-(3) and (B) of Regulation S-X.

exceptions for companies with less than $200 million in total assets and for services provided under safeguards to ensure management's ultimate responsibility.[11]

The rule prohibits any internal audit service that has been outsourced by the audit client and which relates to the audit client's internal accounting controls, financial systems or financial statements, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit.

Rule 2-01(c)(4)(vi) and (vii) – Management Functions or Human Resources. The SEC did not change its existing rules regarding the performance of management functions and the provision of human resources services to audit clients.

The rule regarding *management functions* prohibits 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. The Release states that an auditor would not be performing management functions if it performs services in connection with assessing internal accounting and risk management controls or providing recommendations for improvements.[12] In fact, the SEC notes that accountants should understand their clients' internal controls and be actively involved in "diagnosing, assessing and recommending" ways to improve internal controls. The SEC distinguishes between designing and implementing systems and the "fundamentally different" process of recommending improvements.

The rule regarding *human resources* services prohibits:

- searching for or seeking out prospective candidates for managerial, executive or director positions;
- engaging in psychological testing or other formal testing or evaluation programs;
- undertaking reference checks of prospective candidates for executive or director positions;
- acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits or other conditions of employment; or

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[11] See prior Rule 2-01(c)(4)(v)(A) and (B) of Regulation S-X.

[12] The Release distinguishes between making recommendations to improve internal accounting and risk management controls and actually designing and implementing those systems. The latter function would be impermissible because it would put the auditor in the position of auditing the data generated by the system it created.

- recommending or advising an audit client to hire a specific candidate for a specific job (other than, upon request of the client, interviewing candidates and advising the client on the candidate's competence for financial accounting, administrative or control positions).

Rule 2-01(c)(4)(viii) – Broker-Dealer, Investment Adviser or Investment Banking Services. The SEC substantially maintained its prior description of broker-dealer services, but (1) expanded the title of the rule to include "investment adviser" and "investment banking" services and (2) clarified that the term broker-dealer includes both registered and unregistered broker-dealers.

The rule prohibits acting as a broker-dealer, promoter or underwriter on behalf of an audit client. The rule also prohibits:

- 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).

Rule 2-01(c)(4)(ix) – Legal Services. The SEC substantially maintained its prior description of legal services but expanded the rule to apply to legal services performed outside the United States.

The rule prohibits the provision of any service to an audit client that, under the circumstances, could be provided only by someone licensed, admitted or otherwise qualified to practice law *in the jurisdiction in which the service is provided*.

The prior rule prohibited services that, under the circumstances, could only be provided by someone admitted to practice law *in the United States* – services performed by audit firms overseas were essentially exempt.[13]

The SEC noted that some foreign jurisdictions permit only licensed lawyers to provide tax services. As defined in the rule, accounting firms providing tax work could be deemed to be providing "legal services." The Release, however, states that, as a general matter, the SEC does

[13] See prior Rule 2-01(c)(4)(ix) of Regulation S-X.

not intend the rule to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide.[14]

Rule 2-01(c)(4)(x) – Expert Services Unrelated to the Audit. Prior SEC rules did not restrict "expert services," except insofar as such services would fit within one of the other categories described above or other SEC rules.

The rule prohibits 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. The rule does not prohibit the provision of factual accounts, including in testimony, of work performed or an explanation of the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client. The SEC has clarified in the Release that the auditor also may take any actions necessary to fulfill its duties as an independent accountant, including investigating potential accounting improprieties, inspecting accounts or inventory and otherwise searching for fraud.

Any Other Service that the PCAOB Prohibits Through Regulation. The Act makes it unlawful for an accounting firm to provide its audit clients with "any other service" that the PCAOB prohibits through regulation. At this time, the PCAOB has not prohibited any additional services.

Tax Services Permissible

The Release clarified that nothing in the SEC's rules or the Act is intended to restrict an accounting firm from providing tax services to audit clients (so long as the services have been pre-approved by the client's audit committee pursuant to Section 201 of the Act). The rules do not define "tax services," but the Release references tax compliance, tax planning and tax advice.

Notwithstanding the foregoing, the Release also states that providing tax services to an audit client could impair the independence of the accountant under certain circumstances. Specifically, representing an audit client before a tax court or other court would constitute prohibited "legal services" or "expert services." In addition, the SEC advises audit committees to "scrutinize carefully" the retention of an accountant with respect to potential "tax shelters."[15]

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[14] "In determining whether or not a service would impair the accountant's independence solely because the service is labeled a legal service in a foreign jurisdiction, the [SEC] will consider whether the provision of the service would be prohibited in the United States as well as in the foreign jurisdiction."

[15] "[A]udit committees also 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."

The SEC is concerned that an audit firm's independence could be impaired during the review of the tax and accounting treatment of a shelter designed by members of the firm. In particular, the use of an aggressive or controversial tax structure designed by a company's auditors could make an audit committee susceptible to criticism that it should have required the company to use a different accounting firm to, for example, assess the reasonableness of tax reserves or the treatment and likelihood of future tax credits or losses.

Other Permissible Services: M&A Diligence

The rules do not prohibit due diligence services related to mergers and acquisitions.

Scope of Prohibition – Who and When?

Meaning of "Audit Client"; Effects on Affiliates and Private Equity Firms

The ban on specified non-audit services generally applies only to services provided to an "audit client." The rule does not affect services provided to non-audit clients. The term audit client includes the entity whose financial statements or other information is being audited, reviewed or attested **and such entity's affiliates**.[16]

The use of the term "audit client" in Rule 2-01(c)(4) and elsewhere in the auditor independence rules results in an expansive application of the rule to, for example, private equity firms and their portfolio companies. In some cases, the rule prohibits the performance by an accounting firm of an audit for a portfolio company ("Company A") of a private equity firm if the accounting firm performs any non-audit services described above for another portfolio company ("Company B") of the private equity firm (even though the firm is not the auditor for Company B).

For some types of services, the exceptions to the rules mitigate the effects of this expansive application. For prohibited services that are represented by the SEC's first general

[16] An "affiliate" of an audit client is an entity:

- with control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;
- over which the audit client has significant influence, unless the entity is not material to the audit client;
- with significant influence over the audit client, unless the audit client is not material to the entity; and
- in the investment company complex when the audit client is part of an investment company complex.

principle regarding auditing one's own work[17], the rules permit services to an audit client if it is reasonable to conclude that the results thereof will not be subject to audit procedures during an audit. Therefore, providing bookkeeping services, for example, to Company B likely would not affect an accounting firm's ability to perform an audit for the affiliated Company A, because the results of the bookkeeping services would not be subject to audit procedures in an audit of Company A.

For the categories of prohibited services represented by the SEC's other two general principles regarding the performance of management services and acting as an advocate,[18] the use of the term "audit client" will have broad consequences. For example, if Company A engages an accounting firm to perform internal audit work, that accounting firm *would* be prohibited from auditing Company B. Furthermore, such services could disqualify the accounting firm from continuing to act as an auditor for a company that is acquired by the private equity firm which engages that auditor for prohibited services. The rules are not clear whether past services performed for a new affiliated party would taint a past or future audit.

Meaning of "Audit and Professional Engagement Period"

Rule 2-01(c)(4) only restricts specified non-audit services performed during the "audit and professional engagement period." The rules do not affect services provided by a firm before or after the engagement period.

The "audit and professional engagement period" includes both:·

- the period covered by any financial statements being audited or reviewed (the "audit period"); and
- the period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the SEC (the "professional engagement period").

The professional engagement period begins when the accountant either signs an initial engagement letter or begins audit, review or attest procedures, whichever is earlier. The professional engagement period ends when the audit client or the accountant notifies the SEC that the client is no longer that accountant's audit client.

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[17] Bookkeeping, financial information systems design, appraisal, valuation, actuarial and internal audit outsourcing services.

[18] Management functions or human resources, broker-dealer, investment advisor or investment banking services, legal services and expert services unrelated to the audit.

Because the professional engagement period may include periods prior to the time that a company is required to file reports with the SEC, pre-IPO companies should comply with this rule to ensure that their financial statements prior to an IPO are not tainted by an auditor's provision of prohibited services.

Effective Date for Rule

Amended Rule 2-01(c)(4) applies to services provided on or after May 6, 2003. The SEC adopted a transition period, however, that permits otherwise prohibited services to be performed until May 6, 2004, provided such services (1) are performed pursuant to contracts in existence on May 6, 2003 and (2) were not otherwise prohibited by the prior rules of the SEC, the Independence Standards Board or the accounting profession in the United States.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-01(c)(4) does not contain any exceptions for foreign issuers, registered investment companies or asset-backed issuers. The rules do not expressly apply to voluntary filers of periodic reports, although we would suggest these companies select auditors that would be "independent" under the rules as it appears that services provided prior to an IPO would affect an auditor's independence after the IPO.

For foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the SEC (so long as the foreign private issuer complied with home-country independence standards).

RESTRICTIONS ON AUDIT PARTNER COMPENSATION RELATED TO NON-AUDIT SERVICES

Although not required to do so by the Act, the SEC has prohibited accounting firms from offering certain of their partners cash bonuses and other financial incentives to sell non-audit products or services to their audit clients. Rule 2-01(c)(8) under Regulation S-X provides that an audit firm may not compensate an audit partner that works on a client's audit based on the audit partner procuring engagements to provide non-audit products or services to that client.

For purposes of the auditor independence rules, an "audit partner" means a partner (or person in an equivalent position) who is a member of the audit engagement team with responsibility for decision-making on significant auditing, accounting and reporting matters

that affect the financial statements or who maintains regular contact with management and the audit committee. The definition of "audit partner" for a particular company expressly includes:

- the lead or coordinating audit partner having primary responsibility for the company's audit or review (the "lead partner");
- the partner performing a second level of review to provide additional assurance that the financial statements subject to the company's audit or review are in conformity with GAAP and the audit or review and any associated report are in accordance with generally accepted auditing standards (GAAS) and rules promulgated by the SEC or the PCAOB (the "concurring or reviewing partner");
- other audit engagement team partners who provide more than 10 hours of audit, review or attest services in connection with the company's annual or interim consolidated financial statements; 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 any subsidiary of the company whose assets or revenues constitute 20% or more of the assets or revenues of the company's consolidated assets or revenues.

This definition does not include so-called "national office" partners. The rule provides that a partner who only consults with others on the audit engagement team during the audit, review or attestation engagement regarding technical or industry-specific issues, transactions or events (e.g., a tax specialty partner) would not be an "audit partner."

Rule 2-01(c)(8) does not define "compensation," but the Release notes that the term could include "any form of cash or other assets distributed to the audit partner, including any income or benefit based on an evaluation of the partner's performance."

Scope of Prohibition – Who and When?

Meaning of "Audit Client"

Rule 2-01(c)(8) applies to compensation in respect of an "audit client" with respect to which an individual is the "audit partner." The rule does not affect compensation paid for services sold to non-audit clients. For a discussion of the term "audit client," see the text on page 10 above under the caption "Ban on Specified Non-Audit Services—Scope of Prohibition – Who and When? —Meaning of 'Audit Client'; Effects on Affiliates and Private Equity Firms."

Meaning of "Audit and Professional Engagement Period"

Rule 2-01(c)(8) only applies to compensation earned or received during the "audit and professional engagement period." The rules are not triggered by compensation earned and

received before or after the audit and professional engagement period. For a discussion of the term "audit and professional engagement period," see the text above under the caption "Ban on Specified Non-Audit Services—Scope of Prohibition – Who and When? – Meaning of 'Audit and Professional Engagement Period'."

Effective Date for Rule

Rule 2-01(c)(8) will only apply to compensation earned or received during the **accounting firm's** fiscal years that begin after May 6, 2003.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-01(c)(8) does not contain any exceptions for foreign issuers, registered investment companies or asset-backed issuers. The rules do not expressly apply to voluntary filers of periodic reports, although we would suggest these companies confirm that their auditors comply with the rule before an IPO so as to avoid adversely affecting an auditor's independence after the IPO.

Small Accounting Firms

Rule 2-01(c)(8) does not apply to accounting firms with fewer than 10 partners and fewer than five audit clients that are "issuers."

MANDATORY PARTNER ROTATION

Statutory and Regulatory Background

Section 203 of the Act made it unlawful for an accounting firm to provide audit services to an issuer if the lead or coordinating audit partner, or the audit partner responsible for reviewing the audit, performed audit services for that issuer in each of the five previous fiscal years of that issuer.[19]

The AICPA's existing rules already required an engagement partner to rotate off an engagement after seven years and to remain off the team for two years.[20]

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[19] Because Section 203 amends Section 10A of the Exchange Act, willful violations of this provision are punishable by up to 20 years imprisonment and fines of $25 million.

[20] See American Institute of Certified Public Accountants ("AICPA"), SEC Practice Section, Requirements of Members, at item (e).

New Rule 2-01(c)(6) of Regulation S-X

Rule 2-01(c)(6) of Regulation S-X significantly expands the rotation requirements imposed by the Act. The rule provides that an audit firm cannot act as an audit client's auditor if:

- any audit partner of the firm has, for more than five consecutive years, provided the services of "lead partner" or "concurring or reviewing partner" for the client; or
- any audit partner of the firm has, for more than seven consecutive years, provided either:
  - the services of "lead partner" for a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer's consolidated assets or revenues; or
  - more than 10 hours of audit, review or attest services for the issuer (collectively, "other significant services").

In addition, a partner who provides services in both the "five-year" category and the "seven-year" category must rotate off the engagement after the shorter of (1) "five years" as a "lead partner" or a "concurring or reviewing partner" or (2) seven years total.

After performing "lead partner" services or "concurring or reviewing partner" services for an issuer for the maximum five-year period, an audit partner may not perform those services for that issuer for five years. The audit partner, however, could perform other services for the issuer during that period – subject to compliance with the limitations applicable to "other significant services."

Likewise, after performing "other significant services" for an issuer for the maximum seven-year period, an audit partner may not provide any of the services described above for that issuer for two years.

The rule significantly expands the category of persons required to rotate off an engagement team compared to existing industry rules, which only require rotation of the audit engagement partner. In addition, the five-year period during which a partner must "rotate off" of the engagement team is considerably longer than the two-year period applicable under existing AICPA rules.

Scope of Prohibition – Who and When?

Meaning of "Audit Engagement Team"

Partners providing non-audit services are not subject to the rotation rule because Rule 2-01(c)(6) only applies to partners serving on the "**audit** engagement team." The "audit engagement team" means all partners, principals, shareholders and professional employees participating in an **audit, review or attestation engagement** of an audit client, including audit partners and all persons who consult with others on the audit engagement team during the audit, review or attestation engagement regarding technical or industry-specific issues, transactions or events.

Meaning of "Audit Partner"

For a discussion of the term "audit partner" see the text on page 13 above under the caption "Restrictions on Audit Partner Compensation Related to Non-Audit Services."

Meaning of "Audit Client"

Rule 2-01(c)(6) applies to services provided to an "audit client." For a discussion of the term "audit client," see the text on page 10 above under the caption "Ban on Specified Non-Audit Services—Scope of Prohibition —Who and When?—Meaning of 'Audit Client'; Effects on Affiliates and Private Investment Firms."

Effective Date for Rule

The SEC adopted transition rules to give audit firms time to adjust to the required partner rotation and to stagger the rotation requirement to ensure some stability on audit teams. The rotation requirements applicable to "lead partners" are effective for a company's first fiscal year beginning after May 6, 2003. For these "lead partners," services performed before May 6, 2003 will count in calculating the five-year period.

The rotation requirements applicable to "concurring or reviewing partners" are effective as of the beginning of the first fiscal year after May 6, 2004. For these "concurring or reviewing partners," services performed prior to May 6, 2003 will count in calculating the five-year period.

The rotation requirements applicable to partners performing "other significant services" are effective for the first fiscal year beginning after May 6, 2003. However, services performed prior to the first day of the issuer's fiscal year beginning on or after May 6, 2003 will **not** count in calculating the five-year period. The transition rules take into account the fact that existing industry rules do not require rotation of these partners.

Services performed before May 6, 2003 will not count in calculating the service times for audit partners in foreign firms, even if the partner is a lead, concurring or reviewing partner.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-01(c)(6) does not contain any exceptions for foreign issuers, registered investment companies[21] or asset-backed issuers (except with respect to the transition rules applicable to foreign accounting firms). The rule also does not expressly apply to voluntary filers of periodic reports, although we would suggest that these companies confirm that their auditors rotate partners in compliance with the rules as it is not clear whether violations before an IPO would affect an auditor's independence after the IPO.

Small Accounting Firms

Rule 2-01(c)(6) does not apply to accounting firms with fewer than 10 partners and fewer than five audit clients that are "issuers," so long as the PCAOB conducts a review at least every three years of each client engagement that would otherwise violate the rule.

PROHIBITION ON HIRING MEMBERS OF AUDIT ENGAGEMENT TEAM IN A "FINANCIAL REPORTING OVERSIGHT ROLE"

Statutory and Regulatory Background

Section 206 of the Act makes it unlawful for an accounting firm to perform audit services for an issuer if the issuer's CEO, controller, CFO or chief accounting officer was employed by that accounting firm and participated in the issuer's audit **during the one-year period prior to the audit**.[22]

The previous version of Rule 2-01(c)(2)(iii) of Regulation S-X provides that an accountant is not independent of a client if, at any point **during the audit and professional engagement period**, the accountant has an employment relationship with the client.

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21 The rule includes special provisions applicable only to registered investment companies.

22 Because Section 203 amends Section 10A of the Exchange Act, willful violations of this provision are punishable by up to 20 years imprisonment and fines of $25 million

New Rule 2-01(c)(2)(iii)(B) of Regulation S-X

The SEC's new rule provides that an audit firm cannot provide any audit service required under the securities laws for an issuer if

- any former partner, principal, shareholder or professional employee of the accounting firm is in a "financial reporting oversight role" at the issuer; and

- that individual was a member of the "audit engagement team" at the audit firm during the one-year period prior to commencing audit procedures for the fiscal period during which the individual was initially employed.

A "financial reporting oversight role" is one 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. It includes, but is not necessarily limited to, being a member of the board of directors or similar management or governing body, CEO, president, CFO, COO, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or any equivalent position.

Scope of Prohibition – Who and When?

Meaning of "Audit Engagement Team"

For a discussion of the term "audit engagement team," see the text on page 16 above under the caption "Mandatory Partner Rotation—Scope of Prohibition —Who and When? —Meaning of 'Audit Engagement Team'." Notwithstanding that definition, the following persons are not part of the "audit engagement team" for purposes of Rule 2-01(c)(2)(iii)(B):

- those who provided 10 or fewer hours of audit, review or attest services during the applicable one-year period (other than the lead and concurring partners, who are part of the "audit engagement team" even if they work 10 or fewer hours);

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

- those employed by the company due to an emergency or other unusual situation, provided that the audit committee finds that the relationship is in the interest of investors.

Commencement of Audit Procedures

Rule 2-01(c)(2)(iii)(B) deems audit procedures to have commenced for a fiscal period on the day following the filing of the company's annual report with the SEC for the previous fiscal period.

Effective Date for Rule

Rule 2-01(c)(2)(iii)(B) applies to employment relationships commencing at the issuer on or after May 6, 2003.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-01(c)(2)(iii)(B) does not contain any exceptions for foreign issuers, registered investment companies[23] or asset-backed issuers. This rule only applies to statutory "issuers" and, therefore, does not apply to voluntary filers of periodic reports.

AUDITORS' REPORTS TO AUDIT COMMITTEES

Statutory and Regulatory Background

Section 204 of the Act requires that audit firms must provide their clients' audit committees with timely reports regarding:

- all critical accounting policies and practices to be used;
- all alternative treatments of financial information within GAAP that have been discussed with the issuer's management, including the ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accounting firm; and
- any other material written communications between the accounting firm and the issuer's management.

[23] The rule includes special provisions applicable only to registered investment companies.

Rule 2-07(a) of Regulation S-X

Rule 2-07(a) of Regulation S-X largely tracks the language of Section 204 of the Act. It provides that each accounting firm that performs any audit required under the securities laws for an issuer shall report to the issuer's audit committee, prior to the filing of an audit report with the SEC:

- 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:
    - ramifications of the use of such alternative disclosures and treatments; and
    - the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management, such as any management letter or schedule of unadjusted differences.

Critical Accounting Policies

The Release clarifies that critical accounting policies are those policies that management believes are the most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments (including, for example, those that result in a need to make estimates about effects that are inherently uncertain).[24]

Alternative Accounting Treatments

The Release states that auditors should identify, in respect of a particular transaction, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. If a proposed accounting treatment does not comply with existing company policies, then the Release also calls for auditors to explain to audit committees why existing policies are not appropriate and the reason why the alternative policy was not used.

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[24] The Release suggests that auditors review the SEC's advice regarding preparation of MD&A (SEC Release No. 33-8040 (December 12, 2001)) and its proposed rules requiring additional disclosure regarding critical accounting policies (SEC Release 33-8090 (May 10, 2002)). These pronouncements are discussed in detail in our memoranda dated January 30, 2002 and June 30, 2002, which are available upon request or at our website: *www.simpsonthacher.com*.

Communications regarding alternative accounting treatments should include the following, according to the Release:

- reasons why management selected a particular policy, if the selected accounting treatment is not, in the auditor's opinion, the preferred method;
- the initial selection of policies (and not just changes in existing policies);
- the reasons for any change in accounting policies;
- the impact of management's judgments and accounting estimates; and
- the auditor's judgments about the quality of a company's accounting policies.

Other Material Written Communications

Rule 2-07(a) of Regulation S-X also requires disclosure to the audit committee of any other material written communications. The Release says that auditors should decide which communications are material based on the auditor's subjective judgment (as influenced by auditing standards). Examples of communications that the SEC would expect to be material 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
- independence letters.

Existing GAAS Rules; Timing of Communications

The Release says that the rules largely codify existing requirements under GAAS, except that GAAS does not specifically require that communications occur prior to the filing of reports with the SEC. The new rule requires disclosure prior to the filing of audit reports with the SEC, but the Release says that the SEC expects auditors to communicate information "as frequently as quarterly or more often on a real-time basis."

GAAS requires auditors to make oral or written communications with audit committees regarding:

- methods used to account for significant unusual transactions;
- effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- processes used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates;
- material audit adjustments proposed and immaterial adjustments not recorded by management;
- auditor's judgments about the quality of the company's accounting principles; and
- disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.[25]

Effective Date for Rule

The communication rule became effective May 6, 2003, but the rules only apply to public accounting firms registered with the PCAOB.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-07 does not contain any exceptions for foreign issuers or registered investment companies.[26] The rule does, however, exclude asset-backed issuers and unit investment trusts. The rule only applies to statutory "issuers" and, therefore, does not apply to voluntary filers of periodic reports. Nonetheless, existing professional standards under GAAS would appear to result in substantially the same obligations, where applicable.[27]

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[25] See Codification of Statement on Auditing Standards AU § 380, "Communication with Audit Committees."

[26] The rule includes special provisions applicable only to registered investment companies.

[27] The communications required under GAAS are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (e.g., finance or budget committee) and (2) all SEC engagements.

PRE-APPROVAL OF AUDIT AND NON-AUDIT SERVICES BY THE AUDIT COMMITTEE

Statutory and Regulatory Background

Section 202 of the Act provides that all audit services (including the provision of comfort letters for securities offerings or statutory audits required for insurance companies under state law) and permissible non-audit services (including tax services) provided to an issuer by its auditor must be preapproved by the issuer's audit committee.

Rule 2-01(c)(7) of Regulation S-X

Rule 2-01(c)(7) of Regulation S-X seeks to increase the oversight responsibilities of audit committees and create a forum in which auditors can discuss their concerns without management interference. The Release says audit committees should approve engagements of independent accountants and have ongoing communications with the accountant.

Rule 2-01(c)(7) of Regulation S-X provides that an accountant cannot perform any audit service under the securities laws for an issuer, unless:

- the issuer's audit committee approves, in advance, each engagement for audit or non-audit services; or

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An "SEC engagement" is defined as one that involves the audit of the financial statements of:

- an issuer making an initial filing, including amendments, under the Securities Act of 1933 or the Exchange Act;
- a registrant that files periodic reports with the SEC under the Investment Company Act of 1940 Act or the Exchange Act (except a broker or dealer registered only because of Section 15(a) of the Exchange Act);
- a bank or other lending institution that files periodic reports with the Comptroller of Currency, the Federal Reserve System, the FDIC, or the Federal Home Loan Bank Board because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested in those agencies pursuant to the Exchange Act; or
- a company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the Investment Company Act or the Exchange Act.

- each engagement for audit or non-audit services is entered into pursuant to pre-approval policies and procedures[28] established by the audit committee, so long as:
  - the policies and procedures are "detailed as to the particular service" and do not include a delegation to management of the audit committee's responsibilities imposed by the securities laws; and
  - the audit committee is informed of each service.

The audit committee may delegate to one or more of its independent members the authority to grant these required approvals, so long as the company subsequently presents each approval to the entire audit committee at its next meeting.

The pre-approval requirement only applies to services performed for an "issuer" and its subsidiaries. Pre-approval is not required for services performed for other non-subsidiary affiliates of an issuer.

The rules provide a "de minimis" services exception from the pre-approval requirements for services that are not audit, review or attest services (including, for example, tax services) if:

(A) the fees paid for such services represent no more than 5% of the revenues paid by the client to its accountants during that fiscal year;

(B) the services were not recognized by the company at the time of the engagement to be non-audit services; and

(C) 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 has been delegated).

Disclosure of Pre-Approval Policies and Fees Paid

The SEC also amended its proxy statement and annual report forms to require disclosure of:

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

[28] The SEC will require companies to summarize or otherwise disclose these pre-approval policies and procedures in proxy statements and/or annual reports, beginning with reports for fiscal periods ending on or after December 15, 2003.

- the percentage of the aggregate services categorized, collectively, as "audit-related fees," "tax fees" or "all other fees" that were approved by the audit committee pursuant to *each of* Paragraphs (A), (B) and (C) described above under the "de minimis" services exception.

Effective Date for Rule

Audit committee pre-approval is required for services provided on or after May 6, 2003, except that pre-approval is not necessary for services performed under contracts in existence on that date.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

Rule 2-01(c)(7) applies to registered investment companies[29] and foreign issuers. Although the pre-approval rule does not apply to asset-backed issuers and voluntary filers, the disclosure requirements apply to voluntary filers.

PUBLIC DISCLOSURE OF FEES PAID TO AUDITORS FOR AUDIT AND NON-AUDIT SERVICES

Disclosure of Fees Paid to Principal Auditor

While not mandated by the Act, the SEC amended its proxy statement and annual report forms to require detailed disclosure of fees paid by a company to its principal accountant for the last two fiscal years, including a breakdown by the following categories:

- *audit fees*, including fees for all professional services rendered for the audit of the company's annual financial statements and review of financial statements included in quarterly reports filed with the SEC or services that generally only an independent accountant 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*, including fees for assurance and related services performed by the company's principal auditor that are reasonably related to the performance of the audit or review of its financial statements (other than those services for which fees are reported under "audit fees"); this category would include employee benefit plan

[29] The rule includes special provisions applicable only to registered investment companies.

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;

- *tax fees*, including fees for professional services rendered for tax compliance, tax advice and tax planning, including all services provided by the independent accountant's tax division, except those specifically related to the audit; this category would include preparation of original and amended tax returns, claims for refund and tax payment-planning services, assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities; and

- *all other fees*, including fees for products and services provided by the company's principal auditors, other than those services for which fees are reported under the categories "audit fees," "audit-related fees" or "tax fees"; this category would include permissible financial information systems implementation and design services.

In addition, companies must disclose the "nature of the services" covered by each of the categories (other than audit fees).

The amendments also require disclosure of pre-approval policies and procedures and the quantitative information described above under the caption "Pre-Approval of Audit and Non-Audit Services by the Audit Committee—Disclosure Regarding Pre-Approval Policies and Fees Paid."

Additional Quantitative Disclosure Related to Audits

The rules also amend the SEC's proxy statement and annual report forms to require disclosure of the percentage of hours expended on the principal auditor's engagement to audit the registrant's financial statements for the most recent fiscal year that are attributable to work performed by persons who are not the accountant's full-time permanent employees. This disclosure is not required if the percentage does not exceed 50 percent.

Effective Date for Rule

The new disclosure will be required in all annual reports and proxy statements filed in respect of fiscal periods ending on or after December 15, 2003.

Foreign Private Issuers, Registered Investment Companies, Voluntary Filers and Asset-Backed Issuers

The new disclosure is required for nearly all filers of Exchange Act reports, including voluntary filers, foreign private issuers and registered investment companies. Asset-backed issuers are exempt from the disclosure requirements.

RETENTION OF AUDIT RECORDS

Statutory and Regulatory Background

Section 802 of the Act requires accountants performing audits under the securities laws to maintain all audit or review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded. Anyone who knowingly and willfully violates this requirement is guilty of a felony, punishable by imprisonment for up to 10 years and a fine of up to $500,000.

Rule 2-06 under Regulation S-X

Rule 2-06 under Regulation S-X requires accountants to retain, for seven years after the conclusion of an audit or review, all records relevant thereto, including workpapers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, 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.

"Workpapers" means 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 PCAOB. Prior to the adoption of standards by the PCAOB, "workpapers" will mean the documentation of auditing or review procedures applied, evidence obtained and conclusions reached by the accountant in the audit or review engagement as required by GAAS.

Memoranda, correspondence, communications, other documents, and records (including electronic records) must be retained whether they support the auditor's final conclusions regarding the audit or review or contain information or data relating to a significant matter that is inconsistent with the auditor's final conclusions regarding that matter or the audit or review. The significance of a matter is to be determined based on an objective analysis of the

facts and circumstances. Such documents and records include, but are not limited to, those documenting a consultation on or resolution of differences in professional judgment.

Section 802 of the Act only required a five-year retention period, but Section 103 directed the PCAOB to require auditors to retain work papers for seven years. The SEC decided to harmonize the two periods.

An "accountant" under the rules includes "a certified public accountant or public accountant performing services in connection with an engagement for which independence is required… including any accounting firm with which the certified public accountant or public accountant is affiliated."

The rule does not include exemptions for accountants outside the United States or accountants of foreign issuers.

Effective Date for Rule

The rule applies to all audits and reviews completed on or after October 31, 2003.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

SIMPSON THACHER & BARTLETT LLP