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Client Alert

A report for clients and friends of the firm

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On January 22, 2003, the Securities and Exchange Commission Adopted Rules With Respect To Auditor Independence And Related Subjects Which Have Important Ramifications For Public Companies And The Members Of Their Audit Committee.[1]

These rules are based, in part, on Sections 201, 202, 203, 204, 206 and 208 of the Sarbanes-Oxley Act and on the SEC's general rulemaking authority under the Securities Exchange Act of 1934.

The rules will become effective as follows:

- Rules applicable to auditor independence -- May 6, 2003, with various transition periods of 12 months after the effective date for the audit partner rotation requirements and certain prohibited non-audit services pursuant to contracts existing before the effective date.
- Rules applicable to audit committee responsibilities -- May 6, 2003, with a transition period of 12 months thereafter for completion of non-audit service engagements entered into before the effective date.
- Disclosure rules -- for the first fiscal year ending after December 15, 2003, with earlier adoption encouraged by the SEC.

Summary

The SEC has adopted rules that:

- Prohibit specified non-audit services being provided by a company's auditor;
- Define the circumstances in which an audit committee may pre-approve audit and permitted non-audit services;
- Require rotation of specified partners on an audit engagement team every five to seven years and a two-to-five year "time out" or "cooling off" period for these partners;
- As a "revolving door" rule, prohibit an audit firm auditing an issuer's financial statements if specified members of the issuer's financial management have been members of the audit firm's audit engagement team within the one-year period preceding the audit;
- Require auditors to report specified matters to the issuer's audit committee;
- Define as not being "independent" an audit firm if any of its partners or owners who are members of the engagement team receive compensation based on services, including tax services, to the client other than audit, audit-related or attest services; and
- Require detailed disclosure in proxy statements or annual reports about fees paid to the auditors during the past two fiscal years and policies and procedures for audit committee pre-approval of audit and permitted non-audit services.

Audit Committee Responsibilities and Related Matters

Sarbanes-Oxley imposes a number of responsibilities on audit committees, including engaging the company's auditors, determining their compensation, overseeing their work and terminating their engagement, if circumstances warrant, and pre-approving audit and permitted non-audit services.

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[1] See Rel. 33-8138 (the "Adopting Release").

Sarbanes-Oxley. Sec. 201 of Sarbanes-Oxley, which added section 10A(g) to the Exchange Act, and the SEC's rules prohibit the following ten non-audit services[2] being provided to an issuer by an auditor who audits the issuer's financial statements:

- 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;
- Expert services unrelated to the audit involving "advocacy" by the auditor; and
- Any other service that the Public Company Accounting Oversight Board ("PCAOB")[3] determines, by regulation, is impermissible.

SEC rules on prohibited non-audit services and auditor independence. The SEC's rules are similar to, but somewhat more restrictive than, its pre-Sarbanes-Oxley auditor independence rules and are somewhat more restrictive than required by Sarbanes-Oxley.

Also, the SEC has adopted an auditor independence rule not required by Sarbanes-Oxley. That rule would deem an audit firm not to be independent if any "audit partner", as that term is defined in the rules, who is a member of the audit team, received compensation based on any service provided or sold to the company other than audit, review or attest services.

In addition, Sec. 203 of Sarbanes-Oxley (section 10A(j) of the Exchange Act) requires lead and reviewing audit partner rotation every five years.[4] The SEC rules require rotation of lead partners, and concurring partners involved in the engagement every five years with a subsequent five-year cooling-off period. Other "audit partners" are subject to a seven year rotation and a two year cooling off period.

Sec. 206 of Sarbanes-Oxley (section 10A(e) of the Exchange Act) makes it unlawful for a registered public accounting firm to provide audit services to an issuer if the CEO, Controller, CFO, CAO or person performing similar functions was employed by that firm and participated in any capacity in the one-year period preceding the audit. The SEC's rules under Sec. 206 essentially implement Sec. 206, but modify it to apply only to a lead partner or concurring partner or a partner who provided more than 10 hours of audit, or attest services to the issuer during the one-year period.

PCAOB Authority. The PCAOB has broad authority to regulate accounting firms that audit public companies, including regulations with respect to independence issues. The Board has the authority to expand the list of prohibited non-audit services but not to provide exemptions, except on a case-by-case basis. Subsection 201(b) of Sarbanes-Oxley limits the authority of the PCAOB. It may exempt, only on a "case by case" basis, any person, issuer, public accounting firm, or transaction from the prohibitions on the provision of services, subject to a public interest test and review by the SEC. When the PCAOB is operational and accounting firms are registered with it, the SEC and the PCAOB may consider whether restrictions more far-reaching than those required by Sarbanes-Oxley or the SEC's rules are warranted.

Impact of non-compliance. Failure to comply with these requirements risks violation of the Exchange Act or reaudit of the company's financial statements by another auditing firm.

Pre-approval of Services. Under Sec. 201 (section 10A(h) of the Exchange Act), a registered public accounting firm may engage in any non-audit service that is not prescribed by Sec. 201 or any related SEC or PCAOB rules only if that service is approved in advance by the "audit client's" audit committee in accordance with Sec. 202 of Sarbanes-Oxley (section 10A(h) of the Exchange Act). Section 202 requires that the audit committee preapprove all audit (including "comfort letters" to underwriters) and non-audit services, with a *de minimus* exception.[5] The audit committee may establish policies and procedures for pre-approval detailing the services so approved and may delegate the preapproval function to one of its members.

[2] The first five categories of non-audit services are not prohibited if "it is reasonable to conclude that results of these services will not be subject to audit procedures during an audit of the client's financial statements." Presumably, the audit committee must come to this conclusion when it engages the auditors to perform these services.

[3] The PCAOB also has limited exemptive authority as well.

[4] In addition, Sec. 207 of Sarbanes requires the Comptroller General of the United States to conduct a study and review of mandatory rotation of audit firms and to issue a report by July 2003.

[5] Sec. 301 of Sarbanes-Oxley also requires that the audit committee have the sole authority to hire and fire the company's auditors, determine their compensation and oversee their work. See Rel. 33-8173.

Required Communications by Auditors to Audit Committees. Sec. 204 of Sarbanes-Oxley added section 10A(k) "Reports to Audit Committees" to the Exchange Act. That section requires a registered public accounting firm that performs an audit for an issuer to timely report to the issuer's audit committee:

- All "critical accounting policies" and practices to be used;[6]
- All material alternative treatments of financial information within GAAP that have been discussed with management officials of the issuer, ramification of their use and the treatment preferred by the accounting firm; and
- Other material written communications between the registered public accounting firm and management, such as any management letter or schedule of unadjusted differences.[7]

The SEC implemented Sec. 204's statutory requirement which, in large part, codified similar existing generally accepted auditing standards ("GAAS") requirements, by adopting Rule 2-07 of Regulation S-X. The SEC's rule essentially tracks the language of Sec. 204 of Sarbanes-Oxley, although it has modified the "timely" reporting requirement of Sec. 201 to require the auditor to report to the audit committee before the filing of the audit report with the SEC. Also, the SEC has clarified that the auditor's report may be oral or written.

However, the SEC declined to adopt any materiality standard for reports about critical accounting policies, since by definition these policies are considered material. In addition, the SEC's discussion of "critical accounting policies" in the Adopting Release suggests that auditors also should discuss with the audit committee "critical accounting estimates" to be used by the company.[8]

New Disclosure Requirements

The SEC has adopted new disclosure rules for proxy statements and annual reports to implement certain provisions of Title II of Sarbanes-Oxley.

Disclosure about fees. The SEC's rules require that issuers disclose information in their annual reports on Forms 10-K (Part III, Item 16), 10-KSB (Part III, Item 16), 20-F (Item 15(d)) or 40-F General Instruction B(10),[9] about audit and non-audit services provided to them by their "principal accountant" and the fees paid to the principal accountant for the past two years. The fees must be broken down as follows:

- Under the caption Audit Fees, the aggregate fees billed by the principal accountant for each of the last two fiscal years for audits of the registrant's annual financial statements and review of the financial statements included in

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[6] In Rel. 33-8173, the SEC proposed to require disclosure about critical accounting policies discussed with the auditors.

[7] In addition, GAAS require that the auditor should determine that the audit committee is informed about matters such as:

- Auditor's responsibility under GAAS;
- Significant accounting policies;
- 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;
- Process 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,
- Auditor's responsibility for other information in documents containing audited financial statements;
- Auditor's views about significant matters that were the subject of consultation between management and other accountants;
- Major issues discussed with management prior to retention;
- Difficulties with management encountered in performing the audit; and
- Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.

Auditors are required under GAAS to provide these communications in a timely manner, but not necessarily before the issuance of the audit report. Auditors also may communicate with audit committees on matters in addition to those specifically required by GAAS, including auditing issues, engagement letters, management representation letters, internal controls, auditor independence. The AICPA's Auditing Standards Board is considering revisions of its standards for auditors' communications to audit committee. It is not clear whether the PCAOB will adopt the ASB's auditing standards.

[8] The SEC, in December of 2001, issued Cautionary Advice Regarding Disclosure About Critical Accounting Policies. See Rel. 3-8040. In May of 2002, the SEC issued proposals for Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies. See Rel. 33-8098. Those proposals have not been acted upon.

[9] Companies subject to the SEC's proxy rules are required to disclose this information in their proxy statements, if filed within 120 days of the end of the issuer's fiscal year, and incorporated it by reference in their annual reports filed with the SEC.

the registrant's quarterly reports on Forms 10-Q or 10-QSB or in other filings with the SEC for those fiscal years.

- Under the caption Audit Related Fees, the aggregate fees billed by the principal accountant in each of the last two fiscal years for assurance and related services "reasonably related" to the audit or review of the registrant's financial statements not reported under the caption Audit Fees and a description of each subcategory of such fees;
- Under the caption Tax Fees, the aggregate fees billed by the principal accountant for each of the last two fiscal years for tax compliance, tax consulting and tax planning;
- Under the caption All Other Fees, the aggregate fees billed by the principal accountant for each of the last two fiscal years for all other services and descriptions of each subcategory of such services.

This disclosure requirement, which amended the SEC's previous fee disclosure requirements, is not required by Sarbanes-Oxley.

The SEC's rules also require disclosure, if greater than 50%, the percentage of hours expended by on the audit for the most recent fiscal year by persons other than the principal accountant's full-time, permanent employees.

Pre-approval policies and procedures. Sec. 202 of Sarbanes-Oxley amended the Exchange Act by adding Section 10A(i)(2) "Disclosure to Investors" which requires that "[a]pproval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a)."

The SEC rules require that the issuer disclose in addition to other required disclosures about the audit committee, in detail and clearly, concisely and understandably, in their proxy statements, the audit committee's pre-approval policies and procedures (for services other than audit, review or attest) "described in paragraph (c)(7)(ii) of Rule 2-01 of Regulation S-X" and the percentage of the fees for audit related, tax and other services that were approved by the audit committee under each of paragraphs (A), (B) and (C) of that Rule. (Sec. 202 permits such pre-approvals under certain conditions, but does not require this disclosure.) In the alternative, an issuer could include a copy of the policies with its proxy statement and file copy with the SEC.[10]

Application to foreign issuers. These rules apply to foreign private issuers, including Canadian issuers filing annual reports with the SEC on Form 40-F[11] who will be required to make the required disclosure in their annual reports filed with the SEC.

In addition, because the substantive provisions of these rules, including audit partner rotation and the prohibition on auditors providing legal services to audit clients, may impose difficult practical burdens on foreign companies to comply with, the SEC provided some relief for these companies, including transition relief. The SEC also indicated its willingness to continue to provide ad hoc relief to foreign companies and their auditors in appropriate circumstances.

Application to small business issuers and small audit firms. These disclosure requirements apply to "small business issuers." The substantive provisions of these rules, particularly audit partner rotation requirements, may prove burdensome to these issuers and brave disproportionate impacts on them. The SEC did provide relief for audit firms with fewer than five audit clients and ten partners. They are exempt from the partner rotation and compensation provisions of the rules, if they are subject to a special review by the PCAOB at least every three years.

Conclusion

These rules place yet more responsibilities on the members of a company's audit committee.

[10] Companies that are not required to file proxy statements with the SEC, are required to disclose these policies and procedures in their Forms 10-K, 10-KSB, 20-F or 40-F and file a copy of their audit committee's pre-approval policies as an exhibit to the report.

[11] Notwithstanding the SEC's Multi- jurisdictional Disclosure System for certain Canadian issuers, which generally relies on Canadian disclosure requirements, Canadian issuers filing Form 40-F are subject to these disclosure requirements.

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Proskauer's Corporate Governance and Defense Practice consists of a multidisciplinary team of attorneys from our Corporate and Litigation practices, including renowned experts and former SEC and US Attorneys, who bring to bear considerable sophisticated expertise to serve your needs. The following individuals serve as the contact persons and would welcome any questions you might have.

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