SEC Proposes Auditor Independence Rules

As directed by Section 208(a) of the Sarbanes-Oxley Act of 2002 (the Act), on December 2, 2002, the SEC released proposed amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC. The proposed rules enable the provisions of the Act regarding the independence of accountants based on four guiding principles: an audit firm should not audit its own work, serve as a part of management, act as an advocate of the audit client, or be a promoter of the issuer’s stock or other financial interests. The proposed rules also recognize the critical role played by audit committees in the financial reporting process and in assuring auditor independence.

Summary of Key Provisions

Key provisions of the proposed rules include:

Services Affected

- In defining the various services that are prohibited if provided by an audit firm to its public client, the regulations are to be interpreted in a manner consistent with the guiding principles that the accounting firm should not advocate for the client, function as an employee/manager of the client, audit its own work, or be a promoter the issuer’s stock or financial interests.

- Valuation services where there is a reasonable likelihood that the results will be subject to audit procedures are banned; non-financial reporting valuation services such as transfer pricing services are not covered by this prohibition.

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1 Section 208(a) of the Act provides, in relevant part, that:

Not later than 180 days after the date of enactment of this Act, the Commission shall issue final regulations to carry out each of subsections (g) through (l) of section 10A of the Securities Exchange Act of 1934, as added by this title.


• Legal services that should only be provided by someone licensed, admitted or otherwise qualified to practice law are prohibited.

• Tax services are not directly defined. Classification as a tax service does not mean a service is permitted. Even if it is classified as a tax service, a particular service may still fall into a prohibited category. It appears that the only clear “winner” as far as permitted tax services are concerned, are “traditional tax preparation services” and not the broader “traditional tax services” possibly hoped for after the November 19 SEC meeting. Tax opinions may or may not be permitted. While representatives of the audit firm can not represent the client before the Tax Court, they can represent the client during the examination phase of an IRS audit.

• The SEC asks for input on many of the issues related to defining services and properly identifying them as audit, prohibited non-audit, or permitted non-audit.

• The proposed rules generally do not provide exemptions for non-U.S. accounting firms or non-U.S. issuers; however, the numerous requests for comments relating to this issue suggest the SEC is considering exemptions.

*Auditor Disclosures to the Audit committee*

• The auditor must disclose to the audit committee: (i) all critical accounting practices and policies; (ii) alternative accounting treatment of items that has been discussed with management; and (iii) other material written communication between the firm and management.

• All disclosure must be timely and the proposed rules go further than existing rules to require that such disclosures be made prior to the filing of the audit report with the SEC.

*Mandatory Audit Partner Rotation*

• Audit partners cannot have been on the account for more than five years in a row.

• Audit partners include not just the lead and reviewing partner, but also other “line” partners involved in the audit, such as the tax partner.

*Audit Personnel Employment Cooling Off Period*

• Members of management who are in a financial oversight function cannot have been members of the audit engagement team – including reviewing, consulting or specialty personnel – within one-year of the commencement of the audit or review. This would include internal treasury, finance, and upper-tier (CEO/COO/board) positions. Notably, the tax executive is not listed.

*Enforcement*

• Violation of the proposed rules by a public accounting firm would subject the violator to all the remedies and sanctions available under the Exchange Act, including injunctions and cease-and-desist orders. In addition, a violating firm would have engaged in improper professional conduct and may also be
subject to administrative disciplinary proceedings that could result in a censure or a suspension or bar from practicing before the SEC.

- Moreover, because many of the proposed rules would constitute amendments to the definition of independence contained in Rule 2-01 of Regulation S-X (which sets forth requirements for filings under both the Securities Act and the Exchange Act), a violation of these independence requirements could cause the affected financial statements not to comply with all requirements of either the Securities Act or the Exchange Act. This could create exposure to private causes of action under Sections 11 and 12 of the Securities Act, as well as Section 10(b) and Rule 10b-5 under the Exchange Act, which could also extend to “control persons” of the issuer.

### Non-Audit Services That Would Be Prohibited Under the Proposed Rules

The Act develops a framework that identifies services as fitting in one of three categories: audit services, prohibited non-audit services, and non-audit services that must be approved in advance the audit committee. One of the most awaited aspects of the proposed rules is the delineation of those non-audit services that auditors are prohibited from providing to audit clients, and those non-audit services that auditors are permitted to provide with pre-approval from the client’s audit committee. The Act sets forth nine categories of prohibited activities, and provides that a registered accounting firm can engage in non-audit activities not described in the nine categories only with the pre-approval of the audit committee. Specifically, under Section 201 of the Act, a registered accounting firm is prohibited from providing the following non-audit services to a public audit client:

- 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 (PCAOB) determines, by regulation, is impermissible.

There has been much speculation about whether particular services fall within the list of prohibited categories. In particular, there has been debate about the status of many tax-related services. Some argued that many tax services fall within one of the categories of prohibited activities, and others argued that because the Act states that registered accounting firms can engage in non-audit services not described in the list of pro-
hibited activities, “such as tax services,” all tax-related services are permitted if there is pre-approval. The proposed rule, and particularly the preliminary note, provide a great measure of needed guidance as to which side of the line tax-related services would fall; however, they still leave many questions unanswered.

**Proposed Rule**

The proposed rule provides that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

- **Bookkeeping or other services related to the accounting records or financial statements of the audit client.** Services the results of which are reasonably likely to be subject to audit procedures during an audit of the audit client’s financial statements, including:
  - Maintaining or preparing the audit client’s accounting records;
  - Preparing the audit client’s financial statements that are filed with the SEC or that form the basis of financial statements filed with the SEC; or
  - Preparing or originating source data underlying the audit client’s financial statements.

- **Financial information systems design and implementation.** Directly or indirectly, operating, or supervising the operation of, the audit client’s information systems or managing the 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 the audit client’s financial statements or other financial information systems taken as a whole.

- **Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.** Any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client’s financial statements.

- **Actuarial services.** Any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client’s financial statements.

- **Internal audit outsourcing services.** Any internal audit services related to internal accounting controls, financial systems, or financial statements.

- **Management functions.** 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.

- **Human resources.** Searching for or seeking out prospective candidates for managerial, executive, or director positions or services related to filling those positions.

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• **Broker-dealer, investment adviser, or investment banking services.** Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client or making investment decisions on behalf of the audit client.

• **Legal services.** Providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

• **Expert services unrelated to the audit.** Providing expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acting as an advocate for an audit client in such proceedings.

**Interpreting Guidelines**

The preliminary note to the proposed rules contains principles that the SEC used in drafting the proposed rules, and provides certain other guidelines that are useful in interpreting the scope of the proposed rules. Specifically, the preliminary note to the proposed rules repeatedly emphasizes that the determination of whether an activity or service is a prohibited one, or one permitted with approval, is guided by and should be based on four principles set out in the Senate Report:

- an accounting firm should not audit its own work,
- an accounting should not function as part of management or as an employee of the audit client, and
- an accounting firm should not act as an advocate of the audit client.

These principles are set out in the Senate Report, and also were used as guidance by the SEC in formulating its 2000 auditor independence rules. A fourth principle that an auditor should not be a promoter of the issuer’s stock or other financial interests was added by Senator Sarbanes in a July 25, 2002, floor statement.

It should be noted that the proposed rules do not provide an all-inclusive list of the services that are incompatible with the proposed Rule 2-01(b). The SEC notes that whether the provision of a non-audit service not specified in the proposed rule impairs an accountant’s independence will be measured against the four general principles in the legislative history as noted above.

**Specific Services**

Many of the services that the proposed rule and the preliminary note address do not warrant much discussion; however, there are several which do and that likely will be the focus of the comment process:

**Valuation Services - Transfer Pricing Services**

Current rule. Under the SEC’s current auditor independence rules, an accountant is deemed to lack independence when providing appraisal or valuation services, fairness opinions, or contribution-in-kind reports for audit clients. The current rules contain exceptions for, among other things, (1) valuations performed for planning and implementing tax-planning strategies and (2) valuations for non-financial purposes.
Proposed rule. The proposal would provide that the auditor is not independent if the auditor provides appraisal or valuation services, or contribution-in-kind reports, where there is a reasonable likelihood that the results of the service will be subject to audit procedures by the auditor, reflecting a policy against placing an auditor in a position of auditing his or her own work.

Transfer pricing not covered. The preliminary note states that the proposals would not prohibit an accounting firm from providing valuation services for non-financial reporting purposes (e.g., transfer pricing studies, cost segregation studies). Thus, the existing exception relating to non-financial reporting contained in current SEC rules is proposed to be retained. Many had speculated that “valuation services” included services related to the formulation or evaluation of transfer pricing methodologies to facilitate cross-border operations or intercompany transactions and to satisfy taxing authorities. Notably, the Act itself did not incorporate any limitation based on whether the results of the valuation affected the financial statements. The SEC requests comment on whether providing valuation or appraisal services that are unrelated to the financial statements, such as for certain regulatory purposes, impairs an accountant’s independence. Further, the SEC requests comment on whether providing valuation or appraisal services for tax purposes impairs an accountant’s independence.

Should transfer pricing be exempted? An argument may be made that the results of a transfer pricing study indirectly, if not directly, affect the financial reporting by a company such that an auditor that provides transfer pricing services could be violating the principle that an auditor should not audit its own work. The argument may also be made that even if the results of a transfer pricing study are not viewed as affecting financial reporting, performing transfer pricing services could put the auditor in a position of acting as an advocate on behalf of a client, since the auditor would be taking a position as to the arm’s-length nature of intercompany pricing of goods and services that would be used in an audit by the IRS or another taxing authority.

Foreign issuers. Notably, the SEC requests comment regarding whether an exemption for such services should be provided for foreign private issuers where local law requires such services (e.g., contribution-in-kind reports). The SEC states in the preliminary note to the proposed rule that contribution-in-kind reports in certain foreign countries require the auditor to express an opinion on the fairness of the transaction, the value of a security, or the adequacy of consideration to shareholder.

Legal Services

Current rule. The SEC’s current rule states that an auditor is deemed to lack independence if the auditor provides “any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.”

Proposed rule. The proposed rule would provide that an accountant is not independent if the accountant provides any service to the audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided. The SEC requests comment on whether making the rule’s application depend

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4 See Rule 2-01(c)(4)(ix) of Regulation S-X.
upon the jurisdiction in which the service is provided leaves the rule subject to significant uncertainty and imposes significant unfairness.

The SEC notes that, unlike an auditor, a lawyer takes basic direction from the client. “We have long maintained that an individual cannot be both a zealous legal advocate for management or the client company and maintain the objectivity and impartiality that are necessary for an audit.”

Foreign accounting firms covered. The proposed rule applies equally to foreign and U.S. accounting firms.

Foreign issuers. The SEC notes that in some countries only a law firm may provide tax services, so that an accounting firm providing such services would be deemed to be providing legal services, and asks whether a foreign accounting firm should be permitted to provide, through an affiliated law firm, tax or other services that a U.S. accounting firm could provide to a U.S. audit client without impairing the firm’s independence. The SEC further requests comment on whether there should be an exception for legal services provided to issuers in foreign jurisdictions, and whether any such exception should be tailored to avoid undermining the purpose of the restriction. For example, the SEC asks whether fees for legal services could be limited to a small percentage of the amount of fees for audit services. It also asks whether partners providing audit services could be prohibited from being involved in, or from receiving compensation based on, the provision of legal services. Finally, the SEC requests comment on whether any such exception should have a “sunset provision” that would both allow foreign private issuers a transition period and allow the SEC to review the situation regarding legal services.

Scope of prohibition. While many commentators guessed that the prohibition on legal services would prevent accounting firms from representing clients or participating as an expert in judicial proceedings, some had wondered whether pre-litigation audit work, such as representing a company in the course of its examination by the IRS or a state or foreign taxing authority, also would be prohibited. The discussion at the November 19, 2002 open meeting at the SEC at which the proposed rule was approved, with modifications, indicated that such representation would not be treated as prohibited, since the SEC viewed such work as involving more of a factual presentation service, and did not seem to involve advocacy. At the November 19th meeting the SEC staff likened representing clients before the IRS to appearing before the SEC’s chief accountant to explain factual matters. It will be interesting to see if there are comments of this part of the regulations given such services almost certainly do involve advocacy and resolution frequently of significant proposed tax liabilities. Note also the permissibility of providing such services implicit in the SEC’s proposed expansion of the disclosure requirements relating to fees paid to auditors for non-audit services. As discussed below, the SEC proposes to require issuers to provide more detailed disclosure of fees paid to auditors for non-audit services, including tax services which the SEC says may include “assistance and representation in connection with tax audits and appeals.”
**Expert Services**

Previous consideration of prohibition on expert services. Expert services were considered by the SEC when the auditor independence rules adopted in 2000 were first proposed, but ultimately were not added to the list of prohibited services in the final rules. The previously proposed rule stated that an accountant’s independence was impaired as to an audit client “if the accountant renders or supports expert opinions for the audit client or an affiliate of the audit client in legal, administrative, or regulatory filings or proceedings.”

Proposed rule. The current proposed rule states that an accountant’s independence would be impaired as to an audit client if the accountant provides “expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acts as an advocate for an audit client in such proceedings.” This is similar to the rule that was previously proposed but never adopted.

Services in connection with litigation, administrative or regulatory proceedings covered. The SEC states in the preliminary note that the prohibition on the provision of expert services would include providing consultation and other services to an audit client’s legal counsel in connection with litigation, administrative or regulatory proceedings. It notes that, under the proposed rule, an auditor’s independence would be impaired if the auditor were engaged by the audit client’s legal counsel to provide expert witness or other services, including accounting advice, opinions, or forensic accounting services, in connection with the client’s participation in a legal, administrative, or regulatory proceeding.

Testifying as a fact witness not prohibited. The SEC notes, however, that the proposals would not prohibit an auditor from testifying as a fact witness to its audit work for a particular audit client. In those instances, the SEC notes, the auditor is merely providing a factual account of what he or she observed and the judgments he or she made. An accounting firm that, after receiving appropriate authorization from an audit client’s audit committee, had prepared an audit client’s tax returns, also could appear as a fact witness in tax court to explain how the returns were prepared.

Where to draw the line. Among other things, the SEC requests comment on whether the distinction between advocacy and providing appropriate assistance to an audit committee is sufficiently clear. The line is difficult to draw. For example, are transfer pricing services expert services? Are they analogous to auditing services performed by an auditor, or are they closer to a legal or other service where the service performer is “taking its direction” from the client?

**Tax Services**

Guidance provided by Act. The Act states that a registered public accounting firm could engage in any non-audit service, “including a tax service,” that is not described in any of the prohibited categories, only if the

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6 See June 2000 Release at 45.
activity is approved in advance by the audit committee of the issuer. A considerable amount has been written about what the Act might mean by tax services, and what specific tax services are intended to be prohibited versus permitted with pre-approval.

**Tax services not defined.** The proposed rules would not define “tax services.” The SEC notes, however, in the preliminary note that tax services “can include a range of activities including the preparation of tax returns, tax compliance, tax planning, tax recovery, and other tax-related activities.”

**Tax accrual.** The preliminary note indicates that reviewing tax accruals is part of audit services. While this would seem appropriate where relatively simple tax provision calculations are involved, it may not be where the tax provision calculations involve the evaluation of complex issues and calculations. Such evaluation would seem to implicate review and possible even advocacy.

**Traditional tax preparation.** The preliminary note states:

The Congressional intent behind the reference to “tax services” would appear to be that auditor independence is not impaired by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

Some commentators came away from the SEC’s November 19, 2002, open meeting with an understanding that “traditional tax services” would not impair an accountant’s auditor independence. It is noteworthy that the proposed rules speak of “traditional tax preparation services” and not more broadly of “traditional tax services” as not impairing the accountant’s independence.

**Services classified as tax services could nevertheless fall within a prohibited category.** The SEC notes that classifying a service as a “tax service” does not mean that the service may not be within one of the categories of prohibited services or may not impair independence. The accounting firm and the registrant’s audit committee should consider, for example, whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service. Again, the SEC directs that as part of this process, the accounting firm and the audit committee be mindful of the three basic principles (although at times the SEC refers to the four basic principles) which cause an auditor to lack independence with respect to the audit client. For example, the SEC specifically expresses the view that, where an accountant provides representation before a Tax Court, the accountant serves as an advocate for his or her client and the accountant’s independence would be impaired. The implication is that such representation would be a legal service.

**Tax shelters.** Another specific example of a prohibited tax service given by the SEC is the formulation of tax strategies designed to minimize a company’s tax obligations (e.g., tax shelters). The provision of these types of services may require the accountant to audit his or her own work, to become an advocate for the client’s position on novel tax issues or to assume a management function. It isn’t clear within which prohibited category of services the SEC would consider such services to fall, but it may be expert services.

**Tax opinions.** The SEC states that it is considering whether special considerations apply when an auditor provides a tax opinion for the use of a third party in connection with a business transaction between an audit client and the third party. The SEC notes that the tax opinion may be vital in the audit client’s efforts
to induce the third party to enter into the transaction, particularly when the transaction is tax-driven. Under those circumstances, the auditor may be acting as an advocate for the audit client by actively promoting the client’s interests. In other circumstances, such as tax opinions, reorganizations or spin-off transactions, the advocacy component may not be present. It is noteworthy that a very similar request for comment was made in connection with the adoption of the existing auditor independence rules. A prohibition on such opinions did not become part of the final auditor independence rules adopted in 2000. The SEC has requested specific comment on whether providing tax opinions, including tax opinions for tax shelters, to an audit client or an affiliate of an audit client under the circumstances above would impair, or would appear to reasonable investors to impair, an auditor’s independence.

Request for comments. The SEC requests further comment on whether there are tax services that should be prohibited by the SEC’s independence rules, and whether it is meaningful to categorize tax services into permitted and disallowed activities, and if so, what categories and related definitions would make the demarcation meaningful.

Audit Committee Pre-Approval Requirements

As noted above, pursuant to Section 202 of the Act, a registered accounting firm will be able to engage in non-audit services not falling within the list of prohibited activities, such as tax services, only if the activity is approved in advance by the audit committee of the issuer. The audit committee is also required to pre-approve all auditing services. Pursuant to Section 202 of the Act, the audit committee may delegate to one or more designated members of the audit committee who are independent directors, the authority to grant required pre-approvals. Pre-approvals by any member(s) to whom such authority is delegated must be reported to the full audit committee at each of its scheduled meetings.

De minimis Exception to Pre-Approval.

Pre-approval is not required for the provision of permitted non-audit services if (i) fees for such services amount to no more than 5% of the amounts paid to the auditor for the year, (ii) the services were not recognized by the company at the time of the engagement as being non-audit services, and (iii) such services are promptly brought to the attention of the audit committee and the audit committee (or a designated member of the audit committee) approves such services prior to the completion of the audit. According to the Senate Report, this exception is intended to cover the “atypical circumstance” where an auditor is providing an audit service within the scope of the engagement, but it is later discovered to be a non-audit service.7

Proposed Rule

The proposed rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. In addition, the proposals require that either (i) before the accountant is engaged to provide non-audit services the audit client’s audit com-

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7 Report of the Senate Committee on Banking, Housing, and Urban Affairs, “Public Company Accounting Reform and Investor Protection Act of 2002,” Senate Report 107-205, 107th Cong., 2d Sess., at 21 (July 3, 2002). The Senate report addresses the version of the Act first passed by the Senate, before the conference committee reported the Act in its final form.
mittee expressly approve the particular engagement, or (ii) any such engagement be entered into pursuant to
detailed pre-approval policies and procedures established by the audit committee with the audit committee
being informed on a timely basis of each such engagement.

**Disclosures Required to be Made by the Auditor to the Audit Committee**

Pursuant to Section 204 of the Act, the proposed rules would require each public accounting firm registered
with the PCAOB to disclose to the issuer’s audit committee:

- All critical accounting policies and practices used by the issuer;
- All alternative accounting treatments of financial information within generally accepted accounting
  principles (GAAP) that have been discussed with management, including the ramifications of the use
  of such alternative treatments and the treatment preferred by the accounting firm; and
- Other material written communications between the accounting firm and management.\(^8\)

While Section 204 of the Act requires that these disclosures be timely reported to the audit committee, the
proposed rules go further and would require such disclosures to be made prior to the filing of the audit report
with the SEC under applicable securities laws. As a result, the SEC expects these disclosures to occur at least
during the annual audit and more frequently—on a quarterly or real-time basis—as the circumstances dictate.
While much of this disclosure is already required under generally accepted auditing standards (GAAS), the
timing of the disclosure in some instances must now be prior to the issuance of the audit report.

**Critical Accounting Policies and Practices**

Under the proposed rules, public accounting firms would be required to disclose to the audit committee
either orally or in writing all of the issuer’s critical accounting policies. As stated in earlier guidance from the
SEC regarding the Management’s Discussion and Analysis (MD&A) section of an annual report\(^9\) and reiter-
ated in the proposed rules, the SEC defines critical accounting polices to be those accounting policies that are
both most important to the portrayal of the issuer’s financial condition and results and require management’s
most difficult, subjective or complex judgments, often as a result of the need to make estimates about the
effects of matters that are inherently uncertain.

In determining the types of matters that should be disclosed to the audit committee, the SEC suggests that
public accounting firms refer to its May 2002 proposed rules relating to accounting estimates\(^10\) in addition to

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\(^8\) The proposed rules would amend Rule 2-07 of Regulation S-X.


\(^10\) See Proposed Rule: Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies,
the earlier SEC guidance mentioned above. The May 2002 proposed rules would define a critical accounting estimate as an accounting estimate recognized in the financial statements that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and 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.

At a minimum, the SEC stated that discussion of critical accounting estimates and the selection of initial accounting policies should include the rationale behind the determination that certain estimates or policies are or are not critical and an explanation of the impact of current and anticipated events on such determination. The SEC also expressed the view that the dialogue between the public accounting firm and audit committee should include an assessment of management’s disclosures together with any significant modifications proposed by the public accounting firm that were rejected by management.

**Alternative Accounting Treatments**

The proposed rule would require the oral or written disclosure of recognition, measurement and disclosure considerations related to the accounting for specific transactions and general accounting policies. At a minimum, disclosure regarding a specific transaction would be expected to include:

- The underlying facts, financial statement accounts affected and the applicability of existing corporate accounting policies to the transaction;
- If the proposed accounting treatment does not comply with existing corporate accounting policies or if such policies do not apply, then an explanation of why the existing policy was inappropriate or inapplicable and the basis for the selection of the alternative policy;
- The entire range of alternatives available under GAAP that were discussed with management and the public accounting firm and the basis for not choosing such alternatives; and
- If management rejected the accounting treatment preferred by the public accounting firm, then the reasons for such rejection.

Disclosure regarding general accounting policies would be expected to focus on the initial selection of and changes in significant accounting policies and, at a minimum, would include:

- The impact of management’s judgments and accounting estimates;
- The public accounting firm’s judgments about the quality of the company’s accounting principles;
- The range of alternatives available under GAAP that were discussed with management and the public accounting firm as well as the basis for selecting the chosen accounting policy;

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11 Although certain items disclosed under the category of alternative accounting treatments may overlap those disclosed under critical accounting policies and practices, the SEC notes that these two categories are distinct and the discussion of one should not be considered a substitute for the discussion of the other.
• If an existing accounting policy is being modified, then the reasons for such modification; and
• If the accounting policy is not the public accounting firm’s preferred policy, then the basis for the rejection of the public accounting firm’s preferred policy.

**Other Material Written Communications**

Section 204 of the Act specifically requires the disclosure of the management representation letter and the schedule of material adjustments and reclassifications proposed, including a listing of adjustments and reclassifications not recorded, if any. To this non-exhaustive list of examples, the proposed rules would add:

• Reports on observations and recommendations on internal controls;
• Engagement letter; and
• Independence letter.

**Mandatory Rotation of Audit Partners**

Section 203 of the Act requires rotation of certain audit partners on a five-year basis in order to continue to provide audit services for an issuer:

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer . . . .

As the SEC points out, the concept of audit partner rotation is not new. Accounting firms that audit public companies are currently subject to the audit partner rotation requirements of the AICPA’s SEC Practice Section that call for the engagement partner to rotate off the engagement after seven years, and remain off the engagement for two years.\(^\text{12}\) The requirements of the Act are broader than those of the AICPA in some respects, and with respect to determining which partners (a term that includes principals and shareholders) should be rotated, the SEC’s proposed rules would go beyond the minimum requirements of the Act.

**Proposed Rotation**

Partners would be required to rotate off of the account after five years, and would not be able to return to the account for five years thereafter.

**Partners Covered**

The SEC’s proposal would cover:

• The lead partner and the reviewing partner;

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\(^\text{12}\) See American Institute of Certified Public Accountants (AICPA), SEC Practice Section, Requirements of Members, at item e, [http://www.aicpa.org/members/div/secps/require.htm](http://www.aicpa.org/members/div/secps/require.htm).
• All other partners who perform audit services, including the client service partner and other “line” partners directly involved in the performance of the audit;\(^{13}\)

• Tax partners, to the extent the tax services are a necessary part of the firm’s ability to complete the audit; and

• Partners who serve on the engagement team that conducts the review of the company’s quarterly financial information, or on the team that conducts the attest engagement of management’s report on the company’s internal controls required by Section 404 of the Act.\(^ {14}\)

**Audit Personnel Employment “Cooling-Off” Period**

The proposed rules also would prohibit an accounting firm from auditing an issuer’s financial statements if certain members of management who are in a financial reporting oversight role have been members of the accounting firm’s audit engagement team within the one-year period preceding the commencement of audit or interim review procedures.

**Covered Employees**

The one year cooling off period would apply to partners, principals, shareholders and professional employees of the accounting firm who participate in an audit, review or attestation engagement, including those conducting concurring or second partner reviews and all persons who consult with others on the audit engagement team during the engagement regarding technical or industry-specific issues, transactions or events.\(^{15}\)

**One-year “cooling off” period**

The cooling-off period would begin one year prior to the earlier of:

• when the accountant begins the current fiscal year’s audit, or

• when the accountant review procedures necessary to conduct a timely review of the registrant’s quarterly financial information associated with the current fiscal year.

In other words, members of an issuer’s management who serve in a financial accounting oversight role must not have worked on that issuer’s audit engagement (including a review of quarterly financial information)

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\(^{13}\) This requirement recognizes the fact that many larger audit engagements involve multiple partners. In the release, the SEC states that the covered group would include partners who are involved on a continuous basis in the audit of material balances in the financial statements. For example, an actuarial specialist who assists in auditing the loss reserves for an insurance company would be subject to the rotation requirement. Notably, the SEC states that “national office” partners, consulted only on specific issues, would not be covered.


\(^{15}\) See Rule 2-01(f)(7) of Regulation S-X.
as an auditor for a period of one year prior to the commencement of a new audit or review. The proposing release offers the following example:

If, audit engagement team member A last worked on the audit engagement on January 31, 2002 (audit report filed with the Commission on February 19, 2002) and joined audit client B on September 1, 2003 and the review procedures for B commenced on February 20, 2003 the accounting firm would not lose its independence with respect to the audit client since audit engagement team member A did not participate as an audit engagement team member subsequent to February 19, 2002.16

As a practical matter, the cooling off period in most instances will be somewhat longer than one year. Since preparation of an audit often takes several weeks (or months) and fiscal years tend to remain constant, the last date that an audit engagement team member works on the audit engagement likely will not precede the beginning of the next year’s audit by the required one year. Since GAAS requires that an audit engagement be properly planned, procedures associated with the planning of the engagement constitute the planning of an audit.17 Similarly, since SAS 7118 establishes the review procedures necessary to conduct a timely review of interim information, the commencement of these review procedures would constitute the beginning of the engagement.19

“Financial Accounting Oversight Role”

A financial reporting oversight role refers to a role in which an individual has direct responsibility or oversight of the persons who prepare the registrant’s financial statements and related information, such as Management’s Discussion and Analysis (MD&A).20 The proposed rules would include among these persons:

- Members of the board of directors;
- Chief executive officer;
- President;
- Chief financial officer;
- Chief operating officer;
- General counsel;
- Chief accounting officer;

16 Proposing Release at 6.
17 Proposing Release at 6.
18 Note that SAS 71 has been superseded by SAS 100 and is effective for interim periods within fiscal year beginning after December 15, 2002. See Proposing Release at 89.
19 Proposing Release at 6.
20 Proposing Release at 34.
• Controller;
• Director of internal audit;
• Director of financial reporting;
• Treasurer; and
• Positions equivalent to the above.\(^{21}\)

Rule 2-01 of Regulation S-X currently speaks in terms of an “accounting or financial reporting oversight role.” (Emphasis added) The proposed rules would create a separate definition for an “accounting role” in order to tailor more precisely the application of the proposed rules.\(^{22}\) Accordingly, the one-year cooling off period would not apply to persons in “accounting roles,” such as those in clerical positions or those who report to individuals in “financial accounting oversight roles.”\(^{23}\) The proposed rules do not, however, alter Rule 2-01’s current prohibition on persons in an accounting role or a financial reporting oversight role from having a financial interest in an accounting firm.\(^{24}\) One question oddly not addressed is whether tax personnel are included in this prohibition. While the tax partner functioning in connection with an audit must rotate it would appear that that same tax professional could move from the audit firm to the client and not be covered by this rule.

**Compensation of Auditors for Selling Non-Audit Services**

The SEC proposes to amend the auditor independence rules to address the practice of auditors being compensated by their firms for selling non-audit services to their audit clients. The new rule would provide that an accountant is not independent if, at any point during the audit and professional engagement period, any partner, principal or shareholder of the accounting firm who is a member of the audit engagement team earns or receives compensation based on the performance of, or procuring of, engagements with that audit client to provide any services, other than audit, review, or attestation services.

The expressed concern of the SEC is that such incentive programs are inconsistent with the independence and objectivity of external auditors and that partners could be influenced adversely as a result of the economic benefits that may be derived by promoting the firm’s non-audit services to audit clients. “Compensation,” as used in the proposed rule, would include any form of income or monetary benefit distributed to the partner. For example, allocation of partnership “units,” based on the sale of non-audit services would be prohibited. It will be interesting to see how practice in audit firms and enforcement of this requirement develops. Since compensation typically contains at least some subjective component, determining whether “indirect” benefits are bestowed on an audit team member may be difficult to determine.


\(^{22}\) Proposing Release at 34.

\(^{23}\) Proposing Release at 34.

\(^{24}\) Rule 2-01(c)(2) of Regulation S-X; Proposed Rule 2-01(c)(2)(iii)(A).
Expansion of Required Disclosure of Audit and Non-Audit Services and Fees

Current proxy rules require an issuer to disclose the professional fees it paid to its principal independent accountant in the most recent fiscal year. The proposed rules would expand the types of fees that must be disclosed as well as the number of years for which disclosure is required. The proposed rules would require:

- Separate disclosure of audit fees, audit-related fees, tax fees and all other fees;
- Disclosure of such fees for the two most recent fiscal years;
- A description in subcategories of the nature of the services provided that are categorized as audit-related fees and all other fees;
- Disclosure of audit committee pre-approval policies and procedures for audit and non-audit services provided by an independent public accountant; and
- Disclosure of the percentage of fees that were pre-approved.25

Principal Accountant’s Fees

In revising the categorical disclosure of fees, the proposed rules would expand those fees which may be included in audit fees to include services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the SEC, in addition to those fees necessary to perform an audit or review in accordance with GAAS.

Audit-related fees would include fees for assurance and related services that are traditionally performed by the independent accountant, including employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with proposed or consummated acquisitions, internal control reviews, and consultation concerning financial accounting and reporting standards.

Tax fees would include all services performed by professional staff in the independent accountant’s tax divisions. Such services typically include:

- Tax compliance – preparation of original and amended tax returns, claims for refund and tax payment-planning services; and
- Tax consultation and planning – assistance and representation in connection 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.

Audit Committee Actions

As discussed above, Section 202 of the Act requires audit committee pre-approval for all audit and non-audit services provided by auditors, including certain de minimis exceptions. The proposed rules would require the

25 The proposed rules would amend Item 9 of Schedule 14A, Item 15 of Form 20-F and Instruction B of Form 40-F, and add Item 16 to Form 10-K and Item 16 to Form 10-KSB.
disclosure of any policies and procedures developed by the audit committee concerning such pre-approvals. These policies and procedures must also detail specific processes in place that permit and monitor activities meeting the *de minimis* exceptions.

Registrants could comply with this disclosure requirement by providing either concise, clear and understandable descriptions of the policies or procedures or a copy of such policies and procedures with the proxy statement. The disclosure would be included in the company’s annual meeting proxy statement or information statement and could be incorporated by reference into annual reports on Forms 10-K or 10-KSB. Those registrants not required to file proxy statements would still be required to include the relevant disclosure in their annual filings on Form 10-K, Form 10-KSB, 20-F, Form 40-F or the proposed Form N-CSR.26

**Effect of Failure to Comply with the New Rules**

Pursuant to Section 3(b) of the Act, a violation of any rule issued by the SEC under the Act constitutes a violation of the Exchange Act. Accordingly, violation of the proposed rules would subject the violator to all the remedies and sanctions available under the Exchange Act, including injunctions and cease-and-desist orders. In addition, a public accounting firm who violated a provision of the proposed rules would have engaged in improper professional conduct and may also be subject to administrative disciplinary proceedings that could result in a censure, or a suspension or bar from practicing before the SEC under Rule 102(e) of the SEC’s Rules of Practice.

Moreover, because many of the proposed rules would constitute amendments to the definition of independence contained in Rule 2-01 of Regulation S-X (which sets forth requirements for filings under both the Securities Act and the Exchange Act), a violation of these independence requirements could cause the affected financial statements not to comply with all requirements of either the Securities Act or the Exchange Act. This could create exposure to private causes of action under Sections 11 and 12 of the Securities Act, as well as Section 10(b) and Rule 10b-5 under the Exchange Act, which could also extend to “control persons” of the issuer.

**Effective Date**

Prior to the issuance of the proposals, commentators noted the uncertainty in the effective date of the rules. Unfortunately, the proposed rules do not shed much light on this uncertainty. Section 208 of the Act requires the SEC to issue final regulations by January 26, 2003. Notably, however, the regulations will apply to “registered public accounting firms,” which will not exist until the SEC organizes the Board (by no later than April 26, 2003) and the accounting firms have become registered with the Board (by no later than 180 days after the Board is organized). Accordingly, even though the final auditor independence rules must be adopted by January 26, 2003, there is not likely to be any “registered public accounting firms” in existence until much later in 2003.

The comments made by the SEC staff and Commissioners at the open meeting at which the proposed rules were approved illustrate that the effective date remains an open question. It is interesting to note that

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26 Proposed Form N-CSR would be applicable to registered management investment companies.
Commissioner Pitt and others at the meeting, in the course of discussing the application of the proposals to non-U.S. persons, noted the short time-frame within which foreign regulatory authorities would have to submit comments. Commissioner Pitt went on to note that the SEC could provide an opportunity to comment even after the rules are finalized, so that if after the rules are put in place people are still struggling to put together observations, or if after some experience with the rules they see difficulties, there would still be opportunity to take advantage of public comments. Given the uncertainty under the Act regarding when the rules are required to be effective, the short deadline for their adoption, their release during the holiday season, and comments made at the open meeting, it is difficult to speculate about when issuers will be required to comply with the new rules. It is possible that the SEC would issue final rules by January 26, 2003, but delay their effectiveness until the Board is organized and accounting firms become registered, thereby creating additional time to receive and analyze comments and make supplemental changes to the final rules before they become effective. But, it is also possible that issuers will be struggling to comply with the new rules this coming proxy season. In any event, we strongly encourage issuers to maintain a watchful eye on developments in this area.

Conclusions

The proposed rules relating to auditor independence could be the most controversial rules considered under the Act as a result of their broad coverage, and the size of the constituency affected by them – accountants, lawyers and public companies. The proposed rules in many respects go well beyond the auditor independence rules adopted by the SEC in 2000, and there are significant implications for non-compliance. It will be interesting to see what comments are received by the SEC with respect to the rules and how the final rules deal with many issues. Despite many of the questions that remain open, it is clear that the Act has significantly changed the relationship between a public company and its auditors.

On December 17, 2002, the SEC will host a roundtable on the international impact of the proposed rules. The roundtable meetings are scheduled to take place in the William O. Douglas Room at SEC headquarters, 450 Fifth Street, N.W. Washington, D.C. The roundtable discussion concerning the auditor independence rules will begin at 9 a.m. The discussion of the attorney conduct rules will start at 2 p.m. Both meetings will be open to the public and will be webcast. Real time and archived audio webcasts of the roundtables will be accessible at [http://www.sec.gov/news/otherwebcasts.shtml](http://www.sec.gov/news/otherwebcasts.shtml).

To help companies and tax practitioners understand the impact and mechanics of the proposed rules and the state of thinking as to tax issues under the Act, Alston & Bird LLP will be holding seminars on the auditor independence provisions of the Act in Charlotte on Wednesday, January 29th, in Atlanta on Thursday, January 30th, and in New York on Friday, January 31st. Please contact Joel Stafford at 404-881-4370 or jstafford@alston.com for further information.
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Pinney L. Allen  
404-881-7485  
pallen@alston.com

J. Vaughan Curtis  
404-881-7397  
vcurtis@alston.com

Mark F. McElreath  
212-210-9595  
mmcelreath@alston.com

Saba Ashraf  
404-881-7648  
sashraf@alston.com

Bryan E. Davis  
404-881-7591  
bdavis@alston.com

Nils H. Okeson  
404-881-7889  
nokeson@alston.com

David E. Brown, Jr.  
202-756-3345  
dbrown@alston.com

Gary C. Ivey  
704-444-1090  
givey@alston.com

Jonathan H. Talcott  
202-756-3304  
jtalcott@alston.com

Frank M. Conner III  
202-756-3303  
fconner@alston.com

M. Hill Jeffries  
404-881-7823  
hjeffries@alston.com

Charles W. Wheeler  
202-756-3308  
cwheeler@alston.com

Jasper L. Cummings, Jr.  
919-862-2302  
jjcumings@alston.com

Brad S. Markoff  
919-862-2210  
bmarkoff@alston.com

If you would like to receive future Securities Law Advisories electronically, please forward your contact information including your e-mail address to securities.advisory@alston.com. And if you would like to receive future Federal Tax Advisories electronically, please forward your contact information including your e-mail address to tax.advisory@alston.com. Be sure to put “subscribe” in the subject line.