



SEC Adopts Final Auditor Independence Rules

The SEC has adopted final rules strengthening auditor independence. The rules implement Section 208(a) of the Sarbanes-Oxley Act of 2002.

The adopting release, “Strengthening the Commission’s Requirements Regarding Auditor Independence”, Release No. 33-8183, is available at <http://www.sec.gov/rules/final/33-8183.htm>.

Effective Dates

The effective date of the rules is May 6, 2003, with transition periods as summarized below for certain rules, including those relating to audit partner rotation, the provision of certain non-audit services, the disclosure of fees paid to auditors and conflicts arising from employment relationships and audit partner compensation. In addition, the rules adopted with respect to reports to the audit committee of critical accounting policies and the like are dependent on auditors’ being registered with the Public Company Accounting Oversight Board, which must be by October 23, 2003 at the latest.

Summary of Rules

The rules are intended to, among other things:

- strengthen the existing auditor independence rules, in some respects going beyond the requirements of the Act;
- clarify the scope of non-audit services prohibited to be performed by a company’s outside auditor;
- specify the audit committee pre-approval requirements in respect of audit and non-audit services;
- require that critical accounting policies and other material written communications between management and registered audit firms be reported to the audit committee;
- require mandatory rotation of certain audit partners, as well as a “time-out” period after that, with the timing for each depending on the partner’s involvement in the audit;

- address auditor conflicts of interest arising from audit partner compensation and employment by issuer clients; and
- require disclosures of information related to audit and non-audit services provided by, and fees paid to, a company’s outside auditor.

Summary of Changes from Proposals

The final rules were adopted substantially as proposed, although some important changes were made. Below is a summary of some of the most significant changes from the original proposals:

- The SEC clarified the scope of certain prohibited non-audit services;
- The audit partner rotation rules were changed from the proposals to provide a five-year rotation period and a five-year “time-out” period for lead and concurring partners and a seven-year mandatory rotation period with a two-year “time-out” period for certain other audit partners depending on the partner’s involvement in the audit, and to exempt all other audit partners;
- The SEC added an exemption to the rules related to avoiding conflicts arising from employment with an audit client to exclude from such rule members of an audit engagement team that provide less than ten hours of services during an annual audit period, and also provided additional exemptions for conflicts created through mergers or acquisitions and for emergency or unusual circumstances;
- The SEC also clarified the determination of the time period during which members of an audit engagement team may not take a position and serve in a financial reporting oversight role at an issuer client by providing a uniform date for all members of the engagement team; and
- The SEC narrowed the rules related to compensation of partners for non-audit services to apply only to audit partners, not every member

of an audit engagement team, and specified that the compensation must be based on an audit partner's procuring engagements to provide non-audit services.

Audit Committee Oversight of the Audit Engagement

Recognizing "the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence", the SEC rules, consistent with Section 202 of the Act, require that the audit committee pre-approve all audit, review and attest services, as well as all engagements for permissible non-audit services.

Audit Committee Pre-Approval

The SEC's rules require that, before the audit firm is engaged to provide any audit or permissible non-audit services, the engagement must be pre-approved by the audit committee or entered into pursuant to pre-approval policies and procedures established by the audit committee. If the latter, such policies and procedures must be detailed as to the particular service, may not include delegation of the audit committee's responsibilities to management and must be disclosed as discussed below. The SEC clarified that either alternative is equally valid. The SEC noted in its adopting release that it expects that pre-approval policies and procedures would be "prudent and responsible" and, further, that audit committees would establish policies for the maximum period in advance of the service that the approval may be granted. In addition, the SEC noted that Section 202 of the Act allows the audit committee to delegate to one or more of its members the authority to grant pre-approval of non-audit services, including tax services, and all audit, review and attest services so long as the pre-approval policies are detailed as to the particular service approved, the audit committee is informed of each service and the pre-approval policies do not delegate the audit committee's responsibilities to management.

The pre-approval requirement would be waived for non-audit services that (i) were not recognized to be non-audit services at the time of engagement, (ii) constitute less than five percent of the total revenues paid to the auditors during the same fiscal year, and (iii) are promptly brought to the attention of the audit committee and approved prior to completion of the audit. As the SEC noted in the proposing release, this *de minimis* exception is intended to mitigate the costs of inadvertent violations of the Act and the rules. Thus, it is not intended as a safe harbor on which to rely prospectively.

The pre-approval requirement applies to all engagements for audit, review and attest services and permissible non-audit services entered into after May 6, 2003. Audit and permissible non-audit services, even if not pre-approved, may continue after May 6, 2003 and will not be considered to impair an accountant's independence, but only if they are pursuant to contracts entered into before that date. However, for permissible non-audit services entered into prior to May 6, 2003, regardless of whether or not they were pre-approved by the audit committee, the audit firm must complete those services by May 6, 2004.

Non-Audit Services

In accordance with Section 201(a) of the Act, the SEC rules prohibit auditors registered with the Public Company Accounting Oversight Board, certified public accountants and public accountants in connection with an engagement for which independence is required from performing the following non-audit services for an audit client during the audit and professional engagement period:

- bookkeeping or other services related to the audit client's accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing;
- management functions or human resources;
- broker-dealer, investment adviser or investment banking services;
- legal services; and
- expert services unrelated to the audit.

The rules provide a transition period for the provision of prohibited non-audit services. Until May 6, 2004, the provision of the above services will not impair an accountant's independence so long as they are provided pursuant to contracts in existence on May 6, 2003.

The SEC's principles for determining which services would impair an accountant's independence are based on prohibiting any service that could "reasonably" conflict with the principles set forth in the existing auditor independence rules under Regulation S-X, namely, that an auditor should not:

- *audit its own work* as it would if it provided internal audit outsourcing services, financial

information systems design, or appraisal, valuation, actuarial, or bookkeeping services that would later be subject to its own audit procedures to an audit client;

- *perform management functions* as it would if it provided human resources services such as recruiting, hiring, and designing compensation packages for the officers, directors, and managers of an audit client;
- *act as an advocate for its audit client* as it would if it provided legal and expert services to an audit client in judicial or regulatory proceedings; or
- *promote the company's stock or other financial interests* as it would be if it served as a broker, dealer, investment adviser, or investment banker for the company.

With respect to the prohibitions on bookkeeping, financial information systems design and implementation, appraisal, valuation, fairness opinions or contribution-in-kind reports, actuarial services, and internal outsourcing services, the final rules clarify that the provision of such services will cause the auditor to lack independence unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. In its adopting release, the SEC noted that the change from "reasonably likely" in the proposals to "unless it is reasonable to conclude" in the final rules was intended to emphasize the responsibility the audit firm has in making the determination that the provision of these services will not be subject to audit procedures.

Expert Services

In its final rules, the SEC has taken the position that expert services, which the Act includes in the list of prohibited services but which the SEC had expressly decided not to prohibit at the time it adopted its existing rules, may impair an accountant's independence as to an audit client.

The rules prohibit the provision of expert services on the ground that it violates the basic principle that an auditor should not act as an advocate for its audit client. Specifically, auditors would be prohibited from providing 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, including providing forensic accounting services to the audit client's counsel in connection with an SEC enforcement investigation or serving as an expert witness in a utility rate setting proceeding in support of an audit client's request for an increase in fees.

The SEC's rules, however, would not prohibit an auditor from assisting the audit committee in its own investigation of a potential accounting impropriety or complying with the auditor's obligations under Section 10A of the Exchange Act to search for fraud material to an issuer's financial statements and keep the audit committee informed of its findings, so long as the auditor did not take on the role of an advocate. For example, an auditor may render forensic services to the audit committee and share its work product with the audit committee's counsel. Similarly, an auditor would be permitted to testify as a fact witness to its audit work for a particular audit client. Moreover, an accounting firm that, after receiving appropriate authorization from an audit client's audit committee, had prepared an audit client's tax returns could appear as a fact witness in tax court to explain how the returns were prepared. The SEC noted that should a litigation arise or an investigation be commenced at the time the auditors were conducting their investigation, the completion of their procedures would not be deemed prohibited expert services so long as the auditors remain in control of their work and do not become subject to the direction or control of counsel to the issuer.

Tax Services

The rules permit tax services such as tax compliance, tax planning and tax advice to continue to be provided to an audit client if they have been pre-approved by the client's audit committee and are not, in effect, prohibited legal or expert services. Tax services that might be regarded as prohibited legal or expert services include representing an audit client before a tax court, which would involve an accountant's serving as an advocate for his or her client, and formulating tax shelters, which may require the accountant to audit his or her own work, assume a management function or become an advocate for a client in seeking to minimize tax obligations or defend novel tax issues.

Auditor Communication with Audit Committees

The SEC's rules require each accounting firm registered with the Oversight Board that audits a company's financial statements to report (orally or in writing) to the audit committee prior to filing the related audit report with the SEC:

- all critical accounting policies and practices used by the company, including critical accounting estimates, the selection of initial accounting policies, reasons why certain policies are or are not considered critical, and how current and future events affect that determination;

- all material alternative accounting treatments that have been discussed with management, including the ramifications of their use and the auditors' preferred treatment; and
- other material written communications between management and the auditors that would facilitate auditor and management oversight by the audit committee (e.g., management representation letters, internal controls reports, schedules of material adjustments and proposed reclassifications, listings of adjustments and reclassifications not recorded, engagement letters and independence letters).

The final rules were clarified to make clear that the rules only required communication of "material" alternate accounting treatments and were not meant to require reporting on the application of accounting principles to relatively small transactions or events.

As noted above, the rules regarding auditor communications with the audit committee do not become effective until the accounting firm is registered with the Oversight Board.

Audit Partner Rotation

Section 203 of the Act requires the lead audit partner and the reviewing partners directly involved in an audit, review or attest engagement to rotate off the engagement after five consecutive fiscal years. The SEC's rules implement this provision by requiring that the lead and concurring partners rotate after five consecutive fiscal years as the lead or concurring partner on an engagement and require a five-year "time-out" period after that.

Unlike the original proposals, which also proposed to extend the rotation requirements to all other partners on the audit engagement, the final rules only extend rotation and time-out period requirements to certain other partners performing audit services. In addition to the lead and concurring partners, the rotation rules also apply to a set of partners defined as "audit partners". The rules require that "audit partners", other than the lead and concurring partners, must rotate off the engagement after seven consecutive years and then are subject to a two-year "time-out" period.

As defined by the rules, "audit partners" are those partners who have responsibility for decision-making affecting the audit or who maintain regular contact with management and the audit committee. In addition to the lead and concurring partners, "audit partners" include all partners who serve the client at the parent or issuer level, other than "specialty" partners. Further, the lead partner on significant subsidiaries (those constituting 20% or more of consolidated revenues or assets of the client) is included within the

definition of "audit partners". Other partners that do not fall within the term audit partners are not subject to the rotation requirements. A partner could, in compliance with the rotation requirements, serve either as a lead partner on a significant subsidiary or as an "audit partner" at the parent or issuer level for two years prior to becoming the lead or concurring partner on the engagement and still be able to serve in that capacity for five years.

The rotation and time-out requirements would apply to "tax" partners who perform significant tax services related to the audit and necessary to its completion, but not to partners providing tax compliance or tax planning services pursuant to audit committee pre-approval.

"National office" partners who serve as technical resources for the audit team and may be consulted on issues related to a specific client on a regular basis would not be considered members of the audit engagement team and, thus, would not be subject to the rotation requirement.

In order to allow firms to establish an orderly transition of their audit engagement teams, the SEC adopted transition rules for the partner rotation requirements. The rotation requirements applicable to the lead partner are effective for the first fiscal year of the issuer client ending after May 6, 2003. In determining when the lead partner must rotate, time served in the capacity of lead partner prior to the effective date of the rules is included. The rotation requirements for the concurring partner are effective for the second fiscal year ending after May 6, 2003. Similar to the lead partner, time served in that capacity prior to the effective date of the rules is included in determining when rotation is required. For all other partners, the rules are effective as of the beginning of the first fiscal year after May 6, 2003. However, in determining the time served, that first fiscal year will constitute the first year of service for such partners. For all partners with foreign accounting firms who are subject to the rotation requirements, including lead and concurring partners, the rules are effective as of the beginning of the first fiscal year after May 6, 2003. In determining time served for these partners, that first fiscal year will constitute the first year of service for such partners. The staggered effective dates and varying treatments of years of service were meant to provide longer transition periods for partners that had not previously been subject to rotation requirements.

Avoiding Conflicts Arising From Employment and Compensation

Employment Relationships

The SEC adopted a one-year “cooling-off” period, during which certain members of an audit engagement team may not take a position and serve in a financial reporting oversight role at an “issuer”. The scope of the final rules was changed to only address employment relationships entered into between members of the audit engagement team and an “issuer” (as apposed to an “audit client” as originally proposed). This was intended to narrow the relationships affected, particularly in situations where a member of the audit engagement team begins employment with an affiliate of the audit client. The term “financial reporting oversight role” means a role in which a person is in a position to, or does, influence (i) the financial statements and related information (e.g., MD&A) to be included in an SEC filing or (ii) any person who prepares them, including the company’s directors, president, CEO, CFO, COO, general counsel, chief accounting officer, controller, director of internal audit or financial reporting or treasurer.

The cooling-off period adopted in the final rule was modified to result in a uniform date for all members of the engagement team. The cooling-off period must be for one full audit year and is based on the dates an issuer files its periodic annual report with the SEC. The one-year period begins the day after the prior year’s annual report (e.g., Form 10-K, 10-KSB, 20-F or 40-F) is filed with the SEC and ends the day the current year’s periodic annual report is filed with the SEC. Any person who performed audit, review or attest services at any time during an audit year would not be able to begin employment with an issuer until one full audit year had passed subsequent to when such person was a member of the audit engagement team. For example, if an issuer client files its Form 10-K annual report for 2002 on March 20, 2003 and its Form 10-K annual report for 2003 on March 15, 2004, its audit firm will lose its independence if an audit firm employee was a member of the audit engagement team that provided any audit, review or attest services to that client at any time between March 21, 2003 and March 15, 2004 (e.g., at any time during the last full completed audit engagement period) and is hired before the day after the issuer files its annual report for 2004.

Pursuant to the final rules, only certain members of the audit engagement team would be subject to the cooling-off period. A distinction was added in the final rules exempting members of the audit team, other than the “lead” or “concurring” partner, who provide less than ten hours of services from the scope

of the rules. As a result, all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement and all persons who consult with others on the audit engagement team regarding technical or industry specific issues, transactions or events who provided more than ten hours of services are subject to the cooling-off period. The lead partner and the concurring partner would be subject to the cooling-off period regardless of the number of hours of services provided. The final rules also provide exceptions to the cooling-off period for persons who become employed by an issuer as a result of a business combination, provided employment was not in contemplation of the business combination and the audit committee of the successor is aware of the prior employment relationship, as well as persons employed due to an emergency or other unusual situation, provided that the audit committee determines that the relationship is in the interest of investors.

The rules are effective for employment relationships with an issuer that begin after May 6, 2003.

Compensation

Under the SEC’s proposal, an accountant would not be independent if at any time during the audit and professional engagement period any person who is a part of the audit engagement team earns or receives compensation based on performing or procuring an engagement to provide a service other than an audit, review or attestation. The final rules differ in several material respects. The final rules apply only to “audit partners.” “Audit partner” is a new term that, as defined by the SEC, includes the lead and concurring partners and other partners on an audit engagement who have significant decision-making responsibilities in connection with the audit or who maintain regular contact with management or the audit committee. In addition to the lead and concurring partners of the issuer, specifically included in the definition of “audit partners” is the lead partner on significant subsidiaries of the issuer (those constituting 20% or more of consolidated revenues or assets of the client). The rules as adopted do not include “specialty” partners who have limited relationships with management in the definition of “audit partners”. The rules also do not apply to non-partner audit engagement team members. The final rules also clarified that compensation concerns exist only where the audit partner’s compensation is based on the act of procuring engagements to provide non-audit services to his or her own clients. This was intended to clarify that the rules would not preclude an audit partner from receiving as compensation a proportionate share of an accounting firm’s overall profits, including fees for non-audit services earned by other partners. The SEC clarified that a specialty partner (e.g., a tax part-

ner) could be compensated for selling non-audit services within his or her discipline without threatening his or her independence.

Significantly, while the final rule does not apply to persons other than audit partners, the SEC noted that, when pre-approving non-audit services, an audit committee may wish to consider whether compensating a senior staff member of the audit engagement team based on his or her success in selling the services to the company compromises that individual's or the audit firm's independence.

These rules are effective for fiscal periods of the accounting firm that commence after May 6, 2003.

Expanded Disclosure

Principal Accountants' Fees

To enable investors to better evaluate the reliability of financial statements and the independence of the auditors that prepare them, the SEC's rules expand disclosure of fees paid for audit and non-audit services to include, in addition to audit fees¹ and "all other fees" (disclosure as to which is currently required for U.S. issuers), audit-related fees and tax fees. Non-U.S. issuers will now be required to provide disclosure for all four categories of fees. The final rules clarified that audit fees are expected to include all fees for services to comply with GAAS. The disclosure is required to be included in a company's proxy or information statement and incorporated by reference into its annual report. Companies that do not file proxy statements, including non-U.S. issuers, are required to include the disclosure in their annual reports on Form 10-K, 20-F or 40-F. (Asset-backed issuers are exempt.)

Audit-related fees include fees for employee benefit plan audits, M&A due diligence, accounting assistance and audits in connection with proposed or consummated acquisitions, internal control reviews, and consultations concerning financial accounting and reporting standards.

Tax fees include (i) tax compliance, including the preparation of tax returns, refund claims and tax payment planning services, and (ii) tax consultation and planning, including assistance and representation in connection with tax audits and appeals, M&A and employee benefit plan tax advice, and requests for rulings or tax advice from taxing authorities.

Disclosure is required for the two most recent fiscal years rather than only for the most recent fiscal year, as is currently required. Other than for the audit fees category, the rules also require a description, in qualitative terms, of the types of services provided under the remaining three categories.

Audit Committee Actions

The SEC's rules also require that companies filing proxy statements disclose any pre-approval policies and procedures developed by the audit committee for the purpose of engaging the independent auditor to perform audit, review and attest services or any non-audit services. Additionally, to the extent that an audit committee has applied the *de minimis* exception discussed previously, companies must disclose the percentage of the total fees, by category, paid to the independent accountant where the *de minimis* exception was used.

Non-U.S. issuers that do not file proxy statements would be required to include these disclosures in their annual reports on Form 20-F or 40-F.

These expanded disclosure provisions are effective for periodic annual filings for fiscal years ending after December 15, 2003, although earlier adoption is encouraged.

Exchange Act Violations

The SEC adopted these auditor independence rules (except for the proxy disclosure changes) as part of Regulation S-X, where the current auditor independence requirements are located. In addition, the SEC adopted a separate rule under Section 10A of the Exchange Act to clarify that conduct impairing independence also constitutes an Exchange Act violation.

1. Audit fees include fees for services that generally only the independent auditor can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of SEC filings.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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