On January 22, 2003, the SEC adopted rules that implement portions of Sections 201, 202, 203, 204 and 206 of the Sarbanes-Oxley Act of 2002 (the “Act”). The new rules, which apply to domestic and foreign companies filing annual reports under the Securities Exchange Act of 1934 (the “Exchange Act”) and their auditors, strengthen and expand the SEC’s rules on auditor independence. The newly adopted auditor independence rules:

- revise the Commission’s regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm’s independence;
- require that an issuer’s audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of the issuer’s financial statements;
- prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years;
- prohibit an accounting firm from auditing an issuer’s financial statements if certain members of management of that issuer had been members of the accounting firm’s audit engagement team within the one-year period preceding the commencement of audit procedures;
- require that the auditor of an issuer’s financial statements report certain matters to the issuer’s audit committee, including critical accounting policies used by the issuer;
- require disclosure to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of an issuer’s financial statements; and
- provide that an accountant would not be independent from an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

### Scope of Services Provided by Auditors

Section 201(a) of the Act, which added new Section 10A(g) to the Exchange Act, enumerates nine categories of non-audit services that are unlawful for registered public accounting firms to provide to an issuer where the accounting firm is simultaneously providing audit services to that issuer. The Commission’s new rules modify Rule 2-01(c)(4) of Regulation S-X to clarify the scope of the prohibited categories of non-audit services. Under the revised Rule, an accounting firm will not be independent with respect to a client issuer if the accounting firm provides any of the following categories of non-audit services to the client issuer:

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

The new rules define the scope of these prohibited services and will need to be closely examined both by auditors and by issuers seeking to retain their auditor for any non-audit services.

In order to facilitate the transition of issuers and accounting firms to these new rules, the rules provide that until May 6,
2004 the provision of the prohibited services will not impair an auditor’s independence so long as those services are provided pursuant to contracts that are in existence on May 6, 2003, and so long as those services do not impair independence under the pre-existing rules.

Audit Committee Administration of the Audit Engagement

Section 202 of the Act provides that the audit committee of a public company must pre-approve any services, whether audit or permitted non-audit services, to be provided by the company’s accounting firm. The SEC has adopted new Rule 2-01(c)(7) of Regulation S-X to embody this requirement of the Act and to clarify that, to the extent permitted by the Act, the audit committee may pre-approve audit and non-audit services based on policies and procedures and that explicit approval and approval based on policies and procedures are equally acceptable. Under the SEC’s new rules, before an accountant is engaged by an issuer or its subsidiaries, or by a registered investment company or its subsidiaries, to provide audit, review or attest services, the engagement must be:

- approved by the audit committee of the issuer or registered investment company; or
- entered into pursuant to the pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided that:
  - the policies and procedures are detailed as to the particular service,
  - the audit committee is informed of each service, and
  - the policies and procedures do not include delegation of the audit committee’s responsibilities to management.

In addition, the new rules would permit an audit committee to delegate authority to an individual member of the audit committee, who must be independent, to pre-approve services. Any approval made by a designated audit committee member must be reported to the full audit committee at the committee’s regular meetings.

The new rules also provide a de minimis exception related to the provision of permitted non-audit services to an issuer, if:

- all such services do not aggregate to more than five percent of total revenues paid by the issuer to its accountant for the fiscal year in which such services are provided;
- the services were not recognized as non-audit services at the time of the engagement; and
- the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives.

Partner Rotation

Section 203 of the Act requires rotation of certain audit partners on a five-year basis. In order to implement this requirement, the SEC’s newly adopted new Rule 2-01(c)(6) of Regulation S-X requires the rotation of “audit partners” on a five-year or seven-year basis. The SEC has defined “audit partners” to include partners on the audit engagement team (i) who have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements or (ii) who maintain regular client contact with management and the audit committee. This definition would include those who service an issuer at the issuer or parent level, other than specialty partners, as well as the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer. Specialty partners and partners with national office duties are not included in the definition of audit partners.

Audit partners who are the lead or concurring partner on an audit engagement will be required to rotate after no more than five years and, upon rotation, will be subject to a five-year “time out” period. All other audit partners on an engagement will be required to rotate after no more than seven years and to be subject to a two-year time-out. The SEC has also provided a limited exemption to these rotation requirements for very small accounting firms.

The rotation requirements for lead partners will be effective for the first fiscal year ending after May 6, 2003. In determining when the lead partner must rotate, time served in that capacity prior to May 6, 2003 will be counted.
The rotation requirements for concurring partners will be effective for the second fiscal year ending after May 6, 2003. In determining when the concurring partner must rotate, time served in that capacity prior to May 6, 2003 will be counted.

The rotation requirements for all audit partners other than lead and concurring partners are effective as of the beginning of the first fiscal year ending after May 6, 2003. In determining the time served, however, that first fiscal year will constitute the first year of service for these audit partners.

Conflicts of Interest Resulting from Employment Relationships

Section 206 of the Act requires a “cooling-off” period of one year before a member of an audit engagement team can begin working for a public company in certain key positions. Accordingly, the Commission has revised Rule 2-01(c)(2) of Regulation S-X to require that when the lead partner, the concurring partner or any other member of the audit engagement team who provides more than ten hours of audit, review or attest services for the company accepts a position with the issuer in a financial reporting oversight role within the one year preceding the commencement of audit procedures for the year that included the commencement of employment by the company of the former member of the audit engagement team, the accounting firm is not independent with respect to that company.

The SEC defines “financial reporting oversight role” to include any individual who has direct responsibility for oversight over those who prepare the company’s financial statements and related information, such as the Management’s Discussion and Analysis included in filings with the Commission. This definition would capture, among others, the CEO, COO, CAO and other similar officers, as well as members of the Board of Directors who have significant interaction with the audit engagement team.

For purposes of the rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year’s periodic annual report (e.g., Form 10-K, 10-KSB, 20-F or 40-F) is filed with the Commission.

The rule as adopted does include certain exceptions, including an exception for conflicts created as a result of mergers and other acquisitions.

This rule is effective for employment relationships with the issuer that commence after May 6, 2003.

Communication with Audit Committees

Section 204 of the Act directs the Commission to issue rules requiring timely reporting of specific information by accountants to audit committees. Accordingly, the Commission has adopted new Rule 2-07 of Regulation S-X to require that accountants report to audit committees regarding:

- critical accounting policies and procedures;
- alternative accounting treatments; and
- other material written communications with management.

The SEC is not requiring that discussions regarding critical accounting policies and procedures follow a specific form or manner. The Commission does expect, however, that, at a minimum, the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the applicable accounting guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, the Commission anticipates that the communications regarding critical accounting policies will include an assessment of management’s accounting disclosure along with any significant proposed modifications by the accountants that were not included in management’s accounting disclosure.

The rules require communication, either orally or in writing, by accountants to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm. If the accounting treatment selected is not, in the accountant’s view, the preferred method, the accountant should also discuss with the audit committee the reasons why the accountant’s preferred method was not selected by management.

In adopting the new rules, the SEC provided the following examples of written communications that it will consider to be material to an issuer and, therefore, that it will consider to be required disclosures to the audit committee:

- the management letter;
• schedules of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any;
• the management representation letter;
• reports on observations and recommendations of internal controls;
• the engagement letter; and
• the independence letter.

The new rule provides that the required communications must occur prior to the filing of an audit report with the SEC pursuant to applicable securities laws. This means that the communications must occur at least annually, although the Commission expects that, in practice, they will occur at least quarterly. The new communications requirements will be effective May 6, 2003.

**Expanded Investor Disclosure**

Existing Item 9(e) of Schedule 14A under the Exchange Act requires each issuer to annually disclose the amount of audit fees paid by the issuer to its accounting firm. In light of the prohibition of the provision of certain non-audit services by public company auditors and the expanded role of the audit committee in administering the audit engagement, the SEC has revised Item 9(e) of Schedule 14A under the Exchange Act to require expanded disclosure. Under the revised rule, an issuer must provide disclosure of fees paid to the independent accountant segregated into four categories:

- Audit Fees;
- Audit-Related Fees;
- Tax Fees; and
- All Other Fees.

Additionally, for each category other than Audit Fees, the issuer must describe, in qualitative terms, the types of services provided. The information is required for each of the two most recently completed fiscal years. The issuer must provide the disclosure either in its proxy statement or in its periodic annual filing (e.g., Form 10-K, 10-KSB, 20-F or 40-F).

The amended disclosure provisions will be effective for periodic annual filings for the first fiscal year ended after December 15, 2003. The SEC, however, encourages issuers to comply with the revised requirements earlier.

**Audit Partner Compensation**

While not addressed by the Act specifically, the SEC has raised the issue of whether the manner in which some accounting firms compensate their professionals may adversely affect auditor independence. As a result of this concern, the Commission has adopted new Rule 2-01(c)(8) of Regulation S-X to prohibit accounting firms from establishing an audit partner’s compensation or allocation of partnership units based on the sale of non-audit services to the partner’s audit clients. The definition of audit partners for purposes of this prohibition is the same as that used for purposes of the auditor rotation requirements discussed above.

The new rule does not preclude an audit partner from sharing in the profits of the audit practice and those of the overall firm. Instead, the rule provides that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner, other than specialty partners, earns or receives compensation based on selling engagements to that audit client to provide any services other than audit, review or attest services.

The provisions of this new rule will be effective with respect to an accounting firm beginning in the fiscal period of the accounting firm that commences after May 6, 2003.

**Next Steps**

The new and revised auditor independence rules adopted by the Commission are highly fact-specific. As a result, it is very important that the management and audit committee of each issuer begin discussions as soon as possible with their auditor to determine the impact of these rules on the issuer’s relationship with the auditor.

**Obtaining the SEC’s Release**

You can locate the SEC’s release, which contains greater detail about the new auditor independence rules, on the SEC’s Web site at:

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For more information on the foregoing or other securities matters, please contact the author of this client memorandum (Troy M. Calkins at 202-230-5139), any member of our Securities Practice Group listed below, or your regular Gardner Carton & Douglas contact.

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