



# TROUTMAN SANDERS LLP

February 3, 2003

## SEC ISSUES FINAL RULES ON AUDITOR INDEPENDENCE

On January 28, 2003, the Securities and Exchange Commission released final rules implementing Title II of the Sarbanes-Oxley Act, which addresses auditor independence. The effective date of the rules is ninety days after their publication in the Federal Register, which will occur in the next few weeks. Specific transition periods for certain provisions are described below.

**Scope.** The new rules apply to public companies and their auditors. As a practical matter, however, the rules may affect other entities as well.

**State Modeling.** Although both the Senate Report and the Release note that these rules may not be appropriate models for broader state regulation, states may nonetheless pass Sarbanes-like laws with broader applicability.

**"Best Practices."** If the market begins to perceive the new requirements as being "best practices," there may be pressure for entities that are not legally obligated to comply with the new requirements to comply nonetheless.

**One Year "Cooling Off" Period.** The rules strengthen current conflicts of interest provisions by implementing a one year "cooling off" period during which a former member of an audit engagement team cannot assume a "financial reporting oversight role" with a former audit client. A "financial reporting oversight role" is a role in which one has direct responsibility for, or oversight over, the preparation of a registrant's financial statements and related information, such as MD&A disclosure, which will be filed with the SEC. The audit team members covered include the lead partner, the concurring partner, and any other member of an audit engagement team who provides more than ten hours of audit, review, or attest services for an issuer within the prior annual audit period.

The cooling off period for an audit team member commences at the conclusion of the audit procedures for a year with respect to which the member provided services. Audit procedures for a given year will be deemed to have begun the day after the filing of the previous year's Form 10-K and to have ended the day the current year's Form 10-K is filed. In other words, the rules require that an accounting firm must have completed one annual audit after a person was a member of an audit engagement team before that person may take a financial

reporting oversight role with that issuer. The rules allow exceptions in instances of subsequent mergers or acquisitions and unusual circumstances.

The rules regarding the one year “cooling off” period will apply to employment relationships that begin after the effective date of the rules.

***Services Outside the Scope of the Practice of Auditors.*** The rules prohibit the contemporaneous provision of both audit and non-audit services to a client, unless the non-audit service is pre-approved by the issuer’s audit committee, and independence is not impaired under current Rule 2-01(b) of Regulation S-X. However, the rules delineate certain non-audit services as “prohibited services” which may never be performed contemporaneously with audit services. The “prohibited services” apply only to non-audit services provided by independent accountants to audit clients; they do not limit the permissible scope of non-audit services provided to non-audit clients.

***“Prohibited Services.”*** The “prohibited services” are: (i) bookkeeping services; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing; (vi) management functions; (vii) human resources functions; (viii) broker-dealer, investment adviser or investment banking services; (ix) legal services; and (x) expert services unrelated to the audit (e.g., forensic accounting services in connection with litigation).

***Tax Services.*** The Release specifically notes that accountants may continue to provide tax services to its audit clients without impairing their independence if the services (i) are pre-approved by the audit committee (as described below), (ii) do not impair independence under the existing standard of Rule 2-01(b), and (iii) are not also “prohibited services.”

Merely labeling a service a “tax service” will not make it permissible if it is, in fact, a prohibited service or otherwise violates Rule 2-01(b). For example, an accountant could not skirt the prohibition on providing broker-dealer services by arguing that the tax implications of some brokerage activity make such services permissible “tax services.” The Release cites tax compliance, tax planning and tax advice services as permissible non-audit tax services. Representation of an audit client before a tax court, district court or federal court of claims, however, would impair auditor independence.

To allow time for completion of existing contracts, the provision of “prohibited services” will not impair an accountant’s independence until twelve months after the effective date of the rules; provided, those services are pursuant to contracts entered into prior to the effective date of the rules.

***Audit Committee Pre-Approval.*** The rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities law. Any such engagement must be (i) approved by the issuer’s audit committee or (ii)

entered into pursuant to detailed pre-approval policies and procedures established by the audit committee. The Release states that neither method of approval is favored over the other.

The rules do not mandate the creation of an audit committee. If there is no such committee, the rules deem the board of directors to be the audit committee for pre-approval purposes. The audit committee may delegate its authority to pre-approve audit and non-audit engagements to a single member. There is a *de minimis* exception to pre-approval, which the legislative history indicates is intended for rare instances where a non-audit service is commenced under the belief that it is an audit service.

The rules regarding pre-approval will apply to all audit, review, and attest services and non-audit services entered into after the effective date of the rules. Accounting firms must complete any non-audit services entered into prior to the effective date of the rules within twelve months of that effective date.

***Partner Rotation.*** The rules adopt partner rotation requirements that go beyond the requirements of the Sarbanes-Oxley Act.

The rules implement a “five years on, five years off” rotation requirement for lead and concurring partners. The rotation requirement for lead partners will be effective for the first fiscal year ending after the effective date of the rules. The rotation requirement for concurring partners will be effective as of the end of the second fiscal year after the effective date of the rules. For both lead and concurring partners, time served in that role prior to the effective date will be included in calculating rotation periods.

The rules implement a “seven years on, two years off” rotation requirement for “audit partners.” The term “audit partner” includes partners who have responsibility for decision-making on significant matters affecting the financial statements of an audit client or who maintain regular contact with management and the audit committee. All partners who serve the client at the issuer or parent level would be covered. Additionally, “audit partner” includes the lead partner on subsidiaries whose assets or revenues are 20% or more of consolidated assets or revenues of an issuer. National-office partners and specialty partners, such as tax partners, will not be considered “audit partners” who are subject to rotation. The rotation requirement for “audit partners” will be effective as of the beginning of the first fiscal year after the effective date of the rules. For purposes of calculating rotation periods, that first fiscal year will be the first year in the seven year rotation period, regardless of prior service.

To ease the impact of the rotation requirements on smaller firms, the rules provide an alternative for firms with fewer than five issuer audit clients and fewer than ten partners. Such firms may either comply with the partner rotation requirements or undergo review of all their engagements subject to these rules by the Public Company Accounting Oversight Board at least once every three years.

***Ban on Compensation for “Cross-Selling.”*** The rules provide that an accounting firm is not independent if any “audit partner” (other than specialty partners, such as tax partners) receives compensation based on the cross-selling to the audit client of services other than audit,

review or attestation services. “Compensation” is any form of income or monetary benefit, including the allocation of partnership shares or units. The rules, however, do not preclude an audit partner from sharing in profits of the audit practice or of the firm as a whole. Furthermore, accounting firms with fewer than five issuer audit clients and fewer than ten partners are exempt from these rules. These provisions will be effective as of the beginning of an accounting firm’s first fiscal year following the effective date of the rules.

***Communication with the Audit Committee.*** The rules mandate that the auditor communicate the following items to the audit committee prior to the filing of an audit report with the SEC pursuant to securities laws: (i) “critical accounting policies”; (ii) alternative accounting treatments; and (iii) other written material communications. The communications do not have to be written, but the SEC does expect that communications will be documented by the accountant and audit committee.

***“Critical Accounting Policies.”*** “Critical accounting policies” encompass both the policies and estimates (i) most important to the audit client’s results and condition and (ii) that require the most difficult, subjective or complex judgments by management. The rules do not specify a specific format for these communications. However, the Release notes that the SEC expects that the discussion will include the reasons why policies and estimates are or are not considered critical, how current and anticipated events impact those determinations, an assessment of management’s disclosures and any significant modifications proposed by the accountants.

***Alternative Accounting Treatments.*** The auditor must communicate to the audit committee the available accounting treatments under GAAP and the bases for the chosen approaches regarding all material items discussed with management, including recognition, measurement and disclosure issues, as well as general accounting policies. If the auditor does not apply an existing accounting policy, or there is no applicable policy, the auditor must also explain why there is no standing policy and the basis for the eventual choice. If the audit client chooses an accounting treatment other than that preferred by the auditor, the auditor must convey the reason for that choice to the audit committee as well.

***Other Written Material Communications.*** The auditor must also communicate to the audit committee any other written material communications that the auditor had with the company. Examples of such communications are management representation letters, schedules of unadjusted differences and engagement letters, among other documents.

***Expanded Disclosure.*** The rules expand disclosure currently required regarding audit engagements by modifying required disclosure of accountant’s fees and adding a requirement to disclose audit committee pre-approval policies.

***Accountant’s Fees.*** Previously, registrants who filed proxy statements were required to disclose the fees paid to their principal accountants in their proxy statement. The new rules expand the required disclosure from the most recent fiscal year to the ***two*** most recent fiscal years. In addition, the types of fees required to be disclosed have been expanded and reorganized. The old disclosure categories consisted of (i) audit fees, (ii) financial systems

design and implementation fees and (iii) all other fees. The new rules require disclosure of (i) audit fees, (ii) audit-related fees, (iii) tax fees and (iv) all other fees. Within each of the four fee categories, the registrant must disclose the percentage of those fees where the *de minimis* exception to pre-approval was used.

*Pre-approval policies.* The rules require disclosure of the policies of the audit committee regarding pre-approval of audit and non-audit services. Registrants who file proxy statements must make the disclosure in their proxy statements, which must then be incorporated into their annual filings. Registrants who do not issue proxy statements must make the disclosure directly in the appropriate annual filing.

The new disclosure requirements will be effective for periodic annual filings for the first fiscal year ending after December 15, 2003.

**Penalties.** Violations of the rules will not only impair auditor independence but will also constitute separate violations under the Securities Exchange Act of 1934.

*This e-mail alert is intended to provide general legal information and does not render legal advice or legal opinion. Such advice may only be given when related to actual fact situations.*

**Contact Us.** If you have any questions or comments, please let any member of our Corporate and Securities Group know, or you can contact the individuals listed below:

**Atlanta**

Jim Smith	james.smith@troutmansanders.com	(404) 885-3111
Brink Dickerson	brink.dickerson@troutmansanders.com	(404) 885-3822
Cal Smith	cal.smith@troutmansanders.com	(404) 885-3352

**Northern Virginia/Virginia Beach**

Jim Wheaton	jim.wheaton@troutmansanders.com	(757) 687-7719
-------------	---------------------------------	----------------

**Richmond**

Jeff Gill	jeff.gill@troutmansanders.com	(804) 697-1332
Jay Johnston	jay.johnston@troutmansanders.com	(804) 697-1214
Susan Ancarrow	susan.ancarrow@troutmansanders.com	(804) 697-1861
Mark Jones	mark.jones@troutmansanders.com	(804) 697-1294