



**FENWICK & WEST LLP**

*CORPORATE & SECURITIES LAW UPDATE*

## SEC Issues Final Rule on Strengthening Auditor Independence

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## SEC Issues Final Rule on Strengthening Auditor Independence

On January 28, 2003 the SEC issued a final rule implementing several sections of Title II of the Sarbanes-Oxley Act of 2002 regarding auditor independence. The complete text of the rule can be found at [www.sec.gov/rules/final/33-8183.htm](http://www.sec.gov/rules/final/33-8183.htm).

Three subsections of the rule relate to corporate governance and disclosure matters affecting public companies generally.<sup>1</sup> These are:

- Scope of services provided by the auditors
- Audit Committee administration of the engagement
- Expanded disclosure

### I. Rule Regarding Scope of Services Provided by the Auditors

The Sarbanes-Oxley Act added provisions to section 10A of the Securities Exchange Act of 1934 prohibiting auditors from providing specified non-audit services to their audit clients and from providing any non-audit services unless pre-approved by the audit committee. In the new rule, the SEC added the new prohibitions to the existing Regulation S-X subsection pertaining to prohibited services. The SEC addressed pre-approval requirements by adding a subsection to Regulation S-X, as discussed in the following section on Audit Committee Administration of the Engagement.

**Prohibited Services.** The nine categories of prohibited services specified in the new rule were also expressly identified in the Sarbanes-Oxley Act. These are:

Bookkeeping or Other Services Related to Accounting Records or Financial Statements of the Audit Client. Regulation S-X previously prohibited bookkeeping services, with limited exceptions that have now been eliminated. Now the auditor can provide bookkeeping services only if it is reasonable to conclude that the results of these services will not be subject to audit procedures.

Financial Information Systems Design and Implementation. The new rule retains the pre-existing prohibition on providing services related to the client's financial information systems unless it is reasonable to conclude that the results of these services will not be subject to audit procedures. This prohibition does not prevent the auditor, in connection

<sup>1</sup> The other sections of the rule, which we do not address here, relate to: conflicts of interest arising from hiring audit firm personnel; the rotation of audit personnel; the prohibition of audit firms from compensating partners for generating other business from their audit clients; and required communications with the audit committee. We would be pleased to discuss further with our clients their impact.

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with its audit or attest services, from evaluating the internal controls of a system as it is being designed, implemented or operated and making recommendations to management.

Appraisal or Valuation Services, Fairness Opinions, or Contribution-in-Kind Reports. The new rule continues an existing prohibition on these services and eliminates exceptions to the prohibition, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures. The rule does not prohibit the accounting firm from providing such services for non-financial reporting, such as transfer pricing studies, cost segregation studies and other tax-only valuations.

Actuarial Services. Auditors may not provide actuarial services involving the determination of amounts that are recorded in the company's financial statements, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures. The new rule does allow the auditor to assist the client in understanding methods, models, assumptions and inputs used in computing amounts recorded in the financial statements.

Internal Audit Outsourcing. Previously a company's internal audit functions could be performed by the independent auditor, with some exceptions. The new rule precludes the auditor from providing these services if they are related to internal accounting controls, financial systems or financial statements, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures.

Management Functions. The new rule maintains the existing prohibition on serving, temporarily or permanently, as a director, officer or employee of the audit client or performing any decision-making, supervisory or ongoing monitoring function for the client.

Human Resources. An auditor may not engage in HR activities relating to management search activities, psychological or other testing services, negotiating employment terms on behalf of the audit client or undertaking reference checks.

Broker-Dealer, Investment Adviser or Investment Banking Services. Auditors are prohibited from providing brokerage or investment advising services, making investment decisions on behalf of the client, executing a transaction to buy or sell a client's investment or having custody of client assets.

Legal Services. The auditor is precluded from providing services that could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction where the services are provided.

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Expert Services. The auditor may not provide an expert opinion or other expert services for an audit client, or the audit client's counsel, for the purpose of advocating the client's interests in litigation or in a regulatory or administrative proceeding or investigation.

***Guiding Principles Re Auditor Independence.*** As indicated by these descriptions of prohibited services, the lines distinguishing permitted from prohibited non-audit services are not completely clear. In interpreting and applying these rules, companies and their auditors should bear in mind the SEC's principles for providing non-audit services to audit clients consistent with auditor independence. These guiding principles are that the auditor cannot:

- function in the role of management
- audit his or her own work
- serve in an advocacy role for the client

***Tax Services.*** The Sarbanes-Oxley Act expressly noted that the auditor was not prohibited from providing tax services for an audit client, subject to requisite pre-approval. Auditors can continue to provide tax services such as tax compliance, planning and advice. However, merely labeling a service as a "tax service" will not insulate that activity if it otherwise falls within one of the prohibited classes of services contained in Regulation S-X, including those described above. In particular, auditors will impair their independence by representing an audit client before a tax or district court or before a court of claims. Further, the SEC advises companies to scrutinize carefully the advisability of retaining the auditor in a transaction recommended by the auditor for the purpose of tax avoidance.

***Transition Period.*** The new rule contains transition provisions for an auditor performing non-audit services that are prohibited by the new rule but not by previous rules of the SEC, the Independence Standards Board or the accounting profession in the United States. If such services are provided under a contract in place on or before May 6, 2003, then these services may continue until May 6, 2004.

## **II. Rule Regarding Audit Committee Administration of the Engagement**

Section 202 of the Sarbanes-Oxley Act requires that audit committees pre-approve all audit and non-audit services provided by the company's audit firm. The new rule adds a subsection to Regulation S-X that states that an accountant is not independent in respect of the company unless the accountant's engagement for audit or non-audit tasks is pre-approved by the audit committee. The pre-approval may occur in one of two ways - actual pre-approval by the audit committee or pursuant to pre-approval policies and procedures established by the committee.

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**Direct Approval.** The committee may directly approve a permitted service before the auditor is engaged for the project. In all cases this approval must occur before the auditor is engaged. Engaging the auditor prior to receipt of audit committee approval would cause the auditor not to be independent of the company.

**Policies and Procedures.** A company may engage the auditor for a permitted service project pursuant to policies and procedures adopted by the audit committee. Approval of services by a single independent member of the audit committee, as allowed by the Sarbanes-Oxley Act, would represent approval pursuant to such a policy and procedure. Companies employing the policies and procedures approach will need to disclose these procedures in their annual filings, as discussed below under Expanded Disclosure.

To engage an audit firm to provide a permitted service based on policies and procedures established by the audit committee, the policies and procedures must be detailed as to the particular service and the audit committee must be informed of the service. The SEC expects that audit committees will indicate the maximum period in advance of the activity that approval may be granted. In addition, the company's policies and procedures must not be so expansive as to represent a delegation of the audit committee responsibilities to management.

**De Minimis Exception.** The new rule contains a limited de minimis exception, under which an auditor will not lose its independent status even though it performs non-audit services without pre-approval. This exception requires that:

- the aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenue paid to the audit firm by the company during the fiscal year in which the services are provided;
- such services were not recognized by the issuer, at the time of the engagement, to be non-audit services; and
- such services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the committee or a single member of the committee to whom authority has been delegated.

**Transition Period.** The new rule applies to all audit and non-audit services entered into after May 6, 2003. Services entered into prior to May 6, 2003 must be completed by May 6, 2004.

### III. Disclosure Obligations

The new rule expands a public company's disclosure requirements in two ways. First, it requires more detailed information about fees paid to the auditors. Second, it requires new disclosure describing the policies and procedures employed to authorize non-audit services without express pre-approval of the audit committee.

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***Fees Paid to Auditors.*** Since 2000 public companies have disclosed in their proxy statements the fees paid to their auditors for audit and non-audit services. Now a greater level of detail will be required, and the information will be provided for the last two fiscal years instead of simply the most recent year. In addition, the rule requires that this information be included in the Annual Report on Form 10-K as well as the proxy statement, but will allow companies to incorporate the information into their Form 10-K from their proxy statements, as is currently allowed for the other information in Part III of Form 10-K.

Commencing with Forms 10-K for fiscal year ending after December 15, 2003, companies must disclose:

- **Audit fees** – this category includes traditional audit and review fees, fees paid for services normally provided by the accountant in connection with statutory and regulatory filings, such as comfort letters, the review of a company’s filings with the SEC and the soon-to-be required attest services. These fees should include fees paid for the involvement of tax personnel to the extent necessary to complete an audit in accordance with generally accepted auditing standards.
- **Audit-related fees** – these are fees paid for services reasonably related to the audit and review of a company’s financial statements, such as benefit plan audits, M&A due diligence, accounting consultations and audits in connection with M&A projects, internal control reviews, attest services not required by statute or regulation and consultation concerning financial accounting and reporting standards.
- **Tax fees** – this category includes fees for all services provided by tax personnel other than services properly included as audit fees.
- **All other fees** – this consists of all fees for products and services not included in one of the other categories.

In addition to providing this fee information, the company must describe in qualitative terms the types of non-audit services that were provided.

***Policies and Procedures.*** Companies that adopt policies and procedures for engaging the auditor on non-audit services must describe these policies and procedures in the proxy statement and annual report on Form 10-K. Similar to the fee disclosure, this information can be included in the proxy statement and incorporated into the Form 10-K. The SEC expects these descriptions to be clear, concise and understandable. Companies may choose to include the policies and procedures themselves rather than a description. If the company used the de minimis exception, the company must disclose the percentage of the total fees paid to the auditor where this exception was used and must provide this information in the specified categories for which fee information is required.

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**Transition Period.** The new rule applies to periodic annual filings for the first fiscal year ending after December 15, 2003. The SEC urges companies to adopt these disclosure provisions earlier.

**What if I have more questions?**

Should you have any questions about these new requirements, please feel free to contact any member of your Fenwick & West team. You may also contact Dan Winnike ([dwinnike@fenwick.com](mailto:dwinnike@fenwick.com)), David Michaels ([dmichaels@fenwick.com](mailto:dmichaels@fenwick.com)), Horace Nash ([hnash@fenwick.com](mailto:hnash@fenwick.com)) or Laird Simons ([lsimons@fenwick.com](mailto:lsimons@fenwick.com)) who contributed to this update.