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Commission Adopts Rules Strengthening Auditor Independence

FOR IMMEDIATE RELEASE 2003-9

Washington, D.C., January 22, 2003 -- The Securities and Exchange Commission today voted to adopt rules to fulfill the mandate of Title II of the Sarbanes-Oxley Act of 2002, strengthen auditor independence and require additional disclosures to investors about the services provided to issuers by the independent accountant.

The Commission approved measures that will

- revise the rules related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence;
- require that certain partners on the audit engagement team rotate after no more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempt from this requirement;
- establish rules that an accounting firm would not be independent 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;
- establish rules that an accountant would not be independent from an audit client if any "audit partner" received compensation based on the partner procuring engagements with that client for services other than audit, review and attest services;
- require the auditor to report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer;
- require the issuer's audit committee to pre-approve all audit and non-audit services provided to the issuer by the auditor; and
- require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor.

Non-Audit Services

Section 201 of the Sarbanes-Oxley Act lists nine non-audit services that, if provided by the accounting firm, impair the firm's independence. The rules approved for adoption by the Commission, will define the prohibited services as follows.

- **Bookkeeping or other services related to the accounting records or financial statements of the audit client**

The rules will prohibit an accountant from auditing the bookkeeping work performed by his or her accounting firm.

- **Financial information systems design and implementation**

Consistent with our previous rules, these rules will prohibit the accounting firm from providing any service related to the audit client's information system, 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. These rules will not preclude an accounting firm from working on hardware or software systems that are

unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

- **Appraisal or valuation services, fairness opinions, or contribution-in-kind reports**

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction. These rules will prohibit the accountant from providing such services 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.

- **Actuarial services**

These rules will prohibit an accountant from providing to an audit client any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client 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. The accountant, however, may assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.

- **Internal audit outsourcing services**

These rules will prohibit the accountant from providing any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems or financial statements 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.

During the conduct of the audit or when providing attest services related to internal controls, the auditor evaluates the company's internal controls and, as a result, may make recommendations to the audit client for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, is not a prohibited service.

- **Management functions or human resources**

Consistent with our proposal, the final rules will prohibit the accountant from 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.

These rules also will provide that an accountant's independence is impaired with respect to an audit client when the accountant seeks out prospective candidates for managerial, executive or director positions; acts as negotiator on the audit client's behalf; or undertakes reference checks of prospective candidates. Under the rule, an accountant's independence also will be impaired when the accountant engages in psychological testing or other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

- **Broker or dealer, investment adviser, or investment banking services**

Acting as a broker-dealer (registered or unregistered), promoter or underwriter on behalf of an audit client and similar activities will make the accountant an advocate for the audit client and will impair the accountant's independence.

- **Legal services**

An accountant will be prohibited from providing to an audit client any service 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**

These rules will prohibit an accountant from providing expert opinions or other expert services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. An accountant's independence will not be impaired, however, by an accountant providing factual accounts or testimony or explaining the positions taken or conclusions reached during the performance of any service by the accountant.

Audit Committee Pre-Approval of Services Provided by Auditor

Sections 201 and 202 of the Sarbanes-Oxley Act provide that an issuer's audit committee must pre-approve allowable services to be provided by the auditor of the issuer's financial statements. The rules will implement those sections of the Act by requiring that the audit committee pre-approve all services. In doing so, the audit committee may establish policies and procedures for pre-approval provided they are consistent with the Act, detailed as to the particular service, and designed to safeguard the continued independence of the accountant.

Consistent with the Act, the rules also will reflect a de minimis exception solely related to the provision of non-audit services for an issuer. This exception waives the pre-approval requirements for non-audit services provided that all such services (1) do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (2) were not recognized as non-audit services at the time of the engagement; and (3) 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.

Disclosures to Investors of Services Provided by the Auditor

Section 202 of the Sarbanes-Oxley Act will require disclosure in periodic reports of non-audit services approved by the audit committee. The rules will require that issuers provide, in their annual reports, fees paid to the independent accountant for (1) audit services, (2) audit-related services, (3) tax services, and (4) other services. Additionally, the disclosures must include the audit committee's policies and procedures for pre-approval of services by the independent accountant as well as the percent of fees paid subject to the de minimis exception.

Permitted Non-audit Service — Tax Service

Section 201 of the Sarbanes-Oxley Act specifically provides that "a registered public accounting firm may engage in any non-audit service, including tax services," that is not expressly prohibited, after audit committee pre-approval. Accordingly, accountants will be able to continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements. There are, however, some circumstances where providing certain tax services to an audit client would impair the independence of an accountant, such as representing an audit client in tax court or other situations involving public advocacy.

Audit Partner

The rules will define a new term—audit partner—for purposes of the requirements for partner rotation and partner compensation. An audit partner will be defined as a partner who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee. The term audit partner will include the lead and concurring partners as well as partners who serve the client at the issuer level, other than a partner who consults with others on the audit engagement team regarding technical or industry-specific issues, and 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.

Partner Rotation

Section 203 of the Sarbanes-Oxley Act specifies that the lead and concurring partner must be subject to rotation requirements after five years. The rules will specify that the lead and concurring partner must rotate after five years and be subject to a five-year "time out" period after rotation. Additionally, certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year time out period.

Compensation

The new rule will provide that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on that partner procuring engagements with the audit client to provide any services other than audit, review or attest services.

Cooling Off Period

Section 206 of the Sarbanes-Oxley Act establishes a one-year cooling off period before a member of the audit engagement team may accept employment in certain, designated positions with an issuer. The rules, therefore, will provide that an accounting firm is not independent if a member of management involved in overseeing financial reporting matters was the lead partner, the concurring partner, or any other member of the audit engagement team who provided more than ten hours of audit, review or attest services for the issuer within the one year period preceding the commencement of the audit of the current year's financial statements.

Auditor Communication With Audit Committee

Section 204 of the Sarbanes-Oxley Act directs the Commission to issue rules requiring timely reporting of specific information by accountants to audit committees. In response to the Act, the rules will require the accounting firm to report, prior to the filing of its audit report with the Commission, to the audit committee (1) all critical accounting policies and practices used by the issuer; (2) all material alternative accounting treatments of financial information within GAAP 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; and (3) other material written communications between the accounting firm and management.

Small Business/Small Firm Considerations

We recognize that some of these provisions may impose an undue burden on certain smaller accounting firms. Accordingly, the rules will provide that firms with fewer than five audit clients and fewer than ten partners may be exempt from the partner rotation and compensation provisions, provided each of these engagements is subject to a special review by the Public Company Accounting Oversight Board at least every three years.

Foreign Considerations

Foreign accounting firms or foreign private issuers may face additional issues in implementing

certain rules. Changes to the proposed rule relating to the depth of partner rotation and the scope of personnel subject to the "cooling off" period apply to foreign accounting firms. Moreover, additional time is being afforded to foreign accounting firms with respect to compliance with rotation requirements. The release also provides guidance on the provision of non-audit services by foreign accounting firms, including the treatment of legal services and tax advice. The SEC also stands ready to work with other regulatory bodies on these issues.

These measures will be effective 90 days after their publication in the Federal Register, with appropriate transition periods for various provisions.

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The full text of detailed releases concerning each of these items will be posted to the SEC Web site as soon as possible.

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