Federal Register

Friday,
December 13, 2002

Part II

Securities and Exchange Commission

17 CFR Parts 210, 240, 249, and 274
Strengthening the Commission's Requirements Regarding Auditor Independence; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 240, 249 and 274

[Release No. 33–8154; 34–46934; 35–27610; IC–25838; IA–2088, FR–64, File No. S7–49–02]

RIN 3235–AI73

Strengthening the Commission's Requirements Regarding Auditor Independence

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''SEC'' or ''Commission'') is proposing amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. The proposed rules recognize the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence. As directed by section 208(a) of the Sarbanes-Oxley Act of 2002, we are proposing rules to: 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; define the circumstances whereby an issuer's audit committee can and should pre-approve all audit and allowable non-audit services provided to the issuer by the auditor of an issuer's financial statements; prohibit partners on the audit engagement team from providing audit services to the issuer for more than five 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; and 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.

In addition to the provisions required by the Act, we also are proposing rules defining an accountant as not being independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based on any service provided or sold to that client other than audit, review and attest services. Further, we proposed to amend and require additional disclosures to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.

DATES: Comments should be received on or before January 13, 2003.

ADDRESSES: You should send three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC, 20549–0609. You also may submit your comments electronically to the following address: *rule-comments@sec.gov.* To help us process and review your comments more efficiently, comments should be submitted by one method only. All comment letters should refer to File No. S7–49–02; this file number should be included in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549–0102. We will post electronically-submitted comment letters on the Commission's Internet Web site (*http://www.sec.gov*). We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Samuel L. Burke, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, at (202) 942–4400, Office of the Chief Accountant, or, with respect to questions about investment companies, Brian D. Bullard, Chief Accountant, at (202) 942–0590, Division of Investment Management, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing to add rule 2–07 to Regulation S–X [1] and to amend rule 2–01 of Regulation S–X,[2] to amend item 9 of Regulation S–K,[3] to amend forms 10–K, 10–KSB, 20–F and 40–F [4] and to amend proposed form N–CSR.[5]

I. Introduction and Background

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley Act'' or ''the Act'') was enacted.[6] Title II of the Sarbanes-Oxley Act, entitled ''Auditor Independence,'' requires the Commission to adopt, by January 26, 2003, final rules, under which certain non-audit services will be prohibited, conflict of interest standards will be strengthened, auditor partner rotation and second partner review requirements will be strengthened, and the relationship between the independent auditor and the audit committee will be clarified and enhanced.

As directed by the Sarbanes-Oxley Act, the proposed rules focus on key aspects of auditor independence:[7] the provision of certain non-audit services and the unique ability of the audit committee to insulate the auditor from the pressures that may be exerted by management, the potential conflict of interest that can be created when a former member of the audit engagement team accepts a key management position with the audit client, and the need for effective communications between the auditor and audit committee. The proposed rules also address the possibility of any partner, principal or shareholder who is a member of the audit engagement team being unduly influenced by financial incentives to sell non-audit services to the audit client.

Title II of the Sarbanes-Oxley Act adds new subsections (g) through (l) to section 10A of the Securities Exchange Act of 1934 as follows:

- Section 201 adds subsection (g), which specifies that a number of non-audit services are prohibited. Many of these services were previously prohibited by the Commission's independence standards adopted in November 2000 (with some exceptions and qualifications).[8] These proposed rules amend the Commission's existing rules on auditor independence and clarify the meaning and scope of the prohibited services under the Sarbanes-Oxley Act.
- Section 201 also adds subsection (h) and requires that non-audit services that are not prohibited under the Sarbanes-Oxley Act and the Commission's rules be subject to pre-approval by the registrant's audit committee. These proposed rules specify the requirements

[1] 17 CFR 210.2–07.

[2] 17 CFR 210.2–01.

[3] 17 CFR 240.14a–101.

[4] 17 CFR 249.310; 17 CFR 249.310b; 17 CFR 249.220f; 17 CFR 249.240f.

[5] 17 CFR 249.331; 17 CFR 274.128.

[6] Pub. L. 107–204, 116 Stat. 745 (2002).

[7] Consistent with the Commission's existing independence rules, these proposals would apply to foreign audit firms as well as firms domiciled in the United States. Additionally, these proposals coupled with the Commission's existing independence rules are proposed with the Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence issued by the International Organization of Securities Commissions (IOSCO) in October 2002 in mind.

[8] The Commission adopted a comprehensive set of rules governing auditor independence on November 21, 2000. *See* Release No. 33–7919 (Nov. 21, 2000); 65 FR 76008 (Dec. 5, 2000) (hereinafter ''November 2000 release'').

for obtaining such pre-approval from the registrant's audit committee.

• Section 202 adds subsection (i), which requires an audit committee to pre-approve allowable non-audit services and specifies certain exceptions to the requirement to obtain pre-approval. These proposed rules specify the requirements of the registrant's audit committee for pre-approving non-audit services by the auditor of the registrant's financial statements.

• Section 203 adds subsection (j), which establishes mandatory rotation of the engagement partner, and the reviewing (or ''concurring'') partner every five years. These proposed rules expand the number of engagement personnel covered by the rotation requirement and clarify the ''time out'' period.

• Section 204 adds subsection (k), which requires that the auditor report on a timely basis certain information to the audit committee. In particular, the Sarbanes-Oxley Act requires that the auditor report to the audit committee on a timely basis (a) all critical accounting policies used by the registrant, (b) alternative accounting treatments that have been discussed with management along with the potential ramifications of using those alternatives, and (c) other written communications provided by the auditor to management, including a schedule of unadjusted audit differences.[9] These proposed rules strengthen the relationship between the audit committee and the auditor.

• Section 206 adds subsection (l) addressing certain conflict of interest provisions. The Sarbanes-Oxley Act prohibits an accounting firm from performing audit services for a registrant if certain key members of management have recently been employed in an audit capacity by the audit firm. These proposed rules clarify which members of management are covered by these conflict of interest rules.

In addition to the mandate under title II of the Act, these proposed rules address situations where partners, principals, or shareholders of the firm who work on the audit of a company are compensated for selling non-audit services to the same audit client.

As noted above, the proposed rules establish and clarify the important roles and responsibilities of registrant audit committees as well as the registrant's independent accountant.[10]

We have proposed a separate rule under Exchange Act section 10A (240.10A–2) to implement section 3(b)(1) of the Sarbanes-Oxley Act and clarify that our rules implementing title II of Sarbanes-Oxley not only define conduct that impairs independence but also constitute separate violations under the Exchange Act. We have otherwise drafted the proposed rules (except for the proxy disclosure changes) as part of Regulation S–X, and propose to place them among the current auditor independence provisions. These provisions are generally based on whether an accountant is ''independent'' in the conduct of the audit. We are considering changing the format from rules defining actions that impair the auditor's independence to rules prohibiting such actions and placing them with other Exchange Act rules. The Act supplemented section 10A of the Exchange Act and gave us express authority to adopt rules to implement these new statutory provisions. Among the reasons to move these rules under that provision is to: (1) Organize the related statutory and regulatory provisions more logically, and (2) make explicit that violations would be punishable as Exchange Act violations, as contemplated by sections 3(b)(1) and 208 of the Sarbanes-Oxley Act, with all the remedies available for Exchange Act violations, including penalties. Even if we were to move the rules out of Regulation S–X, we would intend for these provisions also to remain professional standards of independence. If we move them to be Exchange Act rules, we are considering a new provision in Regulation S–X that would state that a violation of these rules would also render the auditor not independent under Regulation S–X. Violations of these provisions could therefore also result in professional discipline in the event of a violation and cause the issuer's financial statement to fail to conform to Regulation S–X.

We seek comment on this alternative approach. We recognize that auditors have traditionally looked to Regulation S–X as the place where rules relating to audits are placed, and we do not intend to make reference to and compliance with the rules more difficult. We seek comment on whether any conforming changes in other parts of the securities laws would be necessary if we adopted these rules and made them Exchange Act rules. We also seek comment on whether any of the current auditor independence rules or definitions under Regulation S–X, the substance of which we do not propose to change in light of the Sarbanes-Oxley Act, should also be made into Exchange Act rules, or conversely, whether any of the particular proposed or existing rules relating to audits should stay in Regulation S–X even if all or most of the remaining proposed rules are adopted as Exchange Act rules.

II. Discussion of Proposed Rules

A. Conflicts of Interest Resulting From Employment Relationships

The Commission's existing rules deem a firm to not be independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm[11] accepts employment with a client if he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. These proposed rules renumber, but do not otherwise change, that existing requirement.[12]

Consistent with section 206 of the Sarbanes-Oxley Act, we propose adding a restriction on employment with audit clients by former employees of the accounting firm. The Act specifies that an accounting firm cannot perform an audit for a registrant:

> * * * [i]f a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and *participated in any capacity in the audit* of that issuer during the 1-year period preceding the date of the initiation of the audit.[13] (Emphasis added.)

Consistent with that directive, we propose that the employment of audit engagement team[14] members of an accounting firm in a financial reporting oversight role at an audit client within one year prior to the commencement of procedures for the current audit engagement would cause the accounting firm not to be independent with respect to that registrant. The rules that we are proposing would apply to employment relationships entered into between audit engagement team members and their audit clients.[15]

As discussed later in this release, the term ''financial reporting oversight role'' refers to any individual who has direct responsibility for oversight over those

[9] Statement on Auditing Standards No. 89, ''Audit Adjustments,'' (Dec. 1999).

[10] The Commission's proposals respond not only to the provisions of the Sarbanes-Oxley Act but also the rulemaking petitions filed by the AFL–CIO on December 11, 2001, and The Honorable H. Carl McCall on January 21, 2002. Both petitions are available on the Commission's Web site (*http://www.sec.gov*).

[11] The terms accounting firm and accountant are used interchangeably in this proposing release. The term ''accountant'' is defined in 210.2–01(f) below.

[12] 17 CFR 210.2–01(c)(2)(iii)(A).

[13] *See* section 206 of the Sarbanes-Oxley Act.

[14] 17 CFR 210.2–01(f)(7).

[15] 17 CFR 210.2–01(f)(6).

who prepare the registrant's financial statements and related information (*e.g.*, management's discussion and analysis) that are included in filings with the Commission.

The concept of a ''cooling-off'' period before an auditor can take a position at the audit client was previously considered by the Independence Standards Board.[16] In considering a cooling-off period, the Independence Standards Board noted that a mandated cooling-off period for partners and professional staff might create a greater appearance of independence between the accounting firm and the registrant.[17] Ultimately, however, the Independence Standards Board provided for an alternative to a strict cooling-off period. The Independence Standards Board concluded that:

> An audit firm's independence is impaired with respect to an audit client that employs a former firm professional who could, by reason of his or her knowledge of and relationships with the audit firm, adversely influence the quality or effectiveness of the audit, unless the firm has taken steps that effectively eliminate such risk.[18]

Independence Standards Board's Standard No. 3 specifically notes that additional caution is warranted when it has been less than one year since the professional disassociated him or herself from the firm.[19] The provisions of the Sarbanes-Oxley Act reflect the view that the passage of time is the only appropriate safeguard to reduce the perceived loss of independence for the audit firm caused by the acceptance of employment by a member of the engagement team with an audit client.

The Act specifies that the cooling off period must be one year. Under our proposed rules, the prohibition would commence one year prior to the earlier of either when the accountant began the current fiscal year's audit or when the accountant began review procedures necessary to conduct a timely review of the registrant's quarterly financial information associated with the current fiscal year. The measurement period is based upon the year the former employee commenced initial employment. For example, if audit engagement team member A last worked on the audit engagement on January 31, 2002 (audit report filed with the Commission on February 19, 2002), and joined audit client B on September 1, 2003, and the review procedures for B commenced on February 20, 2003, the accounting firm would not lose its independence with respect to the audit client since audit engagement team member A did not participate as an audit engagement team member subsequent to February 19, 2002. With respect to determining commencement dates, generally accepted auditing standards require that an audit engagement be properly planned. As such, procedures associated with the planning of the engagement constitute the commencement of an audit.[20] Additionally, SAS No. 71 establishes the procedures necessary to conduct a timely review of interim information.[21]

The Commission is also considering whether it should provide an exemption from these requirements for companies meeting certain criteria, in order to address the practical difficulties that some companies to hire qualified personnel. The criteria might include the available pool of candidates for a position, the size of the company, and the audit committee's role in ensuring the independence of the auditor.

- Is the one-year cooling-off period sufficiently long to achieve an appearance of independence by the accounting firm? If not, what period would be appropriate?
- Is the term audit engagement team sufficiently clear? If not, what changes would improve the description to describe the group of accountants who would be covered?
- Is the phrase commencement of the audit sufficiently clear? If not, what changes would improve the description? Is that the appropriate time to mark the commencement of the period? Is there a better mark?
- Is the phrase commencement of review procedures sufficiently clear? If not, what changes would improve the description?
- Is it appropriate that the cooling-off period provisions apply to employment relationships involving audit engagement team members and their audit clients? Should the requirements be limited to audit clients who are issuers as defined in section 205 of the Act?
- Are the appropriate officers covered by the proposed rule? If not, which additional individuals should be subject to the cooling-off period provision? For example, should national office personnel who would be excluded under the proposal be included?
- Should the proposed rules apply equally to large firms/companies as small firms/companies? Would the proposed rules impose a cost on smaller issuers that is disproportionate to the benefits that would be achieved? Why or why not? Should there be an exemption to this requirement for smaller businesses?
- The ''cooling off'' period applies to all entities in the investment company complex. Is this too broad? Why or why not?
- Should the Commission include exceptions subject to certain criteria? If so, what should these criteria be?

B. Services Outside the Scope of the Practice of Auditors

Section 201(a) of the Sarbanes-Oxley Act adds new section 10A(g) to the Securities Exchange Act of 1934. This section states that it shall be unlawful for a registered public accounting firm that performs an audit of an issuer's financial statements (and any person associated with such a firm) to provide to that issuer, contemporaneously with the audit, any non-audit service, including nine services set forth in the Act. There is an exception, however, for ''any non-audit service, including tax services, that is not described'' as a prohibited service ''only if'' the service has been pre-approved by the issuer's audit committee. The nine prohibited non-audit services included in the Act are:

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

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[16] The Independence Standards Board was a private sector body that, from 1997 to 2001, was charged with the responsibility to set auditor independence standards for auditors of the financial statements of SEC registrants. *See* Financial Reporting Release Nos. 50 (February 18, 1998) and 50A (July 17, 2001).

[17] Independence Standards Board, ''Employment with Audit Clients,'' *Discussion Memorandum 99–1* (March 12, 1999).

[18] Independence Standards Board, ''Employment with Audit Clients,'' *Standard No. 3* (July 2000).

[19] Id., ¶2(b)(iii).

[20] Considerations necessary to plan an audit engagement are discussed in SAS Nos. 22, ''Planning and Supervision'' (AU § 311), 47, ''Audit Risk and Materiality in Conducting an Audit'' (AU§ 312), 48, ''The Effects of Computer Processing on the Audit of Financial Statements'' (AU §§ 311, 326), 54, ''Illegal Acts by Clients'' (AU § 317), 55, ''Consideration of Internal Control in a Financial Statement Audit'' (AU § 319), 56, ''Analytical Procedures'' (AU § 329), 65, ''The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements'' (AU § 322), 70, ''Service Organizations'' (AU § 324), 73, ''Using the Work of a Specialist'' (AU § 336), 78, ''Consideration of Internal Control in a Financial Statement Audit'' (AU § 319), 82, ''Consideration of Fraud in a Financial Statement Audit'' (AU § 312), 83, ''Establishing an Understanding With the Client'' (AU § 310), 84, ''Communications Between Predecessor and Successor Auditors'' (AU § 315), 89, ''Audit Adjustments'' (AU § 310), and 94, ''The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit'' (AU § 319) as well as amendments to these documents.

[21] SAS No. 71, ''Interim Financial Information'' (AU § 722). In November 2002, the Auditing Standards Board issued SAS No. 100, ''Interim Financial Information.'' SAS No. 100 supercedes SAS No. 71 and is effective for interim periods within fiscal years beginning after December 15, 2002.

- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the Board [22] determines, by regulation, is impermissible.

Many of these services are already the subject of our rules. As explained more fully below, we interpret the legislative history as indicating (1) Congress did not intend the rules to contain broad categorical exceptions and (2) the scope of the prohibited services should be judged against three basic principles. Those three broad principles are that an auditor cannot (1) audit his or her own work, (2) perform management functions, or (3) act as an advocate for the client. To do so would impair the auditor's independence.

Under section 201(b) of the Act, the Board,[23] on a case-by-case basis, may exempt any issuer, accounting firm or transaction from the prohibition on the provision of services under section 10A(g) to the extent that the exemption is ''necessary or appropriate in the public interest and is consistent with the protection of investors, and subject to review by the Commission.''

The Senate Report on the bill that was the primary foundation for the Act,[24] states, in part:

> The intention of this provision is to draw a clear line around a limited list of non-audit services that accounting firms may not provide to public company audit clients because their doing so creates a fundamental conflict of interest for the accounting firms. The list is based on simple principles. An accounting firm, in order to be independent of its audit client, should not audit its own work, which would be involved in providing bookkeeping services, financial information systems design, appraisal or valuation services, actuarial services, and internal audit outsourcing services to an audit client. The accounting firm should not function as part of management or as an employee of the audit client, which would be required if the accounting firm provides human resources services such as recruiting, hiring, and designing compensation packages for the officers, directors, and managers of an audit client. The accounting firm should not act as an advocate of the audit client, which would be involved in providing legal and expert services to an audit client in legal, administrative, or regulatory proceedings, or serving as a broker-dealer, investment adviser, or investment banker to an audit client, which places the auditor in the role of promoting a client's stock or other interests.[25]

In statements made on the floor of the Senate on July 25, 2002, the day the Senate passed the final bill, Senator Sarbanes discussed the auditor independence provisions in the bill and stated, in part:

> What has happened in recent years is that the fees earned from the consulting work have dwarfed the fees earned from the auditors, which inevitably leads to concerns that punches be pulled on the audit to accommodate the significant and remunerative involvement on the consulting side. Certain enumerated consulting practices are therefore not allowed, with the exception that a case-by-case exemption can be obtained from the oversight board that this legislation establishes.* * *
>
> Senator Gramm has suggested that the conference report should be changed to give the SEC or the Oversight Board authority to grant broad categorical exemptions from the list of non-audit services that section 201 of the bill prohibits registered public accounting firms to provide to public company audit clients. Such a change, in my view, would weaken one of the fundamental objectives of the conference report: to draw a bright line around a limited list of non-audit services that accounting firms may not provide to public company audit clients because their doing so creates a fundamental conflict of interest for the accounting firms.
>
> This list is based on a set of simple principles:
>
> A public company auditor, in order to be independent, *should not audit its own work* (as it would if it provided internal audit outsourcing services, financial information systems design, appraisal or valuation services, actuarial services, or bookkeeping services to an audit client).
>
> A public company auditor *should not function as part of management or as an employee of the audit client* (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).
>
> A public company auditor, to be independent, *should not act as an advocate of its audit client* (as it would if it provided legal and expert services to an audit client in judicial or regulatory proceedings).
>
> A public company auditor *should not be a promoter of 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).
>
> The exemptive authority provided to the Board is intentionally narrow to apply to individual cases where the application of the statutory requirement would impose some extraordinary hardship or circumstance that would merit an exemption consistent with the protection of the public interest and the protection of investors. But the fundamental presumption of the provision is that these non-audit services, by their very nature, present a conflict of interest for an accounting firm if provided to a public company audit client.* * *
>
> The conference report chose not to follow the approach of imposing a complete prohibition on the provision of non-audit services to audit clients. Instead it chose the approach of identifying the non-audit services which by their very nature pose a conflict of interest and should be prohibited.* * *
>
> In my view granting broad exemption authority to the Oversight Board or the SEC to permit these non-audit services would undermine the separation the conference report is intended to establish.[26]
>
> (Emphasis added.)

The Commission last amended its auditor independence rules in November 2000. In so doing, the Commission identified many of the same services included in the Act that would impair an auditor's independence. In doing so, after public comment, the Commission included certain exceptions and qualifications to these services in those rules. As part of that rulemaking, the Commission utilized concepts similar to those expressed in the Senate Report in evaluating independence matters. Rule 2–01 of Regulation S–X [27] contains a preliminary note that is comprised of concepts that are similar to those outlined in the legislative history to the Sarbanes-Oxley Act. The preliminary note is used to evaluate independence matters that arise but that are not specifically addressed in rule 2–01. The proposals that we are considering are based on the same factors that have been utilized by the staff in evaluating independence matters.

The Commission had proposed more restrictive independence rules in June 2000.[28] In the period between

[22] As used in this section of the Act, the term Board refers to the Public Company Accounting Oversight Board.

[23] *Id.*

[24] Report of the Senate Comm. on Banking, Housing, and Urban Affairs to Accompany S. 2673, Public Company Accounting Reform and Investor Protection Act of 2002, S. Report 107–205, 107th Cong., 2d Sess. (July 3, 2002).

[25] Id. at 18.

[26] 148 Cong. Rec. S7351 and S7364 (July 25, 2002).

[27] *See* Release No. 33–7870 (June 30, 2000), proposed rules 2–01(b)(1)–(4), and preliminary note to rule 2–01 of Regulation S-X, 17 CFR 210.2–01. As stated in the preliminary note, in making independence determinations ''the Commission looks in the first instance to whether a relationship or the provision of a service: (a) Creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in the position of being an advocate for the audit client.''

[28] Release No. 33–7870 (June 30, 2000); 65 FR 43148 (July 12, 2000).

publication of the proposed rules and the adoption of the final rules, the Commission conducted public hearings at which over 100 persons testified, a congressional hearing was held, and over 3,000 comment letters were received.

It seems clear that Congress did not intend to codify unchanged the current auditor independence rules, as the Commission adopted them in November 2000. In Senator Sarbanes' statements, quoted above, he notes the debate with Senator Gramm about the use of ''categorical exemptions'' from the prohibitions in the Act and states that the Act was not intended to give the Commission ''broad exemption authority.'' We assume, therefore, that Congress intended the Commission to revise its existing rules, at a minimum, to eliminate categorical exceptions and exemptions.

We note that the terms used by Congress could be construed very broadly. We nevertheless believe that Congress did not intend to ban any service that could conceivably fall within one of the prohibited categories of services. Both the language in the Act and the legislative history argue against such a broad construction. Each service as properly interpreted would be banned; however, proper interpretation must be made in light of the three basic principles. For example, the statute prohibits ''expert'' services. A broad interpretation of this prohibition could lead one to conclude that almost all services provided by a certified public accountant (CPA) could be considered to be ''expert'' services. For example, tax services would seem to be among the services that are provided by an ''expert.'' However, it is clear that Congress did not wish to ban all expert services because the Act specifically provided for an auditor to be able to perform certain services, including tax services, if the audit committee approves them in advance.

Both the Senate Report and Senator Sarbanes' statements on the Senate floor describe each service as fulfilling one of the enumerated ''simple principles.'' In the Senate Report, these principles are that an accounting firm should not (1) audit its own work, (2) function as a part of management or as an employee of the audit client, or (3) act as an advocate of the audit client. In his July 25th floor statement, Senator Sarbanes added a fourth principle, the notion that an accounting firm should not be a promoter of the issuer's stock or other financial interests.[29]

We therefore propose to amend the auditor independence rules to remove categorical exemptions and to define each term in the list of prohibitions in section 201(a) of the Act in relation to the ''simple principle'' that is at the foundation of that prohibition. In doing so, we intend to prohibit any service or scenario that reasonably could create one or more of the conflicts identified in the principles.

The proposed rules, like our current independence requirements, govern non-audit services provided by an accountant to an audit client during the audit and professional engagement period.[30] They do not govern non-audit services when provided to non-audit clients.

The proposed rule does not provide an all-inclusive list of the services that are incompatible with proposed rule 2–01(b). Whether the provision of a non-audit service not specified in the proposed rule impairs an accountant's independence will be measured against the four general principles set forth in the preliminary note to rule 2–01 and the ''simple principles'' in the legislative history noted above.

- Are there other non-audit services that are incompatible with rule 2–01(b) or that raise independence concerns? If so, what are they, and why do they raise independence concerns?
- Is the meaning of the general principles sufficiently clear?

1. Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements of the Audit Client

Currently, an auditor's independence is impaired if the auditor provides bookkeeping services to an audit client except in limited situations, such as in an emergency or where the services are provided in a foreign jurisdiction and certain conditions are met.[31] Proposed rule 2–01(c)(4)(i) continues the prohibition on bookkeeping, but we propose to eliminate the limited situations where bookkeeping services may be provided under the current rules. As noted earlier, the proposed rules are predicated on three basic principles. One of those principles is that an auditor cannot audit his or her own work and maintain his or her independence. When an auditor performs bookkeeping services for a client, he or she is placed in a situation of auditing his or her own work. Accordingly, we are proposing that all bookkeeping services would cause the auditor to lack independence.

The proposed rules utilize the existing definition of bookkeeping or other services, which focuses on the provision of services involving: (1) Maintaining or preparing the audit client's accounting records, (2) preparing financial statements that are filed with the Commission or the information which forms the basis of financial statements filed with the Commission, (3) preparing or originating source data underlying the audit client's financial statements.

When an accounting firm provides bookkeeping services for an audit client, the firm may be put in the position of later auditing the accounting firm's work. If, during an audit, an auditor must audit the bookkeeping work performed by his or her accounting firm, it is questionable that the auditor could, or that a reasonable investor would believe that the auditor could, remain objective and impartial. If the auditor found an error in the bookkeeping, the auditor could well be under pressure not to raise the issue with the client if raising the issue could jeopardize the firm's contract with the client for bookkeeping services or result in heightened litigation risk for the firm. In addition, keeping the books is a management function, the performance of which leads to an inappropriate mutuality of interests between the auditor and the audit client.[32]

We understand that auditors are sometimes asked to prepare statutory financial statements for foreign companies, and these are not filed with us. Consistent with the Commission's existing rules, an accountant's independence would be impaired where

[29] These principles are similar to those that the Commission proposed in June 2000 as part of the auditor independence rules and subsequently adopted as a preliminary note to those rules. *See* Release No. 33–7870 (June 30, 2000), proposed rules 2–01(b)(1)–(4), and preliminary note to rule 2–01 of Regulation S–X, 17 CFR 210.2–01. As stated in the preliminary note, in making independence determinations ''the Commission looks in the first instance to whether a relationship or the provision of a service: (a) Creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in the position of being an advocate for the audit client.''

[30] Audit client is a term defined generally in § 2–01(f)(6) of Regulation S–X, as the entity whose financial statements or other information is being audited and any affiliates of the audit client. Affiliates of the audit client, as defined in § 2–01(f)(4), are entities that have control relationships or other significant influence relationships with the audit client, which in the case of registered investment companies includes all entities in the investment company complex, as defined under § 2–01(f)(14).

[31] 17 CFR 210.2–01(c)(4)(i).

[32] Letter of Samuel L. Burke, Associate Chief Accountant, SEC, to Florida Institute of Certified Public Accountants re: bookkeeping (March 4, 2002).

the accountant prepared the statutory financial statements if those statements form the basis of the financial statements that are filed with us. Under these circumstances, an auditor or accounting firm who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP converted financial statements.

- Should the definition of bookkeeping be further clarified? If so, how?
- Does the definition cover all the bookkeeping services that would impair an accountant's independence?
- Should an auditor be permitted to provide bookkeeping services to an audit client if it is not reasonably likely that the results of those services will be subject to audit procedures during the audit of the client's financial statements? Why or why not?
- Is the standard of reasonably likely sufficiently clear? If not, should we use some other standard? If so, what standard should we use?
- Is the phrase ''preparing statutory statements which form the basis of U.S. GAAP statements'' sufficiently clear? If not, how might the phrase be revised?

2. Financial Information Systems Design and Implementation

Currently, paragraph (c)(4)(ii) identifies certain information technology services that, if provided to an audit client, impair the accountant's independence. The proposed rules identify the information technology services that would impair the auditor's independence. Under paragraph (c)(4)(ii)(A) of the proposed rule, an accountant is not independent if the accountant directly or indirectly operates or supervises the operation of the audit client's information system or manages the audit client's local area network or information system. Further, paragraph (c)(4)(ii)(B) of the proposed rule provides that an accountant is *not* deemed independent if the accountant designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole. These services impair an accountant's independence under existing Commission rules.[33] However, consistent with the Commission's existing rules, the proposed rules do not preclude an audit 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.

By ''significant'' to the financial statements taken as a whole, we refer to information that is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm by necessity will need to evaluate the general nature of the information rather than only system output during the period of the audit engagement. An accountant, for example, would not be independent of an audit client for which it designed an integrated Enterprise Resource Planning (''ERP'') system.

Operating, designing or implementing systems affecting the financial statements may place the auditor in a management role, or result in the accountant auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by that accountant.[34] For example, if an auditor designs and installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on his or her firms' own work. Investors may perceive that the accountant would be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or installed.

- Is an auditor's independence impaired when the auditor helps select or test computer software and hardware systems that generate financial data used in or underlying the financial statements? Why or why not?
- Whether a system is used to generate information that is ''significant'' to the audit client's financial statements may depend on the size of the engagement. Does the magnitude as a percentage of either audit fees or total fees of the fees for such services make a difference on whether performance of the service impairs independence?

3. Appraisal or Valuation Services, Fairness Opinions, or Contribution-in-Kind Reports

Under the Commission's current independence rules, an accountant is deemed to lack independence when providing appraisal or valuations services, fairness opinions, or contribution-in-kind reports for audit clients. However, the current rules contain certain exemptions that we propose to eliminate.[35] These proposals would provide that the auditor is not independent if the auditor provides appraisal or valuation services, or contribution-in-kind reports,[36] where there is a reasonable likelihood that the results of the service will be subject to audit procedures by the auditor because the auditor is in a position of auditing his or her own work. Additionally, an auditor is not independent under the proposal if he or she provides a fairness opinion because to do so requires the auditor to function as a part of management and may require the auditor to audit the results of his or her own work.

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. 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.

Providing these services to audit clients raises several auditor independence concerns. When it is time to audit the financial statements, the accountant could likely end up reviewing his or her own work, including key assumptions or variables that underlie an entry in the financial statements. Also, where the appraisal methodology involves projection of future results of operations and cash flows, some believe that the accountant that prepares the projection could have a mutuality of interest with the client in attaining forecast results.[37] The auditor may feel constrained by the valuation and appraisal issued by the firm, and as a result, the auditor may be unable to evaluate skeptically and without bias

[33] 17 CFR 210.2–01(c)(4)(ii).

[34] *See* Section 404(b) of the Sarbanes-Oxley Act.

[35] Current exemptions include: (1) Firm's valuation expert can review the work of a client's specialist; (2) firm's actuaries can value a client's pension or other post-retirement benefit obligation provided that the client assumes responsibility for significant assumptions; (3) valuations performed for planning and implementing tax-planning strategies; and (4) valuations for non-financial purposes which do not affect the financial statements.

[36] Contribution-in-kind reports in certain foreign countries require the auditor to express an opinion on the fairness of the transaction, the value of a security, or the adequacy of consideration to shareholders.

[37] As discussed in the preliminary note to rule 2–01, the Commission considers the impact on the auditor's independence of situations where the auditor has a mutuality of interest with its auditor client. This concept was not included in the legislation.

the accuracy of that valuation or appraisal.

Our proposals do not prohibit an accounting firm from providing such services for non-financial reporting (*e.g.*, transfer pricing studies, cost segregation studies) purposes.

The proposed rule does not limit an accounting firm from utilizing its own valuation specialist to review the work done by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements. In those instances, because a third party or the audit client is the source of the financial information subject to the review or audit, the accountant will not be reviewing or auditing his or her own work. Additionally, the quality of the audit may be improved where specialists are utilized in such situations.

- Does providing valuation or appraisal services that are unrelated to the financial statements, such as for certain regulatory purposes, impair an accountant's independence?
- Does providing valuation or appraisal services for tax purposes impair an accountant's independence?
- Are there certain types of appraisal or valuation services, or certain instances in which they are provided, that do not raise auditor independence concerns? Are there circumstances in which an accounting firm may be required by law or regulation to provide such services, either in the United States or abroad?
- Should we provide an exemption for such services provided to a foreign private issuer by its accountant where local law requires such services (*e.g.* contribution in-kind reports)?
- The Commission staff, when providing interpretations of the application of the auditor independence rules to contribution in-kind reports, has worked with foreign jurisdictions to accommodate the statutory requirements in those jurisdictions.[38] Should the Commission's rules provide that similar practices or arrangements be permitted where contribution in-kind reports are required by foreign statute?

4. Actuarial Services

The current rules generally bar auditors only from providing actuarial services related to insurance company policy reserves and related accounts. Consistent with our approach to implementing the Act, we are proposing to broaden this prohibition by providing that the accountant is not independent if the auditor provides any advisory service involving the amounts recorded in the financial statements and related accounts for the audit client where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements because providing these services may cause an accountant later to audit his or her own work. Additionally, accountants providing these services assume a key management task. Stated differently, to perform these services would violate two of the three basic principles espoused in the legislative history of the Act. In addition, actuarially oriented advisory services may affect amounts reflected in some company's financial statements, such as an insurance company's financial statements. The proposed rules provide that the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

- Are there certain circumstances under which an accountant can provide actuarial services to an audit client without impairing independence?
- Have we appropriately described the actuarial services prohibited by the Act?

5. Internal Audit Outsourcing

Our current rules allow a company to outsource part of its internal audit function to the independent audit firm subject to certain exemptions. For example, smaller businesses are exempted from the internal audit outsourcing prohibition because there have been concerns about the potentially disproportionate impact on such companies. The line between performing management functions and performing an audit is not always clear. Some companies ''outsource'' internal audit functions by contracting with an outside source to perform, among other things, all or part of their audits of internal controls. As emphasized by the Committee of Sponsoring Organizations (''COSO''), internal auditors play an important role in evaluating and monitoring a company's internal control system.[39] As a result, some argue that internal auditors are, in effect, part of a company's system of internal accounting control.[40]

Since the external auditor generally will rely, at least to some extent, on the internal control system when conducting the audit of the financial statements,[41] the auditor may be relying on his or her firm's own work, which was performed as part of the internal controls and internal audit function. In essence, by outsourcing the internal audit function, the auditor assumes a management responsibility and becomes part of the company's control system.

Proposed rule 2–01(c)(4)(v) provides that an auditor is not independent when the auditor performs internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client. This does not include nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function. It also does not include operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

We are concerned about the effect of the proposed rule on small businesses that have no internal audit department or staff. Smaller firms may not have sufficient need for full-time internal auditors but nonetheless, may need some services that internal auditors typically provide, which they obtain from their external auditors. We understand that, unless these companies can turn to their external auditors, the work may not be done at all or only at a significant cost to the company because the company would have to engage a separate accounting firm to provide these services.[42] Existing Commission independence rules contain an exception for small businesses identified as those with assets totaling less than $200 million.[43] However, our proposed rules contain no such exception because, regardless of the entity's size, the Act appears to view the auditor as being in a position of auditing his or her own work.

- Is the definition of the ''internal audit function'' sufficiently clear?
- We solicit comment on whether an exception should be provided for small

[38] Letter of Lynn Turner, Chief Accountant, SEC, to Commissione Nazionale per la Societa Sonieta e la Borsa re: statutory procedures (August 24, 2000).

[39] *See* Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework,* at 7 (1992) (the ''COSO Report'').

[40] *See* SAS No. 65, ''The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,'' AU§ 322.

[41] AICPA SAS No. 55, AU § 319 (effective for audits on or after January 1, 1990).

[42] *See* Release No. 33–7919.

[43] 17 CFR 2–01(c)(4)(v) currently includes a $200 million threshold.

businesses. If so, what criteria should we consider in providing such an exception?

• Does it impair an auditor's independence if the auditor does not provide to the client outsourcing services related to the internal audit function of the audit client, but rather performs individual audit projects for the client?

• Are there safeguards that can be established by the auditor that would allow the audit client to outsource the internal audit function to the auditor without impairing its independence?

• Would it impair the auditor's independence if the auditor performs only operational audits that are unrelated to the internal controls, financial systems, or financial statements?

• Is additional guidance necessary to distinguish the services that would be prohibited under this proposed rule from those services that would be permitted as operational audits?

6. Management Functions

We are not proposing any significant change to our current rule on management functions. Proposed rule 2–01(c)(4)(vi) provides that an accountant's independence is impaired with respect to an audit client for which the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any decision-making, supervisory, or ongoing monitoring functions for the audit client. This provision is consistent with the provisions of existing rule 2–01(c)(4)(vi).[44]

We believe, however, that provided the auditor does not act as an employee or perform management functions, services in connection with the assessment of internal accounting and risk management controls as well as providing recommendations for improvements do not impair an auditor's independence. Accountants must gain an understanding of their audit clients' systems of internal accounting controls when conducting an audit in accordance with generally accepted auditing standards.[45] With this insight, auditors often become involved in diagnosing, assessing, and recommending to audit committees and management, ways in which their audit client's internal controls can be improved or strengthened.[46] These services can be extremely valuable to companies, and they may also facilitate the performance of a high quality audit. For these reasons, we are proposing to continue to allow auditors to assess the effectiveness of internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls.

At the same time, we recognize that when an auditor designs and implements its audit client's internal accounting and risk management control systems, some believe that the auditor will lack objectivity if called upon to audit financial statements that are derived, at least in part, from data from those systems or when reporting on those controls or on management's assessment of those controls. As such, we believe that design and implementation of internal accounting and risk management controls are fundamentally different from obtaining an understanding of the controls and testing the operation of the controls which is an integral part of any audit of the financial statements of a company. Likewise, design and implementation of these controls is different from recommending improvements in the internal accounting and risk management controls of an audit client.

Because of this fundamental difference, we believe that designing and implementing internal accounting and risk management controls impairs the auditor's independence because it places the auditor in the role of management. Conversely, obtaining an understanding of, assessing effectiveness of, and recommending improvements to the internal accounting and risk management controls is fundamental to the audit process and does not impair the auditor's independence.

• Do services related to designing or implementing internal accounting controls and risk management controls result in the auditor auditing his or her own work? Would such services impair an auditor's independence when the auditor is required to issue an opinion on the effectiveness of the control systems that he or she designed or implemented?

• Do services related to assessing or recommending improvements to internal accounting controls and risk management controls result in the auditor auditing his or her own work? Would such services impair an auditor's independence when the auditor is required to issue an attestation report on the effectiveness of the control systems that he or she has assessed or evaluated for effectiveness?

• We request comment on whether there are circumstances under which an accounting firm can perform or assume management functions or responsibilities for an audit client without impairing independence?

7. Human Resources

Our current rules deem an auditor to lack independence when performing certain human resources functions, and we do not propose any significant change to those rules. Consistent with our current rules, proposed rule 2–01(c)(4)(vii) provides that an auditor's independence is impaired with respect to an audit client when the auditor searches for or seeks out prospective candidates for managerial, executive or director positions; acts as negotiator on the audit client's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment; or undertakes reference checks of prospective candidates. Under the proposed rule, an auditor's independence also is impaired when the auditor advises an audit client about the design of its management or organizational structure, when it 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.

Assisting management in human resource selection or development places the auditor in the position of having an interest in the success of the employees that the auditor has selected, tested, or evaluated. Accordingly, observers may perceive that an auditor would be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the auditor to be reluctant, because doing so would require the auditor to acknowledge shortcomings in its human resource service. The auditor also would have other incentives not to report such employees' ineffectiveness, including that the auditor would identify and be identified with the recruited employees.

• Are there additional types of human resource and employee benefit services that impair an auditor's independence?

• Would an auditor's independence be impaired if the auditor provided personnel hiring assistance for only non-executive or non-financial personnel?

[44] 17 CFR 210.2–01(c)(4)(vi).

[45] AU 319, ''Consideration of Internal Control in a Financial Statement Audit.'' In addition, section 404(b) of the Act requires a company's audit to attest to the internal control report provided annually by management.

[46] AU 325, ''Communication of Internal Control Related Matters Noted in an Audit,'' requires the auditor to communicate reportable conditions and material weaknesses in internal control to the company's audit committee or equivalent.

• Does it impair an auditor's independence if the auditor provides consultation with respect to the compensation arrangements of the company's executives?

8. Broker-Dealer, Investment Adviser Or Investment Banking Services

Our current rules deem an auditor to lack independence when performing brokerage or investment advising services for an audit client.[47] We are proposing to add serving as an unregistered broker-dealer[48] to our rules that prohibit serving as a promoter or underwriter, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, or executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client. The proposed rule is substantially the same as the Commission's existing rule related to the provision of these types of services to audit clients.[49] We are including unregistered broker-dealers within the proposed rules because the nature of the threat to independence is unchanged whether the entity is or is not a registered broker-dealer.

Selling—directly or indirectly—an audit client's securities is incompatible with the auditor's responsibility of assuring the public that the company's financial condition is fairly and accurately presented. When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended. These concepts are echoed in the ''simple principles'' included in the legislative history to the Sarbanes-Oxley Act.[50] For example, if an auditor uncovers an accounting error in a client's financialstatements, and the auditor, in an investment adviser capacity, had recommended that client's securities to investment clients, the auditor performing the audit may be reluctant to recommend changes to the client's financial statements if the changes could negatively affect the value of the securities recommended by the auditor to its investment adviser clients.

Broker-dealers[51] often give advice and recommendations on investments and investment strategies. The value of that advice is measured principally by the performance of a customer's securities portfolio. When the customer is an audit client, the accountant has an interest in the value of the audit client's securities portfolio, even as the accountant values the portfolio as part of an audit. Thus, the auditor would be placed in a position of auditing his or her own work. Furthermore, the auditor is placed in a position of acting as an advocate on behalf of the client.

• We solicit comment on the scope of the proposal. Are there other securities professional services that the rule should expressly identify as impairing independence?

• Would an auditor's independence be impaired if the auditor acted as a securities analyst covering the sector or industry of an audit client?

• Should we adopt rules that would clarify when the auditor is acting as an unregistered broker-dealer? If so, what should those rules be?

9. Legal Services

Our current rule states that an auditor is deemed to lack independence when he or she provides legal services to an audit client. The proposed rule provides that an accountant is not independent of an audit client if the accountant provides any service to the audit client 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. The proposed rules would apply to foreign and U.S. accounting firms equally, minimizing the instances where legal services are provided by the auditor to the audit client.

A lawyer's core professional obligation is to advance clients' interests. Rules of professional conduct require the lawyer to ''represent a client zealously and diligently within the bounds of the law.''[52] The lawyer must ''take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. * * * In the exercise of professional judgment, a lawyer should always act in a manner consistent with the best interests of the client.''[53] Unlike an auditor, a lawyer takes basic direction from the client. We have long maintained that an individual cannot be both a zealous legal advocate for management or the client company, and maintain the objectivity and impartiality that are necessary for an audit.[54] The Supreme Court has agreed with our view. In *Arthur Young,* the Supreme Court emphasized, ''If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.''[55]

We recognize that there may be implications for some foreign registrants from this proposal. For example, we understand that in some jurisdictions it is mandatory that someone licensed to practice law perform tax work, and that an accounting firm providing such services, therefore, would be deemed to be providing legal services. Accordingly, we are interested in understanding the implications of this proposal on foreign private issuers.

• Are there any particular legal services that should be exempted from the rule?

• Would making the rule's application depend upon the jurisdiction in which the service is provided leave the rule subject to any

[47] These proposed rules are not meant to change the Commission's current position that an audit firm's broker-dealer division can cover an industry which includes an audit client when performing analyst functions. However, analysis of a specific audit client's stock places the auditor in the position of acting as an advocate for the client and would cause the auditor to lack independence.

[48] Accountants and the companies that retain them should recognize that the key determination required here is a functional one (*i.e.*, is the accounting firm or its employee acting as a broker-dealer?). The failure to register as a broker-dealer does not necessarily mean that the accounting firm is not a broker-dealer. In relevant part, the statutory definition of ''broker'' captures persons ''engaged in the business of effecting transactions in securities for the account of others.'' Securities Exchange Act of 1934 § 3(a)(4). Unregistered persons who provide services related to mergers and acquisitions or other securities-related transactions should limit their activities so they remain outside of that statutory definition. A person may ''effect transactions,'' among other ways, by assisting an issuer to structure prospective securities transactions, by helping an issuer to identify potential purchasers of securities, or by soliciting securities transactions. A person may be ''engaged in the business,'' among other ways, by receiving transaction-related compensation or by holding itself out as a broker-dealer. Involvement of accounting personnel as unregistered broker-dealers not only can impair auditor independence, but also would violate section 15(a) of the Exchange Act.

[49] 17 CFR 210.2–01(c)(4)(viii) and Release No. 33–7919, at Section D.

[50] Floor Statement of Senator Sarbanes, 148 Cong. Rec. S7364 (July 25, 2002) ''. * * * A public company auditor should not be a promoter of the company's stock or other financial interest (as it would be if it served as broker-dealer, investment adviser, or investment banker for the company).''

[51] In the past, some have expressed concern that terms such as ''securities professional'' and ''analyst'' are not defined in the securities laws and use of the terms could cause confusion. Because of that concern, we have not used those terms in these proposed rules. We note, however, that broker-dealers provide an array of services that may include certain analyst activities.

[52] *See, e.g.*, D.C. Rules of Professional Conduct, rule 1.3(a).

[53] *Id.* at rule 1.5.

[54] In the Matter of Charles Falk, AAER No. 1134 (May 19, 1999) (formally disciplining an attorney/accountant who gave legal advice to an audit client of another partner in his accounting firm).

[55] *United States* v. *Arthur Young,* 465 U.S 805 (1984) at 819–20 n.15.

significant uncertainty, or pose the prospect of any significant complexity or unfairness?

• Should there be any exception for legal services provided in foreign jurisdictions? For example, in some countries only a law firm may provide tax services. Should a foreign accounting firm be permitted to provide, through an affiliated law firm, tax or other services that a U.S. accounting firm could provide to a U.S. audit client without impairing the firm's independence? Why or why not?

• Should there be an exception for legal services provided to issuers in foreign jurisdictions? Should any such exception be tailored to avoid undermining the purpose of the restriction? For example, could fees for legal services be limited to a small percentage (*e.g.*, 5% or 10%) of the amount of fees for audit services? Could partners providing audit services be prohibited from being involved in the provision of legal services or from receiving compensation based on such services?

• Should any such exception have a ''sunset'' provision that would both allow foreign private issuers a transition period and allow the Commission to review the situation regarding legal services?

10. Expert Services

Our current rules do not provide that an auditor is deemed to lack independence when providing expert services to an audit client. The Act, however, includes expert services in the list of prohibited services. As discussed earlier, the legislative history, particularly related to expert services, is focused on the auditor's role when serving in an advocacy capacity. Our proposed rules interpret the legislative prohibition in light of the three basic principles of independence discussed previously.

During the Senate Floor debate, Senator Sarbanes stated, ''A public company auditor, to be independent, should not act as an advocate of its audit client (as it would if it provided legal and expert services to an audit client in judicial or regulatory proceedings).'' [56] The proposed rule, therefore, states that an accountant's independence is impaired as to an audit client if the accountant provides expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acts as an advocate for an audit client in such proceedings.

Clients retain experts to lend authority to their contentions in various proceedings by virtue of the expert's specialized knowledge and experience. The provision of expert services by the accountant may create the appearance that the accountant is acting as the client's advocate in pursuit of the client's interests. The appearance of advocacy (and the corresponding appearance of mutual interest) created by providing expert services is sufficient to deem the accountant's independence impaired.

Our prohibition on the provision of expert services would include providing consultation and other services to an audit client's legal counsel in connection with litigation, administrative or regulatory proceedings. As discussed above in the context of the provision of legal services, legal counsel have an ethical duty to ''represent a client zealously and diligently within the bounds of the law'' and to ''take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor.'' [57] An auditor who takes on such duties, either directly or by being engaged by the audit client's legal counsel, takes on a role as an advocate for the client.

The prohibition on providing ''expert'' services included in this rule proposal covers services that result in the accounting firm's specialized knowledge, experience and expertise being used to support the contentions of the audit client in various adversarial proceedings. Therefore, under our proposed rule, an auditor's independence would be impaired if the auditor were engaged by the audit client's legal counsel to provide 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. For example, an auditor could not provide forensic accounting services to the audit client's legal representative in connection with an investigation by the Commission's Division of Enforcement. Nor could an accounting firm appear as an expert witness in a utility rate setting proceeding in support of an audit client's request for an increase in fees.

Our proposals, however, would not prohibit an auditor from assisting the audit committee in fulfilling its responsibilities in connection with the financial reporting process.[58] Although under our proposals, an auditor's independence would be impaired if it were engaged by the audit client's counsel to provide advice or forensic accounting services in connection with a legal, administrative or regulatory proceeding,[59] the auditor's independence would not be impaired if it were assisting the audit committee in fulfilling its responsibility to conduct its own investigation of a potential accounting impropriety, so long as the auditor did not take on the role of an advocate in such an investigation.[60] For example, an audit committee may engage the auditor to render forensic services, and should the audit committee choose to engage counsel, the work product of the auditor may be provided to the audit committee's counsel without impairing the auditor's independence. We believe it is important that auditors be allowed to assist the audit committee in their capacity as investors' representatives.

In this regard, our proposals also would not prohibit an auditor from testifying as a fact witness to its audit work for a particular audit client. In those instances, the auditor is merely

[56] *See* Floor Statement of Senator Sarbanes, 148 Cong. Rec. S7364 (July 25, 2002).

[57] *See, e.g.*, D.C. Rules of Professional Conduct, rule 1.3(a) and 1.5.

[58] For example, section 301 of the Act stipulates that each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

[59] In October 2001, we set forth some of the criteria that we considered important to assessing whether to credit self-policing, self-reporting, remediation and cooperation in SEC enforcement investigations. One of the criteria we identified related to whether the company had undertaken a thorough review of the conduct at issue:

10. Did the company commit to learn the truth, fully and expeditiously? Did it do a thorough review of the nature, extent, origins and consequences of the conduct and related behavior? Did management, the Board or committees consisting solely of outside directors oversee the review? Did company employees or outside persons perform the review? If outside persons, had they done other work for the company? Where the review was conducted by outside counsel, had management previously engaged such counsel? Were scope limitations placed on the review? If so, what were they?

Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Accounting and Auditing Enforcement Release (''AAER'') No. 1470 (Oct. 23, 2001).

Depending on the conduct at issue, it may be necessary for a company to engage an accountant to conduct a forensic accounting review or audit. While our proposal does not set forth independence requirements for forensic consultants, consistent with the principles we set forth in October 2001, we will consider the objectivity of the forensic accountant as to the issues being investigated in assessing whether to credit the forensic work.

[60] An auditor's independence would, however, be impaired if its assistance to the audit committee included defending, or helping to defend, the audit committee or the company generally in a shareholder class action or derivative lawsuit, other than as a fact witness.

providing a factual account of what he or she observed and the judgments he or she made. An accounting firm that, after receiving appropriate authorization from an audit client's audit committee, had prepared an audit client's tax returns, also could appear as a fact witness in tax court to explain how the returns were prepared.

- Are there circumstances in which providing audit clients with expert services in legal, administrative, or regulatory filings or proceedings should not be deemed to impair independence?
- Should an auditor be permitted to serve as a non-testifying expert for an audit client in connection with a proceeding?
- Is the definition of prohibited expert services appropriate? Why or why not?
- Is the distinction between advocacy and providing appropriate assistance to an audit committee sufficiently clear?

11. Tax Services

Section 201 of the Sarbanes-Oxley Act identifies specific categories of non-audit services that are prohibited for accounting firms to provide for their audit clients. Additionally, the Act specifies that the audit committee must pre-approve all non-prohibited non-audit services. In particular, the Act states that:

> A registered public accounting firm may engage in any non-audit service, *including tax services,* that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer.[61] (Emphasis added.)

Nothing in these proposed rules is intended to prohibit an accounting firm from providing tax services to its audit clients when those services have been pre-approved by the client's audit committee. As discussed in our previously proposed rules[62] on independence, tax services are unique, not only because there are detailed tax laws that must be consistently applied, but also because the Internal Revenue Service has discretion to audit any tax return.[63] In addition, the Congressional intent behind the above quoted reference to ''tax services'' would appear to be that auditor independence is not impaired by an accountant providing traditional tax preparation services to an audit client or an affiliate of an audit client.

While we do not define ''tax services,'' we understand that tax services can include a range of activities including the preparation of tax returns, tax compliance, tax planning, tax recovery, and other tax-related services. In addition, many engagements will require that an auditor review the tax accrual that is included in the financial statements. Reviewing tax accruals is part of audit services and is not, in and of itself, deemed to be a tax compliance service.

Classifying a service as a ''tax service'' however, does not mean that the service may not be within one of the categories of prohibited services or may not result in an impairment of independence under rule 2–01(b). The accounting firm and the registrant's audit committee should consider, for example, whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service. As part of this process, the accounting firm and the audit committee should be mindful of the three basic principles which cause an auditor to lack independence with respect to an audit client: (1) The auditor cannot audit his or her own work, (2) the auditor cannot function as a part of management, and (3) the auditor cannot serve in an advocacy role for the client.[64] For example, where an accountant provides representation before a tax court the accountant serves as an advocate for his or her client and the accountant's independence would be impaired. Another example would be the formulation of tax strategies (*e.g.* tax shelters) designed to minimize a company's tax obligations.[65] The provision of these types of services may require the accountant to audit his or her own work, to become an advocate for the client's position on novel tax issues, or to assume a management function.

We also are considering whether special considerations apply when the auditor provides a tax opinion for the use of a third party in connection with a business transaction between the audit client and the third party. The tax opinion may be vital in the audit client's efforts to induce the third party to enter into the transaction, particularly when the transaction is tax-driven. Under those circumstances, the auditor may be acting as an advocate for the audit client by actively promoting the client's interests.

- We request comment on whether providing tax opinions, including tax opinions for tax shelters, to an audit client or an affiliate of an audit client under the circumstances described above would impair, or would appear to reasonable investors to impair, an auditor's independence.
- Are there tax services that should be prohibited by the Commission's independence rules?
- Is it meaningful to categorize tax services into permitted and disallowed activities? If so, what categories and related definitions would make the demarcation meaningful?

C. Partner Rotation

Section 301 of the Sarbanes-Oxley Act specifies that the audit committee has the responsibility for appointment, compensation, and oversight of the work of the company's audit firm. In that capacity, the audit committee has the responsibility for evaluating and determining that the audit engagement team has the competence necessary to conduct the audit engagement in accordance with GAAS.

The Sarbanes-Oxley Act also requires rotation of certain audit partners on a five-year basis in order to continue to provide audit services for a registrant. Section 203 of the Sarbanes-Oxley Act of 2002 specifies that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

The concept of audit partner[66] rotation is not new. Indeed, accounting firms that audit registrants are currently subject to audit partner rotation requirements. The current requirements of the AICPA's SEC Practice Section (''SECPS'') call for the engagement partner to rotate off the engagement after seven years to remain off the engagement for two years.[67]

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[61] Sarbanes-Oxley Act of 2002, section 201.

[62] Release Nos. 33–7870, ''Revision of the Commission's Auditor Independence Requirements,'' (June 30, 2000) (65 FR 43148).

[63] *Id.*

[64] These principles are similar to the four governing principles included in the preliminary note to the Commission's current independence rules. The four governing principles are whether the accountant: (1) Has a mutual or conflicting interest with the audit client, (2) audits his or her firm's own work, (3) functions as management or an employee of the audit client, or (4) acts as an advocate for the audit client.

[65] *U.S.* v *KPMG LLP* (July 9, 2002) and *U.S.* v *BDO Seidman* (July 9, 2002).

[66] For purposes of this portion of the release, the term partner refers to an individual who is a proprietor, partner, principal, or shareholder of the accounting firm.

[67] American Institute of Certified Public Accountants (AICPA), SEC Practice Section, Requirements of Members, at item e. The membership requirements are available online at *http://www.aicpa.org/members/div/secps/require.htm.* Audit firms which are members of the SEC Practice Section must comply with its rules (*e.g.,* partner rotation) and undergo periodic peer review to ensure that the firms' audit practice is consistent with both the rules of the AICPA and those of the Commission.

The Sarbanes-Oxley Act clearly specifies that the lead audit partner and reviewing partner should serve on the engagement in that capacity for no more than five consecutive years. The Commission is proposing rules to clarify the five-year rotation requirement specified in the Sarbanes-Oxley Act.

As noted above, existing SECPS membership requirements stipulate that a rotated partner may not serve on the audit engagement for two consecutive years following rotation.[68] In addition to covering more partners,[69] the proposed rules expand this requirement and require that, following rotation, a partner may not provide such services for a period of five consecutive years. We believe that partners should not return to the engagement for five-years in order to ensure investors that there will be a periodic fresh look at the accounting and auditing issues confronting the company. If a shorter ''time-out'' provision is used, investors might believe that partners merely would be placed in secondary role for a year or two, only to resume the same roles that they previously occupied and to return to the prior engagement team's approach to the accounting and auditing issues. If a partner is removed from an engagement for five-years, it would appear more likely that the partner will be placed on a different engagement and not held in abeyance only to return to the previous engagement. While we anticipate that accounting firms, when possible, would stagger the rotation of partners to provide a continuity of knowledge about the company, we believe the five-year period in the proposed rule would assure a complete turnover of personnel every five years.

With respect to determining which partners, principals and shareholders should be included, the proposed rules would go beyond the minimum specified by the Act. As noted above, the Act requires that the lead or coordinating audit partner and the audit partner responsible for reviewing the audit rotate every five years. Clearly, the lead partner as well as the concurring review partner perform critical functions that affect the conduct and effectiveness of the engagement. However, in many larger engagements, the engagement team will include more than just the lead partner and the concurring review partner. Obviously, the larger the registrant and the more diversified the registrant's activities, the more likely that the engagement team will include multiple partners, principals or shareholders.

While under this proposal, firms would be required to rotate multiple partners in these situations, nothing in this proposal is intended to imply that all partners would need to be rotated at the same time. Indeed, we would expect that firms would stagger the rotation of partners to ensure that the engagement team continues to have appropriate expertise to allow the audit engagement to be conducted in accordance with GAAS.

Partners, principals or shareholders who are members of the audit engagement team[70] make significant decisions that can affect the conduct and effectiveness of the audit. As a result, the proposed rules would require rotation not just of the lead and reviewing partner,[71] but of partners who perform audit services for the issuer.[72] This rotation requirement would include the lead partner, the concurring review partner, the client service partner, and other ''line'' partners directly involved in the performance of the audit. The proposed rules ensure that professionals do not ''grow-up'' or spend their entire career on one engagement.

Since most registrants are taxable entities, an assessment of the registrant's tax provision accounted for in accordance with GAAP[73] is a necessary part of the audit engagement. As a consequence, there may be ''tax'' partners who perform significant services related to the audit engagement. To the extent that such services are a necessary part of the accounting firm's ability to complete the audit, partners providing those services would be subject to these rotation requirements. However, the accounting firm may also perform tax services for the registrant. These services can include tax compliance services as well as certain tax planning services.[74] Such services are not, in and of themselves, deemed to be part of the audit or other attest engagement.[75] Thus, a partner who only provides tax services for the registrant would not be subject to the rotation requirements. However, since the financial statements typically include the amount currently payable or refundable, the accounting firm must carefully evaluate whether ''tax'' partners are performing exclusively tax services or whether their services play a role in the audit engagement.

In many cases, registrants have complex business transactions and other situations which may require that the engagement team consult with the accounting firm's national office or others on technical issues. Partners assigned to ''national office'' duties (which can include both technical accounting and centralized quality control functions) who may be consulted on specific accounting issues related to a client are not considered members of the audit engagement team even though they may consult on client matters regularly.[76] While these partners play an important role in the audit process, they serve, primarily, as a technical resource for members of the audit team. Because these partners are not involved in the audit *per se* and do not routinely interact or develop relationships with the audit client, we do not believe that it is necessary to rotate the involvement of these personnel.

In addition to the audit, registrants are required to have their quarterly financial information subjected to a timely review by the accounting firm. Such review is typically conducted according to the provisions required by generally accepted auditing standards.[77] Furthermore, section 404 of the Sarbanes-Oxley Act, as well as the Commission's proposed rules,[78] would require the accounting firm to attest to management's report on the registrant's internal controls. Both a timely review engagement and an attestation engagement require the accounting firm to be independent with respect to the registrant. Accordingly, the Commission's proposed rules for partner rotation extend to partners who serve on the engagement team that conducts the timely review of the registrant's interim financial

[68] *Id.*

[69] The current SECPS membership requirements stipulate that the audit engagement partner be rotated every seven years except that firms with less five SEC audit clients and less than ten partners are exempted. The existing SECPS membership requirements also do not require that the concurring partner be rotated.

[70] 17 CFR 210.2–01(f)(7).

[71] For purposes of this requirement, references to partner include principals, shareholders and other positions with equivalent responsibility.

[72] Under these proposals, we believe that those partners who are involved on a continuous basis in the audit of material balances in the financial statements would be subject to the rotation requirements of this proposal. For example, an actuarial specialist who assists in auditing the loss reserves for an insurance company would be subject to the rotation requirement.

[73] Statement of Financial Accounting Standards No. 109, ''Accounting for Income Taxes'' (Feb 1992).

[74] These services would, of course, be subject to the audit committee pre-approval requirements specified in section 202 of the Sarbanes-Oxley Act and the accompanying rules proposed in this release.

[75] *See* the discussion in part B.11 of this release, *supra.*

[76] 17 CFR 210.2–01(f)(7).

[77] *See* Codification of Statements on Auditing Standards AU§ 722.

[78] Release No. 33–8138 (Oct. 22, 2002) (67 FR 66208).

information as well as the engagement team that conducts the attest engagement on management's report on the registrant's internal controls.

Under the proposed rules, a partner performing audit, review or attest services to an investment company could only do so if they had not performed such services for any entity within the investment company complex, as defined in rule 2–01(f)(14) of Regulation S–X during the previous five consecutive years. For example, the proposed rule would prohibit a partner from rotating between two separate investment company issuers within an investment company complex. The proposed rule also would prohibit a partner from rotating between an investment company issuer and any other entity within the investment company complex.

While we are proposing that all partners on the engagement team who perform a continuing audit function be subject to the partner rotation requirements, we are interested in understanding the implications of this proposed requirement on audit firms. For example, it has been suggested by some that the need for the audit firm to rotate its audit partners might be obviated by having a second audit firm periodically perform a forensic audit to evaluate the work of the existing auditor, the condition of the company's internal controls, the company's accounting and reporting practices, and other matters. Forensic audits are typically conducted by specialized accountants and are designed to go beyond the scope of a financial statement audit. Indeed, forensic audits are typically conducted when there is already reason to suspect wrongdoing or fraud. Some believe that having a separate set of examiners conduct periodic forensic audits would encourage financial statement auditors to take greater responsibility for the detection of fraud and illegal acts when auditing financial statements due to the fact that another set of auditors would be critically evaluating their role. Additionally, forensic audits conceivably could give the audit committees a tool to better evaluate the quality of the financial statement auditors.

A possible consequence of the auditor rotation requirement is that some firms may be unable staff the audit engagement team with sufficient partners who are qualified to understand some of the difficult issues that the audit client faces. This may be particularly true in industries where there are specialized transactions, regulatory processes, or accounting principles. Nonetheless, the auditor is required to conduct the audit in accordance with generally accepted auditing standards. In particular, the third general standard requires that the auditor exercise due professional care in the conduct of the audit (*see* AU 150.02). In order to exercise due professional care, it would be necessary to ensure that the engagement was properly staffed with individuals competent to understand the unique issues relevant to that audit. Additionally, the quality control standards require that the firm have processes in place to ensure that appropriate personnel are assigned to each audit engagement (*see* QC 20.13).

- Should the Commission adopt rules requiring that issuers engage forensic auditors periodically to evaluate the work of the financial statement auditors? If so, how often should the forensic auditors be engaged? What should be the scope of the forensic auditors' work? Would doing so obviate the need to require partner rotation for the audit firm? Alternatively, could the company obtain the necessary expertise by engaging other outside consultants? If so, what type of consultants should it engage?
- Would the establishment of rules requiring companies to engage forensic auditors periodically provide an opportunity to other firms to enter the market to provide these services?
- Should the Commission establish requirements for firms conducting forensic audits? If so, what should those requirements be?
- Should issuers be given a choice between engaging forensic auditors periodically and having the audit partners on their engagement team be subject to the rotation requirements? Why or why not?
- What are the costs and benefits of engaging forensic auditors to evaluate the work of the financial statement audit firm?
- This proposed rule would apply to the audits of the financial statements of ''issuers.'' Should the Commission consider applying this rule to a broader population such as audits of the financial statements of ''audit clients'' as defined in 2–01(f)(6) of Regulation S–X? Why or why not?
- For organizations other than investment companies, the rotation requirements would apply to significant subsidiaries of issuers. Should a different approach be considered? Is so, what approach would be appropriate?
- Should the rotation requirements apply to all partners on the audit engagement team? If not, which partners should be subject to the requirements?
- Is the proposed guidance sufficiently clear as to which audit engagement team partners would be covered by the rule? Is the proposed approach appropriate? If not, how can it be improved?
- Is the exclusion of certain ''national office partner'' personnel from the rotation requirements appropriate?
- Is the guidance on national office partners who are exempted from the rotation requirements sufficiently clear?
- Is the distinction between a member of the engagement team and a national office partner who consults regularly (or even continually) on client matters sufficiently clear?
- Should certain partners performing non-audit services for the client in connection with the audit engagement be excluded from the rotation requirements?
- Should additional personnel (such as senior managers) be included within the mandatory rotation requirements?
- Is it appropriate to provide transitional relief where the proposed rules are more restrictive that the provisions of the Sarbanes-Oxley Act?
- Are there situations in foreign jurisdictions that extended partner rotation could be modified with additional safeguards or limitations that would recognize the jurisdictional requirements as well as logistical limitations that may exist?
- Should the rotation requirements be different for small firms? What changes would be appropriate and why? If so, how should small firms be defined?
- Would the proposed rules impose a cost on smaller firms that is disproportionate to the benefits that would be achieved?
- Is the five-year ''time out'' period necessary or appropriate? Would some shorter time period be sufficient, such as two, three or four years? Should there be different ''time out'' periods based on a partner's role in the audit process?
- If a partner rotates off an engagement after fewer than five years, should the ''time out'' period also be reduced? Why or why not? If so, how much should the reduction in the time out period be?
- Are the partner rotation requirements, as proposed, for investment company issuer's or other entities in the investment company complex too broad? Should we only prohibit a partner from rotating between investment company issuers within the same investment company complex? Why or why not?
- The proposed rules would not require all partners on the audit engagement team to rotate at the same time. Should it? Why or why not?

D. Audit Committee Administration of the Engagement

The proposed rules recognize the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence. An effective audit committee may enhance the auditor's independence by, among other things, providing a forum apart from management where the auditors may discuss their concerns. It may facilitate communications among the board of directors, management, internal auditors and independent accountants. An audit committee also may enhance auditor independence from management by appointing, compensating and overseeing the work of the independent auditors.

The audit committee should approve the engagement of the independent accountant to audit the issuer and its subsidiary's financial statements and have ongoing communications with the accountant. The proposals would require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. The proposals require that either:

- Before the accountant is engaged by the audit client to provide services other than audit, review or attest services, the audit client's audit committee expressly approve the particular engagement; or
- Any such engagement be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee and the audit committee is informed on a timely basis of each service.

As provided in the Sarbanes-Oxley Act, the proposed rules recognize audit services to be broader than those services required to perform an audit pursuant to generally accepted auditing standards. For example, the Act identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.[79] We recognize that domestically and internationally there are various requirements for statutory audits. These proposals contemplate this fact; accordingly, such engagements are viewed as audit services in the context of these proposals. These rules require that the audit committee pre-approve all such services. These proposals do anticipate that the audit committee may approve broadly the provision of audit, review and attest services by the auditor to the issuer and its subsidiaries.

The audit committee also would have the sole authority to pre-approve the engagement of the company's independent accountant to expressly perform particular non-audit services. The audit committee also could establish policies and procedures provided they are detailed as to the particular service and designed to safeguard the continued independence of the auditor. Additionally, the Sarbanes-Oxley Act allows for one audit committee member to pre-approve the service.

Unlike other issuers, the investment adviser to the investment company issuer will generally engage the issuer's accountant to perform non-auditing services that might impact the accountant's independence. The proposed rule would require pre-approval not only of the non-auditing services provided to the investment company issuer, but also require pre-approval by the investment company issuer's audit committee of the non-auditing services provided to the investment adviser of an investment company issuer and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company. The proposed rule would not, however, require the audit committee of an investment company to approve the auditing or non-auditing services provided: (i) To another investment company registrant within an investment company complex as defined in rule 2–01(f)(14); (ii) to a sub-adviser that primarily provides portfolio management services and is under the direction of another investment adviser; and (iii) to other entities within the investment company complex that do not provide services to the fund.

Under the proposed rule, the investment company's audit committee would be able to establish policies and procedures for pre-approving non-auditing services provided not only to the investment company issuer, but also its investment adviser and related entities that provide services to the fund. The proposed rule would permit, for purposes of determining whether a non-auditing service meets the *de minimis* exception, the investment company's audit committee to aggregate the total amount of revenues paid to the investment company's accountant by the investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company.

Also, as discussed later in this release, these provisions are supplemented as a result of the proposed proxy disclosure requirements. We believe that disclosure of the procedures the audit committee uses to pre-approve audit services will provide investors valuable information that may be used to evaluate the relationships that exist between the auditor and the audit client.

- Should the Commission create other exceptions (beyond the *de minimis* exception) that would allow an audit committee to adopt a policy that contracts that are recurring (*e.g.*, due diligence engagements in connection with a series of insignificant acquisitions) and less than a stated dollar amount (such as $25,000) or less than a stated percentage of annual revenues (such as 1% or 5%) could be entered into by management and would be reviewed by the audit committee at its next periodic meeting?
- Is allowing the audit committee to engage an auditor to perform non-audit services by policies and procedures, rather than a separate vote for each service, appropriate? If so, how do we ensure that audit committees have rigorous, detailed procedures and do not, in essence, delegate that authority to management?
- Should more or fewer aspects be left to the discretion of the audit committee?
- Are there specific matters that should be communicated to or considered by the audit committee prior to its engaging the auditor?
- What, if any, audit committee policies and procedures should be mandated to enhance auditor independence, interaction between auditors and the audit committee, and communications between and among audit committee members, internal audit staff, senior management and the outside auditor?
- Our proposed rules do not contain exemptions for foreign filers. Are there legal or regulatory impediments which may make it difficult for certain foreign filers to comply? If so, what safeguards can these foreign filers employ to ensure that they comply with the proposed rules?
- Our proposed rules requiring the audit committee to pre-approve non-audit services to be provided by the company's auditor do not contain an exemption for foreign filers. Are there legal or regulatory impediments which may make it difficult for certain foreign filers to comply? If so, what safeguards can these foreign filers employ to ensure that there is an authorization process to

[79] Section 202 of the Sarbanes-Oxley Act; 15 U.S.C 78j–1(i)(1)(A).

pre-approve such services that is separate from management?

• In addition to legal or regulatory impediments, are there practical impediments which would make it difficult for certain foreign filers to comply with the pre-approval requirements? If so, what are these impediments? What safeguards can such an entity establish to better implement the proposed rules (which is to separate the decision to engage the auditor for non-audit services from management)?

• Should the Commission provide additional specific guidance to assist audit committees when deliberating auditor independence issues? What topics would be helpful?

• Our proposed rules would require the audit committee of an investment company to pre-approve the non-auditing services provided by the accountant of the investment company to the investment company's investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the investment company. Should the audit committee of an investment company registrant be required to approve any non-auditing services provided to the investment adviser and any entity controlled, controlled by, or under common control with the investment adviser that provides services to the fund? Should the scope of the pre-approval requirement be expanded or narrowed? Why or why not?

• Under the proposed rules, the pre-approval of non-auditing services would permit, for purposes of determining whether a non-auditing service meets the *de minimis* exception, the investment company's audit committee to aggregate total revenues paid to the investment company's accountant by the investment company, its investment adviser and any entity controlled, controlled by, or under common control with the investment adviser that provides services to the fund. Should the *de minimis* exception be determined separately based on the total revenues paid to the investment company's accountant by each entity?

• This proposed rule would apply to ''issuers.'' Should the Commission consider applying this rule to a broader population such as ''audit clients'' as defined in 2–01(f)(6) of Regulation S–X? Why or why not?

• In addition to the requirement that a majority of the directors who are not interested persons of the registered investment company appoint the independent accountant of a registered investment company under the Investment Company Act of 1940, the proposed rules would also require the audit committee of an investment company to separately approve the accountant. For registered investment companies, who should approve the selection of the accountant, *i.e.* independent directors, the audit committee, or both? If both, should the audit committee nominate the independent accountant with the independent directors making the selection?

E. Compensation

We propose to amend the auditor independence rules to address the practice of auditors being compensated by their firms for selling non-audit services to their audit clients. The new rule would provide that an accountant is not independent if, at any point during the audit and professional engagement period,[80] any partner, principal or shareholder of the accounting firm who is a member of the audit engagement team earns or receives compensation based on the performance of, or procuring of, engagements with that audit client, to provide any services, other than audit, review, or attest services.

Some accounting firms offer their professionals cash bonuses and other financial incentives to sell products or services, other than audit, review, or attest services to audit clients. We view such incentive programs as inconsistent with the independence and objectivity of external auditors that is necessary for them to maintain, both in fact and in appearance. The Commission believes that any partner, principal or shareholder who is a member of the audit engagement team could be influenced adversely as a result of the economic benefits that may be derived by promoting the firm's non-audit services to audit clients. We are concerned that an auditor might be viewed as compromising accounting judgments in order not to jeopardize the potential for increased income from sales of non-audit services.

''Compensation,'' as used in the proposed rule, would include any form of income or monetary benefit distributed to the partner, principal or shareholder. Compensation would be based on the performance or sale of non-audit services if the partner, principal, or shareholder were financially rewarded in any way for the performance or sale of such services. For example, this provision would result in accounting firms removing the sale of non-audit services to a partner's audit clients from the criteria used to allocate partnership ''units'' to that partner. It also would apply to any other vehicle used in determining compensation for any partner, principal or shareholder who is a member of the engagement team. This provision also reinforces the position that accountants at the partner level should be viewed as skilled professionals and not as conduits for the sale of non-audit services. This proposal recognizes and focuses on the need for independence of the most senior members of the engagement team as well as the accounting firm.

• We seek comments on all aspects of incentive compensation for audit partners, principals and shareholders and on the following:

• What economic impact will our proposal have on the current system of partnership compensation in accounting firms?

• Are there other approaches that should be considered with respect to compensation packages that pose a concern about auditor independence? If so, what are they?

• Would the proposed rule change be difficult to put into practice? If so, why? How could it be changed to be more effectively applied?

• Should managers, supervisors or staff accountants who are members of the audit engagement team also be covered by this proposal?

• Does this proposal cover the appropriate time period or should a measure other than the audit and professional engagement period be considered?

• Does the proposed rule cover the entire component of an audit partner's compensation that gives rise to independence concerns?

• Will this compensation limitation disproportionately affect some firms because of their size or compensation structure? If so, how may we accomplish our goal while taking these differences into account?

• Our proposal references compensation based on the performance or sale of non-audit services. Is there a better test that permits partners to participate in the overall success of the firm while addressing the influence that such services might have on a particular auditor-client relationship?

[80] ''Audit and professional engagement period'' includes both the period covered by the financial statements being audited or reviewed and the period of engagement to audit or review the client's financial statements or to prepare a report filed with the Commission. The period of engagement begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or the auditor notifies the Commission that the client is no longer the auditor's audit client. *See* rule 2–01(f)(5) of Regulation S–X, 17 CFR 210.2–01(f)(5).

F. Definitions

1. Accountant

The term ''accountant'' currently is defined under the rules of the Commission as a ''certified public accountant or public accountant performing services in connection with an engagement for which independence is required.''[81] The proposed rules add to the definition the phrase a ''registered public accounting firm.'' Under the provisions of the Sarbanes-Oxley Act, public accounting firms must register with the Public Company Accounting Oversight Board (the ''Board'') in order to prepare or issue, or to participate in the preparation or issuance of any audit report with respect to any issuer.[82] Thus, the term ''registered public accounting firm'' refers to a firm that has registered in accordance with the requirements of the Sarbanes-Oxley Act. Accordingly, the proposals would include registered public accounting firms within the definition of accountants.

2. Accounting Role

Under the existing rules of the Commission, accounting role and financial reporting oversight role were included as a single definition. However, because the proposed rules that require a cooling-off period relate only to those performing a financial reporting oversight role, the Commission proposes to define separately ''accounting role'' and ''financial reporting oversight role.'' As proposed, the term ''accounting role'' refers to a role where a person can or does exercise more than minimal influence over the contents of the accounting records or over any person who prepares the accounting records. All persons in a ''financial reporting oversight role'' (defined below) are also in an ''accounting role.'' However, persons in an accounting role include individuals in clerical positions responsible for accounting records (*e.g.*, payroll, accounts payable, accounts receivable, purchasing, sales) as well as those who report to individuals in financial reporting oversight roles (*e.g.*, assistant controller, assistant treasurer, manager of internal audit, manager of financial reporting).

• Is this proposed definition sufficiently clear? If not, what changes would make the definition clearer and more operational?

3. Financial Reporting Oversight Role

The term ''financial reporting oversight role'' refers to a role in which an individual has direct responsibility or oversight of those who prepare the registrant's financial statements and related information (*e.g.*, management discussion and analysis), which will be included in a registrant's document filed with the Commission. As noted above, ''accounting role and financial reporting oversight role'' previously was one definition. In order to subject the appropriate individuals to certain portions of the proposed rules, we are proposing to bifurcate the definitions.

• Is this proposed definition sufficiently clear? If not, what changes would make the definition clearer and more operational?

4. Audit Committee

Section 205 of the Sarbanes-Oxley Act defines an audit committee as:

> A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.

The Act further stipulates that if no such committee exists, then the audit committee is the entire board of directors. The Commission proposes to adopt the same meaning for audit committee as used in the Act.

The audit committee serves as an important body, serving the interests of investors, to help ensure that the registrant and its auditors fulfill their responsibilities under the securities laws. Because the definition of an audit committee includes the entire board of directors if no such committee of the board exists, these rules do not require registrants to establish audit committees.

Some companies do not have boards of directors and therefore do not have audit committees. For example, some limited liability companies and limited partnerships that do not have a corporate general partner may not have an oversight body that is the equivalent of an audit committee. We do not propose to exempt these entities from the proposed requirements. Rather, such issuers should look through each general partner of the limited partnerships acting as general partner until a corporate general partner or an individual general partner is reached. With respect to a corporate general partner, the registrant should look to the audit committee of the corporate general partner or to the full board of directors as fulfilling the role of the audit committee. With respect to an individual general partner, the registrant should look to the individual as fulfilling the role of the audit committee.

We do, however, propose to exempt asset-backed issuers[83] and unit investment trusts[84] from this proposed requirement. Because of the nature of these entities, such issuers are subject to substantially different reporting requirements. Most significantly, asset-backed issuers are not required to file financial statements like other companies. Similarly, unit investment trusts are not required to provide shareholder reports containing audited financial statements. Also, such entities typically are passively managed pools of assets. Therefore, we do not propose to apply the requirements related to audit committees in this release to such entities.

• Some registrants may not have designated boards of directors or audit committees (*e.g.* benefit plans required to file form 11–K). Does the definition of audit committee sufficiently describe who should serve in this capacity where such situations exist? If not, what additional guidance would be appropriate?

• Our proposed rules exempt unit investment trusts and asset-backed issuers from the rule requiring the audit committee to approve auditing and non-auditing services. Should unit investment trusts and asset-backed issuers be subject to these requirements? If so, given that unit investment trusts and asset-backed issuers are not actively managed, who should be responsible for approving the auditing and non-auditing services? Are there other, similar entities that should be exempt from the pre-approval requirements?

• Are the existing definitions in Regulation S–X and rule 2–01 of Regulation S–X of audit client, issuer, and subsidiary sufficiently clear?

G. Communication With Audit Committees

Section 204 of the Sarbanes-Oxley Act directs the Commission to issue rules requiring timely reporting of specific information by auditors to audit committees. We are proposing to amend Regulation S–X to require each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements to report, prior to the filing of such report with the Commission, to the issuer or registered investment

[81] 17 CFR 2–01(f)(1).

[82] *See* section 102(a) of the Sarbanes-Oxley Act.

[83] As defined in 17 CFR 240.13a–14(g) and 240.15d–14(g).

[84] As defined by section 4(2) of the Investment Company Act (15 U.S.C. 80a–4(2)).

company's audit committee: (1) All critical accounting policies and practices used by the issuer or registered investment company, (2) all alternative accounting treatments of financial information within generally accepted accounting principles (''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 of the issuer or registered investment company.

We believe that this section of the Sarbanes-Oxley Act and these proposed rules largely codify current requirements under Generally Accepted Auditing Standards (''GAAS'') for auditors of public companies to discuss matters with management and audit committees. We further believe that specifying the timing of these communications will facilitate more open dialogue between auditors and audit committees.

Certain specific oral or written communications with audit committees are currently required by GAAS, including:

(1) Methods used to account for significant unusual transactions,

(2) Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus,

(3) Process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates,

(4) Material audit adjustments proposed and immaterial adjustments not recorded by management,

(5) Auditor's judgments about the quality of the company's accounting principles, and

(6) Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.[85]

Auditors are required under GAAS to provide these communications in a timely manner but not necessarily before the issuance of the audit report.[86] Auditors also may communicate with audit committees on matters in addition to those specifically required by AU § 380, including auditing issues, engagement letters, management representation letters, internal controls, auditor independence, and others.

- In light of the requirements for the CEO and CFO to certify information in the company's periodic filings,[87] should the auditor be required to communicate information on critical accounting policies and practices and alternative accounting treatments to management as well as to the audit committee?

1. Critical Accounting Policies and Practices

We are proposing rules requiring communication by auditors to audit committees of all critical accounting policies and practices. This communication can be oral or written. In December 2001, we issued cautionary advice regarding each issuer disclosing in the Management's Discussion and Analysis[88] Section of its annual report those accounting policies that management believes are most critical to the preparation of the issuer's financial statements.[89] The cautionary advice indicated that ''critical'' accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.[90] As part of that cautionary advice, we stated:

> Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.[91]

In May 2002, the Commission proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies.[92] The May 2002 proposed rules cover (1) accounting estimates a company makes in applying its accounting policies and (2) the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of those proposed rules, a ''critical accounting estimate'' is defined as an accounting estimate recognized in the financial statements (1) that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and (2) for which different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the registrant's financial condition, changes in financial condition or results of operations. The May 2002 proposed rules outline certain disclosures that a company would be required to make about its critical accounting estimates. In addition, under the second part of the May 2002 proposed rules, a company would be required to make certain disclosures about its initial adoption of accounting policies, including the choices the company had among accounting principles.

Auditors may want to read and refer to the December 2001 Cautionary Guidance as well as the May 2002 proposed rules as a guide to determining the types of matters that should be communicated to the audit committee under this proposed rule. We do not propose to require that those discussions follow a specific form or manner, but we expect, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why certain estimates or policies are or are not considered critical and how current and anticipated future events impact those determinations. In addition, we anticipate that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the auditors that were not included.

- Should the auditor be required to provide additional information to the audit committee regarding the company's critical accounting policies?
- When should the communication take place?
- Should the auditor be required to provide the communication in writing?
- Is it appropriate that investment companies would be subject to the rules regarding critical accounting policies?

[85] *See* Codification of Statement on Auditing Standards AU § 380, ''Communication with Audit Committees.''

[86] *Id.*

[87] *See* Release No. 33–8124, ''Certification of Disclosure in Companies' Quarterly and Annual Reports,'' (Aug. 29, 2002).

[88] Item 303 of Regulation S–K, (17 CFR 229.303), which requires disclosure about, among other things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

[89] Release No. 33–8040 (Dec. 12, 2001) (66 FR 65013).

[90] *Id.*

[91] *Id.* (footnotes omitted).

[92] Release No. 33–8090 (May 10, 2002) (67 FR 35620).

2. Alternative Accounting Treatments

We recognize that the complexity of financial transactions results in accounting answers that are often the subject of significant debate between management and the auditors. We believe that these discussions of accounting alternatives that occur between management and the auditors should be shared with the audit committee in their oversight role. The report by the Senate Committee on Banking, Housing, and Urban Affairs on the bill that later became the foundation for the Sarbanes-Oxley Act, in addressing section 204, stated, in part:

> The Committee believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statements and of disagreements that the auditor has with management. The audit committee should be informed in a timely manner of such disagreements, so that it can independently review them and intervene if it chooses to do so in order to assure the integrity of the audit.[93]

Therefore, we are proposing rules requiring communication, either orally or in writing, by auditors to audit committees of 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. This proposed rule is intended to cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

We believe that communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the auditors would be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not the preferred method in the auditor's opinion, we would expect that the reasons why the auditor's preferred method was not selected by management also would be discussed.

Communications regarding general accounting policies would focus on the initial selection of and changes in significant accounting policies, as required by AU § 380, and would include the impact of management's judgments and accounting estimates, as well as the auditor's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies would include the range of alternatives available under GAAP that were discussed by management and the auditors along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change would also be communicated. If the accounting policy selected is not the auditor's preferred policy, then we would expect the discussions to include the reasons why the auditor considered one policy to be preferred but that policy was not selected by management.

The separate discussion of critical accounting policies and estimates is not considered a substitute for communications regarding general accounting policies, since the discussion about critical accounting policies and estimates might not encompass any new or changed general accounting policies and estimates. Likewise, this discussion of general accounting policies and estimates is not intended to dilute the communications related to critical accounting policies and estimates, since the issues affecting critical accounting policies and estimates, such as sensitivities of assumptions and others, may be tailored specifically to events in the current year, and the selection of general accounting policies and estimates should consider a broad range of transactions over time.

- Is the discussion of which accounting policies require communication with the audit committee sufficiently clear?
- Should additional matters be required to be communicated to the audit committee? If so, which matters?
- Is it appropriate that investment companies would be subject to the proposed rules regarding alternative accounting treatments?

3. Other Material Written Communications

We understand written communications between auditors and management range from formal documents, such as engagement letters, to informal correspondence, such as administrative items. We also acknowledge that not all forms of written communications provided to management also are provided to the audit committee. The decision whether to provide written communications to the audit committee is subjective and is influenced by auditing standards. Our proposed rule is intended to clarify the substance of information that would be provided by auditors to audit committees to facilitate auditor and management oversight by those committees. We anticipate that the proposed rule would result in auditors and audit committees having more robust discussions of accounting and auditing matters.

The Sarbanes-Oxley Act specifically cites the management letter and schedules of unadjusted differences as examples of material written communications to be provided to audit committees. Examples of additional written communications that we expect would be considered material to an issuer include:

- Management representation letter; [94]
- Reports on observations and recommendations on internal controls; [95]
- Schedule of material adjustments and reclassifications proposed, and a listing of adjustments and reclassifications not recorded, if any; [96]
- Engagement letter; [97] and
- Independence letter.[98]

These examples are not exhaustive, and auditors are encouraged to critically consider what additional written communications should be provided to audit committees.

4. Timing of Communications

The Act requires that the aforementioned communications should be timely reported to the audit committee. For purposes of the requirements of this provision, the proposed rule specifies that the proposed communications between the

[93] Report of the Senate Committee on Banking, Housing, and Urban Affairs, ''Public Company Accounting Reform and Investor Protection Act of 2002,'' Senate Report 107–205, 107th Cong., 2d Sess., at 21 (July 3, 2002).

[94] *See* SAS 85 AU§ 333, ''Management Representations.''

[95] *See* SAS 60 AU § Communication of Internal Control Related Matters Noted in an Audit.''

[96] *See* SAS 89, AU§ 333, ''Audit Adjustments,'

[97] *See* SAS 83 AU§ 310, ''Establishing an Understanding With the Client.''

[98] *See* SQCS 2 QC§ 20, ''System of Quality Control for a CPA Firm's Accounting and Auditing Practice.''

auditor and the audit committee occur prior to the filing of the audit report with the Commission pursuant to applicable securities laws. As a result, these discussions will occur, at a minimum, during the annual audit, but we expect that they could occur as frequently as quarterly or more often on a real-time basis.

The timing of these communications is intended to occur before any audit report is filed with the Commission pursuant to the securities laws. We believe that this proposed rule will ensure that these communications occur prior to filing of annual reports and proxy statements, as well as prior to filing registration statements and other periodic or current reports when audit reports are included.

- Should the timing of these communications be required to occur before any audit report is filed with the Commission or at some other time?
- Should these communications regarding critical accounting policies be required to be in writing? If so, why?
- Should we include specific instructions within the proposed rule regarding the nature of communications of critical accounting policies? If so, what instructions should be provided and why?
- Do these required communications fulfill existing GAAS requirements? If not, why?
- Should these communications regarding alternative accounting treatments be required to be in writing? If so, why?
- Do these required communications fulfill the statutory requirements? If not, why?
- Should the minimum requirements for discussion of alternative accounting treatments be expanded or reduced? If so, how?
- Should the list of recommended other communications be expanded or reduced? If so, what specific items should be added and why?
- Should the list of recommended other communications be required to be communicated to the audit committee? Why or why not?
- Are the appropriate entities included under the term ''issuer'' appropriate? If not, what entities should be included or excluded?
- Is it appropriate that investment companies are required to make these communications to their audit committees? Why or why not?
- This proposed rule would apply to ''issuers.'' Should the Commission consider applying this rule to a broader population such as ''audit clients'' as defined in 2–01(f)(6) of Regulation S–X? Why or why not?

H. Expanded Disclosure

1. Principal Accountants' Fees

To allow investors to be better able to evaluate the independence of the auditor of a company's financial statements in which they invest, the proxy disclosure rules currently require that a registrant disclose the professional fees it paid to its principal independent accountant in the most recent fiscal year. We propose to change both the types of fees that must be detailed and the years of service that are covered by the disclosure.[99] The proposed rules would increase the disclosed categories of professional fees paid for audit and non-audit services from three to four. The categories of reportable fees would be: (1) Audit Fees, (2) Audit-Related Fees, (3) Tax Fees, and (4) All Other Fees.[100] The new disclosure would show fees for each of the two most recent fiscal years, rather than just the most recent fiscal year. In addition, registrants will be required to describe in subcategories the nature of the services provided that are categorized as audit-related fees and all other fees. We are also proposing disclosure requirements related to audit committee pre-approval policies and procedures for audit and non-audit services provided by an independent public accountant as well as the percentage of fees that were pre-approved.

We are proposing these changes partly in response to public comment on this disclosure since we adopted the requirement in 2000. For example, the definition of ''Audit Fees'' restricts the fees reportable in that category to the services necessary only to complete the basic audit, sign the audit opinion and perform the required quarterly reviews. This category was intended to include fees for only those services specifically required under GAAS.[101] Some have suggested that the categories are not as clear as they can be and some commentators have questioned the usefulness of the current fee disclosures.

We recognize that there are certain accounting, audit, assurance and related services that accountants, in effect, must perform for their audit clients. Presently, registrants are required to combine fees for those services with fees paid for consulting and present the aggregate in the ''All Other Fees'' category. We recognize that this framework may make it difficult for shareholders to distinguish between fees for services traditionally performed by the accounting firm's auditors and fees for services performed by the accounting firm's consulting division. Some reporting companies have sought to add clarity by including further subcategories under ''All Other Fees'' to provide greater detail.

While the proposed rules continue to require issuers to disclose fees paid to the principal accountant for audit services, we are expanding the types of fees that should be included in this category. In addition to including fees for services necessary to perform an audit or review in accordance with GAAS,[102] this category also may include services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission.

We believe that the addition of a new category, ''Audit-Related Fees,'' will enable registrants to present the audit fee relationship with the principal accountant in a more transparent fashion. In general, Audit-Related Fees are assurance and related services that are traditionally performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with proposed or consummated acquisitions, internal control reviews, consultation concerning financial accounting and reporting standards.

We also believe it is appropriate to add transparency regarding a second category of fees: ''Tax Fees.'' Tax services traditionally have been viewed as closely related to audit services and as not being in conflict with an auditor's independence. However, such services would be subject to pre-approval by the audit committee. The review of a registrant's tax accruals and reserves is a task that requires extensive knowledge about the audit client—knowledge that has already been assimilated by the audit and tax professionals. In many public companies, the fee for tax services is substantial in relation to other services. Investors may benefit from being able to consider those fees

[99] *See* proposed item 9(e), schedule 14A.

[100] Currently, registrants need disclose only ''Audit Fees,'' ''Financial Systems Design and Implementation Fees'' and ''All Other Fees.'' (17 CFR 240.14a–101, item 9(e)). We are proposing to delete the category of ''Financial Systems Design and Implementation Fees'' because such services generally are prohibited. *See* section II.B.2 of this release.

[101] *See* Application of Revised Rules on Auditor Independence: Frequently Asked Questions. Office of the Chief Accountant, January 16, 2001, Question and answer no. 1.

[102] *See also* section 2(a)(2) the Sarbanes-Oxley Act which defines the term ''audit''.

separately from the ''All Other Fees'' category. The ''Tax Fees'' category would capture all services performed by professional staff in the independent accountant's tax division. Typically, it would include fees for tax compliance, consultation and planning. Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax consultation and tax planning encompass a diverse range of services, including assistance and representation in connection with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities.

The category of ''All Other Fees'' would remain unchanged from the existing rule, except that to the extent that financial information systems implementation and design exist they would be disclosed as a component of ''All Other Fees.''

Thus, this proposal would add two new categories to the disclosures: (1) Audit-related fees and (2) tax fees. This proposal also would eliminate one of the current categories: financial information technology consulting fees. This category would be eliminated under this proposal because under the section of the proposal addressing nonaudit services, auditors would no longer be permitted to provide most of these consulting services to audit clients. Thus, the Commission believes that this disclosure of fees paid in this category would no longer be necessary.

For comparison purposes, two dollar amounts would be shown under each one of the four categories—one for each of the two most recent fiscal years. Each amount reported would represent the aggregate of all fees billed by the principal independent accountant that is appropriate to that category in one of those two years. As we note in the proposed Item, registrants also are required to describe each subcategory of services comprising the fees included in the ''audit related'' and ''all other fees'' categories.

The disclosures of the percentage of audit services that are not provided by permanent, full-time employees of the independent public accounting firm remain unchanged from previous rules.

2. Audit Committee Actions

We propose to require that registrants filing proxy statements disclose any policies and procedures developed by the audit committee of the board of directors concerning pre-approval of the independent accountant to perform both audit and non-audit services. Section 202 of the Sarbanes-Oxley Act states the pre-approval requirements for all auditing and non-audit services, with exceptions provided for *de minimis* amounts under certain circumstances, as described in the Act and the proposed rules. This section also describes the delegation authority of the audit committee related to pre-approvals. We believe that investors should be informed of audit committee pre-approval procedures and policies in place to give investors a better understanding of how audit committees are managing relationships with independent accountants, including evaluating engagements with the accountant that could impair the accountant's independence.

The proposed disclosure would set out in detail the audit committee's policies and procedures for engaging the independent accountant to perform services other than audit, review and attest services. We expect registrants to provide clear, concise and understandable descriptions of the policies and procedures. Alternatively, registrants could include a copy of those policies and procedures with the proxy statement delivered to investors and filed with the Commission. Either method should allow shareholders to obtain a complete and accurate understanding of the audit committee's policies and procedures. We expect the policies and procedures would address auditor independence oversight functions in a prudent and responsible manner. Additionally, these procedures would describe, if applicable, the specific processes in place that permit and monitor activities meeting the *de minimis* exception.

We also believe investors would benefit from knowing what percentage of the fees reported in each of the ''Audit-Related Fees,'' ''Tax Fees,'' and ''All Other Fees'' categories were pre-approved by the audit committee pursuant to the policies and procedures instituted by the audit committee. That disclosure would provide insight into the extent to which the audit committee takes an active, direct role in considering each category of non-audit fee engagements.

The Sarbanes-Oxley Act requires the Commission to promulgate rules requiring companies to disclose the required information together with periodic reports required pursuant to sections 13(a) and 15(d) of the Exchange Act. In accordance with this mandate, we propose to require the new disclosures in a company's annual report. However, because we believe that this information is relevant to a decision to vote for a particular director or to elect, approve or ratify the choice of an independent public accountant, we propose to require this disclosure in a company's proxy statement on schedule 14A or information statement on schedule 14C. Because the information is proposed to be included in part III of annual reports on forms 10–K and 10–KSB, domestic companies would be able to incorporate the required disclosures from the proxy or information statement into the annual report.

Our intent is that this information be made available to investors of all registrants. However, not all registrants are required to file proxy statements. Thus, consistent with the provisions in the Act, registrants that do not issue proxy statements would be required to include appropriate disclosures in their annual filing included in form 10–K, form 10–KSB, 20–F, form 40–F and proposed form N–CSR as appropriate. For the reasons noted previously in this release, we propose to exempt asset-backed issuers and unit investment trusts from such disclosure requirements.

In addition, we propose to require parallel disclosure for registered management investment companies (''funds'') in annual reports on proposed form N–CSR.[103] Like operating companies, registered management investment companies would also be required to include this information in proxy or information statements that relate to the election of directors, or the election, approval, or ratification of an independent public accountant.[104] However, in recent years, the proxy statement has become an ineffective vehicle for making information available to fund shareholders on a regular basis because many funds are no longer required to hold annual meetings.[105]

[103] Proposed form N–CSR would be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002. *See* Investment Company Act Release No. 25723 (Aug. 30, 2002) (67 FR 57298 (Sept. 9, 2002)); Sarbanes-Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745 (2002).

[104] 17 CFR 240.14a–101, item 9(e).

[105] For historical and other reasons, most funds are organized under the laws of Massachusetts or Maryland. The organizational and operational requirements of Massachusetts business trusts are not specified by statute, and a fund's essential structure is contained in the trust agreement, which generally includes a provision eliminating the need for annual shareholder meetings to elect directors. *See generally* Jones, Moret, and Storey, *The Massachusetts Business Trust and Registered Investment Companies,* 13 DEL. J. CORP. L. 421 (1988). Under Maryland corporate law, fund charters or by-laws are not required to provide that annual meetings be held in any year in which election of directors is not required by the

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Accordingly, we believe that the disclosure regarding audit committee pre-approval policies and procedures for audit and non-audit services and professional fees billed by auditors should also be required in annual reports on proposed form N–CSR, which would be filed with the Commission and available to investors.

- Is the proxy statement the appropriate location for this disclosure? If not, why?
- Should we permit incorporation by reference into the company's annual report?
- Would expansion of the proxy disclosure of professional fees paid to the independent auditor from three categories to four provide more useful information to investors?
- Are the new categories of disclosure appropriate? Are they well defined, or should they be more accurately defined? Should there be additional (or fewer) categories?
- Is disclosure of two years of fees appropriate? Should the proposed additional fee disclosures be expanded to three years or remain at one year?
- What, if any, additional information about professional fees would be useful to investors?
- For a registrant not subject to the proxy disclosure rules, such as foreign private issuers, should we require that the same disclosures be placed in annual reports?
- Is there any additional disclosure concerning the activities of audit committees that would be beneficial to investors?
- Should companies be required to provide the information in their quarterly reports? Should it be required that the information be included in other filings such as form 10–Q or 10–QSB?
- Should registered investment companies be required to provide the information in their semi-annual report to shareholders on proposed form N–CSR?
- Registered investment companies are required to provide disclosure of audit fees billed for the registrant only, but are required to disclose other types of fees in the aggregate for the registrant, its investment adviser, and certain other parties.[106] Is this appropriate, or should we also require disclosure of audit fees on an aggregate basis? In the alternative, should we require disclosure of audit-related fees or any other fees for the registrant only and not on an aggregate basis?
- If we adopt such a requirement, should we require or permit registrants to recalculate and report fees already disclosed for more than two years so that all fee information is consistently reported and available?

I. Transition Period

While much of the current proposal implements title II of the Act, we are also proposing changes which go beyond the provisions of the Act. In those areas, we are proposing that the provisions would be effective upon adoption of final rules. However, for those situations, we are considering the appropriate timing for the implementation of final rules and how best to allow for an orderly transition as a result of the new requirements imposed by the proposals. We are considering whether the application of some of these provisions should be delayed to a later date. For example, we are considering transition provisions related to the rules concerning audit partner rotation, audit committee communications, disclosures of fees paid to auditors, and partner compensation.

- Would a period of time beyond the adoption date of the final rules be necessary or appropriate for compliance with the final rules by smaller companies or companies with whose securities currently are not listed or quoted? If so, which rules should we consider a delayed effective date?
- How should an effective date be determined with respect to each amendment?
- Are there special considerations that we should take into account in providing a transition period for foreign private issuers?

III. General Request for Comments

- We invite any interested person wishing to submit written comments on the proposals or any matters that may impact the proposals, to do so. We specifically request comments from investors, issuers, and accounting firms.
- We solicit comment on each component of the proposals.
- Would the proposals related to audit committees and partner compensation help alleviate the pressure that clients may place on engagement partners or accounting firms to acquiesce to the clients' views on accounting issues? What are some of the other scenarios where such pressures might exist?

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulation S–X, schedule 14A and forms 10–K, 10–KSB, 20–F, 40–F and proposed form N–CSR contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'') (44 U.S.C. 3501 *et seq.*), and the Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the proposed requirements would be mandatory. There would be no mandatory retention period for the information disclosed under the rules being proposed in this release. Responses to the disclosure requirements would not be kept confidential.

The titles for the collections of information are: ''Regulation S–X''; ''Proxy Statements—Regulation 14A and Schedule 14A''; ''Form 10–K''; ''Form 10–KSB''; ''Form 20–F''; ''Form 40–F''; and ''Form N–CSR under the Investment Company Act of 1940 and Securities Exchange Act of 1934, Certified Shareholder Report.''

Regulation S–X (OMB Control No. 3235–0009) is the central repository for rules related to the form and content of financial statements filed with the Commission. Regulation S–X, however, does not direct registrants to file financial statements or to collect financial data. Regulation S–X indicates

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Investment Company Act. MD. CODE ANN., CORPS. & ASS'NS Code 2–501(b)(1)(2002). In addition, Delaware, Minnesota, and California also have business trust or special corporate law structures that have the effect of not requiring shareholder meetings other than those required by the Investment Company Act. DEL. CODE ANN. tit. 12, § 3806 (2001); Minn Stat. 302A.431 (2001); CAL. CORP. CODE 600(b) (West 2001).

Closed-end funds registered on national securities exchanges, however, are required to hold an annual meeting to elect directors under the rules of the exchanges. *See, e.g.*, American Stock Exchange Company Guide Listing Standards, Policies and Requirements § 704; New York Stock Exchange Listed Company Manual 302.00. Closed-end fund shareholders therefore generally would receive annual proxy statements.

[106] Item 9(e)(1), (2), and (3) of schedule 14A (17 CFR 240.14a–101, item 9(e)(1), (2), and (3)) (requiring disclosure under the caption ''Audit Fees'' of fees billed for audit of registrant's financial statements and disclosure under the captions ''Financial Information Systems Design and Implementation Fees,'' and ''All Other Fees'' of fees billed for services rendered to the registrant, its investment adviser, and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant); proposed item 9(e)(1), (2), (3) and (4) of schedule 14A; proposed instruction 2 to item 9(e) of schedule 14A (proposing to require disclosure under the caption ''Audit Fees'' of fees billed for audit of registrant's financial statements, and disclosure under the captions ''Audit-Related Fees,'' ''Tax Fees,'' and ''All Other Fees'' of fees billed for services rendered to the registrant, the registrant's investment adviser, and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant).

what should be in the financial statements and how financial statements should be presented when they are required to be filed by other rules or forms under the securities laws. Because Regulation S–X does not require any information to be filed with the Commission, only one burden hour is assigned to cover a reading of the regulation. Burden hours and costs associated with the preparation of financial statements in accordance with Regulation S–X are allocated to the rules or forms that require the financial statements to be filed.

A. Communication With Audit Committees

As required by section 204 of the Sarbanes-Oxley Act, we are proposing to amend Regulation S–X to require each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements to report to the issuer's audit committee (1) all critical accounting policies and practices used by the issuer, (2) alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of ''unadjusted differences.'' The required reports need not be in writing but the report would be required to be presented to the audit committee before the auditor's report on the financial statements is filed with the Commission.[107]

We believe that auditing standards currently require discussions between the auditors and the audit committee of significant unusual, controversial, or emerging accounting policies, of the process used by management to select certain estimates, and of disagreements over certain accounting matters.[108] We further believe that audit committees generally are aware of management's letter making representations to the auditors, which the auditor uses in conducting the audit of the issuer's financial statements. Audit committees also should be aware of ''unadjusted differences,'' if any, as a result of the enactment of section 401 of the Sarbanes-Oxley Act, which added section 13(i) to the Securities Exchange Act of 1934 (''Exchange Act'').[109] Under new section 13(i) of the Exchange Act, therefore, there should be no material ''unadjusted differences.''

Because of these GAAS and legal provisions, we believe that adoption of the proposed rules regarding auditor reports to audit committees would not increase significantly the burden hours on accounting firms or registrants.

B. Disclosures of Audit and Non-Audit Services

1. Proxy and Information Statements

Schedule 14A [110] (OMB Control No. 3235–0059) prescribes the information that a company must include in its proxy statement to ensure that shareholders are provided material information relating to voting decisions. The Commission currently estimates that 7,661 registrants annually file schedule 14A. Schedule 14C [111] (OMB Control No. 3235–0057) prescribes the information that a company that is registered under section 12 of the Exchange Act must include in its information statement in advance of a security holders' meeting when it is not soliciting proxies from its security holders. The Commission currently estimates that 464 registrants annually file schedule 14C.

Item 9 of schedule 14A requires the disclosure of certain information regarding the registrant's relationship with the independent auditor of the company's financial statements when there is a solicitation relating to (1) a meeting at which directors to the company's board of directors are to be elected (or the solicitation of consents or authorizations in lieu of such a meeting) or (2) the election of the auditor, or the approval or ratification of the company's selection of the auditor. We are proposing to amend paragraph (e) of item 9 to provide more detailed information regarding the categories of fees paid by the registrant to the auditor and to inform investors about the critical role that audit committees play in assuring the auditor's independence. We believe that the proposed disclosure would allow investors to better assess an auditor's independence and the certain activities of an audit committee.

Item 9(e) currently requires disclosure of fees billed by the auditor in the last fiscal year, with the fees broken down into three categories: Audit fees, financial information systems design and implementation fees, and all other fees. The proposals would add disclosure of two categories (tax fees and audit-related fees), while eliminating one category (financial information systems design and implementation), and require disclosure of one more past year of each of these fees. Because these fees are already being disclosed, repeating the prior year's disclosures for comparison purposes should not increase significantly a registrant's compliance burden. In addition, breaking tax fees and audit-related fees out of the ''all other'' category of fees currently being disclosed should not result in any significant incremental burden.

Under the proposals, registrants also would be required to disclose any policies and procedures adopted by an audit committee to be followed for auditor engagements for services other than audit, review and attest services in the event that the audit committee does not expressly pre-approve the particular engagements. In addition, the proposals would require registrants to disclose what percentage of fees in each of the categories noted above (audit, audit-related, tax, and other) relate to engagements that were pre-approved by the audit committee.

We estimate that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours on each of the 7,661 filers of schedule 14A, or an aggregate 15,322 additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 11,492 hours, would be expended by internal staff and the remaining 25%, or 3,830 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $1,149,000. Similarly, we estimate that these proposed disclosures would

[107] Release No. 33–8040 (Dec. 12, 2001) (66 FR 65013). In May of this year, we proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies. The proposed disclosures would focus on accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Release No. 33–8098 (May 10, 2002) (67 FR 35620).

[108] *See* SAS 61, AU§ 380, ''Communication with Audit Committees or Others with Equivalent Authority and Responsibility.''

[109] Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.

[110] 17 CFR 240.14a–101.

[111] 17 CFR 240.14c–101.

impose, on average, two additional burden hours on each of the 464 filers of schedule 14C, or an aggregate 928 additional burden hours. Using the same allocation of hours and cost estimate of legal fees as for schedule 14A, we estimate that 696 hours would be expended by internal staff and the remaining 232 hours would be for outside legal assistance, producing an outside legal cost of $69,600.

2. Annual Reports on Form 10–K

The proposed disclosure generally should be presented in a company's proxy statement in accordance with item 9(e) of schedule 14A, and incorporated by reference into the form 10–K (OMB Control No. 3235–0063). Some companies that file forms 10–K, however, are not subject to the proxy disclosure requirements. These companies would, therefore, now be required to present the required disclosures in the form 10–K. We do not believe, however, that the disclosures would be burdensome to these companies because the information to be disclosed (fees billed to the company by the auditor in the last fiscal year, with the fees broken down into certain categories) should be readily available to the company.

We estimate that the incremental disclosure of fees, the audit committee's olicies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 8,484 filers of form 10–K. Six thousand six hundred and seventy-six (6,676) of those filers, however, would provide the information under schedule 14A and 209 of those filers would provide the information under schedule 14C.[112] The burden hours for the disclosure by these filers therefore has been assigned to schedule 14A and schedule 14C, respectively. The burden imposed on the remaining 1,599 filers is being assigned to form 10–K. This results in 3,198 (2 hours x 1,599 filers) additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 2,399 hours, would be expended by internal staff and the remaining 25%, or 799 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $239,700.

3. Annual Reports on Form 10–KSB

Form 10–KSB (OMB Control No. 3235–0420) is the annual report filed with the Commission by ''small businesses issuers.'' A ''small business issuer'' is an entity that (1) has revenues of less than $25,000,000, (2) is a U.S. or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation is also a small business issuer. An entity is not a ''small business issuer,'' however, if the aggregate market value of its outstanding voting and non-voting common stock held by non-affiliates is $25,000,000 or more.[113] We do not believe, however, that these disclosures would be burdensome to these companies because the information to be disclosed (fees billed to the company by the auditor in the last fiscal year, with the fees broken down into certain categories) should be readily available to the company.

We estimate that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 3,820 filers of form 10–KSB. Nine hundred and eighty-five (985) of those filers, however, would provide the information under schedule 14A and 255 of those filers would provide the information under schedule 14C. The burden hours for the disclosure by these filers has been assigned to schedule 14A and schedule 14C, respectively. The burden imposed on the remaining 2,580 filers is being assigned to form 10–KSB. This results in 5,160 (2 hours x 2,580 filers) additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 3,870 hours, would be expended by internal staff and the remaining 25%, or 1,290 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $387,000.

4. Annual Reports by Foreign Private Issuers on Form 20–F

Form 20–F (OMB Control No. 3235–0288) is used for the registration of securities of foreign private issuers pursuant to sections 12(b) or 12(g) of the Exchange Act and annual and transition reports filed with the Commission pursuant to sections 13(a) or 15(d) of the Exchange Act.[114]

Foreign private issuers generally are not subject to the proxy disclosure requirements and, therefore, would be required to present the required disclosures on form 20–F. We do not believe, however, that these disclosures would be burdensome to these companies because the information to be disclosed (fees billed to the company by the auditor in the last fiscal year, with the fees broken down into certain categories) should be readily available to the company.

We estimate that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 1,194 filers of form 20–F, or 2,388 additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 25% of the extra burden hours, or approximately 597 hours, would be expended by internal staff and the remaining 75%, or 1,791 hours, would be for outside legal costs associated with reviewing the proposed disclosures because this form is prepared by foreign private issuers who rely more heavily on outside counsel for assistance. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $537,300.

5. Reports by Certain Canadian Issuers on Form 40–F

Form 40–F is used by certain Canadian issuers to register securities with the Commission pursuant to section 12(b) or section 12(g) and for reports pursuant to section 15(d) of the Exchange Act. A Canadian issuer may use the form if it is subject to the reporting requirements solely by reason of having filed a registration statement on form F–7, F–8, F–9, F–10, or F–80 under the Securities Act of 1933. A Canadian issuer also may use the form if it has a reporting obligation under the Exchange Act and (1) the issuer is incorporated under the laws of Canada or any Canadian province or territory, (2) the issuer is a foreign private issuer

[112] These numbers are obtained by reviewing the number of filers that filed a form 10–K and schedule 14A or schedule 14C, respectively, between October 1, 2001, and September 30, 2002.

[113] 17 CFR 240.12b–2.

[114] 17 CFR 249.220f.

or a crown corporation, (3) the issuer has been subject to periodic reporting requirements of any securities commission or equivalent regulatory authority in Canada for a period of at least 12 calendar months immediately preceding the filing of the form and currently is in compliance with such obligations, and (4) the aggregate market value of the public float of the issuer's outstanding equity shares is $75 million or more (no market value threshold needs to be satisfied, however, in connection with non-convertible securities eligible for registration on form F–9).[115]

Canadian companies that file form 40–F generally are not subject to the proxy disclosure requirements and, therefore, would be required to present the required disclosures on form 40–F. We do not believe, however, that these disclosures would be burdensome to these companies because the information to be disclosed (fees billed to the company by the auditor in the last fiscal year, with the fees broken down into certain categories) should be readily available to the company.

We estimate that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 134 filers of form 40–F, or 268 additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. Consistent with our treatment of foreign private issuers filing form 20–F, we further estimate that approximately 25% of the extra burden hours, or approximately 67 hours, would be expended by internal staff and the remaining 75%, or 201 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $60,300.

6. Proposed Form N–CSR

We issued a release proposing form N–CSR on August 30, 2002, pursuant to section 30 of the Investment Company Act (15 U.S.C. 80a–29) and sections 13 and 15(d) of the Exchange Act (15 U.S.C. 78m and 78o(d)). The proposed disclosure would be required in a registered management investment company's annual report on proposed form N–CSR. We estimate that the additional disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, 1.5 additional burden hours per year on each of the anticipated 3,700 filers of proposed form N–CSR. This results in 5,550 (1.5 hours x 3,700 filers) additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We estimate that the cost of these burden hours would $81 per hour, resulting in aggregate internal costs of $449,550.[116] Further, we estimate that this additional disclosure would require 0.5 hours in legal review by outside counsel at an average rate of $300 per hour, resulting in aggregate annual outside legal costs of $555,000.

Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–49–02. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No.S7–49–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

V. Cost—Benefit Analysis

We are sensitive to the costs and benefits imposed by our rules, and we have identified certain costs and benefits of these proposals. Additionally, certain of these costs are imposed by Congressional mandate through the enactment of the Sarbanes-Oxley Act. We request comments on all aspects of this cost-benefit analysis, including the identification of any additional costs or benefits. We encourage commenters to identify and supply relevant data concerning the costs or benefits of the proposed amendments.

A. Background

The Sarbanes-Oxley Act was enacted on July 30, 2002. Title II to that Act adds sections 10A(g) through 10A(l) to the Securities Exchange Act of 1934 (''Exchange Act'') and requires that the Commission, within 180 days of enactment, adopt rules to carry out each of those sections.[117]

The proposed rules, in general, would:

- 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[118];
- Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements[119];
- Prohibit any partner on the audit engagement team from providing audit services to the issuer for more than five consecutive years[120];
- 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[121];
- 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[122]; and

[115] 17 CFR 249.240f.

[116] *See* Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2002* (2002).

[117] Section 208(a) of the Sarbanes-Oxley Act of 2002.

[118] *See* section 201 of the Sarbanes-Oxley Act.

[119] *See* section 202 of the Sarbanes-Oxley Act.

[120] *See* section 203 of the Sarbanes-Oxley Act.

[121] See section 206 of the Sarbanes-Oxley Act.

[122] See section 204 of the Sarbanes-Oxley Act.

• Require disclosures to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.[123]

In addition, under the proposed rules, an accountant would not be independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review and attest services. We believe that accounting firms should discontinue compensating these individuals for ''cross-selling'' services. While many of these proposed rules would respond directly to the provisions of title II of the Sarbanes-Oxley Act, certain of these proposals would go beyond the specific provisions of the Act to more fully address what we believe to be the Congressional intent. These provisions include:

• Our proposal requiring any partner on the audit engagement team be subject to the rotation requirements;

• Requiring a one-year cooling-off period for all audit client's employment of engagement team personnel; and

• Our proposal to limit an audit partner from receiving compensation for recommending non-audit services to an audit client.

B. Potential Benefits of the Proposed Rules

Potential benefits resulting from the proposed amendments include increased investor confidence in the independence of auditors, in the audit process, and in the reliability of reported financial information. As discussed below, clearer auditor independence regulations should provide investors with comfort that auditors are placing the interests of investors over financial or personal incentives. Proposed rules mandating that auditors communicate certain matters to audit committees should benefit investors by enhancing the opportunities for meaningful audit committee oversight of the financial reporting process. Investors also would benefit from the enhanced disclosure of the non-audit services provided by, and fees paid to, the accounting firm that audits and reviews the company's financial statements, and from better disclosure of the audit committee's role in approving the provision of non-audit services by the accounting firm that audits the company's financial statements. We believe that these factors could improve the efficiency of the markets and result in a lower cost of capital.

1. Auditor Independence

The amendments would facilitate the independence of the auditor from management in the following ways.

• Providing clearer definition of the lines of non-audit services that would impair an auditor's independence;

• Requiring that each engagement of the auditor to perform audit or non-audit services for the company be pre-approved by the audit committee, which serves as the representative of investors;

• Requiring the ''rotation'' of partners on the audit engagement to assure a periodic fresh look at the accounting and auditing issues presented in the engagement;

• Providing that the auditor's independence would be impaired if revenues to the accounting firm from the sale of non-audit services or products to a company were directly paid to any partner, principal, or shareholder of the firm who works on the audit of that company's financial statements. This provision should decrease the appearance of any pressure on the audit engagement partner to appease management during the audit process in order to facilitate sales of non-audit services and increase the appearance and reality of auditor independence; and

• Requiring a ''cooling off'' period between working on the audit engagement team and joining the client as a member of management in order to assure that personal relationships and the new member of management's knowledge of the audit plan do not negatively impact the audit process.

Strengthening auditor independence should provide investors with more comfort that the auditors would play their ''gatekeeper'' role in companies'' financial reporting and provide further assurance that the true financial condition of companies is reflected in their financial reporting thereby allowing public companies less costly access to the capital markets.

2. Auditor Reports to Audit Committees

The proposed rules would require that each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements report to the issuer's audit committee (1) All critical accounting policies and practices used by the issuer, (2) alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of ''unadjusted differences.''

The report by the Senate Committee on Banking, Housing, and Urban Affairs on the bill that later became the foundation for the Sarbanes-Oxley Act, in addressing the need for such reports from the auditor to the audit committee, stated, in part:

> The Committee believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statements and of disagreements that the auditor has with management. The audit committee should be informed in a timely manner of such disagreements, so that it can independently review them and intervene if it chooses to do so in order to assure the integrity of the audit.[124]

Almost eight months before passage of the Sarbanes-Oxley Act, in December 2001, we issued cautionary advice regarding each issuer disclosing in the Management Discussion and Analysis [125] section of its annual report those accounting policies that management believes are most critical to the preparation of the issuer's financial statements.[126] The cautionary advice indicated that ''critical'' accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.[127] As part of that cautionary advice, we stated:

> Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior

[123] *See generally,* section 202 of the Sarbanes-Oxley Act; section 10A(i)(2) of the Exchange Act, 15 U.S.C. 78j–1(i)(2).

[124] Report of the Senate Committee on Banking, Housing, and Urban Affairs, ''Public Company Accounting Reform and Investor Protection Act of 2002,'' Senate Report 107–205, 107th Cong., 2d Sess., at 21 (July 3, 2002).

[125] Item 303 of Regulation S–K (17 CFR 229.303), which requires disclosure about, among other things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

[126] Release No. 33–8040 (Dec. 12, 2001) (66 FR 65013).

[127] *Id.*

management and auditor about critical accounting policies are appropriate.[128]

We continue to believe that such communications are appropriate and facilitate the audit committee's oversight of the financial reporting process. Investors should benefit by the audit committee being in a position to challenge what it may view as novel or aggressive use of GAAP to enhance reports of the company's financial results or financial condition.

The rules proposed in May 2002 provide additional information about the application of critical accounting policies, including ''critical accounting estimates'' and the initial adoption of material accounting policies. Auditors may want to refer to these proposed rules,[129] as well as the December 2001 cautionary advice, in determining the types of matters to be communicated to the audit committee.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

Investors would receive more detailed information about:

- Any policies and procedures adopted by an audit committee that are designed to assure that the provision of non-audit services and products by the auditor do not impair the auditor's independence,
- The fees paid by the registrant to the auditor in each of the last two years for audit, audit-related, tax, and all other services, and
- The percentage of fees in each of those categories that were pre-approved by the audit committee.

The proposed disclosures will afford investors greater visibility into those aspects of the auditor-client relationship. Providing better, more complete information in cases where non-audit services occur allows investors to determine for themselves whether there are concerns related to the auditor's independence. It also may allow investors to ask more direct and useful questions of management and directors regarding their decisions to engage the auditors for such services.

4. Compensation

The proposed rules specify that audit partners that are compensated for cross-selling non-audit services are not independent. This would further enhance the independence of the audit function since the audit partner's focus would be on the conduct of the audit rather than on efforts to sell other services to management. The danger inherent in compensation to audit partners for cross-selling non-audit services is that it might create a temptation for auditors to compromise the quality of the audit in order to maintain their relationship with clients to whom they hope to cross-sell such services.[130]

C. Potential Costs of the Proposals

1. Auditor Independence

Changes in our auditor independence regulations may impose costs on accounting firms and on any issuers that engage, or would like to consider engaging, the auditor of an issuer's financial statements to perform non-audit services.

(a) *Non-audit services.* According to the information available to the staff in 2000, approximately 12,600 registrants did not purchase any consulting services from the auditor of their financial statements, and 4,100 registrants reported purchasing such services.[131] Based on the scrutiny that these services have received over the past year, the Commission staff believes that the number of companies purchasing non-audit services from their auditor might have decreased significantly.

The current auditor independence rules state that the performance of certain non-audit services will impair an auditor's independence. The proposed rules, in some cases, would redefine the limits of those services and would add one more item, ''expert services,'' to the list of prohibited services. These changes could impact the competitive markets for these services. Issuers would be precluded from engaging auditors to perform certain services in the categories of internal audit services, financial systems design and implementation services, appraisal and valuation services, actuarial services, and others, that may be performed under the current rules. These companies may incur costs from having to use a separate vendor for such services resulting in the possible loss of any synergistic benefits of having a single provider for both audit and non-audit services. In particular, the loss of company-specific information that might flow from the non-audit team to the audit engagement team, or vice versa, could in some instances lower the quality of either service. Issuers also may incur costs locating a new vendor and developing a business relationship with that vendor. In addition, issuers may incur costs from not being able to retain their preferred provider of non-audit services, if that preferred provider happens to also be their auditor. The difference in value between a preferred provider and a second choice may be substantial, particularly if the preferred provider has relatively unique service offerings or service offerings that are particularly well suited to the needs of the issuer.

Accounting firms may lose one or more sources of revenue if the proposed rules are adopted because they would no longer be able to sell certain non-audit services to their audit clients. We believe, however, that in view of the statements by the largest four accounting firms, and others, that they would no longer provide internal audit outsourcing services and financial system design and implementation services to audit clients,[132] costs associated with the proposed rules may be limited. Also, to the extent non-audit services are merely redistributed among the firms, there would be no net loss of revenue to public accounting firms as a whole.

(b) *Audit Committee Pre-approval of Services.* Under the proposed rules, all auditing and non-audit services to be provided by the auditor of an issuer's financial statements must be pre-approved by the issuer's audit committee.[133] There may be incremental

[128] *Id.* (footnotes omitted).

[129] Release Nos. 33–8098 (May 10, 2002) (67 FR 35620).

[130] Moreover, such compensation might increase the effect of any conflict of interest inherent in the provision of non-audit services. It would do this by inadvertently providing a mechanism by which an issuer may influence an audit partner short of the threat to change auditors. That is, if issuers are not pleased with the results of an audit, such a compensation structure gives them the option to ''punish'' the audit partner by discontinuing the purchase of (or by not purchasing) the *non-audit services* and thereby causing the audit partner's compensation to be directly reduced. Since this punitive action is apt to be less costly to the issuer than would be a change in auditors, it represents a more credible threat to the audit partner than does the threat to change auditors. As a consequence, issuers may be more willing to employ this avenue of improper influence than to actually change auditors, and, indeed, audit partners may be more responsive to such pressure, given its enhanced credibility.

[131] *Id.*; 65 FR at 43185.

[132] Report of the Senate Committee on Banking, Housing, and Urban Affairs, ''Public Company Accounting Reform and Investor Protection Act of 2002,'' Senate Report 107–205, 107th Cong., 2d Sess., at 18 (July 3, 2002).

[133] Section 301 of the Sarbanes-Oxley Act of 2002 requires the Commission to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not meet certain criteria, including having an audit committee that performs certain functions. *See* section 10A(m) of the Exchange Act, 15 U.S.C. 78j–1(m). The Sarbanes-Oxley Act defines ''audit committee'' to be ''(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the

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costs associated with audit committees performing this function. Such costs might include more frequent committee meetings, an increased workload on audit committee members, and having legal counsel review the audit committee's draft policies and procedures for engaging the auditors for non-audit services. The increased burden on audit committee members might result in the need to increase their compensation, resulting in additional costs to issuers. Some of these costs may be mitigated by the provisions in the Act and in the proposed rules that would allow the audit committee to delegate to one or more audit committee members the authority to grant pre-approvals of these services.[134]

Inadvertent violations of the Act and the proposed rules that would add to the costs of the rules also may be mitigated by the de minimus exception to the pre-approval requirement.[135] Under this exception, the pre-approval requirement is waived if: (1) The aggregate amount of the non-audit services is not more than five percent of the total amount of revenues paid by the issuer to the auditor during the fiscal year in which the non-audit services were provided, (2) at the time of the engagement the issuer did not recognize the services to be non-audit services, and (3) the services are approved by the audit committee prior to the completion of the audit.[136]

We also believe that as a result of the Commission's audit committee disclosure requirements adopted in 1999,[137] prior disclosures related to the involvement of the audit committee in recommending or approving changes in auditors and the resolution of disagreements between management and the auditors,[138] and professional standards that require communications between the auditor and audit committees on auditor independence issues,[139] many companies currently have audit committees that closely monitor issues related to the auditor's independence and the engagement of auditors to perform non-audit services. Accordingly, we believe that the incremental costs associated with the proposals would not be significant.

(c) *Rotation of Partners on the Audit Engagement.* Under the proposed rules, no partner would serve on an audit engagement team for more than five years.[140] Current professional requirements state that the partner in charge of an audit engagement should be replaced at least once every seven years.[141] The proposals, therefore, would require more partners to be rotated and the engagement partner to be rotated more often.

Costs associated with the periodic replacement of partners might include more frequent company-specific training, conducted by both the accounting firm and the company, as new partners join the team auditing that company's financial statements. For example, the new partners would need to learn the company's accounting and financial reporting procedures, controls and personnel. The proposed rules also might result in incremental costs related to some partners being required to relocate from one part of the country to another.

The costs related to these proposed rules would vary based on the proximity of an accounting firm's audit clients, the concentration of the firm's practice within an industry, and the availability of partners to whom the work may be redistributed, and similar factors.

Smaller firms that do not have sufficient partners to replace the partners on an audit engagement team may be particularly affected by the proposed rules in that they would have to accept more partners into the firm or lose the audit engagement.

It is difficult to calculate the costs associated with this portion of the proposed rules. However, it is likely that these costs may be passed on to issuers in the form of higher audit fees. As noted below, we request comments on the anticipated costs associated with all aspects of the proposed rules.

(d) *One-Year Cooling Off Period.* The proposed rules would indicate that an accounting firm is not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm is in a ''financial reporting oversight role'' at that client, unless the individual had not been a member of the audit engagement team for that client's financial statements during the one year period preceding the initiation of the audit.[142] A ''financial reporting oversight role'' is a role in which a person is in a position to or does influence the contents of financial statements or anyone who prepares them.[143] Such persons would include directors, chief executive officers, chief financial officers, chief accounting officers, controllers, and others.[144]

Currently, when a former professional employee of an accounting firm joins an audit client within one year of leaving the firm, and the individual has significant interaction with the accounting firm's audit engagement team, professional standards require the accounting firm to perform procedures to assure that the individual's knowledge of, or relationships with, the accounting firm do not adversely influence the quality of the audit.[145] These procedures include modifying the audit plan to adjust for the risk that the individual would be able to circumvent key aspects of the audit, and assuring that the people on the audit engagement team have the stature and objectivity not to be influenced by their former partner or co-employee and to be have the appropriate level of skepticism when evaluating the individual's representations and views. Because the proposed rules would limit the situations in which this situation could occur, accounting firms and audit

financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.'' Section 205(a) of the Sarbanes-Oxley Act, which, among other things, adds section 3(a)(58) to the Exchange Act.

[134] Section 202 of the Sarbanes-Oxley Act; section 10A(i)(3) of the Exchange Act, 15 U.S.C. 78j–1(i)(3).

[135] Section 202 of the Sarbanes-Oxley Act; section 10A(i)(1)(B) of the Exchange Act, 15 U.S.C. 78j–1(i)(1)(B).

[136] *Id.*

[137] Item 306 of Regulation S–K (17 CFR 229.306), and item 306 of Regulation S–B (17 CFR 228.306); *see* generally, Release No. 34–42266 (Dec. 22, 1999) (64 FR 73389). These disclosure requirements are discussed *supra,* in section II.C. of this release.

[138] Item 4 of form 8–K, 17 CFR 249.308 and item 304 of Regulation S–K, 17 CFR 229.304, which require disclosure of ''whether the decision to change accountants was recommended or approved by: (A) Any audit or similar committee of the board of directors, if the issuer has such a committee; or (B) the board of directors, if the issuer has no such committee'' and ''whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of each of such disagreements with the former accountant* * *.'' Item 304(a)(1)(iii)(A), (iii)(B), and (iv)(B). 17 CFR 229.304(a)(1)(iii)(A), (iii)(B) and (iv)(B). For small business issuers, item 304(a)(1)(iii) of Regulation S–B, 17 CFR 228.304(a)(1)(iii) requires disclosure of ''whether the decision to change accountants was recommended or approved by the board of directors or an audit or similar committee of the board of directors.''

[139] *See, e.g.,* American Institute of Certified Public Accountants (''AICPA''), ''Communications With Audit Committees,'' Statements on Auditing Standards No. (''SAS'') 61, as amended by SAS 89 and 90; AICPA, Codification of Statements on Auditing Standards (''AU'') § 380; Independence Standards Board, ''Independence Discussions with Audit Committees,'' Independence Standard No. 1 (Jan. 1999).

[140] *See generally*, section 203 of the Sarbanes-Oxley Act.

[141] *See* American Institute of Certified Public Accountants, SEC Practice Section, *Requirements of Members*, at item e. The membership requirements are available online at *http://www.aicpa.org/members/div/secps/require.htm.*

[142] *See* section 206 of the Sarbanes-Oxley Act.

[143] *See* 17 CFR 210.2–01(f)(3) and proposed rule 2–01(f)(3)(B).

[144] *Id.*

[145] Independence Standards Board, ''Independence Standard No. 3: Employment with Audit Clients'' (July 2000).

clients would not have to pay for the performance of these procedures.

Costs might occur, however, from the company being required to delay the hiring, or not being able to hire, the individual that it believes is the most qualified person to perform a ''financial reporting oversight role'' at the company. This may add to recruitment costs or less efficient operations. Such costs are difficult to estimate and would vary from one company to another.

(e) *Compensation.* The proposed rules would provide that an auditor is not independent with respect to an audit client if a partner, principal or shareholder of an accounting firm, who is a member of the audit engagement team conducting an audit of that client's financial statements, earns or receives compensation based on the performance of, or in consideration of procuring, engagements to provide any services to that client other than audit, review, or attest services. This provision might affect the compensation plans of those firms that currently reward partners, principals, and shareholders of the firm for generating sales of non-audit services to their respective audit clients. If the proposed rules were adopted, those revenues would be allocated to other persons within the accounting firm. Absent this incentive, auditors may be less inclined to inform issuers of ways to improve their performance or condition through non-audit services. We do not expect, however, that there would be any incremental costs to the firm or to the client.

2. Auditor Reports to Audit Committees

Under the proposed rules, each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements must report to the issuer's audit committee (1) all critical accounting policies and practices used by the issuer, (2) alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of ''unadjusted differences.'' [146] The required reports need not be in writing but the report would be required to be presented to the audit committee before the auditor's report is filed with the Commission.

Because of existing GAAS and legal provisions,[147] we believe that adoption of the proposed rules regarding auditor reports to audit committees will not significantly increase costs for accounting firms or registrants. Any such costs may arise from the timing of the communications, which, under the proposed rules, must occur before the auditor's report is filed with the Commission.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

The existing proxy disclosure rules require disclosure of all professional fees billed by the principal auditor in the last fiscal year, with the fees broken down into three categories: audit fees, financial information systems design and implementation fees, and all other fees. The proposals would divide the disclosure into two more categories—tax fees and audit-related fees—and add disclosure of one more year of these fees while eliminating separate disclosure of fees related to financial information systems design and implementation. The proposals also would require companies that do not file proxy statements to file this information with the Commission in their annual reports on forms 10–K and 10–KSB, foreign private issuers to file the information on form 20–F, certain Canadian issuers to file the information on form 40–F, and registered management investment companies to file the information on proposed form N–CSR.[148]

Registrants also would be required to disclose the audit committee's policies and procedures for approval of auditor engagements, and the percentage of fees in each of the four categories noted above (audit, audit-related, tax, and all other) that were pre-approved by the audit committee during each of the last two fiscal years.

Based on the staff's experience, we believe that the additional disclosure contemplated by the proposed rules would require, on average, approximately one-half of a page in a company's proxy statement or annual report. A financial printing company informed the staff that adding one-half of a page in the proxy statement would not be likely to increase the printing cost to the company because that much more text normally can be incorporated without increasing the page length by reformatting the document.[149] Accordingly, based on our preliminary estimates, there should be little, if any, additional printing costs from these additional disclosures.

For the purposes of the Paperwork Reduction Act, we have estimated that the incremental disclosure of fees, the disclosure of the audit committees policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee would impose, on average, two additional burden hours for each of the 7,661 filers of schedule 14A, or an aggregate annual burden of 15,322 additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 11,492 hours, would be expended by internal staff and the remaining 25%, or 3,830 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that the internal staff costs the company an average of $125 per hour,[150] the aggregate annual cost for internal staff assistance would be approximately $1,436,500. If we assume that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $1,149,000. The total annual paperwork costs associated with the proposed disclosures, therefore, would be approximately $2,585,500. Similarly, we estimated that the 464 filers of schedule 14C would incur an additional annual burden of 928 hours, or which 696 hours would be imposed on the company itself and 232 would represent a cost for outside legal assistance. Based on these numbers, we estimate that the annual internal cost would be $87,000 (696 hours x $125 per

[146] *See* section 204 of the Sarbanes-Oxley Act.

[147] *See* item 303 of Regulation S-K, 17 CFR 229.303; Release No. 33–8040 (Dec. 12, 2001); and SAS 61, AU § 380, ''Communication with Audit Committees or Others with Equivalent Authority and Responsibility.''

[148] Form 10–K is the annual report that registrants file with the Commission pursuant to section 13 or 15(d) of the Exchange Act, if no other annual reporting form has been prescribed. Small business issuers may use abbreviated form 10–KSB. A ''small business issuer'' is an entity that (1) has revenues of less than $25,000,000, (2) is a U.S. or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation is also a small business issuer. An entity is not a ''small business issuer,'' however, if the aggregate market value of its outstanding voting and non-voting common stock held by non-affiliates is $25,000,000 or more. *See* 17 CFR 240.12b–2. Registered management investment companies would use proposed form N–CSR to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002. *See* Investment Company Act Release No. 25723 (Aug. 30, 2002) (67 FR 57298 (Sept. 9, 2002)).

[149] *See* Release No. 34–41987 (Oct. 7, 1999) (64 FR 55648, at 55658).

[150] This cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (Oct. 2001).

hour) and the annual external cost would be $69,600 (232 hours x $300 per hour), for a total annual cost of $156,600.

For those registrants who would be providing the information on form 10–K, we estimated for the purposes of the Paperwork Reduction Act that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 8,484 filers of form 10–K.[151] Six thousand six hundred and seventy-six (6,676) of those filers, however, would provide the information under schedule 14A and 209 of those filers would provide the information under schedule 14C. The burden hours for the disclosure by these filers therefore has been assigned to schedule 14A and schedule 14C, respectively. The burden imposed on the remaining 1,599 filers is being assigned to form 10–K. This results in 3,198 (2 hours x 1,599 filers) additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 2,399 hours, would be expended by internal staff and the remaining 25%, or 799 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming a cost of $125 per hour for internal costs results in aggregate internal costs of $299,875. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $239,700. The total annual paperwork costs associated with the proposed disclosures, therefore, would be approximately $539,575.

For smaller companies that file forms 10–KSB [152] we estimated for the purposes of the Paperwork Reduction Act that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the 2,590 filers of form 10–KSB that do not file either schedule 14A or schedule 14C, or 5,180 additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that internal staff would expend approximately 75% of the extra burden hours, or approximately 3,885 hours. Assuming a cost $125 per hour for internal staff, the aggregate internal costs would be approximately $485,625. The remaining 25%, or 1,295 hours, would be for outside legal costs associated with reviewing the proposed disclosures. Assuming that outside legal costs would be an average of $300 per hour, the aggregate annual legal costs would be $388,500. The total annual paperwork costs associated with the proposed disclosures, therefore, would be approximately $874,125.

Using a similar analysis, we estimated an increase of 2,388 burden hours and $537,300 in annual legal costs (2,388 x .75 x $300) for form 20–F. This produces an estimate of $298,500 (2,388 hours x $125 per hour) for internal costs, or a total cost of $835,800 ($537,300 + $298,500) for such filers. For form 40–F filers, we estimated an increase of 268 burden hours and $60,300 in annual legal costs (200 x .25 x $300). This produces an estimate of $33,500 (268 hours x $125 per hour) for internal costs, or a total cost of $93,800 ($60,300 + $33,500).

Proposed form N–CSR. We issued a release proposing form N–CSR on August 30, 2002, pursuant to section 30 of the Investment Company Act (15 U.S.C. 80a–29) and sections 13 and 15(d) of the Exchange Act (15 U.S.C. 78m and 78o(d)). For registered management investment companies that would be providing the information on proposed form N–CSR, we estimate that the incremental disclosure of fees, the audit committee's policies and procedures for approval of audit engagements, and the percentage of fees pre-approved by the audit committee, would impose, on average, two additional burden hours per year on each of the estimated 3,700 filers of proposed form N–CSR. This results in 7,400 (2 hours x 3,700 filers) additional burden hours. We estimate that most of this time would relate to consideration and review of the disclosures of the audit committee's policies and procedures. We further estimate that approximately 75% of the extra burden hours, or approximately 5,550 hours, would be expended by internal staff and the remaining 25%, or 1,850 hours, would be for outside legal costs associated with reviewing the proposed disclosures. We estimate a cost of $40 per hour for internal staff review, resulting in aggregate internal costs of $222,000. Further, we estimate that outside legal costs would be an average of $300 per hour, resulting in aggregate annual legal costs of $555,000. The total annual paperwork costs associated with the proposed disclosures, therefore, would be approximately $1,004,550.

D. Request for Comments

As noted above, we request comments on all aspects of this cost-benefit analysis, including the identification of any additional costs or benefits. We encourage commenters to identify and supply relevant data concerning the costs or benefits of the proposed amendments. We request comments, including supporting data, on the magnitude of the costs and benefits mentioned in this section.

- Are there any other costs or benefits that we have not identified? For example, would the additional duties on audit committees increase the cost of maintaining those committees? Would the amount of compensation demanded by audit committee members increase? Would there be a shortage of potential audit committee members that would lead to higher costs related to finding and retaining such members? Would the cost of officer/director liability insurance increase? Please describe any such costs and provide relevant data.
- Are there additional costs related to the proposed disclosures? If there are, please identify them and provide supporting data.
- We request comments on the reasonableness of the burden hour, cost estimates, and underlying assumptions related to the proposed disclosures.
- Will the prohibition of certain non-audit services impose greater costs on companies? If so, what will those costs be and how significant will those costs be?
- How much cost will issuers incur from not being able to retain their preferred providers of non-audit service, when that preferred provider happens to also be their auditor?
- What will be the impact, if any, on audit fees from the proposal to prohibit certain non-audit services?
- Are there any economies of scope that will be lost due to implementation of the auditor independence rules?
- Are there any economies of scale that will be lost due to implementation of the auditor independence rules?

VI. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of

[151] As noted previously, the proposed rules also would amend forms 20–F and 40–F. However, because the number of registrants which use these forms is very small, it is not expected to have a significant burden increase.

[152] 17 CFR 240.12b–2.

1996,[153] the Commission is requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commentators should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act [154] requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. In this regard, we note that it may be possible that some small accounting firms would not have professionals, other than those working on the audit of a client's financial statements, with the expertise to provide non-audit services to that client. Because, under the proposed rules, receipt of fees by that professional from the provision of non-audit services would impair the auditor's independence, the accounting firm might not be in a position to provide non-audit services to that client. This proposal, therefore, could result in some companies seeking new providers of non-audit services. In addition, some companies that engage accounting firms for non-audit services permitted under the current rules, but not allowed under the Sarbanes-Oxley Act and the proposed rules, would be required to switch vendors for those services. This may have an impact on competition for those services, although to the extent the new vendor is another accounting firm, the result may a redistribution of services among firms rather than an increase or decrease in services. Small accounting firms also may be disadvantaged by the prohibition on partners providing auditing services to the issuer for more than five consecutive years, since they may not have other partners available to retain the client.

• Given that only larger clients have more than two partners as part of the audit process, would this provision impose higher costs on mid-tier firms?

In addition, section 2(b) of the Securities Act of 1933,[155] section 3(f) of the Exchange Act,[156] and section 2(c) of the Investment Company Act [157] require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.

One possible adverse impact on capital formation may come from additional costs related to audit committees. Although the proposed rules do not require companies to have audit committees, many companies may choose to establish such committees to facilitate application of the rules. Additional costs may be associated with forming such committees and, if necessary, recruiting and retaining independent directors to serve on those committees.

We believe, however, that investors need to have confidence in the independence of auditors and in the integrity of the financial information that fuels our securities markets. The proposals are designed to bolster investor confidence in the securities markets by strengthening auditor independence, improving the transparency of the role of corporate audit committees, and enhancing the reliability and credibility of financial statements of public companies. Accordingly, on the whole, the proposals should promote capital formation and market efficiency.

• We request comment on the anti-competitive effects of the proposals.

• The possible effects of our rule proposals on efficiency, competition, and capital formation are difficult to quantify. We request comment on these matters in connection with our proposed rules.

VII. Initial Regulatory Flexibility Act Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed revisions to Regulation S–X and to item 9 of schedule 14A, and to forms 10–K, 10–KSB, 20–F, 40–F and proposed form N–CSR. The proposals would strengthen the Commission's requirements regarding the independence of auditors and related disclosures.

A. Reasons for the Proposed Action

The proposed rules generally implement a congressional mandate. Some of the proposals, although not specifically required by the statute, are designed to implement the intent of the Sarbanes-Oxley Act and to assure investors that independent auditors critically are examining reported financial information. The proposed rules should provide greater assurance to investors that independent auditors are performing their public responsibilities and that the financial information published by registrants and issuers is reliable.

The proposed rules, in general, would:

• 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;[158]

• Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements;[159]

• Prohibit any partner on the audit engagement team from providing audit services to the issuer for more than five consecutive years;[160]

• 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;[161]

• 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;[162] and

• Require disclosures to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.[163]

In addition, under the proposed rules, an accountant would not be independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based on any service provided or sold to that client other than audit, review and attest services.

B. Objectives

Our objectives are to implement title II of the Sarbanes-Oxley Act in order to increase investor confidence in the independence of auditors, in the audit process, and in the reliability of reported financial information.[164] This would be accomplished by having: (1) Clearer auditor independence regulations that would provide investors with comfort that auditors are placing the interests of investors over financial or personal incentives, (2) rules mandating that auditors communicate certain matters to audit committees, which should enhance the opportunities for meaningful audit committee oversight of the financial reporting process, and (3) enhanced disclosure of

[153] Pub. L. 104–121, tit. II, 110 Stat. 857 (1996).

[154] 15 U.S.C 78w(a)(2).

[155] 15 U.S.C. 77b(b).

[156] 15 U.S.C. 78c(f).

[157] 15 U.S.C. 80a–2(c).

[158] *See* section 201 of the Sarbanes-Oxley Act.

[159] *See* section 202 of the Sarbanes-Oxley Act.

[160] *See* section 203 of the Sarbanes-Oxley Act.

[161] *See* section 206 of the Sarbanes-Oxley Act.

[162] *See* section 204 of the Sarbanes-Oxley Act.

[163] *See generally,* section 202 of the Sarbanes-Oxley Act; section 10A(i)(2) of the Exchange Act, 15 U.S.C. 78j–1(i)(2).

[164] *See* section 208 of the Sarbanes-Oxley Act.

the non-audit services provided by, and fees paid to, the accounting firm that audits and reviews the company's financial statements, and from better disclosure of the audit committee's role in approving the provision of non-audit services by the accounting firm that audits the company's financial statements. We believe that these factors may improve the efficiency of the markets and result in a lower cost of capital.

C. Legal Basis

We are proposing amendments to Regulation S–X and item 9 of schedule 14A and to forms 10–K, 10–KSB, 20–F, 40–F and proposed form N–CSR under the authority set forth in sections 3(a) and 208 of the Sarbanes-Oxley Act; schedule A and sections 7, 8, 10, 19 and 28 of the Securities Act, sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, sections 5, 10, 14 and 20 of the Public Utility Holding Company Act of 1935, sections 8, 30, 31 and 38 of the Investment Company Act of 1940, and sections 203 and 211 of the Investment Advisers Act of 1940.

D. Small Entities Subject to the Proposed Rules

The proposals would affect small registrants and small accounting firms that are small entities. Exchange Act rule 0–10(a) [165] and Securities Act rule 157 [166] define a company to be a ''small business'' or ''small organization'' if it had total assets of $5 million or less on the last day of its most recent fiscal year. We estimate that approximately 2,500 companies were small entities, other than investment companies.

For purposes of the Investment Company Act, rule 0–10 [167] defines ''small business'' to be an investment company with net assets of $50 million or less as of the end of its most recent fiscal year. We estimate that approximately 225 investment companies met this definition.

Our rules do not define ''small business'' or ''small organization'' for purposes of accounting firms. The Small Business Administration defines small business, for purposes of accounting firms, as those with under $6 million in annual revenues.[168] We have only limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than $6 million in revenues that practice before the Commission. We request comment on the number of accounting firms with revenue under $6 million.

E. Reporting, Recordkeeping and Other Compliance Requirements

1. Auditor Independence

The vast majority of registrants are audited by one of the four largest accounting firms, which clearly are not small entities. Nonetheless, changes in the auditor independence regulations may impose compliance requirements, recordkeeping and reporting requirements on small accounting firms and on any small registrant that engages, or would like to consider engaging, the auditor of an issuer's financial statements to perform non-audit services.

(a) *Non-audit services.* The current auditor independence rules state that the performance of certain non-audit services will impair an auditor's independence. The proposed rules, in some cases, would redefine the limits of those services and would add one more item, ''expert services,'' to the list of prohibited services. These changes could impact the competitive markets for these services. In particular, the Commission is considering withdrawing the specific exemption in the current rules that allows audit clients with less than $200 million in total assets to engage the auditors of their financial statements to perform internal audit services.[169] Under the proposed rules, small issuers also would be precluded from engaging auditors to perform certain services in the categories of financial systems design and implementation services, appraisal and valuation services, actuarial services, and others, that may be performed under the current rules. Small registrants, therefore, may have to use a separate vendor for such services. Small accounting firms may lose one or more sources of revenue if the proposed rules are adopted because they would no longer be able to sell certain non-audit services to their audit clients.

According to the information available to the staff in 2000, however, approximately 12,600 registrants did not purchase any consulting services from the auditor of their financial statements, and 4,100 registrants reported purchasing such services.[170] Based on the attention that has been drawn to this area over the past year, the Commission staff believes that the number of small registrants purchasing non-audit services from their auditor, and the amount of small accounting firms providing services to audit clients that are Commission registrants, might have decreased significantly. Also, to the extent non-audit services are merely redistributed among the firms, there would be no net loss of revenue to public accounting firms as a whole.

(b) *Audit Committee Pre-approval of Services.* Under the proposed rules, all auditing and non-audit services to be provided by the auditor of an issuer's financial statements must be pre-approved by the issuer's audit committee.[171] The definition of audit committee in the Sarbanes-Oxley Act, which is cited in the proposed rules, however, indicates that if no such committee exists, the entire board of directors of the issuer may perform this function.[172] The rules, therefore, would not require a small company to form an audit committee.

There are reasons to believe that many small entities currently have audit committees.[173] Any small entity that does not have such a committee and would form one to facilitate operation of the proposed rules, however, would incur costs to establish such a committee and, if necessary, to recruit and retain the required number of independent directors. Small entities also might spend time and incur costs to document the audit committee's activities in the areas covered by the proposed rules, including drafting and maintaining the audit committee's policies and procedures related to engaging the auditor to perform non-audit services. Small entities also might incur costs in seeking the help of outside experts, particularly outside legal counsel, in drafting the audit committee's policies and procedures.

(c) *Rotation of Partners on the Audit Engagement.* Under the proposed rules, no partner would serve on an audit engagement team for more than five

[165] 17 CFR 240.0–10(a).

[166] 17 CFR 230.157.

[167] 17 CFR 270.0–10.

[168] 13 CFR 121.201.

[169] 17 CFR 210.2–01(c)(4)(v)(A).

[170] *Id.;* 65 FR at 43185.

[171] Section 301 of the Sarbanes-Oxley Act of 2002 requires the Commission to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not meet certain criteria, including having an audit committee that performs certain functions. *See* section 10A(m) of the Exchange Act, 15 U.S.C. 78j–1(m). The Sarbanes-Oxley Act defines ''audit committee'' to be ''(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.'' Section 205(a) of the Sarbanes-Oxley Act, which, among other things, adds section 3(a)(58) to the Exchange Act.

[172] *Id.*

[173] *See, e.g.*, NACD, *2001–2002 Public Company Governance Survey* (Nov. 2001).

years.[174] Current professional requirements state that the partner in charge of an audit engagement should be replaced at least once every seven years.[175] The proposals, therefore, would require more partners to be rotated and the engagement partner to be rotated more often.

Costs associated with the periodic replacement of partners might include more frequent company-specific training because new partners joining the audit engagement team would need to learn the company's accounting and financial reporting procedures, controls and personnel. The proposed rules also might result in incremental costs related to some partners being required to relocate from one part of the country to another.

Smaller firms that do not have sufficient partners to make the required replacements of the partners on an audit engagement team may be particularly affected by the proposed rules. These small accounting firms might have to accept more qualified partners into the firm or lose the audit engagement.

(d) *One-Year Cooling Off Period.* The proposed rules would deem an accounting firm as not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm is in a ''financial reporting oversight role'' at that client, unless the individual had not been a member of the audit engagement team for that client's financial statements during the one year period preceding the initiation of the audit.[176] A ''financial reporting oversight role'' is a role in which a person is in a position to or does influence the contents of financial statements or anyone who prepares them.[177] Such persons would include directors, chief executive officers, chief financial officers, chief accounting officers, controllers, and others.[178] A small registrant might incur costs from a delay in hiring, or not being able to hire, the individual that it believes is the most qualified person to perform a ''financial reporting oversight role'' at the company. This may add to recruitment costs or less efficient operations. We have solicited comment and are considering alternatives to minimize the impact of this proposed rule on small entities.

(e) *Compensation.* Under the proposed rules, an accounting firm's independence would be impaired if any partner, principal or shareholder of the firm, who is a member of an engagement team auditing a client's financial statements, receives any compensation directly based on any service provided or sold to that client other than audit, review and attest services. Thus, accounting firms would have to discontinue compensating these individuals for ''cross-selling'' services.

Some small accounting firms might have a relatively small number of partners, principals or shareholders of the firm available to serve each client. Such firms might not have personnel, other than the partner in charge of the audit of a small company's financial statements, with sufficient expertise to market and provide non-audit services to that company. In such cases, the proposed rule might result in a small company being forced to find another provider for those services. This might result in increased costs related to small entities locating and engaging additional service providers, and might decrease revenues to small accounting firms.

2. Auditor Reports to Audit Committees

Under the proposed rules, each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements must report to the issuer's audit committee (1) all critical accounting policies and practices used by the issuer, (2) alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer such as any management letter or schedule of ''unadjusted differences.'' [179] The required reports need not be in writing, but must be provided to the audit committee before the auditor's report on the financial statements if filed with the Commission.

Auditing standards currently require discussions between the auditors and the audit committee of significant unusual, controversial, or emerging accounting policies, of the process used by management to select certain estimates, and of disagreements over certain accounting matters. Further, audit committees generally are aware of management's letter making representations to the auditors, which the auditor uses in conducting the audit of the issuer's financial statements, and the auditors' letters to management on reportable conditions in internal controls and other matters. Also, due to enactment of section 401 of the Sarbanes-Oxley Act, all material adjustments identified by the auditor should be reflected in the issue's financial statements and, therefore, there should be no material ''unadjusted differences.''

Because of these GAAS and legal provisions, we believe that adoption of the proposed rules regarding auditor reports to audit committees will not significantly increase costs, including costs for small accounting firms and small registrants. Some costs may be incurred, however, to the extent communications would be required before the auditor's report is filed with the Commission.

3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

Currently, disclosure is required in proxy and information statements of the fees billed in the most recent fiscal year under the categories of audit fees, information systems design and implementation fees, and all other fees. The proposals would require disclosure of the fees billed in each of the two most recent years, instead of the current requirement for disclosure of only the most recent year's fees. The proposals also would add the categories of tax fees and audit-related fees but eliminate separate disclosure of information systems design and implementation form the current list of audit fees, information systems design and implementation fees, and all other fees. The proposed rules also would require disclosure of the percentage of fees in each category that were pre-approved by the audit committee as opposed to being entered into under the audit committee's policies and procedures. Finally, the proposals would extend the disclosure requirements to all entities filing forms 10–K, 10–KSB, 20–F, 40–F and proposed form N–CSR.[180]

[174] *See generally,* section 203 of the Sarbanes-Oxley Act.

[175] *See* American Institute of Certified Public Accountants, SEC Practice Section, *Requirements of Members,* at item e. The membership requirements are available online at *http://www.aicpa.org/members/div/secps/require.htm.*

[176] *See* section 206 of the Sarbanes-Oxley Act.

[177] *See* 17 CFR 210.2–01(f)(3) and proposed rule 2–01(f)(3)(B).

[178] *Id.*

[179] *See* section 204 of the Sarbanes-Oxley Act.

[180] Form 10–K is the annual report that registrants file with the Commission pursuant to section 13 or 15(d) of the Exchange Act, if no other annual reporting form has been prescribed. Small business issuers may use abbreviated form 10–KSB. A ''small business issuer'' is an entity that (1) has revenues of less than $25,000,000, (2) is a U.S. or Canadian issuer, (3) is not an investment company, and (4) if a majority owned subsidiary, the parent corporation is also a small business issuer. An entity is not a ''small business issuer,'' however, if the aggregate market value of its outstanding voting and non-voting common stock held by non-affiliates

Continued

The proposed rules would require all entities filing forms 10–K, 10–KSB, 20–F, 40–F and proposed form N–CSR to include the disclosure either in the proxy or information statement or, if the company does not issue a proxy or information statement, in forms 10–K, 10–KSB, 20–F, 40–F or proposed form N–CSR. The proposed rules, therefore, might require small entities to spend additional time and incur additional costs in preparing disclosures. Small entities also might incur costs to set up procedures to monitor the activities of the audit committee in order to collect and record the information to be disclosed under the proposed rules.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission is not aware of any rules that duplicate, overlap, or conflict with the proposed rules.

G. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

1. The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities;

2. The clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities;

3. The use of performance rather than design standards; and

4. An exemption from coverage of the proposed amendments, or any part thereof, for small entities.

We do not propose to exempt small business issuers from the proposals because Congress indicated that any exemptions should be on a case-by-case basis and not by categories. We, nevertheless, are considering whether any exception or classifications for small businesses would be appropriate and consistent with the Sarbanes-Oxley Act. We believe investors in small companies, however, just as investors in large companies, would want and benefit from the proposed revisions in the auditor independence rules and enhanced communications between the auditor and the audit committee.

The proposed rules are designed to enhance auditors' independence and the reliability and credibility of financial statements for all public companies. Currently, we do not believe that it is feasible to further clarify, consolidate, or simplify the proposed rules for small entities. We are particularly mindful of the implications of our proposed rules on the provision of bookkeeping and internal controls services, as well as auditor rotation and cooling-off period requirements for small firms. We invite comments on these and all other issues.

H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. Specifically, we request comments regarding the number of small entities that may be affected by the proposed rules, and the existence or nature of the potential impact on those small entities. We also seek comments on how to quantify the number of small accounting firms that would be affected by the proposals, and how to quantify the impact of the proposed rules on those firms.

Commenters are requested to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules.

VIII. Codification Update

The Commission proposes to amend the ''Codification of Financial Reporting Policies'' announced in Financial Reporting Release No. 1 (April 15, 1982):

By amending section 602 to add a new discussion at the end of that section under the Financial Reporting Release Number (FR–64) assigned to the adopting release and including the text in the adopting release that discusses the final rules, which, if the proposals are adopted, would be substantially similar to section III of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

IX. Statutory Bases and Text of Amendments

We are proposing amendments to rules 2–01 and 2–07 of Regulation S–X, item 9 of schedule 14A, forms 10–K, 10–KSB, 20–F and 40–F, and proposed form N–CSR under the authority set forth in schedule A and sections 7, 8, 10, 19 and 28 of the Securities Act, sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, sections 5, 10, 14 and 20 of the Public Utility Holding Company Act of 1935, sections 8, 30, 31 and 38 of the Investment Company Act of 1940, and sections 203 and 211 of the Investment Advisers Act of 1940 and sections 3(a) and 208 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Broker-dealers, Issuers, Securities.

17 CFR Part 249

Reporting and recordkeeping requirements, Securities.

17 CFR Part 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Amendments

In accordance with the foregoing, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940 AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 78c, 78j–1, 78l, 78m, 78n, 78o(d), 78q, 78u–5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a–8, 80a–20, 80a–29, 80a–30, 80a–37(a), 80b–3, 80b–11 unless otherwise noted.

2. Section 210.2–01 is amended by:

a. Revising paragraph (c)(2)(iii);

b. Revising paragraph (c)(4);

c. Adding paragraph (c)(6);

d. Adding paragraph (c)(7);

e. Adding paragraph (c)(8);

f. Revising paragraph (f)(1);

g. Revising paragraph (f)(3); and

h. Adding paragraph (f)(17).

The revisions and additions read as follows:

§ 210.2–01 Qualifications of accountants.

* * * * *

(c) * * *

(2) * * *

(iii) *Employment at audit client of former employee of accounting firm.*

(A) A former partner, principal, shareholder, or professional employee

is $25,000,000 or more. *See* 17 CFR 240.12b–2. Registered management investment companies would use proposed form N–CSR to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002. *See* Investment Company Act Release No. 25723 (Aug. 30, 2002) (67 FR 57298 (Sept. 9, 2002)).

of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

(1) Does not influence the accounting firm's operations or financial policies;

(*2*) Has no capital balances in the accounting firm; and

(*3*) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

(*i*) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

(*ii*) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee.

(B) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role at an audit client, unless the individual:

(*1*) Was not a member of the audit engagement team of the audit client during the one year period preceding the date that audit procedures commenced. Audit procedures are deemed to have commenced at the earlier of:

(*i*) The date that the accountant commenced the audit for the period covered by the financial statements that included the date of the initial employment of the audit engagement team member by the audit client; or

(*ii*) The date that the accountant commenced review procedures for the period covered by the financial statements that included the initial employment of the audit engagement team member by the audit client.

* * * * *

(4) *Non-audit services.* An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

(i) *Bookkeeping or other services related to the accounting records or financial statements of the audit client.* Any service, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements, including:

(A) Maintaining or preparing the audit client's accounting records;

(B) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or

(C) Preparing or originating source data underlying the audit client's financial statements.

(ii) *Financial information systems design and implementation.* (A) Directly or indirectly, operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network.

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole.

(iii) *Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.* Any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements.

(iv) *Actuarial services.* Any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements.

(v) *Internal audit outsourcing services.* Any internal audit services related to the internal accounting controls, financial systems, or financial statements, for an audit client.

(vi) *Management functions.* 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.

(vii) *Human resources.* (A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

(viii) *Broker-dealer, investment adviser, or investment banking services.* Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) *Legal services.* Providing any service to an audit client 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.

(x) *Expert services unrelated to the audit.* Providing expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acting as an advocate for an audit client in such proceedings.

* * * * *

(6) *Partner rotation.* An accountant is not independent of an audit client that is:

(i) An issuer as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1(f)) when an audit engagement team partner, principal or shareholder performs audit, review or attest services for that issuer or any significant subsidiaries as defined in 17 CFR 210.1–02(w), as a partner, principal or shareholder in each of the five previous fiscal years of the issuer or any significant subsidiaries and continues to serve as a partner, principal or shareholder on the audit engagement team. Following five consecutive years where audit, review or attest services have not been provided to that issuer or any significant subsidiaries by the aforementioned partners, principals or shareholders such partners, principals or shareholders again may perform audit, review or attest services for the audit client.

(ii) An entity that is part of an investment company complex as defined in 17 CFR 210.2–01(f)(14) when any audit engagement team partner, principal or shareholder performs audit, review or attest services for any entity in the investment company complex, as a partner, principal or shareholder in

each of the five previous fiscal years of the entity and continues to serve as a partner, principal or shareholder on the audit engagement team. Following five consecutive years where audit, review or attest services have not been provided to any entity in the investment company complex by the aforementioned partners, principals or shareholders such partners, principals or shareholders again may perform audit, review or attest services for the audit client.

(7) *Audit committee administration of the engagement.* An accountant is not independent of an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1(f))), other than an issuer that is an Asset-Backed Issuer as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–4(2)), unless:

(i) In connection with audit, review and attest reports required under the securities laws, the issuer's or registered investment company's audit committee pre-approves all such engagements;

(ii) For engagements other than those specified in paragraph (c)(7)(i) of this section, in accordance with section 10A(i) of the Securities Exchange Act of 1934, either:

(A) Before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render the service, the engagement is approved by the issuer's or registered investment company's audit committee; or

(B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the audit committee is informed of each service.

(C) Notwithstanding paragraphs (c)(7)(ii)(A) and (B) of this section, the pre-approval requirement is waived with respect to the provision of services covered under paragraph (c)(7)(ii) of this section provided:

(*1*) The aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided;

(*2*) Such services were not recognized by the issuer or registered investment company at the time of the engagement to be non-audit services; and

(*3*) Such services are promptly brought to the attention of the audit committee of the issuer or registered investment company and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee;

(iii) In addition, a registered investment company's audit committee pre-approves its accountant's engagements under paragraph (c)(7)(ii) of this section with the registered investment company's investment adviser (not including a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser) and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the registered investment company in accordance with paragraphs (c)(7)(ii)(A) through (C) of this section, except that with respect to paragraph (c)(7)(ii)(C)(*1*) of this section, the aggregate amount of all services provided constitutes no more than five percent of the total amount of revenues paid to the registered investment company's accountant by the registered investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides services to the registered investment company during the fiscal year in which the services are provided.

(8) *Compensation.* An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any partner, principal or shareholder who is a member of the audit engagement team earns or receives compensation based on the performance of, or procuring of, engagements with that audit client to provide any products or services other than audit, review or attest services.

* * * * *

(f)(1) *Accountant,* as used in paragraphs (b) through (e) of this section, means a registered public accounting firm, certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

* * * * *

(3)(i) *Accounting role* means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.

(ii) *Financial reporting oversight role* means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

* * * * *

(17) *Audit committee* means a committee (or equivalent body) as defined in section 3(a)(58) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(58)).

3. By adding § 210.2–07 to read as follows:

§ 210.2–07 Communication with audit committees.

(a) Each registered public accounting firm that performs for an audit client that is an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1(f))), other than an issuer that is an Asset-Backed Issuer as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a–4(2)), any audit required under the securities laws shall report, prior to the filing of such audit report with the Commission, to the audit committee of the issuer or registered investment company:

(1) All critical accounting policies and practices to be used;

(2) All alternative treatments of financial information within Generally Accepted Accounting Principles that have been discussed with management of the issuer or registered investment company, including:

(i) Ramifications of the use of such alternative disclosures and treatments; and

(ii) The treatment preferred by the registered public accounting firm;

(3) Other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences.

(b) [Reserved]

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

4. The authority citation for part 240 continues to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79j, 79n, 79t(a), 80a–8, 80a–20, 80a–29, 80a–30, 80a–37(a), 80b–4, 80b–11, unless otherwise noted.

* * * * *

5. Section 240.10A–2 is added to read as follows:

§ 240.10A–2 Auditor independence.

It shall be unlawful for an auditor not to be independent under § 210.2–01(c)(2)(iii)(B), 2–01(c)(4), 2–01(c)(6), 2–01(c)(7) and 2–07.

6. Section 240.14a–101 is amended by revising paragraph (e) of item 9 to read as follows:

§ 240.14a–101 Schedule 14A. Information required in proxy statement.

* * * * *

Item 9. *Independent public accountants.*

* * *

* * * * *

(e)(1) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's form 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for those fiscal years.

(2) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(3) Disclose, under the caption *Tax Fees,* the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(4) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(ii) Disclose the percentage of fees described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (c)(7)(ii)(B) and, (c)(7)(ii)(C), of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B) and (C)).

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instruction to Item 9(e).

For purposes of item 9(e)(2), (3), (4), and (5)(ii) registrants that are investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for part 249 is amended by revising the citations, § 249.220f, § 249.240f, § 249.310 and § 249.310b and a citation for § 249.331 is added in numerical order to read as follows:

Authority: 15 U.S.C. 78a *et seq.*, unless otherwise noted.

* * * * *

Section 249.220f is also issued under secs. 3(a), 202, 302, 404 and 407, Pub. L. No. 107–204, 116 Stat. 745.

Section 249.240f is also issued under secs. 3(a), 202, 302, 404 and 407, Pub. L. No. 107–204, 116 Stat. 745.

* * * * *

Section 249.310 is also issued under 15 U.S.C. 78m, 78o(d) and 78w(a) and secs. 3(a), 202 and 302, Pub. L. No. 107–204, 116 Stat. 745.

Section 249.310b is also issued under secs. 3(a), 202 and 302, Pub. L. No. 107–204, 116 Stat. 745.

* * * * *

Section 249.331 is also issued under secs. 3(a), 202, and 302, Pub. L. No. 107–204, 116 Stat. 745.

8. Amend form 20–F (referenced in § 249.220f) by adding paragraph (d) to item 15 to read as follows:

Note: The text of form 20–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20–F

* * * * *

Item 15. *Certain Disclosures.*

* * * * *

(d) Principal Accountant Fees and Services.

(1) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's form 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for those fiscal years.

(2) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(3) Disclose, under the caption *Tax Fees*, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(4) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(ii) Disclose the percentage of fees described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (c)(7)(ii)(B), and (c)(7)(ii)(C), of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B) and (C)).

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instructions to Item 15(d).

1. You do not need to provide the information called for by this item 15(d) unless you are using this form as an annual report.

2. A registrant that is an Asset-Backed Issuer (as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter) is not required to disclose the information required by this item.

* * * * *

9. Amend form 40–F (referenced in § 249.240f) by adding paragraph (10) to general instruction B to read as follows:

Note: The text of form 40–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 40–F

* * * * *

General Instructions

* * * * *

B. Information To Be Filed on This Form.

* * * * *

(10) Principal Accountant Fees and Services.

(1) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's form 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for those fiscal years.

(2) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(3) Disclose, under the caption *Tax Fees*, the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(4) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(ii) Disclose the percentage of fees described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (c)(7)(ii)(B), and (c)(7)(ii)(C), of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B) and (C)).

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Notes to Instruction B.(10).

1. You do not need to provide the information called for by this instruction B.(10) unless you are using this form as an annual report.

2. A registrant that is an Asset-Backed Issuer (as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter) is not required to disclose the information required by this instruction B.(10).

* * * * *

10. Amend form 10–K (referenced in § 249.310) by:

a. Redesignating item 16 of part IV as item 17 of part IV, and

b. Adding new item 16 to part III. The addition reads as follows:

Note: The text of form 10–K does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10–K

* * * * *

General Instructions

* * * * *

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

* * * * *

Part III

* * * * *

Item 16. Principal Accountant Fees and Services.

Furnish the information required by item 9(e) of schedule 14A (§ 240.14a–101 of this chapter).

(1) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's form 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for those fiscal years.

(2) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(3) Disclose, under the caption *Tax Fees,* the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(4) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(ii) Disclose the percentage of fees described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (c)(7)(ii)(B), and (c)(7)(ii)(C), of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B) and (C)).

(6) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instruction to Item 16.

A registrant that is an Asset-Backed Issuer (as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter) is not required to disclose the information required by this item.

* * * * *

11. Amend form 10–KSB (referenced in § 249.310b) by adding item 16 to part III to read as follows:

Note: The text of form 10–KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10–KSB

* * * * *

Part III

* * * * *

Item 16. Principal Accountant Fees and Services.

Furnish the information required by item 9(e) of schedule 14A (§ 240.14a–101 of this chapter).

(1) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's form 10–Q (17 CFR 249.308a) or 10–QSB (17 CFR 249.308b) for those fiscal years.

(2) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under paragraph (e)(1) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(3) Disclose, under the caption *Tax Fees,* the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(4) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (e)(1) through (e)(3) of this section. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(5)(i) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(ii) Disclose the percentage of fees described in each of paragraphs (e)(2) through (e)(4) of this section that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (c)(7)(ii)(B), and (c)(7)(ii)(C), of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B) and (C)).

(6) If greater than 50 percent, disclose the percentage of hours expended on the

principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instruction to Item 16.

A registrant that is an Asset-Backed Issuer (as defined in § 240.13a–14(g) and § 240.15d–14(g) of this chapter) is not required to disclose the information required by this item.

* * * * *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

12. The authority citation for part 274 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted.

Section 274.128 is also issued under secs. 3(a), 202, and 302, Pub. L. 107–204, 116 Stat. 745.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

13. By amending form N–CSR (referenced in §§ 249.331 and 274.128).

a. By revising general instruction D;

b. By redesignating items 5 and 6 as items 6 and 7; and

c. By adding a new item 5.

The revisions and additions read as follows:

Note: The text of form N–CSR does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N–CSR

* * * * *

General Instructions

* * * * *

D. Incorporation by Reference.

A registrant may incorporate by reference information required by items 5 and 7(b). No other items of the form shall be answered by incorporating any information by reference. The information required by item 5 may be incorporated by reference from the registrant's definitive proxy statement (filed or required to be filed pursuant to Regulation 14A (17 CFR 240.14a–1 *et seq.*)) or definitive information statement (filed or to be filed pursuant to Regulation 14C (17 CFR 240.14c–1 *et seq.*)) which involves the election of directors, if such definitive proxy statement or information statement is filed with the Commission not later than 120 days after the end of the fiscal year covered by an annual report on this form. All incorporation by reference must comply with the requirements of this form and the following rules on incorporation by reference: Rule 10(d) of Regulation S–K under the Securities Act of 1933 (17 CFR 229.10(d)) (general rules on incorporation by reference, which, among other things, prohibit, unless specifically required by this form, incorporating by reference a document that includes incorporation by reference to another document, and limits incorporation to documents filed within the last 5 years, with certain exceptions); rule 303 of Regulation S–T (17 CFR 232.303) (specific requirements for electronically filed documents); rules 12b–23 and 12b–32 under the Securities Exchange Act of 1934 (additional rules on incorporation by reference for reports filed pursuant to sections 13 and 15(d) of the Securities Exchange Act of 1934); and rules 0–4, 8b–23, and 8b–32 under the Investment Company Act of 1940 (17 CFR 270.0–4, 270.8b–23, and 270.8b–32) (additional rules on incorporation by reference for investment companies).

* * * * *

Item 5. Principal Accountant Fees and Services.

(a) Disclose, under the caption *Audit Fees,* the aggregate fees billed for each of the last two fiscal years for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements for those fiscal years.

(b) Disclose, under the caption *Audit-Related Fees,* the aggregate fees billed in each of the last two fiscal years for assurance and related services by the principal accountant that are reasonably related to the performance of the audit of the registrant's financial statements and are not reported under paragraph (a) of this item. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(c) Disclose, under the caption *Tax Fees,* the aggregate fees billed in each of the last two fiscal years for professional services rendered by the principal accountant for tax compliance, tax consulting, and tax planning.

(d) Disclose, under the caption *All Other Fees,* the aggregate fees billed in each of the last two fiscal years for products and services provided by the principal accountant, other than the services reported in paragraphs (a) through (c) of this item. Registrants shall describe each subcategory of services comprising the fees disclosed under this category.

(e)(1) Disclose the audit committee's pre-approval policies and procedures described in paragraph (c)(7)(ii) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)).

(2) Disclose the percentage of fees described in each of paragraphs (b) through (d) of this item that were approved by the audit committee pursuant to each of the paragraphs (c)(7)(ii)(A), (B), and (C) of rule 2–01 of Regulation S–X (17 CFR 210.2–01(c)(7)(ii)(A), (B), and (C)).

(f) If greater than 50 percent, disclose the percentage of hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Instructions

1. The information required by this item 5 is only required in a report on this form N–CSR that is required by item 7(a) to include a copy of an annual report transmitted to stockholders.

2. For purposes of paragraphs (b), (c), (d) and (e)(2) of this item, registrants must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

* * * * *

By the Commission.

Dated: December 2, 2002.

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 02–30884 Filed 12–12–02; 8:45 am]

BILLING CODE 8010–01–P