**February 11, 2003**

# SARBANES-OXLEY ACT OF 2002

# SEC'S FINAL RULES ON AUDITOR INDEPENDENCE

The SEC has adopted final rules to "enhance the independence of accountants that audit and review financial statements and prepare attestation reports" filed with the SEC. The final rules contain much of the substance that was included in the proposed rules that the SEC published in this area. The SEC has, however, relaxed or revised certain of the proposed rules in response to comments received on those proposals. The SEC's adopting release on the final rules is available at http://www.sec.gov/rules/final/33-8183.htm.

## Employment-Related Conflicts of Interest

Under the SEC's existing rules on auditor independence, if a former partner, principal, shareholder or professional employee of an accounting firm accepts employment with an audit client and has a continuing financial interest with the accounting firm or is in a position to influence the firm's operations or financial policies, that accounting firm is deemed not to be independent with respect to that audit client. The SEC's final rules generally provide that, in addition to these existing restrictions, if any audit engagement team member serves in a "financial reporting oversight role" for the issuer within one year prior to the commencement of procedures for the year that included employment by the issuer of the former member of the audit engagement team, that accounting firm is not independent with respect to that issuer. This requirement would not apply to audit engagement team members (not including lead or concurring partners) who provide less than 10 hours of audit services, conflicts that are created through merger or acquisition or rare emergencies. An individual would be considered to be serving in a "financial reporting oversight role" if he or she has direct responsibility for or oversight over those who prepare the company's financial statements and related information that are included in filings with the SEC.

The employment conflict rules differ for investment companies because of their unique structure. With respect to investment companies, the rules provide that if a former audit engagement team member is employed in a "financial reporting oversight role" with the registered investment company or any entity in the same investment company complex that is responsible for the financial reporting or operations of the registered investment company or any other registered investment company in the same investment company complex, that accounting firm would not be independent. The rules also provide that if a former audit engagement team member can exert undue influence over the audit process of an investment company, then employment in such a position with an investment company is prohibited.

The employment conflict rules apply to employment relationships with the issuer that commence after May 6, 2003.

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## Auditors Cannot Provide Certain Non-Audit Services to Audit Clients

Consistent with the requirements of Sarbanes-Oxley, the SEC's final rules state that both U.S. and non-U.S. accounting firms cannot, during the audit and professional engagement periods, provide any of 10 enumerated non-audit services or any non-audit service that impairs an accountant's independence from its audit clients. Underlying the prohibition are three basic principles: an accountant should not (i) audit its own work, (ii) function as a part of management or (iii) act as an advocate of the audit client.

An accounting firm, however, can provide "tax services," such as tax compliance, tax planning, and tax advice, to its audit clients when those services have been pre-approved by the client's audit committee. Although the SEC does not explicitly define "tax services," the adopting release suggests that tax planning generally involves the preparation of original and amended tax returns, claims for refund and tax payment-planning services. According to the release, tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals (other than representing a client in a court proceeding), tax advice related to mergers and acquisitions, employee benefit plans and requests for rulings or technical advice from taxing authorities. The proposing release had indicated that certain other tax-related services, such as the formulation of tax strategies (*e.g.*, tax shelters) or providing a tax opinion for the use of a third party in connection with a business transaction between the audit client and a third party, may be precluded because they might impair an accountant's independence. The adopting release does not specifically prohibit these services. The final rules, however, do provide that the representation of clients before a tax court would impair an accounting firm's independence. Additionally, if an accountant recommends and is retained on a transaction the sole purpose of which may be tax avoidance and the tax treatment may not be supported by the tax code and related regulations, the audit committee should carefully consider whether that accountant should be retained.

The final rules state that, until May 6, 2004, an accountant's independence would not be impaired by providing non-audit services to an audit client, as long as the non-audit services are pursuant to contracts that were in existence on May 6, 2003. After May 6, 2004, the 10 non-audit services referenced below may not be provided by an auditor to its audit client.

The first five services listed below qualify for a limited exemption: these services are prohibited "unless it is reasonable to conclude that the results of those services will not be subject to audit procedures during an audit of the audit client's financial statements." The adopting release states that there is a rebuttable presumption against the provision of these services and the limited exemption will be narrowly applied.

### *Bookkeeping; Other Accounting-Related Services*

Subject to the limited exemption described above, an auditor would lack independence if it provides any bookkeeping services (using the SEC's current definition of bookkeeping) to an audit client.

### *Financial Reporting Systems Design/Implementation*

Subject to the limited exemption described above, an accountant's independence would be impaired if the accountant (i) 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 systems or (ii) 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

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statements or other financial information systems taken as a whole. Information is "significant" if it is "reasonably likely" to be material to the financial statements of the audit client taken as a whole.

### *Appraisal or Valuation Services, Fairness Opinions, Contribution-in-Kind Reports*

Subject to the limited exemption described above, the auditor would not be considered independent if the audit firm provides appraisal or valuation services, fairness opinions or contribution-in-kind reports to an audit client. An accounting firm, however, could provide services for non-financial reporting purposes (such as transfer pricing, cost segregation studies and other tax-only valuations). An accounting firm also could employ its own valuation specialist to review the work done by the audit client itself or an independent, third-party specialist as long as the audit client or the client's third-party specialist provides the technical expertise that is used by the client in determining the amounts recorded in the client's financial statements.

### *Actuarial Services*

Other than assisting a client in understanding the methods, models, assumptions and inputs used in computing actuarial figures and subject to the limited exemption described above, an accountant is precluded from providing to an audit client any actuarially-oriented advisory services involving determination of amounts recorded in the company's financial statements and related accounts for the audit client. As long as the company uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities, an accountant may employ its own actuaries to assist in the audit.

### *Internal Audit Outsourcing*

Subject to the limited exemption described above, an auditor may not perform internal audit outsourcing services related to the audit client's internal accounting controls, financial systems or financial statements. This does not include nonrecurring evaluations of discrete items or programs, or operational internal audits that are not related to the internal accounting controls, financial systems or financial statements.

### *Management Functions*

An auditor's independence is impaired when the accountant acts, temporarily or permanently, as a director, officer or employee of the client, or performs any decision-making, supervisory or ongoing monitoring functions for the client. An accountant is not precluded, however, from providing services to an audit client in assessing the effectiveness of internal controls and providing recommendations for improving the design and implementation of internal controls and risk management controls.

### *Human Resources*

An auditor's independence is impaired when the accountant: (i) searches for or seeks out prospective managerial, executive or director positions; (ii) negotiates position, status, compensation, fringe benefits or other conditions of employment on the audit client's behalf; (iii) engages in psychological testing or other formal testing or evaluation programs; or (iv) recommends or advises that the audit client hire a specific candidate for a specific job.

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### *Broker-Dealer, Investment Advisor, Investment Banking*

An auditor lacks independence when the accountant: (i) serves as a broker-dealer, whether registered or unregistered; (ii) serves as a promoter or underwriter; (iii) makes investment decisions on behalf of the audit client; (iv) has discretionary authority over an audit client's investments; (v) executes a transaction to buy or sell an audit client's investment; or (vi) has custody of assets of the audit client.

### *Legal Services*

An accountant is not independent if the accountant provides any service to the audit client that, under the circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.

### *Expert Services*

An accountant may not provide expert opinions or other services for an audit client in connection with legal, administrative or regulatory proceedings or act as an advocate for that audit client in those proceedings. This prohibition includes providing consultation and other services to an audit client's legal counsel in connection with litigation, administrative or regulatory proceedings. The prohibition does not include (i) testifying as a fact witness to its audit work for a particular audit client or (ii) assisting the audit committee in fulfilling its responsibilities to investigate potential accounting impropriety, provided the auditor does not take on the role of an advocate in such investigations. In addition, in connection with their obligations under Section 10A of the Securities Exchange Act and generally accepted auditing standards ("GAAS"), if an auditor commences procedures to search for fraud and litigation arises or an investigation commences during such procedures, the completion of the procedures is not deemed prohibited expert services, provided the auditor remains in control of his or her work and that work does not become subject to the direction or influence of the issuer's legal counsel.

### *Other Prohibited Services*

The newly-established Public Company Accounting Oversight Board may also issue regulations to prohibit other services.

## Partner Rotation

The final rules specify that the lead and concurring audit partners should rotate after serving on the audit engagement for no more than five consecutive years and, upon rotation, a five year (consecutive) time-out period would follow during which the lead or concurring partner may not provide audit services to the company.

The partner rotation rules apply not only to the lead or concurring partner, but also to the "audit partners" who perform audit services for the company. Audit partners (other than lead or concurring partners) are required to rotate after no more than seven consecutive years and, upon rotation, a two year (consecutive) time-out period would follow during which the audit partner may not provide audit services to the company.

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The term "audit partners" is defined to include (i) the lead and concurring partners, (ii) relationship partners who serve the client at the issuer or parent level, (iii) audit engagement team partners who (x) have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements, or (y) who maintain regular contact with management and the audit committee or (iv) lead partners on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenue of the issuer. The term audit partner does not include specialty partners (such as tax partners) or partners who consult with others on the audit engagement team during the audit review or attestation engagement regarding technical or industry-specific issues, transactions or events (such as partners assigned to "national office" duties).

As applied to investment companies, the rules will not permit audit partners to rotate between investment companies in the same complex in order to satisfy their partner rotation obligations, and the rules will be applied to investment companies in the same manner as they are applied to other companies. Since the investment company structure can allow for many different year-ends in the same investment company complex, the SEC created a definition of "consecutive years of service" to be used in this context. For purposes of calculating "consecutive years of service," audits of registered investment companies with different fiscal year-ends that are performed in a continuous 12-month period count as a single consecutive year.

The partner rotation rules are subject to different effective dates, as follows:

- Lead partners are subject to the rotation requirements on the first day of the issuer's fiscal year beginning after May 6, 2003 and must rotate after five years, which period includes any time served in the capacity of a lead partner prior to May 6, 2003.
- Concurring partners are subject to the rotation requirements on the first day of the issuer's fiscal year beginning after May 6, 2004 and must rotate after five years, which period includes any time served in the capacity of a concurring partner prior to May 6, 2003.
- All other audit partners and all partners with foreign accounting firms are subject to the rotation requirements on the first day of the issuer's fiscal year beginning after May 6, 2003, which period does <u>not</u> include any time served prior to May 6, 2003.

The partner rotation rules do not apply to small firms with fewer than 10 partners and fewer than five audit clients that are issuers.

## Audit Committee Administration of the Engagement

The SEC's final rules require that an audit committee pre-approve all permissible non-audit services and all audit, review or attestation engagements required under the securities laws in one of two ways:

- The audit committee may explicitly approve the particular engagement before the accountant is engaged to provide the audit or non-audit service; or
- The engagement may be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee, provided that the policies and procedures are detailed as to the particular service, the audit committee is informed of each service and the polices and procedures do not permit delegation of the audit

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committee's responsibilities to management. These policies must be disclosed by the issuer in its periodic annual reports.

The release notes that the concept of audit services is broader than simply services to perform an audit pursuant to GAAS. The adopting release states that audit services include engagements involving comfort letters, services related to statutory audits and services performed to fulfill the accountant's responsibility under GAAS that must be pre-approved by the audit committee.

There is a *de minimis* exception to the pre-approval requirement, but only for non-audit services. Pre-approval is not required for non-audit services if all such services: (i) do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided, (ii) were not recognized as a non-audit service at the time of the engagement and (iii) are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or one or more designated members of the audit committee.

With respect to investment companies, the final rules provide that the investment company's audit committee can pre-approve only (i) the non-audit services provided directly to the investment company or (ii) any non-audit services provided to an entity in the investment company complex where the nature of the services provided has a direct impact on the operations or financial reporting of the investment company. The services provided (and the fee associated with those services) must be disclosed to the investment company's audit committee. To qualify for the *de minimis* exception, the investment company's audit committee must aggregate all of the services provided to the investment company complex that were subject to the pre-approval requirements. The final rules require that the investment company's audit committee pre-approve all audit, review and attest reports required under the securities laws.

All audit, review and attest services and all non-audit services that are entered into after May 6, 2003 are subject to the new rules. Non-audit services that are provided pursuant to contracts entered into prior to May 6, 2003 (regardless of whether or not they were pre-approved by the audit committee) must be completed by May 6, 2004.

## Compensation Policies of Accounting Firms

The final rules provide that an accountant will not be considered independent if, at any point during the audit and professional engagement period, any audit partner, other than specialty partners, earns or receives compensation based on selling engagements to that audit client to provide any services other than audit, review and attest services.

As applied to investment companies, the final rules prohibit all partners, principals and shareholders of an accounting firm that are members of the engagement team from being compensated for selling non-audit services to a registered investment company audit client or any other entity in the investment company complex.

The compensation rules are effective in the first fiscal period of the accounting firm that commences after May 6, 2003. The compensation rules do not apply to small firms with fewer than 10 partners and fewer than five audit clients that are issuers.

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## Communications with Audit Committees

The SEC's final rules amend Regulation S-X and require each registered public accounting firm that audits a registrant's financial statements to timely report to the company's (including a registered investment company's) audit committee the items listed below, prior to the filing of the accountant's report with the SEC.

### *Critical Accounting Policies and Practices*

Auditors must discuss all critical accounting policies and practices with audit committees. The adopting release states that auditors should review the Cautionary Guidance in the SEC's December 2001 Release No. 33-8040 relating to the disclosure of critical accounting policies in the MD&A to determine the types of matters that should be communicated to the audit committee. At a minimum, however, the discussion should include (i) the reasons certain estimates or policies meeting the criteria in the Cautionary Guidance are or are not considered critical and how current and anticipated future events affect those determinations and (ii) an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

### *Alternative Accounting Treatments*

Auditors must communicate (orally or in writing) to audit committees discussions with management regarding alternative accounting treatments of financial information within generally accepted accounting principles, including the impact of using the alternative treatments and disclosures and the treatment preferred by the accounting firm. The SEC notes in its adopting release that, at a minimum, a discussion of specific transactions should identify the underlying facts, financial statement accounts impacted and applicability of existing corporate accounting policies to the transaction. The adopting release states that general accounting policy discussions should focus on the initial selection of and changes in significant accounting policies and should include (i) the impact of management's judgment and accounting estimates and (ii) the auditor's judgment about the quality of the entity's accounting principles. Discussions of general accounting policies under the rules should not dilute the communication related to critical accounting policies. Correspondingly, a discussion of critical accounting policies is not a substitute for the rules' requirement regarding communications about general accounting policies.

### *Other Material Written Communications*

Because the decision whether to provide written communications to the audit committee is subjective and influenced by auditing standards, the final rules clarify and list the types of written documentation that should be provided by auditors to audit committees. That documentation includes:

- Management representation letters;
- Reports on observations and recommendations on internal controls;
- Schedules of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any;
- Engagement letters; and
- Independence letters.

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Because the list is not all-inclusive, auditors also must consider what additional written communications should be provided to audit committees pursuant to the final rules.

***Effectiveness and Timing of Communications***

A public accounting firm will be subject to the new rules regarding communications with audit committees upon registration with the Public Company Accounting Oversight Board. Communications between the registered public accounting firm and the audit committee pursuant to this rule must occur prior to the filing of the audit report with the SEC. With respect to investment companies, the registered public accounting firm must communicate to the investment company's audit committee annually. If the annual communication does not occur 90 days prior to the filing of the audit report with the SEC, the accountant must provide an update of any changes to the previously reported information during the 90 day period prior to filing.

## Expanded Disclosure Regarding Accounting Fees and Pre-Approval Policies and Procedures

Companies must provide expanded disclosure concerning (i) fees paid to its accounting firm and (ii) audit committee policies or procedures in its proxy statement or, if the company does not file a proxy statement, in its annual report. As stated in the adopting release, the expanded disclosure rules are "effective for periodic annual filings for the first fiscal year ending after December 15, 2003."

***Principal Accountants' Fees***

The final rules require that accountants' fees must be disclosed in separate categories: (i) audit fees; (ii) audit-related fees; (iii) tax fees; and (iv) all other fees. Items (ii) and (iii) are new categories of disclosure. Other than for audit fees, companies are required to describe in qualitative terms the nature and types of services provided, including the percentage of services that were approved by the audit committee. The rules also require disclosure for each of the two most recent fiscal years of both dollar amounts and the percentages of all fees billed. The meaning of "audit fees" has been expanded to include services that generally only the independent accountant can provide, such as comfort letters, statutory audits, attest services, consents, assistance with and review of documents filed with the SEC and all services performed to comply with GAAS. "Audit-related fees" are fees for assurance and any related services such as due diligence services, and includes employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation and consultation concerning financial accounting and reporting standards. "Tax fees" are fees for all services performed by professional staff in the accountant's tax division (excluding any services related to the audit) and includes tax compliance, tax planning and tax advice services as more fully discussed in the non-audit services section. "All other fees" remains unchanged but would include fees for financial information systems implementation and design services.

***Audit Committee Actions***

If an audit committee adopts pre-approval policies and procedures as discussed above, the company must disclose them in its proxy statement or its annual report, as applicable. Asset-backed issuers and unit investment trusts are exempt from this disclosure requirement. The disclosure should set

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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. Alternatively, companies could include a copy of those policies and procedures with the proxy statement or annual report, as applicable. The issuer must disclose the specific processes in place that permit and monitor the *de minimis* exception to the pre-approval requirement and, to the extent that the audit committee has applied the *de minimis* exception, the percentage of total fees paid to independent accountants pursuant to that exception.

***Investment Company Disclosures***

An investment company must "disclose audit and non-audit fees, with a breakdown by types of services, from services provided directly to the investment company and non-audit fees from services provided to all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee." For non-audit services not subject to the investment company audit committee's pre-approval process, if the audit committee has considered whether the provision of non-audit services provided to the investment company's adviser and its related parties is compatible with maintaining the principal accountant's independence, this information must be disclosed.

## Foreign Private Issuers and Foreign Accounting Firms

The SEC's adopting release includes an acknowledgement that the rules may significantly impact non-U.S. issuers and non-U.S. accounting firms that conduct audits of foreign subsidiaries and affiliates of U.S. issuers. Certain of the modifications to the proposed rules were designed to address the impact of the rules on non-U.S. entities. In cases where the new rules conflict with the law in non-U.S. jurisdictions, the SEC will work with non-U.S. regulatory agencies, and non-U.S. entities are encouraged to address issues on an "ad hoc" basis with the SEC.

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For more information on the SEC's final auditor independence rules, please call your regular Sidley Austin Brown & Wood LLP contact or any of the attorneys listed below.

We have posted our prior Client Bulletins on corporate governance matters and related issues on our web site, http://www.sidley.com/corporategovernance, and we will post further updates on Sarbanes-Oxley and related matters.

**CHICAGO**

| | |
|---|---|
| Larry A. Barden | 312-853-7785 |
| Paul Choi | 312-853-2145 |
| Thomas A. Cole | 312-853-7473 |
| Frederick C. Lowinger | 312-853-7238 |
| Richard E. Robbins | 312-853-4346 |

**HONG KONG**

| | |
|---|---|
| Kenneth T. Cote | 852-2509-7890 |

**LONDON**

| | |
|---|---|
| Christopher B. Mead | 44-207-778-1821 |
| Thomas M. Thesing | 44-207-778-1801 |
| E. Mark Walsh | 44-207-778-1851 |

**LOS ANGELES**

| | |
|---|---|
| Robert W. Kadlec | 213-896-6072 |
| Moshe J. Kupietzky | 213-896-6020 |
| Theodore N. Miller | 213-896-6646 |

**NEW YORK**

| | |
|---|---|
| Joseph W. Armbrust | 212-839-5390 |
| Joseph McLaughlin | 212-839-5312 |
| Norman D. Slonaker | 212-839-5356 |

**SAN FRANCISCO**

| | |
|---|---|
| Eric S. Haueter | 415-772-1231 |
| Paul C. Pringle | 415-772-1249 |
| Timothy T. Scott | 415-772-1296 |

**SINGAPORE**

| | |
|---|---|
| Edward D. Eddy, III | 656-230-3901 |

**TOKYO**

| | |
|---|---|
| Mark D. Schultz | 813-3218-5901 |

**WASHINGTON, D.C.**

| | |
|---|---|
| Frank R. Goldstein | 202-736-8550 |
| John K. Hughes | 202-736-8480 |
| Michael Hyatte | 202-736-8012 |

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