

SEC'S GUIDANCE TO THE REVISED RULES ON AUDITOR INDEPENDENCE

On January 17, 2001, the Securities and Exchange Commission (the "SEC") published guidance in response to questions the SEC had received regarding implementation and interpretation of the SEC's recently revised rules on auditor independence, which become effective on February 5, 2001. These amendments involve changes to two areas of the securities laws. First, the amendments amend Item 9 (which requires disclosure of certain information regarding a registrant's independent public accountant) of Schedule 14A (which sets forth the information required in a registrant's proxy statement). Specifically, Item 9(e) was added which requires, among other things, disclosure of certain auditing fees incurred by a registrant as well as disclosure of fees incurred by a registrant as a result of certain non-audit services provided by a registrant's auditor. Second, the amendments amend Rule 2-01 of Regulation S-X. These amendments set forth restrictions on financial, employment and business relationships between an accountant and an audit client, and relationships between accountants and audit clients where the accountants provide certain non-audit services to their audit clients.

Section I below summarizes the SEC's response to certain questions regarding the amendments to Item 9 of Schedule 14A. Section II below summarizes the SEC's response to certain questions regarding the amendments to Rule 2-01 of Regulation S-X.

I. Questions Regarding Amendments to Item 9 of Schedule 14A

1. What fees should be included as "Audit Fees"?

This category should only include fees for audits to financial statements and review services performed by the auditor which are customary under generally accepted auditing standards or which are customary for the purpose of rendering an opinion or review report on the financial statements.

Examples of professional services, the fees for which should be included in the category of "Audit Fees," include:

- Attendance at audit committee meetings at which matters related to the audits or reviews are discussed
- Consultations on audit or accounting matters that arise during or as a result of an audit or review

- Preparation of a “management letter”
- Time incurred in connection with the audit of the income tax accrual

Examples of professional services, the fees for which should not be included in the category of “Audit Fees,” include:

- Work performed in connection with registration statements such as due diligence or the issuance of comfort letters
- Due diligence performed in connection with a merger and acquisition
- Income tax services other than those directly related to the audit of the income tax accrual
- Internal control advisory services outside of the scope of the audit
- Risk management advisory services
- Internal audit services
- Audits of employee benefit plans

2. **Should “out of pocket” costs billed to the company in connection with the auditor’s professional services be included in the fee disclosure requirements?**

Yes. These costs should be included as part of the aggregate fee for the service to which they apply.

3. **In determining which fees are to be disclosed, should the disclosure be based on when the service was performed, the period to which the service applies, or when the bill for the service is received?**

Fees disclosed under the caption “Audit Fees” should include those fees billed or fees expected to be billed in connection with the company’s annual audit as well as fees incurred from review of the company’s financial statements for any interim period within such year. If prior to filing the company’s definitive proxy statement with the SEC the company has not received a bill for such audit services, then the company should ask the auditor for the amount that will be billed for such services and include that amount in the disclosure.

Fees disclosed under the captions “Financial Information Systems Design and Implementation Fees” and “All Other Fees” should include fees billed for services that were rendered during the most recent fiscal year, even if the auditor did not bill the company for those services until after year-end.

4. **Under which caption should fees for one-time information technology consulting projects that do not affect the financial statements be included?**

These fees should be included under the caption “All Other Fees.” Only fees incurred for services described in Rule 2-01(c)(4)(ii) of Regulation S-X should be included under the caption “Financial Information Systems Design and Implementation Fees.” Such services include 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 taken as a whole.

5. **Can the disclosure of fees made under the caption “All Other Fees” include additional detail regarding the services rendered?**

Yes, provided that the total amount of the fees is clearly stated.

6. **Should the fees billed in prior years be disclosed so investors may compare trends in audit, information technology and other non-audit fees?**

The rule does not require comparative disclosures. However, such information may be provided voluntarily.

7. **Does the term “principal accountant” include associated or affiliated organizations?**

Yes. In determining what services rendered by the “principal accountant” must be disclosed, all entities that comprise the “accountant,” as defined in Rule 2-01(f)(1) of Regulation S-X, should be included. This term includes not only the person or entity that furnishes reports or other documents that the registrant files with the SEC, but also all of such person’s or entity’s departments, divisions, parents, subsidiaries and associated entities, including those located outside of the United States.

8. **In situations where other auditors are involved in the delivery of services, to what extent should the fees from the other auditors be included in the required fee disclosures?**

Only the fees billed by the principal accountant need to be disclosed. If the principal accountant’s billings or expected billings include fees for work performed by others (such as where the principal accountant hires someone else to perform part of the work), then such fees should be included in the fees disclosed for the principal accountant.

In some foreign jurisdictions a registrant may be required to have a joint audit requiring both accountants to issue an audit report for the same fiscal year. In these circumstances, fees for each accountant should be separately disclosed as they would both be considered “principal accountants.”

9. **To what extent should audit and non-audit fees billed by the principal accountant to subsidiaries and investees of the registrant be included in the fee disclosures?**

In all cases, audit fees billed pursuant to the engagement letter for the performance of the audit of consolidated financial statements as well as non-audit fees billed to entities that are consolidated entities, should be included as part of the parent company's proxy statement disclosures.

10. **Where in the proxy materials should the disclosures required pursuant to Item 9(e) of Schedule 14A appear? For example, can registrants include the disclosures in the audit committee report?**

Item 9(e) does not specify any particular area within the proxy statement in which such disclosures must appear. The SEC stated that it would be appropriate for these disclosures to accompany the disclosures required by Item 7(e) (which requires disclosure of certain information relating to a registrant's committees) and Items 9(a)-(d) (which requires disclosure of certain information relating to a registrant's independent public accountant) of Schedule 14A. A registrant may include the Item 9(e) disclosures in the audit committee report.¹

11. **Can the fees required to be disclosed under the captions "Audit Fees," "Financial Information Systems Design and Implementation Fees" and "All Other Fees" be provided in tabular format?**

Yes. Item 9 requires that each of these amounts be provided under a specified caption. One way to satisfy this requirement is to provide a table consisting of two columns or rows, the first listing the three captions and the second listing the three amounts. The SEC also stated that any further breakdown of the amounts is optional and could be included in the table itself, in a footnote to the table or in narrative disclosure in proximity to the table.

12. **Item 9(e)(4) requires that the registrant disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of services disclosed under the captions "Financial Information Systems Design and Implementation Fees" and "All Other Fees" is compatible with maintaining the principal accountant's independence. What disclosure is required if the audit committee did not consider this?**

Registrants may state that the audit committee did not consider whether the provision of financial information systems design and implementation services and other non-audit services is compatible with the principal accountant's independence.

¹ The SEC stated that including the Item 9(e) disclosures in the audit committee report would not entitle such disclosures to the safe harbor provided by Item 7(e)(3)(v) of Schedule 14A nor would it entitle such disclosures to the safe harbor provided in Item 306(c) of Regulation S-K.

13. **Does Item 9(e)(4) (as described in question 12 above) require disclosure of an audit committee’s conclusions or of factors considered by the audit committee when assessing the principal accountant’s independence?**

No. The SEC stated, however, that a registrant may voluntarily disclose conclusions reached and factors considered when assessing the principal accountant’s independence.

14. **When there has been a change in auditors during the year, should fees paid to both the predecessor and successor auditor be disclosed pursuant to Item 9(e)?**

No. The fee disclosure should only be made for the auditor who renders an audit opinion on the most recent year’s financial statements.

II. Questions Regarding the Amendments to Rule 2-01 of Regulation S-X

1. **Does the restriction on the independent accountant providing legal services to an audit client apply only to litigation services?²**

No. This standard applies to all legal services.

The only circumstances excluded by the rule are those in which local U.S. law allows certain limited activities without admission to bar (generally confined to advice concerning the law of foreign jurisdictions). Additionally, some firms may be providing legal services outside of the United States to registrants when those services are not precluded by local law and are routine and ministerial or relate to matters that are not material to the consolidated financial statements. The SEC stated that such services “raise serious independence concerns under circumstances other than those meeting at least those minimum criteria.”

2. **Does Rule 2-01(c)(4)(i)³ preclude an auditor from assisting an audit client in preparing its financial statements?**

The SEC stated that “[a]ssistance’ can take many forms.” With respect to this question, the SEC reiterated guidance it had previously given, stating that:

“It is the Commission’s position that an accounting firm cannot be deemed independent with regard to auditing financial statements of a client if it has

² Rule 2-01 (c)(4)(ix) states that “[a]n accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides . . . any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.”

³ Rule 2-01(c)(4)(i) generally provides that “[a]n accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides . . . bookkeeping or other services related to the audit client’s accounting records or financial statements.”

participated closely, either manually or through its computer services, in maintenance of basic accounting records and preparation of financial statements, or if the firm performs other accounting services through which it participates with management in operational decisions.”

3. **The final rule did not define an affiliate of an accounting firm. Does the lack of a definition signal a change in the SEC’s approach to this issue?**

No. The definition of “accounting firm”⁴ includes the accounting firm’s “associated entities.” The SEC stated that this phrase was used to reflect the SEC’s current practice of addressing these questions in light of all relevant facts and circumstances and by looking to factors identified in the SEC’s previous guidance on this subject.

4. **Did the final rule change the SEC’s guidance with respect to business relationships?**

No. The SEC stated that the final rule is consistent with the SEC’s prior guidance on business relationships. The SEC referenced a 1989 letter to Arthur Anderson in which the SEC stated:

“The Commission has recognized that certain situations, including those in which accountants and their audit clients have joined together in a profit-sharing venture, create a unity of interest between the accountant and client. In such cases, both the revenue accruing to each party . . . and the existence of the relationship itself create a situation in which to some degree the auditor’s interest is wedded to that of its client. That interdependence impairs the auditor’s independence, irrespective of whether the audit was in fact performed in an objective, critical fashion. Where such a unity of interests exists, there is an appearance that the auditor has lost the objectivity and skepticism necessary to take a critical second look at management’s representations in the financial statements. The consequence is a loss of confidence in the integrity of the financial statements.”

The SEC stated that the following business relationships may impair an accountant’s independence:

- Joint ventures
- Limited partnerships
- Investments in supplier or customer companies
- Certain leasing interests and sales by the accountant of items other than professional services

⁴ See Rule 2-01(f)(2) of Regulation S-X.

5. **May an auditor provide a fairness opinion on a transaction that is not material to the financial statements and still be considered independent?**

In response to this question, the SEC reiterated the following statement which it had made previously in the adopting release to the rules, stating that:

“Fairness opinions are opinions that an accounting firm provides on the adequacy of consideration in a transaction. [I]f an audit firm provides these services to an audit client, when it is time to audit the financial statements the accountant could well end up reviewing his or her own work, including key assumptions or variables suggested by his or her firm that underlie an entry in the financial statements. [W]e are limiting application of the rule to the provision of appraisals, valuations or services involving a fairness opinion where it is reasonably likely that the results,⁵ individually or in the aggregate, would be material to the audit client’s financial statements or where the results would be audited by the auditor. As a general matter, auditors would be auditing the results when they perform a GAAS audit.”

6. **Is an accountant’s independence always impaired if the accountant renders a report characterized as a “fairness opinion” when that report is mandated by a foreign jurisdiction?**

In response to this question, the SEC reiterated the following statement which it had made previously in the adopting release to the rules, stating that:

“The Commission is sensitive to those issues and in the past had worked with foreign regulators and companies to reach an acceptable resolution. We will continue our practice of determining whether to accept such reports on a case-by-case basis.”

7. **The new rule permits the auditor to continue to provide certain internal audit and financial information systems design and implementation services provided certain criteria are met. Do these criteria for internal audits apply to all internal audit engagements? What are the responsibilities of management pursuant to these criteria?**

The six criteria for internal audit services⁶ apply to all internal audit services the auditor provides to its audit client, including those services related to operational audits or for companies with less than \$200 million in assets.

⁵ Under this rule, the SEC stated that the “results” of the fairness opinion refers to the financial effects of the transaction that is the subject of the fairness opinion.

⁶ Rule 2-01(c)(4)(v)(B)(1) through (6) sets forth the following six criteria which must be satisfied: (1) the audit client’s management must acknowledge in writing to the accounting firm and the audit client’s audit committee, or if there is no such committee then the board of directors, the audit client’s responsibility to

The SEC stated that all of the specified criteria must be met for both internal audit⁷ and financial information systems design and implementation⁸ to ensure that management not only takes responsibility for the services and projects performed by the auditor, but also makes the required management decisions. An audit client that merely signs a letter acknowledging responsibility for the services or project, without actually meeting each of the specified conditions, is not sufficient to ensure the auditor's independence.

We would be pleased to work with you in evaluating the impact of the revised auditor independence rules and above-referenced guidance on your business. If you wish to obtain additional information regarding the impact of these rules, please contact the corporate partner who regularly works with you, or John S. D'Alimonte at (212) 728-8212 or Steven J. Gartner at (212) 728-8222.

establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934; (2) the audit client's management must designate a competent employee or employees, preferably within senior management, to be responsible for the internal audit function; (3) the audit client's management must determine the scope, risk and frequency of internal audit activities, including those performed by the accountant; (4) the audit client's management must evaluate the findings and results arising from the internal audit activities, including those performed by the accountant; (5) the audit client's management must evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the accountant; and (6) the audit client's management cannot rely on the accountant's work as the primary basis for determining the adequacy of its internal controls.

⁷ *See id.*

⁸ Rule 2-01(c)(4)(ii)(B)(1) through (5) sets forth the following five criteria which must be satisfied: (1) the audit client's management must acknowledge in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with Section 13(b)(2) of the Securities Exchange Act of 1934; (2) the audit client's management must designate a competent employee or employees, preferably within senior management, with the responsibility of making all management decisions with respect to the design and implementation of the hardware or software system; (3) the audit client's management must make all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training and conversion plans; (4) the audit client's management must evaluate the adequacy and results of the design and implementation of the hardware or software system; and (5) the audit client's management cannot rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems.

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