

## Audit Committee Pre-Approval of Services

An audit committee is defined as a committee established by and among the board of directors of a publicly traded client for the purpose of overseeing the accounting and financial reporting processes of the client and audits of the financial statements of the client. If no such committee of the board exists, the committee is deemed to be the client's entire board of directors. 15 U.S.C. §7201(3)(A) and (B) (2003). The rule requires that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements. This approval can occur either through express approval, or upon compliance with specific pre-approval policies and procedures set in place by the committee. 68 Fed. Reg. 6006, 6022 (to be codified at 17 C.F.R. §210.2-01(c)(7)).

The rules provide a *de minimis* exception for non-audit related services, waiving the pre-approval requirement where all non-audit services: (1) do not amount to more than five percent of total revenues paid by the audit client to the accounting firm in the fiscal year services are provided; (2) were not recognized as non-audit services at the time of the engagement; and (3) are promptly brought to the attention of the audit committee and approved prior to completion of the audit by the audit committee. *Id.* at 6022-6023 (to be codified at 17 C.F.R. §210.2-01(c)(7)(i)(c)).

## Partner Rotation

An audit engagement team is defined as all partners and professional employees participating in an audit, review, or attestation engagement of an audit client. Congress included in section 203 of the Act a requirement that audit partners "rotate off" of a particular client engagement after a specific period of time. 15 U.S.C. §78j-1(j) (2003). "Audit partner" is defined as a partner who, as a member of the audit engagement team, has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee. 68 Fed. Reg. 6006, 6019 (to be codified at 17 C.F.R. §210.2-01(f)(7)(ii)).

The rule has classified partners into different levels and established rules for each level of partner. The lead and concurring partners are required to rotate after five years, and then are subject to a five-year "time-out" period where they cannot perform services for that audit client. Other audit partners are required to rotate after no more than seven years and be subject to a two-year time-out period. 68 Fed. Reg. 6006, 6018-6019 (to be codified at 17 C.F.R. §210.2-01(c)(6)(i)(B)).

## Small Firm Exception

The SEC adopted a small-firm exception from the partner rotation rules. 68 Fed. Reg. 6006, 6020 n. 143. Audit firms that have fewer than five audit clients that are public companies, and have fewer than 10 partners, are exempted from partner rotation rules. These firms still must be subject to a full review by the Board at least once every three years, however. *Id.* at 6020 (to be codified at 17 C.F.R. §210.2-01(c)(6)(ii)).

## Conflicts Of Interest

Section 206 of the Act sets forth a conflict of interest rule whereby a one-year cooling off period is required before a member of the audit engagement team can begin working for the audit client in certain key positions. 15 U.S.C. §78j-1(l) (2003).

The rule provides that when the lead partner, concurring partner, or any other member of the audit engagement team who provides more than 10 hours of audit, review, or attest services for the client accepts a position with the audit client

in a financial reporting oversight role within one year after they provided such services to the client, the accounting firm is not independent. 68 Fed. Reg. 6006, 6007-6008 (to be codified at 17 C.F.R. §210.2-01(c)(2)(iii)).

The SEC addressed conflicts of interest arising where an audit partner receives compensation based on the act of selling non-audit services to the client. It has adopted the rule that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with the audit client to provide any products or services other than audit, review, or attest services. *Id.* at 6024-6025 (to be codified at 17 C.F.R. §210.2-01(c)(8)).

## Increased Communication and Disclosure

**To Audit Committees.** Section 204 requires the SEC to issue rules requiring timely reporting of specific information to audit committees in order to assist the committee in overseeing both management and accountants. 15 U.S.C. §78j-1(k) (2003). The SEC rule has added substance to this rule by requiring disclosures for three types of information that must occur prior to the filing of the audit report with the SEC.

First, firms are required to disclose to audit committees all critical accounting policies and practices. 68 Fed. Reg. 6006, 6027-6028 (to be codified at 17 C.F.R. §210.2-07(a)(1)).

Second, accounting firms are also required to communicate to the audit committee, either orally or in writing, all alternative treatments within generally accepted accounting principles (GAAP) for policies and practices related to material items that have been discussed with management. *Id.* at 6028 (to be codified at 17 C.F.R. §210.2-07(a)(2)).

Third, the SEC also requires disclosure to the committee of material written communications. *Id.* at 6029 (to be codified at 17 C.F.R. §210.2-07(a)(3)).

**To Investing Public.** Beyond the disclosures to audit committees, the new rule requires that additional information be provided to the public. Public companies must disclose fees paid to their independent accountant(s) for: (1) audit fees, (2) audit-related fees, (3) tax fees, and (4) all other fees. Further, the company must disclose a description of the type of services being provided. Disclosure must also be made of the audit committee's pre-approval policies and procedures, if any. These disclosures are to be provided both in the company's annual report and in their proxy statement. The information must be included for the two most recent fiscal years of the company. *Id.* at 6030 (to be codified at 17 C.F.R. §240.14a-101 Schedule 14A at Item 9(e)).

## Conclusion

This article has sought to provide a summary of the final auditor independence rules. Public companies and registered public accounting firms will likely take very seriously these rules, in view of the Act's harsh criminal penalties. Whether they will prove effective and worth the burden will be determined in the years, and hopefully bull markets, to come. ■

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