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Advisory

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SECURITIES LAW

Auditor Independence

The Securities and Exchange Commission (SEC) has issued final rules required by Section 208(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which are aimed at strengthening auditor independence.[1] These final rules, passed in the light of a series of corporate scandals that highlighted conflicts of interest between accounting firms and their clients, address the following general topics:

- Relationships between audit clients and their independent public accountants that will no longer be permissible because they may create a conflict of interest;
- Mandatory rotation of significant members of an issuer's audit team, along with mandated "cooling off" periods from service;
- The types of non-audit services that auditors may no longer provide to their audit clients;
- The requirement that audit committees pre-approve all audit and non-audit services;
- Disclosures that are required to be given to public company audit committees by companies' independent public accountants; and
- New disclosure in issuers' periodic SEC filings regarding the pre-approval of audit and non-audit services and the fees paid to the independent public accountants.

The requirements imposed by these rules are being phased in between May 6, 2003 and May 6, 2004, as more specifically discussed with regard to each rule below, and as set forth in the chart at the end of this Advisory.

Auditor Independence and Provision of Non-Audit Services

Both the Act and the final SEC rules issued thereunder expand the categories of relationships and services provided by public auditors that will be deemed to impair the auditing firm's independence,

[1] These final rules are available on the SEC's website at http://www.sec.gov/rules/final/33-8183.htm. In addition, on August 13, 2003, the Office of the Chief Accountant of the SEC issued a document including answers to frequently asked questions regarding these rules, which is available at http://www.sec.gov/info/accountants/ocafaqaudind080703.htm.

and will therefore disqualify the auditing firm from performing an audit of the issuer's financial statements.

Relationships that Create a Conflict of Interest

Pursuant to Section 206 of the Act, an auditing firm will not be considered independent of an issuer if any former member of the audit engagement team has taken a position with the issuer in a financial reporting oversight role and such individual was a member of the audit engagement team within the year preceding the commencement of audit procedures for the current audit engagement. This provision is in effect for any employment relationship with an issuer that is entered into on or after May 6, 2003. Audit procedures are deemed to have commenced for the fiscal year under audit on the day following the filing of the issuer's annual report for the prior fiscal year. The rule is meant to ensure that before the issuer hires a former member of its audit engagement team, at least one full annual audit cycle will have been completed since the employee left the accounting firm's audit engagement team for that issuer.

An individual will not be considered to have been a "member of the audit engagement team" for an audit if the individual:

- was not the lead or concurring partner on the audit and provided ten or fewer hours of service on the audit,
- became an employee of the issuer as a result of a business combination, provided that his or her employment was not in contemplation of the business combination and the audit committee is aware of the prior employment relationship, or
- is employed by the issuer due to an emergency or other unusual situation; provided, however, that the audit committee determines that the relationship is in the best interest of investors.

According to the SEC release, the third exemption in the list above is meant to be invoked "very rarely," for example, in situations involving certain foreign jurisdictions where it might otherwise be extremely difficult or costly to comply with these requirements. The SEC also states that a "financial reporting oversight role" refers either to those who have oversight of persons who prepare the issuer's financial statements and related information (for example, Management's Discussion and Analysis) that are included in filings with the SEC, or to those who are directly responsible for the preparation of those financial statements and information.

These new rules are in addition to the SEC's existing rules that deem an accounting firm to be not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm 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.

In addition, an auditing firm will not be considered independent of an issuer if any audit partner earns or receives compensation based on engagements secured by that partner with an audit client for services ***other than*** audit, review and attest services. This prohibition does not apply to public auditing firms with five or fewer audit clients that are publicly traded companies and fewer than ten partners. The limitation on compensation will begin to apply during the accounting firm's first fiscal year that includes May 6, 2003.

Audit Partner Rotation

Pursuant to Section 203 of the Act and the SEC's implementing rules, an auditing firm will not be deemed to be independent of an issuer unless the auditing firm complies with the following partner rotation rules:

- the lead and concurring partners on an audit account must rotate off the account after five consecutive years of service and are subject to a five-year "cooling off" period before they can rejoin the audit engagement team; and
- other audit partners on the engagement team who have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements, or who maintain regular contact with the issuer's

management and audit committee, must rotate off the issuer's account after seven years of service and are subject to a two-year "cooling off" period.

The lead partner on the audit of any subsidiary of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer is also considered to be an "audit partner" subject to the seven-year rotation and two-year cooling off period. "Specialty" partners, such as national office partners who provide very limited and technical advice on an issuer's audit, are exempted from these rotation requirements. In addition, auditing firms with fewer than five audit clients that are publicly traded companies and fewer than ten partners are exempt from these rotation requirements, provided that the Public Company Accounting Oversight Board reviews the firm's engagements for conflicts of interest at least once every three years.

These rules represent a change from the existing rules on audit partner rotation, which have required only that the lead audit partner rotate off an account after seven years, with a two-year cooling off period.

The audit partner rotation rules with regard to lead partners and other audit partners (other than the concurring partner) go into effect for an issuer's first fiscal year beginning after May 6, 2003. In order to facilitate orderly transitions of audit engagement teams, rotation rules for concurring partners will go into effect for an issuer's first fiscal year beginning after May 6, 2004. For audit partners in U.S. accounting firms, time served prior to May 6, 2003, as a lead or concerning partner on an issuer's audit engagement team ***is counted*** for purposes of calculation under the rule. The time served by other audit partners on the engagement team prior to May 6, 2003 and time served by all audit partners in foreign firms prior to May 6, 2003 (including lead and concurring partners) ***is not counted*** for purposes of the calculation under the rule.

In the case of a company that is pursuing an IPO, time served with the client prior to the IPO by the lead, concurring and other audit partners who are subject to the rotation requirements will be counted as prior service in determining the length of time they may continue to serve in those roles after the IPO. The length of pre-IPO service that will be counted will be established by the number of years of audited financial statements that are included in the filing. Accordingly, for issuers that are going public, and which are required to include three years of audited financial statements in their registration statements for their IPOs, the audit, concurring and other partners would have three years of service counted for purposes of the calculation of prior service under the rule (assuming that such persons had, in fact, been serving in those capacities prior to the IPO). Small business issuers are only required to include two years of audited financial statements in their IPO registration statements, and thus their audit, concurring and other partners would only have two years of prior service counted under these rules.

In addition, the SEC has clarified that, if a lead audit partner for a client leaves one accounting firm and begins work at another accounting firm, and that client transfers its auditing work to the new accounting firm, any time spent by the audit partner as the lead partner at the prior firm will be counted towards the time he or she may continue to serve as the lead partner for the audit client at the new firm.

Prohibited Non-Audit Services

Section 201 of the Act sets forth nine categories of so-called non-audit services that may not be provided by a public auditing firm to an issuer contemporaneously with an engagement to audit the issuer's financial statements. The rules do not prevent auditing firms from providing these services to their non-audit clients, as long as the services are otherwise permitted by applicable rules. The SEC states that its philosophy of independence with respect to non-audit services by auditing firms is predicated on three basic principles: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client. Accordingly, the

following nine categories of services will be prohibited starting on or after May 6, 2004 (provided that any of the following services provided prior to May 6, 2004 must be provided pursuant to contracts in existence on May 6, 2003):

1. ***Bookkeeping or other services related to the accounting records or financial statements of the audit client.***
   An auditing firm may not provide services involving:
   - maintaining or preparing the audit client's accounting records;
   - preparing financial statements that are filed with the SEC or information that forms the basis of those financial statements; or
   - preparing or originating source data underlying the client's financial statements;

   unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements. This prohibition includes services provided as to any financial statements of a foreign issuer that are incorporated into or form the basis of financial statements filed with the SEC.
2. ***Financial information systems design and implementation.***
   An auditing firm may not design or implement a hardware or software system that aggregates source data underlying the client's financial statements or generates information that is "significant" to the financial statements of the audit client taken as a whole. Information would be "significant" if it is reasonably likely to be material to the financial statements of the audit client. The rules do not prohibit an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records so long as those services are preapproved by the audit committee.

   Auditing firms may continue to evaluate the internal controls of a system as it is being designed, implemented or operated as part of an audit and may also make recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider. Accordingly, the auditing firm is prohibited from creating the system for an audit client, but not from critiquing it.
3. ***Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.***
   Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. Fairness opinions and contribution-in-kind reports are opinions and reports in which a firm provides its opinion on the adequacy of consideration in a transaction. Auditing firms may not provide these services to an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.
4. ***Actuarial services.***
   Public auditors may not provide an audit client with actuarial services involving the determination of amounts recorded in the financial statements and related accounts, unless the results of these services are not reasonably expected to be subject to audit procedures during an audit of the issuer's financial statements. Public auditors may, however, assist their clients in understanding methods, models, assumptions and inputs used in computing an amount for actuarial purposes.
5. ***Internal audit outsourcing services.***
   An auditing firm may not provide any internal audit service that has been outsourced by the audit client relating to the client's internal accounting controls, financial systems or financial statements, unless the results of these services are not reasonably expected to be subject to audit procedures during an audit of the client's financial statements. However, evaluations by the auditors of an issuer's internal controls, and recommendations to the issuer for improvements to those controls, will not violate this prohibition.

6. ***Management functions or human resources.***
   Public auditors may not serve as directors, officers or employees of an audit client, or perform any decision-making, supervisory or ongoing monitoring function for the audit client, nor may they assist clients in recruiting for managerial, executive or director positions; negotiate on the audit client's behalf; perform reference checks on prospective candidates; or engage in psychological testing or other formal testing or evaluation programs relating to prospective employees of the audit client.
7. ***Broker or dealer, investment adviser or investment banking services.***
   Auditors may not act as broker-dealers, promoters or underwriters on behalf of an audit client, or provide any investment advice or recommendations on investment strategies.
8. ***Legal services.***
   Public auditors may not provide any service to an audit client that could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.
9. ***Expert services unrelated to the audit.***
   Auditing firms may not provide expert opinions or other expert services to an audit client, or a legal representative of an audit client, for the purpose of advocating the audit client's interests in litigation or in regulatory or administrative proceedings or investigations. Public auditors may, however, be engaged to perform internal investigations or fact finding engagements. For instance, the accountants may assist the audit committee in fulfilling its responsibilities to conduct an investigation of a potential accounting impropriety. The auditors may also provide factual accounts or testimony, or explain the positions taken or conclusions reached during the performance of their services on behalf of their clients.

Public auditors will be allowed to continue providing their audit clients with tax services, including tax compliance, tax planning and tax advice, as long as those services are approved in advance by the issuer's audit committee. There may, however, be circumstances involving tax services that would be impermissible, such as the representation of an audit client in tax court or other situations involving public advocacy on behalf of the audit client.

Audit Committee Pre-Approval of All Audit and Non-Audit Services

The Act and the final SEC rules issued thereunder recognize the "critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence." Accordingly, pursuant to Section 202 of the Act, all audit and permitted non-audit services to be provided to an issuer must be pre-approved either by the audit committee in each instance, or pursuant to pre-approval policies and procedures established by the audit committee, which are detailed as to the particular services to be provided, and as long as the audit committee is informed on a timely basis of each service that is in fact provided. Such policies and procedures may not delegate any audit committee responsibilities to management.

There is a *de minimis* exception to the requirement of pre-approval for certain non-audit services that do not constitute more than 5% of the total fees paid by the client to the auditing firm, if such services (1) were not recognized as non-audit services at the time of the engagement, (2) are promptly brought to the attention of the audit committee, and (3) are approved, prior to completion of the audit, by the audit committee or one or more members to whom such power of approval has been delegated prior to the completion of the audit.

These pre-approval requirements apply to all agreements for audit and non-audit services that are entered into after May 6, 2003. With respect to arrangements for non-audit services that were entered into prior to May 6, 2003, the accounting firm will have until May 6, 2004 to complete those services.

Required Communications with Audit Committees

In addition to the communications that are currently required to be provided to an audit committee under generally accepted accounting standards, any public auditing firm that performs an audit for a client will be required, pursuant to Section 204 of the Act, to report to the audit committee of the audit client on the following topics ***prior to*** the filing of any audit report with the SEC:

1. ***All critical accounting policies and practices used in the issuer's financial statements.*** In the final rules on this topic, the SEC refers to its December 2001 cautionary advice regarding critical accounting policies for guidance in complying with this requirement.[2] "Critical accounting policies" are those that are both most important to the portrayal of the issuer's financial condition and operating results and which 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. The SEC states that, "at a minimum," the discussion about critical accounting policies should focus on the reasons why estimates or policies are or are not considered critical and how current and anticipated future events impact those determinations.
2. ***All alternative treatments within generally accepted accounting principles (GAAP) for policies and practices related to material items that have been discussed with management of the audit client.*** The accounting alternatives available under GAAP for policies and practices related to material financial items that were discussed with management should be communicated, along with the reasons for not selecting those alternatives. If the accounting treatment selected is not, in the public auditing firm's view, the preferred method, the final rule requires discussion about why the auditing firm's preferred method was not selected by management.
3. ***Other material written communications between the public auditing firm and the management of the audit client.*** Examples of communications that will be considered material under the rule include: management representation letters, reports on observations and recommendations on internal controls, any schedule of unadjusted audit differences and a listing of adjustments and reclassifications that were not recorded, the engagement letter, and the letter affirming the auditors' independence.

These requirements went into effect on May 6, 2003.

Expanded Disclosure Requirements Regarding Auditing Firm Fees and Services

Additional information regarding auditing firm fees and services will be required to be set forth in the proxy statement relating to the issuer's annual meeting. The information must also be included in the issuer's annual report filed with the SEC, but may be incorporated into that document by reference from the proxy statement. Issuers must disclose the aggregate fees billed for each of the last two fiscal years by their public auditing firm under each of the following captions:

- "Audit Fees," including fees for the usual services rendered by the issuer's principal public auditing firm in connection with the issuer's audit.
- "Audit-Related Fees," including fees for assurance and related services (such as due diligence services, employee benefit plan audits, accounting consultations, audits in connection with acquisitions and internal control reviews) that are "reasonably related" to the performance of the issuer's audit, together with a description of the services rendered.
- "Tax Fees," including fees for tax compliance, tax advice and tax planning, together with a description of the services rendered. This category would include fees for the preparation of original and amended tax

[2] This Guidance is available on the SEC's website at http://www.sec.gov/rules/other/33-8040.htm.

returns, assistance with tax audits and appeals, tax advice related to mergers and acquisitions and employee benefit plans, and requests for rulings or technical advice from tax authorities.
- "All Other Fees," together with a description of the services rendered.

Issuers must also summarize the audit committee's pre-approval policies and procedures and give the percentage of each service captioned above that was approved pursuant to the *de minimis* exception to pre-audit approval (*i.e.*, that was not approved at a meeting of the audit committee or pursuant to written pre-approval policies and procedures).

These disclosure provisions are effective for annual reports for fiscal years ending after December 15, 2003.

What should companies do now in response to these rules?

In order to ensure that they are in compliance with these rules, companies should consider taking the following steps:

- Review all services being provided by the independent public accountants to determine whether any would be characterized as non-audit services. If any non-audit services are being performed, determine whether any are prohibited services under Section 201 of the Act. If any prohibited non-audit services are being performed, they must be pursuant to a contract entered into no later than May 6, 2003, and after May 6, 2004 the service may no longer be provided by the same auditing firm engaged to perform your audit.
- Determine whether the audit committee will implement pre-approval policies and procedures with respect to audit and non-audit services to be performed and/or delegate approval authority to a subset of the committee members.
- Inquire of the independent public accountants as to the length of time remaining before the lead and concurring audit partners will be required to rotate off the account. Ask what transition plans are in place for replacement of the persons serving in those roles in order to ensure a smooth transition of service.
- Notify the human resources department of the restrictions on hiring former members of the company's audit engagement team.
- Ensure that the audit committee is receiving the communications required to be provided to it by the independent public accountants pursuant to Section 204 of the Act.

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Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions regarding this information.

Time Line for Phase-In of Auditor Independence Rules

Requirement	Source	When Effective?
One-year prohibition on employment of former auditors in financial reporting oversight role	Section 206 of Sarbanes-Oxley; Section 10A(l) of Exchange Act; Auditor Rules Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Release No. 33-8183; 34-47265 (the "Auditor Rules")	Employment relationships that commence *after* May 6, 2003 are prohibited; pre-existing relationships are allowed.
Mandatory rotation of lead and concurring audit team partners after five years and mandatory rotation of other audit team partners after seven years	Section 203 of Sarbanes-Oxley; Section 10A(j) of Exchange Act; Auditor Rules	Issuer fiscal years beginning after May 6, 2003 for the lead audit partner and other audit partners (other than concurring partners) and issuer fiscal years beginning after May 6, 2004 for concurring partners, subject to "time-served" provisions identified in the Auditor Rules.
Prohibition on specified non-audit services	Section 201 of Sarbanes-Oxley; Section 10A(g) of Exchange Act	May 6, 2004 if services are performed pursuant to contracts in existence on May 6, 2003; otherwise May 6, 2003.
Audit committee must pre-approve all audit and non-audit services	Sections 201 and 202 of Sarbanes-Oxley; Sections 10A(h) and 10A(i) of Exchange Act; Auditor Rules	Pre-approval must occur for all arrangements entered into after May 6, 2003. For all agreements entered into before May 6, 2003, auditors have until May 6, 2004 to complete those services.
Mandatory reporting to audit committee by outside auditors of certain matters, including critical accounting policies, alternative accounting treatments and material written communications with management, before any audit report is filed with the SEC	Section 204 of Sarbanes-Oxley; Section 10A(k) of Exchange Act; Auditor Rules	May 6, 2003
Revised disclosures in proxy statement (to be incorporated by reference into annual report) regarding audit and non-audit services provided by, and fees paid to, outside auditors; and regarding pre-approval policies and procedures established by the audit committee	Section 202 of Sarbanes-Oxley; Section 10A(i) of Exchange Act; Auditor Rules	In reports for fiscal years ending after December 15, 2003; the SEC encourages early adoption of this disclosure.
Prohibition on receipt by audit partner of compensation based on selling engagements for services other than audit, review and attest services.	Auditor Rules	Effective for fiscal periods of auditors that include May 6, 2003.