

# defining issues<sup>TM</sup>

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## ALERT

## Auditor Independence Proposal Would Affect Companies

The Sarbanes-Oxley Act imposed legal requirements for auditor independence that affect companies as well as auditors, and the SEC's recent rulemaking proposal to "carry out" the Act's provisions would add to the requirements.<sup>1</sup> New procedures would have to be adopted, and new disclosures made. Audit committees are legally required to pre-approve all services performed by their company's auditors; the release proposes acceptable procedures for pre-approvals of nonaudit services; the procedures would have to be disclosed along with amounts for different categories of approved services; partners in the audit engagement team would have to be changed more frequently; and corporate hiring of audit engagement personnel for specified roles would be subject to new restrictions.

KPMG takes full responsibility for maintaining its independence and always has, but clients have inquired about the proposal, and they have the opportunity to participate in the SEC's rulemaking process. This edition of *Defining Issues* therefore highlights the major features of the SEC's proposal.

(1) SEC Release No. 33-8154, *Strengthening the Commission's Requirements Regarding Auditor Independence*, December 2, 2002, available at [www.sec.gov/rules/proposed/33-8154.htm](http://www.sec.gov/rules/proposed/33-8154.htm).

The release contains well over 100 questions to prompt comments from interested parties. Letters of comment are due by January 13, 2003, and final rules must be adopted by January 26, 2003 in order for the SEC to be in compliance with the Sarbanes-Oxley Act.

## AUDIT COMMITTEE OBLIGATIONS

The release builds on the audit committee's legal obligation to pre-approve nonaudit services and all audit, review, and attest engagements required under the securities laws. Each nonaudit service would have to be approved prior to the accounting firm being engaged, whether by express approval of each service prior to the engagement or by detailed pre-approval policies and procedures, with the audit committee promptly informed of each service.

The pre-approval process for investment-company registrants would be more complicated than for other registrants. As currently drafted, the audit committee would be obligated to pre-approve services not only for the registrant, but also for the investment adviser and other entities in the investment company complex that provide services to the investment-company registrant. It is not clear how this proposed requirement can be reconciled with treating the audit committee as the focal point for auditors' relationships with companies, because an investment company complex can include entities with their own independent audit committees.

## DISCLOSURES

Companies would have to disclose in their proxy statements their audit committees' pre-approval process for nonaudit services and the auditor's fees approved by the audit committee in four categories (audit, audit-related, tax, and all other fees), replacing the three categories now required. Registrants that do not file proxy statements, including foreign private issuers, have not been required to make fee disclosures, but under the proposed rule would have to present them in annual-report filings. No matter where presented, the disclosures would have to cover each of the two most recent years.

The disclosures for audit-related and all other fees would have to describe the nature of the services in subcategories.

Companies would also have to disclose the percentages of the three nonaudit fee amounts representing each approval method (express approval, approval by detailed policies and procedures, or subject to a de minimus exception). It is not clear why the Commission would prescribe acceptable methods of pre-approval and still require the fees to be identified by approval method, particularly since the audit committee's approach to pre-approval would be disclosed separately.

## NONAUDIT-SERVICE PROHIBITIONS

The rule proposal specifies nonaudit services that may not be performed for audit clients. The prohibitions, for the most part, would extend bans already in SEC regulations. Several exemptions from prohibitions would be eliminated. Only the prohibition of "expert services" is not already treated in SEC regulations. The box on the next page summarizes the proposal's new prohibitions.

According to the SEC release, the services were selected for prohibition based on the three principles that auditors should not audit their own work, perform management functions, or act as advocates for their clients. The trio omits the so-called mutual-or-conflicting interests principle that is now in the Commission's rules, presumably on the grounds that the other three principles are sufficient and cover all the mutual-or-conflicting interests that need to be covered.

## TAX SERVICES

The Sarbanes-Oxley Act, the related Senate report, and the SEC rule proposal explicitly permit the provision of pre-approved tax services. The release would include tax-planning services among the permissible pre-approved tax services. However, the distinction between certain strategic tax and prohibited services is not clear in the proposing release. Despite some confusion created by different passages in the proposing release, we have no reason to believe at this time that the Commission intended to specifically prohibit any traditional tax services auditing firms provide to their audit clients. We expect that the final rule will remove the ambiguities in the proposing release.

## AUDITORS' COMMUNICATIONS TO AUDIT COMMITTEES

Auditors would be required to communicate to the audit committee three matters mandated by the Sarbanes-Oxley Act: critical accounting policies and practices, alternative accounting treatments that were discussed with management (including their ramifications and the accounting firm's preferred treatment), and other material written communications between the auditor and management. According to the release, the communication on critical accounting policies and practices should include an assessment of management's disclosures and should report any significant modifications proposed by the auditors, but not made by management. These communications would have to take place prior to filing the annual report and would be in addition to those already required by professional auditing standards.

## PARTNER ROTATION

The release proposes to expand the number of partners whose tenure on an audit engagement must be limited and to reduce the maximum tenure the profession has required of some partners from seven to five years. The reduction from seven to five years is required by the Sarbanes-Oxley Act, but the expansion in partners covered by the requirement is far greater in the SEC release than in the Act, which applies the rotation requirement to the lead and concurring review partners only. The SEC proposal would expand the applicability of this requirement to client service partners, engagement partners for significant subsidiaries, partners who review the tax provision or actuarial estimates, and other "line" partners directly involved in performing the audit, quarterly reviews, or internal control attestation.

### Proposed Prohibited Services

Note: The only category below not already treated in the Commission's rules is expert services, and the proposed rule incorporates the prior restrictions.

**Bookkeeping** – Exceptions for foreign and emergency bookkeeping would be eliminated, and a generalization would be added that the services are prohibited if "it is reasonably likely that the results of these services will be subject to audit procedures."

**Financial information systems and design implementation** – These services are currently prohibited unless they meet certain conditions. The proposed rule would change the conditions, but continue to permit systems services unrelated to the financial and accounting records.

**Appraisal or valuation, fairness opinions, or contribution-in-kind reports** – The prohibition would be continued and would be triggered if it is reasonably likely that the results of the services will be subject to audit procedures during an audit of

the financial statements. This permits firms to provide valuation services for other purposes, such as transfer-pricing and cost-segregation studies.

**Actuarial** – The exemption in current rules permitting services in connection with pension and other post-employment arrangements would be removed. The prohibition would be triggered if it is reasonably likely that the results of the services will be subject to audit procedures during an audit of the financial statements.

**Internal audit outsourcing** – The proposal would eliminate the current permission to provide internal audit services related to internal accounting controls, financial systems, or financial statements. Nonrecurring evaluations of "discrete items or programs" that are not in substance internal audit outsourcing are permitted, as are operational internal audits unrelated to internal accounting controls, financial systems, or financial statements.

**Management functions** – No significant change would be made to the current rule. The auditor would continue to be allowed to assess the effectiveness of internal and risk-management controls and to recommend improvements in their design and implementation.

**Human resources** – No significant change from the current prohibition, which bans, for example, searches for managerial candidates and psychological testing. However, executive compensation studies would be added to the list of prohibited services.

**Broker-dealer, investment adviser, or investment banking** – The proposal is substantially the same as the existing rule.

**Legal services** – The proposal adds to the current prohibition any service that can be performed only by persons licensed or otherwise credentialed to practice law in the jurisdiction in which the service is provided. In some foreign countries, tax services can

be provided only by persons credentialed as attorneys. The proposal could conceivably prohibit tax services in foreign jurisdictions that require tax practitioners to be lawyers. To help understand the implications of this issue for foreign jurisdictions, the release asks whether tax services should be permitted in such jurisdictions even if provided by tax practitioners who are required to be lawyers.

**Expert services** – The draft prohibition reads: "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." The auditor, the release explains, could not be engaged by an audit client's legal counsel to provide advice or forensic accounting services, but could provide the same services to the same client's audit committee. The auditor could, however, testify as a fact witness in connection with audit or tax services.



Partners who rotate off an engagement would be required to remain off the engagement for five years before returning. This and the other elements of the rotation requirement will likely increase audit costs. The increased costs would be a consequence of the combined effect of the shorter tenure that partners would be allowed to serve, the longer period a rotated partner would be required to be off the engagement before returning to it, and the greater number of partners subject to the rotation requirements.

**Forensic Audits.** The release also requests comments on periodic forensic audits to evaluate the existing auditor’s work in lieu of partner rotation requirements. However, the forensic-auditing discussion goes far beyond that question. The release mentions a second audit firm periodically performing a forensic audit to evaluate the company’s accounting and reporting practices and the condition of the company’s internal controls. It requests comments on the scope and the costs and benefits of forensic audits, who should perform them, whether the Commission should establish requirements for firms performing forensic audits, and what those requirements should be. The concept of a forensic audit in the proposal bears little resemblance to traditional forensic auditing.

### ONE-YEAR “COOLING OFF” PERIOD

Under the Sarbanes-Oxley Act audit engagement personnel cannot join the corporation’s management team in specified roles for a year after serving on the audit. The Sarbanes-Oxley Act’s “cooling off” period applied to four corporate positions of chief executive officer, controller, and chief financial and accounting officers, including any equivalent position. The rule proposal expands the positions subject to the “cooling off” period through the defined term “financial reporting oversight role,” and it uses the term “audit client” in place of the narrower term “issuer” in the Sarbanes-Oxley Act.

### BAN ON COMPENSATION FOR PROVISION OR SALE OF NONAUDIT SERVICES

The release proposes to ban compensation to partners on an engagement for their sale or performance of nonaudit services to the client. The proposal originates entirely with the SEC. It corresponds to no provision in the Sarbanes-Oxley Act. A ban on compensation for the performance of a nonaudit service would prevent specialists, such as tax partners who are members of the audit engagement team, from performing other services in their specialty for the client.

### TRANSITION

Although the SEC is required to adopt the final rules by January 26, 2003, the rule proposal requests comments on effective-date and transition provisions. Requirements on partner rotation, auditors’ communications to audit committees, and fee disclosures may be subject to some form of delayed effective dates in the final rules. The proposal does not mention any alternatives being considered by the Commission.

Companies should not treat the descriptive and summary statements above about the proposed rules as if they are what the SEC will finally adopt. They should consult the final SEC rules and their accounting and legal advisors.

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