Sarbanes-Oxley Regulation — Non-Audit Services by Independent Accountants

On January 22, 2003, the Securities and Exchange Commission adopted final rules to carry out the provisions of the Sarbanes-Oxley Act of 2002, restricting the types of non-audit services which auditing firms may provide to their audit clients, and imposing audit committee approval requirements and corporate disclosure obligations with respect to audit and non-audit services.

Title II of the Sarbanes-Oxley Act, entitled “Auditor Independence,” added new Subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934. Subsection (g) specifies that it is unlawful for a “registered public accounting firm” that performs for an issuer any audit required under the 1934 Act or regulations promulgated thereunder to provide certain designated non-audit services.

Subsection (h) provides that a registered public accounting firm may engage in any permitted non-audit service, including tax services, only if the activity is approved in advance by the issuer’s audit committee.

Subsection (i) provides that all auditing services, including comfort letters in connection with securities underwritings or statutory audits required for insurance companies, and all non-audit services (other than certain de minimis services) must be preapproved by the audit committee. Subsection (i) also states that approval by an audit committee of an issuer under Subsection (i) of a non-audit service to be performed by the auditor of the issuer must be disclosed to investors in periodic reports required by Section 13(a) of the 1934 Act.

These statutory provisions are applicable to non-audit services provided by “registered public accounting firms.” Section 2(a)(12) of the Sarbanes-Oxley Act defines “registered public accounting firm” as a public accounting firm registered with the Public Accounting Oversight Board established under Section 101 of the Act. Under Section 101, the SEC must determine, not later than 270 days after enactment of the Act, that the Board has been duly organized and has the capacity to carry out the requirements of the statute. Public accounting firms must register with the Board within 180 days after the SEC determination. There has yet been no SEC determination and no registration by public accounting firms. Since there are no “registered” public accounting firms, the statutory provisions restricting non-audit services of registered public accounting firms are not yet operational.

However, unlike the statutory provisions, the final rules adopted by the SEC on January 22, 2003 are not limited to registered public accounting firms. Subject to transitional provisions included in the final rules, which are discussed below, these requirements are effective on May 6, 2003.
Overview

The new requirements relating to non-audit services have three parts. First, a variety of revisions have been made in Rule 2-01 of Regulation S-X, which sets forth the criteria for “independence” of public accountants. An accountant will not be considered independent if, at any point during the audit and professional engagement period, the accountant provides non-audit services to the audit client in any of 10 specified categories.

Second, the SEC has adopted a new Rule 10A-2, under which it is unlawful for an auditor not to be independent under the Regulation S-X requirements. This enables the direct imposition of sanctions against the auditor for violation of the independence requirements.

Third, Item 9 of Schedule 14A (and other comparable disclosure requirements) have been revised to add certain registrant disclosure requirements concerning audit and non-audit services performed by the registrant’s auditor.

Revisions to Regulation S-X Regarding Non-Audit Services

Regulation S-X provides that the Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including evidence bearing on all relationships between the accountant and the audit client.

Regulation S-X then enumerates a “non-exclusive” specification of circumstances inconsistent with the above standard. These include a list of prohibited non-audit services.

The new rules do not change the general standard of independence, and do not modify the “non-exclusivity” of the list of prohibited non-audit services. As a result, under the new rules as under existing law, performance of a non-audit service not specifically enumerated as a prohibited service could result in an accountant being deemed to be not independent if the service results in the fact or reasonable appearance of compromised objectivity.

Prior to the new rules, the non-exclusive list of prohibited non-audit services in Regulation S-X described non-audit services in nine enumerated categories. The new rules generally track the current S-X language relating to these categories, with the exceptions noted below, and add one additional category, discussed below.

Bookkeeping or other services related to the accounting records or financial statements. The new rule differs from the previous S-X requirement by providing that any service of this nature is prohibited, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during an audit of the audit client's financial statements. This “reasonable to conclude” language (which is also used in the paragraphs of the new rule dealing with financial information systems design and implementation, appraisal or valuation services, actuarial services and internal audit outsourcing services) is intended to invoke a presumption that these types of services are prohibited, which presumption can only be overcome by a demonstration that it is reasonable to conclude that the services will not be the subject of audit procedures. The prior S-X prohibitions on maintenance of accounting records and preparation of financial statements or source data are utilized only as examples of the general prohibition on bookkeeping services. The new rule also eliminates the previous exceptions for emergency and foreign situations. The preparation of statutory financial statements for foreign companies which are not filed with the SEC would impair an accountant’s independence if the statutory financial statements form the basis of financial statements that are filed with the SEC.
Financial information systems design and implementation. Previously, the S-X prohibition contained an exception permitting services of this type in circumstances where it is clear that the audit client and its management retain ultimate responsibility. The new rule eliminates this exception, and prohibits all services of this nature unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. The prohibition does not preclude the accountant from evaluating internal controls or from making recommendations on internal controls in conjunction with the design and installation of a system by another service provider.

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Appraisal or valuation services, fairness opinions or contribution-in-kind reports. Previously, the S-X prohibition on these types of services contained an exception permitting valuation services where the client provides the primary support for the recorded amounts, valuation of pension or similar liabilities where the client takes responsibility for significant assumptions and data, tax-related valuations, and valuations which do not affect the financial statements. The new rule eliminates these exceptions and prohibits all such services unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. The new rule also explicitly applies to "contribution-in-kind reports."

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Actuarial Services. The previous prohibition of these types of services related only to insurance company policy reserves, and contained exceptions where the accountant's role is limited. The new rule eliminates these exceptions, and extends the prohibition to any actuarially oriented advisory service involving the determination of amounts recorded in financial statements, other than assisting a client in understanding the methods, models, assumptions and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

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Internal Audit Outsourcing Services. The previous S-X provision prohibited the performance of internal audit services generating fees in excess of specified amounts, and such services generating fees less than such amounts unless management acknowledged its own ultimate responsibility. The new rule eliminates these qualifications and generally prohibits all internal audit services outsourced by the audit client relating to the internal accounting controls, financial systems or financial statements of 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 audit client's financial statements. The prohibition on "outsourcing" does not preclude engaging an accountant to perform nonrecurring evaluations of discrete items that do not amount to an outsourcing of the internal audit function.

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Management Functions/Human Resources/Broker-Dealer Services. These categories of prohibited services are left unchanged by the new rule, except for minor language clarifications.

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Legal Services. The language of this prohibition is clarified in the new rule so as to prohibit services that, under 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.

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Expert Services. The proposed rule adds a new category of prohibited services. Under this category, an accountant is prohibited from providing expert opinions or other expert service to an audit client or an audit client's legal representative for the purpose of advocating an audit client's interests in litigation or in regulatory or administrative proceedings or investigations. The rule provides that the accountant's independence is not deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client. The intent of the rule is to prohibit the accountant from lending its expertise to provide authority to the client's advocacy position in the specified proceedings.

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Tax Services. New Section 10A(h) of the 1934 Act, added by Section 201 of the Sarbanes-Oxley Act, states that an auditor may provide, after audit committee approval, non-audit services "including tax services" that are
not identified as prohibited in the statute. The new Regulation S-X prohibitions on non-audit services make no reference to tax services, and the new rules do not define tax services. The adopting release states that accountants may continue to provide tax services such as tax compliance, tax planning and tax advice to audit clients, subject to the normal audit committee pre-approval requirements.

However, simply classifying a service as a “tax service” does not mean that the service does not compromise the auditor’s independence. Independence may be compromised, according to the language in the adopting release, if accountants represent an audit client before a tax court, district court, or federal court of claims. In addition, the release notes that audit committees should carefully scrutinize the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations.

New Audit Committee Approval Requirements

The new rules also create additional independence requirements, separate from the new prohibitions on non-audit services. Under new S-X Rule 2-01(c)(7), the auditor will not be deemed to be independent unless either (1) prior to the accountant’s engagement to render audit or non-audit services, the engagement is approved by the audit committee; or (2) the engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee; provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee’s responsibilities under the 1934 Act to management.

The new rule indicates that the approval must be made in accordance with Section 10A(i) of the 1934 Act. Under this section, the audit committee may delegate to one or more designated members of the committee who are independent directors of the board of directors, the authority to grant preapprovals. The decisions of any such member are required to be presented to the full audit committee at its scheduled meeting.

The preapproval requirement for non-audit services is inapplicable where the issuer does not recognize at the time of the engagement that the services were to be non-audit services, and where the amount paid for such services is not more than 5 percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided. The “non-recognition” requirement would cover a situation where the issuer did not understand at the time of an audit engagement that particular non-audit services were to be rendered as part of the approved audit engagement.

Disclosure

Currently, Item 9 of Schedule 14A and comparable provisions of other disclosure forms require certain disclosures concerning the issuer’s auditor. The new rules change some of these requirements.

Under the previous version of Item 9, issuers were required to disclose the amount of fees paid to the auditor during the most recent fiscal year for services in each of three categories: audit fees; financial information systems design and implementation fees; and other fees. Under the new rules, fees for each of the two most recent years are required to be disclosed, in each of four categories: audit fees, audit-related fees, tax fees, and other fees.

The audit fee category includes fees paid for the audit of the registrant’s annual financial statements, review of the quarterly financial statements, and services normally provided by the accountant in connection with statutory and regulatory filings or engagements. The adopting release indicates that audit fees also include fees which generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents, and assistance with and review of documents filed with the SEC.
The category of “audit-related fees” includes fees for services reasonably related to the performance of the audit. The adopting release indicates that these could include employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance 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. Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

The category of “tax fees” added by the new rules includes fees for services rendered for tax compliance, tax consulting and tax planning. The adopting release clarifies that tax compliance involves preparation of tax returns and related matters. The release states that reviewing tax accruals, where necessary to comply with generally accepted auditing standards, is part of the audit services and is not itself a tax compliance service. Tax consulting and tax planning includes services in connection with tax audits and appeals, tax advice related to mergers and acquisitions and employee benefit plans, and requests for rulings or technical advice from taxing authorities. Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

The category of “other fees” includes all other fees billed for products and services provided by the principal accountant. Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

In addition to fee disclosure, the proposal requires certain disclosures concerning audit committee approvals of audit and non-audit services.

First, disclosure is required of the audit committee's preapproval policies and procedures, if any, as described above. This disclosure may be accomplished by providing a description of the policies and procedures or supplying a copy of the policies and procedures themselves.

Second, disclosure is required of the percentage of fees in each of the “audit-related,” “tax” and “other” categories described above which were approved by the audit committee pursuant to the de minimis exception described above.

In addition, disclosure is required if more than 50 percent of the hours expended on the audit engagement were worked by persons other than the accountant's full-time permanent employees.

Finally, certain particular disclosures are required for investment companies. First, disclosure is required of the aggregate non-audit fees billed for the last two fiscal years by the investment company's accountant for services rendered to the investment company, and to its investment adviser (excluding certain subadvisers) and any entity controlling, controlled by or under common control with the adviser that provides ongoing services to the investment company. Secondly, disclosure is required as to whether the investment company's audit committee considered whether the provision of non-audit services to such investment adviser and related entities is compatible with maintaining the principal accountant's independence.

Effective Date and Transition Rules

The new rules become effective on May 6, 2003. However, transition periods are provided with regard to certain of the rules. Non-audit services which were previously permissible may continue to be performed under contracts in existence on May 6, 2003, until May 6, 2004. Previously permissible non-audit services may continue to be performed under contracts in existence on May 6, 2003 without audit committee pre-approval. The rules requiring additional disclosures will be effective for periodic annual filings (including proxy statement information incorporated therein) for the first fiscal year ending after December 15, 2003.
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3 “Issuer” is defined in Section 2(a)(7) of the Sarbanes-Oxley Act as a public reporting company.
4 The services prohibited by the statute are:
   (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
   (2) financial information systems design and implementation;
   (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
   (4) actuarial services;
   (5) internal audit outsourcing services;
   (6) management functions or human resources;
   (7) broker or dealer, investment adviser, or investment banking services;
   (8) legal services and expert services unrelated to the audit; and
   (9) any other service that the [Public Company Accounting Oversight Board [established pursuant to Section 201 of the Sarbanes-Oxley Act]] determines, by regulation, is impermissible.
5 As a technical matter, the provisions of new §10A(i) of the Exchange Act, requiring audit committee approval of audit services, became effective on the effective date of the Sarbanes-Oxley Act, July 30, 2002. As a practical matter, most public issuers have for some time secured audit committee approval of audit services.
6 17 CFR §210.2-01.
7 Under Regulation S-X, audited financial statements must be the subject of an audit by “independent” public accountants.
8 The audit and professional engagement period includes the period covered by any financial statements being audited or reviewed and also the period beginning when the accountant either signs an engagement letter or begins audit procedures, and ending when the audit client or the accountant notifies the SEC that the client is no longer the accountant's audit client. This definition is unchanged by the proposed rule. §210.2-01(f)(5).
9 Item 15 of Form 20-F, Item 10 of Form 40-F, Item 16 of Part III of Form 10-K, Item 16 of Form 10-KSB, and Item 5 of Form N-CSR.
10 §210.2-01(b).
11 §210.2-01(c)(4)(i).
12 68 FR at 6011.
13 §210.2-01(c)(4)(ii).
14 68 FR at 6012.
15 §210.2-01(c)(4)(iii).
16 In certain foreign countries, these reports require the auditor to express an opinion on the fairness of a transaction, the value of a security, or the adequacy of consideration to shareholders.
17 §210.2-01(c)(4)(iv).
18 §210.2-01(c)(4)(v).
19 68 FR at 6013.
In addition to the provisions discussed herein, the rules add requirements concerning the rotation of members of the audit engagement team (§210.2-01(c)(6)), and compensation of members of the audit engagement team (§210.2-01(c)(8)).

68 FR at 6016.
68 FR at 6017.
68 FR at 6017.

68 FR at 6030. New Section 10A(i) of the 1934 Act, added by Section 202 of the Sarbanes-Oxley Act, also indicates that providing comfort letters in connection with securities underwritings and statutory audits required for insurance companies for state law purposes are included in the category of auditing services.

68 FR at 6031.