

Person Associated With A Public Accounting Firm (and Related Terms)

The Board is adopting the same meaning for “person associated with a public accounting firm” as used in section 2(a)(9) of the Act, with a few, technical modifications. Commenters raised a number of concerns about the proposed definition. A number of commenters suggested that the definition should be limited to only a public accounting firm’s employees, or at least should leave out certain independent contractors. While the Board does not believe that all independent contractors should be excepted from the definition, the Board has revised the definition to clarify that the term does not include persons whom the applicant reasonably believes are persons primarily associated with another registered public accounting firm. In addition, the Board has clarified that the definition does not cover persons engaged in only clerical or ministerial tasks. Finally, the word “other” has been eliminated before the terms “professional employee” and “independent contractor” to clarify that an employment or an independent contractor relationship with a public accounting firm is not required for a person to be covered by the definition. Commenters’ concerns about this definition were related to their concerns about the scope of Parts V and VIII of the Form. As discussed below, Part V, and, for foreign public accounting firms, Part VIII of the Form are being modified in light of commenters’ concerns.

Play a Substantial Role in the Preparation or Furnishing of an Audit Report

Rule 1001(p)(ii) defines the phrase “play a substantial role in the preparation or furnishing of an audit report” to mean “(1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or (2) to perform the majority of audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20 percent or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report” on the issuer.

The first prong of this definition is based on language in section 106(b)(1) of the Act.¹⁵ Note 1 to Rule 1001(p)(ii)

explains that the term “material services” as used in this definition means services for which the engagement hours or fees constitute 20 percent or more of the total engagement hours or fees, respectively, provided by the principal accountant in connection with the issuance of all or part of its audit report with respect to any issuer.¹⁶

The second prong of this definition is based on a similar standard used in the Commission’s auditor independence rules related to partner rotation.¹⁷ As Note 2 to the rule indicates, the phrase “subsidiary or component” is meant to include any subsidiary, division, branch, office or other component of an issuer, regardless of its form of organization and/or control relationship with the issuer.

For both the definition of material services as well as the second prong of the overall definition, the Board believes that a quantitative, as opposed to a qualitative, test imposes less of a burden on firms in determining whether or not they fall into this category. The Board has included a threshold of 20 percent, since this threshold is consistent with accounting literature on “significance” tests.¹⁸ Several commenters indicated their agreement with the 20 percent threshold.

Commenters raised several concerns about this proposed definition. One commenter expressed concern that the use of the phrase “material services” in the first prong could be read to include non-audit services, such as internal audit services, provided to non-audit clients when those services are relied

the firm issues an opinion or “otherwise performs material services upon which a registered public accounting firm relies in issuing all or part of any audit report or any opinion contained in the audit report.”

¹⁶ One commenter expressed concern that this test would be applied on an aggregated basis. This test would be administered on a firm-by-firm basis. In other words, if a public accounting firm does work for the principal accountant and individually does not meet the 20 percent of engagement hours or fees tests, the firm would not need to register solely because its work, when aggregated with other firms working on the same audit, would meet the 20 percent threshold.

¹⁷ The Commission’s adopting release provides that “the lead partner on subsidiaries of issuers whose assets or revenues constitute 20% or more of the consolidated assets or revenues are included within the definition of ‘audit partner.’” See Commission Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence, Release No. 33–8183 (January 28, 2003), as amended by Release No. 33–8183A (March 26, 2003).

¹⁸ See Commission Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence, Release No. 33–8183 (January 28, 2003), as amended by Release No. 33–8183A (March 26, 2003), note 139 (citing APB Opinion No. 18, “The Equity Method of Accounting for Investments in Common Stock,” and ARB No. 43, Chapter 7, “Capital Accounts.”).

upon by an auditor in issuing its audit report. Several accounting firms indicated that the first prong of the proposed definition would be difficult for non-affiliated foreign public accounting firms to comply with, since they would need access to the total engagement hours and fees, and therefore favored elimination of the first prong. Other commenters, however, raised concerns that the second prong of the definition might capture firms that perform relatively minor services such as routine observations of inventory test counts for a subsidiary or component of an issuer the assets or revenues of which constitute 20 percent or more of the consolidated assets or revenues of the issuer. Finally, commenters raised practical concerns about when and how the assets and revenues tests of the second prong of the definition should be administered.

After carefully considering the comments it received, the Board has decided to keep both prongs of the definition, but to modify both prongs slightly and to clarify the second prong’s application. Specifically, the Board has decided to add a sentence to Note 1 to the rule to clarify that “material services” does not include non-audit services provided to a non-audit client. Second, to avoid capturing routine procedures on a significant subsidiary as part of an audit, the second prong has been limited to performing “the majority of audit procedures * * * necessary for the principal accountant to issue an audit report on the issuer.” Finally, the Board has addressed commenters’ concerns about the implementation of the second prong by adding Note 3 to the rule, which clarifies that the 20 percent determination should be made at the beginning of the issuer’s fiscal year using prior year information and should be made only once during the issuer’s fiscal year.

Public Accounting Firm

Rule 1001(p)(iii) defines “public accounting firm” to mean a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports. The Board has adopted the same meaning of public accounting firm as used in section 2(a)(11)(A) of the Act. However, this definition is intended to include only legal entities, and not natural persons. An individual accountant that prepares or issues an audit report in his or her name would be a “proprietorship” and

¹⁵ Section 106(b)(1) provides that foreign public accounting firms shall be deemed to have consented to produce audit workpapers and to be subject to the jurisdiction of the U.S. courts for purposes of enforcement of any request for such workpapers if