

In particular, the third general standard requires that the accountant exercise due professional care in the conduct of the audit.<sup>116</sup> In order to exercise due professional care, it is necessary to ensure that the engagement is properly staffed with individuals competent to understand the unique issues relevant to that audit.

Additionally, the accounting profession's quality control standards require that the firm have processes in place to ensure that appropriate personnel are assigned to each audit engagement.<sup>117</sup>

In our proposing release, we proposed that all partners on the audit engagement team, with the exception of certain "technical services" or "national office" partners and those serving on significant subsidiaries as defined in 1-02(w) of Regulation S-X, be subject to rotation after five years and that after rotation, they would be subject to a five year time-out before they could return to that engagement. Furthermore, the proposed rules would have applied the partner rotation requirements at the audit client<sup>118</sup> level.

Some commenters<sup>119</sup> have suggested that the fresh look can only be accomplished by requiring mandatory rotation of audit firms. In contrast, others<sup>120</sup> expressed the concern that the loss of continuity and audit competence created by mandatory firm rotation creates an even greater risk to audit quality. The issue of mandatory audit firm rotation as an effective means of safeguarding auditor independence has been debated for many years. Several different groups, including appointed commissions, professional organizations, and academics, have researched and analyzed the issue of audit firm rotation.<sup>121</sup> The results of

interim financial information as well as the engagement team that conducts the attest engagement on management's report on the registrant's internal controls.

<sup>116</sup> See, AU § 150.02.

<sup>117</sup> See, QC § 20.13.

<sup>118</sup> As defined in Rule 2-01(f).

<sup>119</sup> See, e.g., letter from Jason Zahner, dated December 23, 2002; letter from Hugh Higgins, dated November 20, 2002.

<sup>120</sup> See, e.g., letter from American Institute of Certified Public Accountants, dated January 9, 2003.

<sup>121</sup> See, The Commission on Auditors' Responsibilities, "Report, Conclusions, and Recommendations," 1978, p. 109; Report of the National Commission on Fraudulent Financial Reporting, 1987, p. 54; research commissioned by the Committee of Sponsoring Organizations of the Treadway Commission, "Report of the National Commission on Fraudulent Financial Reporting," 1987, p. 113; Committee of Sponsoring Organizations of the Treadway Commission, "Fraudulent Financial Reporting: 1987-1997 An Analysis of U.S. Public Companies," 1999, p. 28; United States General Accounting Office, Report to

those efforts have raised many of the same concerns as our commenters which the Commission considered in this rule-making. This issue will continue to be monitored by the Commission and others. As directed by Section 207 of the Sarbanes-Oxley Act, the issue of mandatory firm rotation is a matter requiring further study.<sup>122</sup>

#### 1. Rotation of the Lead and Concurring Partner

Under the current requirements of the profession, the balance between the need for a fresh look with concerns about loss of continuity and competence is accomplished by requiring the lead partner to rotate off the audit engagement of SEC registrants after seven years with a two year time out period.<sup>123</sup> However, some commenters<sup>124</sup> believed that extending the partner rotation requirements to other audit partners would be a better balance of the need for a fresh look with concerns about continuity and competence.

These commenters' views are consistent with the provisions of the Sarbanes-Oxley Act, which clearly specify that, at a minimum, two partners be subject to rotation: the lead audit partner and the concurring partner. Furthermore, the Act specifies a five-year period prior to rotation rather than the current seven-year period specified in the membership requirements of the SECPS.<sup>125</sup> While the Act specified that

the Ranking Minority Member, Committee on Commerce, House of Representatives, "The Accounting Profession, Major Issues: Progress and Concerns," 1996, p. 56; Arrunada, Benito, "Mandatory Rotation of Company Auditors: A Critical Examination," *International Review of Law And Economics*, March 1997; St. Pierre, K. and J. Anderson, "An Analysis of Factors Associated with Lawsuits Against Public Accountants," *Accounting Review* (1984), p. 256; and Dallochio, M. and A. Vigaño "The Impact Of Mandatory Audit Rotation On Audit Quality And On Audit Pricing: The Case Of Italy," SDA Università Bocconi, 2003.

<sup>122</sup> Section 207 of the Act directs the Comptroller General of the United States to conduct a study and review of the potential effects of mandatory rotation of firms.

<sup>123</sup> AICPA, SEC Practice Section, Requirements of Members, at item e. The membership requirements are available online at [www.aicpa.org/members/div/secps/require.htm](http://www.aicpa.org/members/div/secps/require.htm). Audit firms which are members of the SEC Practice Section must comply with its rules (e.g., partner rotation) and undergo periodic peer review to ensure that the firms' audit practice is consistent with both the rules of the AICPA and those of the Commission.

<sup>124</sup> See, e.g., letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Denzil Dias, dated December 11, 2002; letter from HSBC, dated January 11, 2003.

<sup>125</sup> While the current lead partner rotation requirements specify a seven-year period prior to rotation, the original rotation requirements developed by the SECPS specified a five-year rotation period. See, AICPA, *Division for CPA Firms SEC Practice Section Peer Review Manual*, 1978, p.1-5.

these two partners were subject to rotation after five years, the Act is silent with regard to the time out period. One approach to the partner rotation rules could have been to preclude the partner from returning to the audit client after he or she rotates off to that engagement. Many commenters,<sup>126</sup> however, believed that the time out should be shorter than in our proposal. Other commenters<sup>127</sup> did not object to or even agreed with the five-year time out period for the lead and concurring partners.

The Commission is adopting rules to require the lead and concurring partners to rotate after five years and, upon rotation, be subject to a five-year "time out" period. Because of the importance of achieving a fresh look to the independence of the audit function, we believe that a five-year time out period is appropriate for these two partners.

#### 2. Additional Partner Rotation

Clearly, the lead partner and the concurring partner perform critical functions that affect the conduct and effectiveness of the engagement. However, in many larger engagements, the engagement team will include more than just the lead partner and the concurring partner. Often, those other partners on the engagement team play a significant role in the conduct of the audit and maintaining ongoing relationships with the audit client.

Our proposal would have applied the same rotation requirements to all partners on the audit engagement team with the exception of certain "national office" technical partners and those who did not work on significant subsidiaries as defined in Rule 1-02(w) of Regulation S-X. Some commenters<sup>128</sup> believed that the rotation requirements should be at or extend beyond our proposal level to include, for example, "national office" or "technical" partners<sup>129</sup> or other audit engagement team members below the level of

<sup>126</sup> See, e.g., letter from The Putnam Funds, not dated; letter from Commercial Federal Bank, dated January 13, 2003; letter from Dixon Odom, dated December 20, 2002; letter from American Institute of Certified Public Accountants, dated January 9, 2003.

<sup>127</sup> See, e.g., letter from Aetna, Inc., dated January 13, 2003; letter from Royal Philips Electronics, dated January 9, 2003; letter from Lynn Turner, dated January 13, 2003; letter from Medtronic, Inc., dated January 13, 2003.

<sup>128</sup> See, e.g., letter from Denzil Dias, dated December 11, 2002.

<sup>129</sup> See, e.g., letter from California Public Employees' Retirement System dated January 10, 2003.