

constitute the first year of service for such partners. Thus, for a partner from a foreign firm who is serving as the lead partner for an issuer with a calendar year, 2004 would constitute the first year of the five year rotation period for that partner, without regard to the number of years he or she had previously served in that capacity.

D. Audit Committee Administration of the Engagement

Historically, management has retained the accounting firm, negotiated the audit fee, and contracted with the accounting firm for other services. Our proposed rules, however, recognized the critical role that audit committees can play in the financial reporting process and in helping accountants maintain their independence from audit clients. An effective audit committee may enhance the accountant's independence by, among other things, providing a forum apart from management where the accountants may discuss their concerns. It may facilitate communications among the board of directors, management, internal auditors and independent accountants. An audit committee also may enhance auditor independence from management by appointing, compensating and overseeing the work of the independent accountants.

In that light, Section 202 of the Sarbanes-Oxley Act requires that audit committees pre-approve the services—both audit and permitted non-audit—of the accounting firm.

Specifically, our proposed rules would have required the audit committee to approve the engagement of the independent accountant to audit the issuer and its subsidiary's financial statements and have ongoing communications with the accountant. The proposals also would have required that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws either:

- before the accountant is engaged by the audit client to provide services other than audit, review or attest services, the audit client's audit committee expressly approve the particular engagement; or
- any such engagement be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee and the audit committee be informed on a timely basis of each service.

Finally, consistent with the provisions of the Act, under our proposals, audit committees could apply a *de minimis* exception to the pre-

approval requirements in certain circumstances.

Some commenters¹⁵⁵ believed that the pre-approval alternatives stated above, coupled with the disclosure of fees based on the pre-approval practices conveyed an impression that one method of pre-approval was preferable. Other commenters¹⁵⁶ stated that it was uncertain whether audit committees could use policies and procedures as the basis for pre-approving audit services.

The rules we are adopting are intended to clarify that, to the extent permitted by the Sarbanes-Oxley Act,¹⁵⁷ the audit committee may pre-approve audit and non-audit services based on policies and procedures and that explicit approval and approval based on policies and procedures are equally acceptable. As discussed later in this release, we have revised the proposed disclosures to match our conclusions about pre-approval processes.

Accordingly, the final rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements required under the securities laws. The rules require that before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render the service, the engagement is:

- approved by the issuer's or registered investment company's audit committee; or
- entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and such policies and procedures do not include delegation of the audit committee's responsibilities to management.

As provided in the Sarbanes-Oxley Act, the rules recognize audit services to be broader than those services required to perform an audit pursuant to GAAS. For example, the Act identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for

purposes of state law as audit services.¹⁵⁸ We recognize that domestically and internationally there are various requirements for statutory audits. These rules recognize this fact; accordingly, such engagements are viewed as audit services in the context of these rules.

Furthermore, audit services also would include services performed to fulfill the accountant's responsibility under GAAS. For example, in some situations, a tax partner may be involved in reviewing the tax accrual that appears in the company's financial statements. Since that is a necessary part of the audit process, that activity constitutes an audit service. Likewise, complex accounting issues may require that the firm engage in consultation with "national office" or other technical reviewers to reach an audit judgment. Whether or not the firm separately charges for that consultation, the activity constitutes an audit service since it is a necessary procedure used by the accountant in reaching an opinion on the financial statements.

This would contrast with a situation where a registrant is evaluating a proposed transaction and asks the independent accountant to evaluate the accounting for the proposed transaction. After research and consultation, the accounting firm provides an answer to the registrant and bills for those services. In considering the nature of the services, these services would not be considered to be audit services.

These rules require that the audit committee pre-approve all services. In doing so, the Act permits the audit committee to establish policies and procedures for pre-approval provided they are detailed as to the particular service and designed to safeguard the continued independence of the accountant. For example, the Sarbanes-Oxley Act allows for one or more audit committee members who are independent board directors to pre-approve the service. Decisions made by the designated audit committee members must be reported to the full audit committee at each of its scheduled meetings.¹⁵⁹

Consistent with the Sarbanes-Oxley Act, our rules also reflect a *de minimis*

¹⁵⁵ See, e.g., letter from The Business Roundtable, dated January 13, 2003; letter from Chamber of Commerce of the United States of America, dated January 9, 2003; letter from Investment Company Institute, dated January 13, 2003; letter from Pfizer, dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from Wells Fargo & Company, dated January 13, 2003.

¹⁵⁶ See, e.g., letter from America's Community Bankers, dated January 13, 2003; letter from American Society of Corporate Secretaries, dated January 13, 2003; letter from Ernst & Young, dated January 6, 2003.

¹⁵⁷ Section 202 of the Sarbanes-Oxley Act.

¹⁵⁸ Section 202 of the Sarbanes-Oxley Act; 15U.S.C 78j-1(i)(1)(A).

¹⁵⁹ The Act permits the audit committee to pre-approve a service at any time in advance of the activity. We expect that audit committees will establish policies for the maximum period in advance of the activity the approval may be granted. See "Report of the Senate Committee on Banking, Housing and Urban Affairs, Public Company Accounting Reform and Investor Protection Act of 2002," 107th Cong., 2nd Sess., at 20 (Report 107-205, July 3, 2002).