

on an evaluation of the partner's performance.

This rule prohibits accounting firms from establishing an audit partner's compensation or allocation of partnership "units" based on the sale¹⁷⁵ of non-audit services to the partner's audit clients.¹⁷⁶ This provision also reinforces the position that accountants at the partner level should be viewed as skilled professionals and not as conduits for the sale of non-audit services to the audit partner's individual clients. This provision recognizes and focuses on the need for independence of the most senior members of the engagement team. However, this rule does not preclude an audit partner from sharing in the profits of the audit practice and those of the overall firm.¹⁷⁷ And, an audit partner's evaluation could take into account a number of factors directly or indirectly related to selling services to an audit client.¹⁷⁸

Accordingly, we are amending the auditor independence rules to address the practice of accountants being compensated by their firms for selling non-audit products and services to their audit clients.¹⁷⁹ The new rule would provide that an accountant is not independent if, at any point during the audit and professional engagement period,¹⁸⁰ any audit partner,¹⁸¹ other

than specialty partners,¹⁸² earns or receives compensation¹⁸³ based on selling engagements to that audit client, to provide any services,¹⁸⁴ other than audit, review, or attest services.

The lead partner is responsible for managing not only the audit engagement but also the client relationship. The lead partner is in a position to identify potential services that could benefit the audit client. Furthermore, because of the lead partner's frequent interaction with management, he or she has the opportunity to "pitch" those services to management. Thus, the lead partner relationship with management has been used by some as a conduit to sell non-audit services to the audit client.¹⁸⁵ In contrast, partners at smaller operating units and "specialty" partners typically have a low level of involvement with senior management and the responsibility for the overall presentation in the financial statements is relatively low.

The application of these rules allows partners to be compensated for selling services with their discipline. Thus, just as an audit partner can be compensated for selling audit and audit-related services, so, too, can a tax partner be compensated for selling tax services. A specialty partner receiving compensation for selling within his or her discipline does not create the same threat to independence as when an audit partner is compensated for selling those non-audit services because the lead partner retains overall responsibility for the conduct of the audit. Additionally, there is a concurring partner who reviews the work on the audit engagement team. Finally, specialty partners have limited relationships with management in the context of their activities as a member of the audit engagement team.

The rules that we are adopting mitigate the concerns that an audit partner might be viewed as compromising audit judgments in order not to jeopardize the potential for selling non-audit services. These rules do not specifically address the provision

of compensation to other audit engagement team members for directly selling non-audit services. We believe that, however, the other audit engagement team members will perform in a fashion that is consistent with the direction and tone set by the audit partners. Nonetheless, as it pre-approves non-audit services an audit committee may wish to consider whether, in the company's particular circumstances, compensating a senior staff member on the audit engagement team based on his or her success in selling the service to the company compromises that individual's or the firm's independence.

Further, in conducting its oversight review of registered public accounting firms, we expect that the Board will monitor the impact of these rules on audit quality and independence.

With respect to investment companies, the proposed rule on compensation would have prohibited all partners, principals and shareholders of an accounting firm that are members of the audit engagement team from being compensated for selling non-audit services to a registered investment company audit client or any other entity in the investment company complex. One commenter¹⁸⁶ suggested the rule on partner compensation for investment companies should apply only to the selling of non-audit services to the investment company itself and not to other entities in the investment company complex. We disagree and continue to believe a partner on a registered investment company audit should not be directly compensated for selling non-audit services to other entities in the investment company complex, for example, the investment company's investment adviser. Thus, we have not made changes to this aspect of the rule.

We understand that because of the seasonal nature of accounting firms that many firms have fiscal periods that end in the April to September time frame. In recognition of this fact and understanding that individuals may be operating in the current period under an established set of performance goals, the provisions of this paragraph will be effective in the fiscal periods of the accounting firm that commence after the effective date of these rules. Further, recognizing that the application of this rule could have a disproportionate economic impact on small firms, we are exempting firms with fewer than five

¹⁷⁵ For purposes of this rule, the term "sale" is meant to encompass any revenue, fees, or compensation related to non-audit services provided over the period of the evaluation, regardless when contracted.

¹⁷⁶ *Id.*

¹⁷⁷ Consistent with the idea that an audit partner cannot be directly compensated for selling non-audit services, no part of that partner's distribution or other form of compensation should be directly received from selling of non-audit services (for example, from a "pool" of profits generated by a valuation services business unit). In contrast, that partner may receive distributions or other compensation from the "pool" attributable to the audit practice, a geographic unit comprised of several services or offices, or the entire firm.

¹⁷⁸ For example, an audit partner could be evaluated on the complexity of his or her engagements, the overall management of the relationship with an audit client including the provision of non-audit services, and/or the attainment of explicit sales goals.

¹⁷⁹ An audit partner could be compensated for selling audit or audit-related services to an audit client. Additionally, an audit partner could be compensated for selling either audit or non-audit services to a non-audit client.

¹⁸⁰ "Audit and professional engagement period" includes both the period covered by the financial statements being audited or reviewed and the period of engagement to audit or review the client's financial statements or to prepare a report filed with the Commission. The period of engagement begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or the auditor notifies the Commission that the client is no longer the auditor's audit client. See Rule 2-01(f)(5) of Regulation S-X, 17 CFR 210.2-01(f)(5).

¹⁸¹ 17 CFR 210.2-01(f)(7)(ii).

¹⁸² Specialty partners are, among others, those partners who consults with others on the audit engagement team during the audit, review or attestation engagement regarding technical or industry-specific issues. For example, such partners would include tax specialist and valuation specialist.

¹⁸³ Nothing in these rules is meant to limit the ability of an accounting firm from distributing profits in a manner that is consistent with the operation of a partnership or service organization.

¹⁸⁴ For purposes of this discussion, services include tangible products as well as professional services.

¹⁸⁵ See e.g., *In the Matter of Arthur Andersen LLP*, Accounting and Auditing Enforcement Release No. 1405 (June 19, 2001), at notes 15-17.

¹⁸⁶ See, letter from Investment Company Institute, dated January 13, 2003.