

parent level, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, and the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer.<sup>193</sup>

#### *G. Communication With Audit Committees*

Auditors are required by GAAS to communicate certain matters to the audit committee. In particular, GAAS require that the accountant should determine that the audit committee is informed about matters such as:

- Auditor's responsibility under GAAS,
- Significant accounting policies,
- Methods used to account for significant unusual transactions,
- Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus,
- Process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates,
- Material audit adjustments proposed and immaterial adjustments not recorded by management,
- Auditor's judgments about the quality of the company's accounting principles,
- Auditor's responsibility for other information in documents containing audited financial statements,
- Auditor's views about significant matters that were the subject of consultation between management and other accountants,
- Major issues discussed with management prior to retention,
- Difficulties with management encountered in performing the audit, and
- Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.<sup>194</sup>

<sup>193</sup> The term "audit partner" also would include any audit partner on a registered investment company whether or not the investment company issues consolidated financial statements.

<sup>194</sup> See, AU § 380, "Communication with Audit Committees." There are additional GAAS requirements related to auditor communications that are not included in this rule, such as the auditor's responsibilities under GAAS, the auditor's responsibilities related to documents containing audited financial statements, and disagreements with management, consultations with other accountants, major issues discussed with

Accountants are required under GAAS to provide these communications in a timely manner but not necessarily before the issuance of the audit report.<sup>195</sup> Accountants also may communicate with audit committees on matters in addition to those specifically required by GAAS, including auditing issues, engagement letters, management representation letters, internal controls, auditor independence, and others.

Section 204 of the Sarbanes-Oxley Act directs the Commission to issue rules requiring timely reporting of specific information by accountants to audit committees. In response to the Act, we proposed amending Regulation S-X to require each public accounting firm registered with the Board that audits an issuer's financial statements to report, prior to the filing of such report with the Commission, to the issuer or registered investment company's audit committee: (1) All critical accounting policies and practices used by the issuer or registered investment company, (2) all alternative accounting treatments of financial information within generally accepted accounting principles ("GAAP") that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer or registered investment company.

Some commenters<sup>196</sup> believe that these communications should be the responsibility of management alone. Others,<sup>197</sup> however, believe that both the accountant and management should share the responsibility for informing the audit committee about such matters. While we understand that management has the primary responsibility for the information contained in the financial statements, since the accounting firm is retained by the audit committee, we share the view reflected in Section 205 of the Sarbanes-Oxley Act and current auditing standards, that the accounting firm has a responsibility to communicate certain information to the audit committee. As discussed below, we are adopting rules requiring that

management prior to retention, and difficulties encountered in performing the audit, to the extent that those matters do not relate to accounting policies and practices.

<sup>195</sup> *Id.*

<sup>196</sup> See, e.g., letter from The Institute of Chartered Accountants of Scotland, dated January 8, 2003; letter from Battelle & Battelle, LLP, dated December 20, 2002; letter from Grant Thornton LLP, dated January 13, 2003.

<sup>197</sup> See, e.g., letter from Gelford Hochstadt Pangburn, PC, dated January 3, 2003; letter from Ernst & Young LLP, dated January 6, 2003.

certain information be communicated by the independent accountant to the audit committee. Some commenters<sup>198</sup> believe that the Commission should require that these communications be in writing. Others,<sup>199</sup> however, disagree. We have not required that the communication be in writing. We would expect, however, that such communications would be documented by the accountant and the audit committee. We believe that many of these communications currently are being made as accountants fulfill their responsibilities under GAAS and the securities laws.<sup>200</sup>

In describing the role and responsibilities of the audit committee, Warren Buffett has stated that:

Their function \* \* \* is to hold the auditor's feet to the fire. And, I suggest \* \* \* the audit committee ask [questions] of the auditors [including]: if the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and non-material differences. If the auditor would have done anything differently than management, then explanations should be made of management's argument and the auditor's response.<sup>201</sup>

Requiring that the accountants communicate information to the audit committee will aid the audit committee in fulfilling its responsibilities.

#### **1. Critical Accounting Policies and Practices**

Consistent with our proposal, we are establishing rules requiring communication by accountants to audit committees of all critical accounting policies and practices.<sup>202</sup> In December 2001, we issued cautionary advice regarding each issuer disclosing in the Management's Discussion and Analysis<sup>203</sup> section of its annual report

<sup>198</sup> See, e.g., letter from Piercy Bowler Taylor & Kern, dated January 7, 2003; letter from Robert G. Beard, undated; letter from Eide Bailly LLP, dated January 8, 2003; letter from California Public Employees' Retirement System, dated January 10, 2003; letter from Lynn E. Turner, dated January 13, 2003.

<sup>199</sup> See, e.g., letter from Computer Sciences Corporation, dated January 13, 2003; letter from Sullivan & Cromwell LLP, dated January 10, 2003; letter from America's Community Bankers, dated January 13, 2003; letter from Deloitte & Touche LLP, dated January 10, 2003.

<sup>200</sup> See, "Audit Committee Disclosures," Release No. 34-42266, Dec. 22, 1999.

<sup>201</sup> Warren Buffett, Comments during SEC "Roundtable Discussion on Financial Disclosure and Auditor Oversight," March 4, 2002.

<sup>202</sup> In this release, the terms "critical accounting policies and practices" and "critical accounting policies" are used interchangeably.

<sup>203</sup> Item 303 of Regulation S-K, (17 CFR 229.303), which requires disclosure about, among other