

estimate that the cost of these burden hours is \$81 per hour, resulting in aggregate internal costs of \$449,550.²⁵⁵ Further, we estimate that this additional disclosure will require 0.5 hours in professional review by outside counsel at an average rate of \$300 per hour, resulting in an estimated aggregate annual outside professional costs of \$555,000.

IV. Cost—Benefit Analysis

We are sensitive to the costs imposed by and benefits derived from our rules, and we have identified certain costs and benefits of these rules. Additionally, certain of these costs are imposed by Congressional mandate through the enactment of the Sarbanes-Oxley Act.

A. Background

The Sarbanes-Oxley Act was enacted on July 30, 2002. Title II to that Act adds Sections 10A(g) through 10A(l) to the Securities Exchange Act of 1934 (“Exchange Act”) and requires that the Commission, within 180 days of enactment, adopt rules to carry out each of those sections.²⁵⁶

The final rules:

- Revise the Commission’s regulations related to the non-audit services that, if provided to an audit client, would result in the accounting firm being deemed to lack independence with respect to the audit client;²⁵⁷
- Require that an issuer’s audit committee pre-approve all audit and non-audit services provided to the issuer by the independent accountant;²⁵⁸
- Prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner’s involvement in the audit (smaller accounting firms may be exempted from this requirement);²⁵⁹
- Prohibit an accounting firm from auditing an issuer’s financial statements if a person in a financial reporting oversight role of that issuer had been a member of the accounting firm’s audit engagement team within the one-year period preceding the commencement of audit procedures;²⁶⁰
- Require that the auditor of an issuer’s financial statements report

certain matters to the issuer’s audit committee, including “critical” accounting policies and practices used by the issuer;²⁶¹ and

- Require disclosures to investors of information related to audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer’s financial statements.²⁶²

In addition, under the final rules, an accountant will be deemed to be not independent from an audit client if any “audit partner” receives compensation based directly on selling engagements to that client other than audit, review, or attest services. We have narrowed the final rule by exempting accounting firms with fewer than ten partners and fewer than five audit clients from this provision.²⁶³ While many of the final rules respond directly to the provisions of Title II of the Sarbanes-Oxley Act, certain of the rules go beyond the specific provisions of the Act. These provisions include:

- Applying the partner rotation rules to additional “audit partners”;
- Applying the one-year cooling off period to persons in a financial reporting oversight role with the issuer; and
- Prohibiting an accounting firm from compensating an audit partner for directly selling non-audit services to an audit client.

B. Potential Benefits of the Final Rules

Potential benefits resulting from the final amendments include increased investor confidence in the independence of accountants, in the audit process, and in the reliability of reported financial information. As discussed below, clearer auditor independence regulations should provide investors with comfort that auditors are placing the interests of investors over financial or personal incentives. The final rules mandating that accountants communicate certain matters to audit committees should benefit investors by enhancing the opportunities for meaningful audit committee oversight of the financial reporting process. Investors also will benefit from the enhanced disclosure of the non-audit services provided by, and fees paid to, the accounting firm that audits the company’s financial statements, and from better disclosure of the audit committee’s role in approving the provision of audit and non-audit

services by the accounting firm that audits the company’s financial statements. We believe that these factors could improve the efficiency of the markets and result in a lower cost of capital.

1. Auditor Independence

The amendments are intended to facilitate the independence of the accountant from management in the following ways:

- Providing clearer definition of the types of non-audit services that would be deemed to impair an auditor’s independence;
- Requiring that each engagement of the accountant to perform audit or non-audit services for the company be pre-approved by the audit committee, which serves as the representative of investors;
- Requiring the “rotation” of “audit partners” on the audit engagement team to assure a periodic fresh look at the accounting and auditing issues related to the issuer’s financial statements;
- Providing that the accountant’s independence would be deemed to be impaired if an “audit partner” is compensated directly for selling non-audit services or products to an audit client. This provision should mitigate the concerns that an accountant might be viewed as compromising accounting judgments in order not to jeopardize the potential for increased income from the act of selling non-audit services to the audit client; and
- Requiring a “cooling off” period between working on the audit engagement team and joining the client in a “financial reporting oversight role” in order to assure that personal relationships and the new member of management’s knowledge of the audit plan do not negatively impact the audit process.

Strengthening auditor independence should provide investors with more confidence that the accountants are playing their “gatekeeper” role related to companies’ financial reporting and provide further assurance that the financial condition, results of operations, and cash flows of companies are fairly reflected in their financial reports thereby allowing public companies less costly access to the capital markets.

The final rules specify that “audit partners” who are compensated for cross-selling non-audit services are deemed to be not independent with respect to the audit client. This will further enhance the independence of the audit function since the audit partner’s focus will be on the conduct of the audit rather than on efforts to sell other engagements to the audit client. The

²⁵⁵ See, Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2002* (2002).

²⁵⁶ Section 208(a) of the Sarbanes-Oxley Act of 2002.

²⁵⁷ See, Section 201 of the Sarbanes-Oxley Act.

²⁵⁸ See, Section 202 of the Sarbanes-Oxley Act.

²⁵⁹ See, Section 203 of the Sarbanes-Oxley Act.

²⁶⁰ See, Section 206 of the Sarbanes-Oxley Act.

²⁶¹ See, Section 204 of the Sarbanes-Oxley Act.

²⁶² See, generally, Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(2) of the Exchange Act, 15 U.S.C. 78j-1(i)(2).

²⁶³ See, e.g., letter from U.S. Small Business Administration’s Office of Advocacy, January 13, 2002.