

danger inherent in compensating audit partners for cross-selling non-audit services is that it might create a temptation for accountants to compromise the quality of the audit in order to maintain their relationship with management to whom they wish to cross-sell such services.

## 2. Auditor Reports to Audit Committees

The final rules require that each public accounting firm registered with the Board that audits an issuer's financial statements report specified information to the issuer's audit committee, including: (1) All critical accounting policies and practices used by the issuer, (2) all material alternative accounting treatments within GAAP that have been discussed with management, (3) other material written communications between the accounting firm and management of the issuer, such as any management letter or schedule of "unadjusted differences," and (4) in the case of registered investment companies, all non-audit services provided to entities in the investment company complex that were not pre-approved by the investment company's audit committee.

The report by the Senate Committee on Banking, Housing, and Urban Affairs on the bill that later became the foundation for the Sarbanes-Oxley Act, in addressing the need for such reports from the accountant to the audit committee, stated, in part:

The Committee believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statements and of disagreements that the auditor has with management. The audit committee should be informed in a timely manner of such disagreements, so that it can independently review them and intervene if it chooses to do so in order to assure the integrity of the audit.<sup>264</sup>

Almost eight months before passage of the Sarbanes-Oxley Act, in December 2001, we issued cautionary advice regarding the disclosure in the Management's Discussion and Analysis<sup>265</sup> section of its annual report of those accounting policies that management believes are most critical to the preparation of the issuer's financial

statements.<sup>266</sup> As part of that cautionary advice, we stated:

Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.<sup>267</sup>

Communications with the audit committee about such policies facilitate the audit committee's oversight of the financial reporting process. Investors should benefit by the audit committee being better informed and, thus, in a position to better challenge what it may view as non-typical, aggressive, or improper applications of GAAP used by management to enhance or manipulate reports of the company's financial results or financial condition.

## 3. Enhanced Disclosures About the Services Provided by Auditors to Registrants

Investors will receive more detailed information about:

- Any policies and procedures adopted by an audit committee for pre-approving audit and non-audit services provided by the independent accountant,
- The fees paid by the registrant to the accountant in each of the last two years for audit, audit-related, tax, and all other services,<sup>268</sup> and
- The percentage of fees in each of those categories where the audit committee used the *de minimis* exception.

These disclosures will provide greater transparency to investors of certain aspects of the auditor-client relationship. Providing better, more complete information in cases where non-audit services occur allows investors to determine for themselves whether there are concerns related to the auditor's independence. It also may allow investors to ask more direct and useful questions of management and directors regarding their decisions to engage the accountants for such services.

## C. Potential Costs of the Final Rules

### 1. Auditor Independence

Changes in our auditor independence rules may impose costs on accounting firms and on any issuers that engage, or would like to consider engaging, the accountant of an issuer's financial statements to perform non-audit services.

a. *Non-audit services.* According to the information available to the staff in 2000, approximately 12,600 registrants did not purchase any consulting services from the auditor of their financial statements, and 4,100 registrants reported purchasing such services.<sup>269</sup> Based on the scrutiny that these services have received over the past year, the Commission believes that the number of companies purchasing non-audit services from their accountant might have decreased further.

The current auditor independence rules state that the performance of certain non-audit services will be deemed to impair an auditor's independence. The final rules, in some cases, redefine those services and add one more item, "expert services," to the list of prohibited services. These changes may impact the competitive markets for these services. Audit clients are precluded from engaging their independent accountants to perform services in the categories of bookkeeping services, financial systems design and implementation services, appraisal and valuation services, actuarial services, internal audit outsourcing services, management functions, human resources, broker-dealer, investment adviser or investment banking services, legal services and expert services. These companies may incur costs from having to use a separate vendor for such services resulting in the possible loss of any benefits of having a single provider for both audit and non-audit services. Companies also may incur costs in locating a new vendor and developing a business relationship with that vendor. In addition, companies may incur costs from not being able to retain their preferred provider of non-audit services, if that preferred provider is their independent accountant. The difference in value between a preferred provider and a second choice may be substantial, particularly if the preferred provider has relatively rare service offerings or service offerings that are particularly well suited to the needs of the company.

The final rules may cause accountants to lose one or more sources of revenue because they will no longer be able to

<sup>264</sup> Report of the Senate Committee on Banking, Housing, and Urban Affairs, "Public Company Accounting Reform and Investor Protection Act of 2002," Senate Report 107-205, 107th Cong., 2d Sess., at 21 (July 3, 2002).

<sup>265</sup> Item 303 of Regulation S-K (17 CFR 229.303), which requires disclosure about, among other things, trends, events or uncertainties known to management that would have a material impact on reported financial information.

<sup>266</sup> Release No. 33-8040, Dec. 12, 2001, (66 FR 65013).

<sup>267</sup> *Id.* (footnotes omitted).

<sup>268</sup> In the case of an investment company, the investors will receive this information for the investment company registrant and separately, for all other entities in the investment company complex where the services were subject to pre-approval by the investment company's audit committee.

<sup>269</sup> *Id.*; 65 FR at 43185.