

sell certain non-audit services to their audit clients. Additionally, accounting firms may incur additional costs to market these services with non-audit clients as well as additional learning costs to familiarize themselves with the operations of those non-audit clients. Finally, to the extent that there exist economies of scope in the provision of audit and non-audit services (as, for example, through the use of shared knowledge management systems and other infrastructure) and to the extent that the preclusion of certain non-audit services to audit clients results in the exit of personnel who provide such services from accounting firms, there may be an increase in the cost of both audit and non-audit services.

We believe, however, that in view of the statements by the largest four accounting firms, and others, that they no longer intend to provide internal audit outsourcing services and financial system design and implementation services to audit clients,²⁷⁰ the cost associated with the adoption of the final rules may be limited. Also, to the extent that the provision of non-audit services is merely redistributed among the firms, there would be no net loss of revenue to public accounting firms as a whole.

b. Audit Committee Pre-approval of Services. Under the final rules, all auditing and non-audit services to be provided by the independent accountant must be pre-approved by the issuer or investment company's audit committee.²⁷¹ There may be incremental costs associated with audit committees performing this function. Such costs might include more frequent committee meetings, an increased workload on audit committee members, and having the audit committee's legal counsel review the audit committee's draft policies and procedures for engaging the

independent accountants for non-audit services. The increased burden on audit committee members might result in the need to increase their compensation, resulting in additional costs to issuers or investment companies. Some of these costs may be mitigated by the provisions in the Act and the final rules that allow the audit committee to delegate to one or more audit committee members the authority to grant pre-approvals of these services.²⁷²

Inadvertent violations of the Act and the final rules that would add to the costs of the rules also may be mitigated by the *de minimis* exception to the pre-approval requirement.²⁷³ This exception applies if: (1) The aggregate amount of the non-audit services is not more than five percent of the total amount of revenues paid by the issuer to the accountant during the fiscal year in which the non-audit services were provided;²⁷⁴ (2) at the time of the engagement the issuer did not recognize the services to be non-audit services, and (3) the services are approved by the audit committee prior to the completion of the audit.²⁷⁵

We also believe that as a result of the Commission's audit committee disclosure requirements adopted in 1999,²⁷⁶ prior disclosures related to the involvement of the audit committee in recommending or approving changes in independent accountants and the resolution of disagreements between management and the accountants,²⁷⁷

²⁷² Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(3) of the Exchange Act, 15 U.S.C. 78j-1(i)(3).

²⁷³ Section 202 of the Sarbanes-Oxley Act; Section 10A(i)(1)(B) of the Exchange Act, 15 U.S.C. 78j-1(i)(1)(B).

²⁷⁴ In the case of an investment company, the five percent threshold is calculated based on the services provided to the investment company complex that were subject to the pre-approval requirements for the investment company's audit committee.

²⁷⁵ *Id.*

²⁷⁶ Item 306 of Regulation S-K (17 CFR 229.306), and Item 306 of Regulation S-B (17 CFR 228.306); see generally, Release No. 34-42266, Dec. 22, 1999, (64 FR 73389). These disclosure requirements are discussed *supra*, in Section I.C. of this release.

²⁷⁷ Item 4 of Form 8-K, 17 CFR 249.308 and Item 304 of Regulation S-K, 17 CFR 229.304, which require disclosure of "whether the decision to change accountants was recommended or approved by: (A) Any audit or similar committee of the board of directors, if the issuer has such a committee; or (B) the board of directors, if the issuer has no such committee" and "whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of each of such disagreements with the former accountant * * *." Item 304(a)(1)(iii)(A), (iii)(B), and (iv)(B). 17 CFR 229.304(a)(1)(iii)(A), (iii)(B) and (iv)(B). For small business issuers, Item 304(a)(1)(iii) of Regulation S-B, 17 CFR 228.304(a)(1)(iii) requires disclosure of "whether the decision to change accountants was recommended or approved by the board of directors or an audit or similar committee of the board of directors."

and professional standards that require communications between the accountant and the audit committee on auditor independence and other issues,²⁷⁸ many companies currently have audit committees that carefully evaluate the engagement of accountants to perform non-audit services. Accordingly, we believe that the incremental costs associated with these rules will not be substantial.

c. Rotation of Partners on the Audit Engagement. Under the final rules, no "audit partner" will serve on an audit engagement team for more than seven consecutive years, and the "lead" and "concurring" partners will be prohibited from serving for more than five consecutive years. Current professional requirements state that the "lead" partner should be replaced at least once every seven years.²⁷⁹ The proposed rules would have required any partner on the audit engagement team of an issuer and its significant subsidiaries to rotate after five years. Many commenters believed that the reach of the proposal was too deep, particularly for individuals that have limited participation in the audit. The final rules require fewer partners to rotate than under the proposal. Under the final rules, the lead partner, who has primary responsibility for the audit, along with the concurring partner, must rotate after five years. Other audit partners at the issuer,²⁸⁰ or a subsidiary of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer must rotate after seven years. Accounting firms with fewer than five audit clients and fewer than ten partners may be exempted from the partner rotation requirements if the Board conducts a special review of each of the firm's audit engagements for audit clients at least once every three years. In total, the final rule expands the rotation requirements to cover a greater number of partners than under the current professional requirements.

A number of commenters expressed concern that under the proposed rules many small accounting firms would be unable to meet the partner rotation requirements and may be driven out of

²⁷⁸ See, e.g., SAS No. 61, as amended by SAS No. 89 and No. 90, "Communications With Audit Committees," AU §380; Independence Standards Board, "Independence Discussions with Audit Committees," *Independence Standard No. 1* (Jan. 1999).

²⁷⁹ See, AICPA, SEC Practice Section, *Requirements of Members*, at item e. The membership requirements are available online at <http://www.aicpa.org/members/div/secps/require.htm>.

²⁸⁰ In the case of investment companies, other audit partners would include all audit partners working on an investment company registrant.

²⁷⁰ 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 18 (July 3, 2002). See also letter from HarborView Partners LLC, dated December 4, 2002.

²⁷¹ Section 301 of the Sarbanes-Oxley Act of 2002 requires the Commission to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not meet certain criteria, including having an audit committee that performs certain functions. See Section 10A(m) of the Exchange Act, 15 U.S.C. 78j-1(m), and Release No. 33-8173 (Jan. 8, 2003). The Sarbanes-Oxley Act defines "audit committee" to be "(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer." Section 205(a) of the Sarbanes-Oxley Act, which, among other things, adds Section 3(a)(58) to the Exchange Act.