

business, potentially burdening the ability of smaller companies to retain auditors and access the public markets. We have attempted to mitigate this effect by providing an exemption for smaller accounting firms in the final rules.²⁸¹

Without the exemption, clients of many of the smaller accounting firms would have to change auditors every five years because their incumbent auditor would not be able to meet the partner rotation requirements. This would have imposed marketing and client-specific learning costs on the accounting firms and costs on clients to familiarize the new accountant with their operations.

Costs associated with the periodic replacement of partners might include more frequent company-specific training, conducted by both the accounting firm and the audit client, as new partners join the audit engagement team. For example, the new partners will need to learn the company's accounting and financial reporting procedures, controls and familiarize themselves with key personnel. The final rules also might result in incremental costs related to some partners being required to travel extensively, relocate from one part of the country to another, or from one country to another.²⁸²

The costs related to these rules will vary based on the proximity of an accounting firm's audit clients, the concentration of the firm's practice within an industry, and the availability of partners to whom the work may be redistributed, and similar factors. We note that these costs may be passed on to issuers in the form of higher audit fees.

Had the proposed rules been adopted, another potential impact would have been the impact on the specialization of accounting firms within each industry. To minimize partners' costs of learning new businesses, accounting firms have an incentive to specialize in certain industries. This, potentially, could have had the effect of creating oligopolies within each industry and could have adversely affected competition among accounting firms.

d. *One-Year Cooling Off Period.* The final rules indicate that an accounting firm is deemed to be not independent with respect to an audit client if a former member of the audit engagement team is employed by the issuer in a "financial reporting oversight role" unless the individual had not been a member of the audit engagement team during the one year period preceding the initiation of the audit.²⁸³

Currently, when a former professional employee of an accounting firm joins an audit client within one year of leaving the firm, and the individual has significant interaction with the accounting firm's audit engagement team, professional standards require the accounting firm to perform procedures to assure that the individual's knowledge of, or relationships with, the accounting firm do not adversely influence the quality of the audit.²⁸⁴ These procedures include modifying the audit plan to adjust for the risk that the individual would be able to circumvent key aspects of the audit, and assuring that the people on the audit engagement team have the stature and objectivity not to be influenced by their former partner or co-employee and to have the appropriate level of skepticism when evaluating the individual's representations and views.

Costs might occur, however, from the company being required to delay the hiring, or not being able to hire, the individual that it believes is the most qualified person to perform a "financial reporting oversight role" at the company. This may add to recruitment costs or result in less efficient operations. Such costs are difficult to estimate and vary from one company to another. However, in response to several commenters' concerns regarding the reach of the proposed rules, the final rules limit the prohibitions based on the individual's role on the audit engagement team. These costs might be ameliorated in unusual circumstances due to the exception provided for emergency and unusual circumstances.

e. *Compensation.* The final rules provide that an accountant is deemed to be not independent with respect to an audit client if any "audit partner" earns or receives compensation in consideration of directly selling

engagements to provide any services to that client other than audit, review or attest services. The final rules differ from the proposed rules in three notable respects. First, the proposed rules also would have provided that any accountant is not independent with respect to an audit client if an audit partner earns or receives compensation based on the selling or performance of engagements with an audit client to provide any products or services other than audit, review or attest services. The final rule applies only to compensation based on the direct selling of engagements in the independence determination. Second, several commenters noted that, as proposed, the rules would have precluded a "specialty" partner from receiving compensation when he or she sold services in his or her specialty area. The final rules address this concern because they apply to "audit partners" rather than all partners who are members of the audit engagement team. Third, several commenters indicated the compensation rules might be particularly difficult for smaller accounting firms. To address this concern, the final rules include an exemption for accounting firms with fewer than five audit clients and fewer than ten partners.

Despite these revisions, the provision might affect the compensation plans of those firms that currently reward audit partners of the firm for selling non-audit services to their audit clients. The final rules may result in those revenues being allocated to other persons within the accounting firm. Absent this incentive, auditors may be less inclined to inform issuers of ways to improve their performance or condition through non-audit services. We do not expect, however, that there would be any incremental costs to the firm or to the client.

2. Auditor Reports To Audit Committees

The final rules are identical to those proposed, with two exceptions. The proposed rules would have required accounting firms to report to audit committees all alternative accounting treatments within GAAP that have been discussed with management, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm. The final rules only require accounting firms to report material alternative treatments, which should aid in focusing the reports to audit committees. The final rules add a specific requirement related to investment companies that requires auditors to disclose to the investment company's audit committee all non-

²⁸¹ According to data provided by the SECPS, out of 767 accounting firms with audit clients, 462 firms are eligible for the exemption from partner rotation.

²⁸² For example, one commenter estimated that on certain large engagements, the proposed rotation requirements would result in an average annual incremental cost of \$1,250,000; see, letter from Deloitte & Touche LLP dated January 10, 2003. Another commenter estimated the cost to be as much as \$2,000,000 per year for large registrants; see, letter from KPMG dated January 9, 2003.

²⁸³ In the case of investment companies, the cooling off period would extend not only to positions at the investment company, but also to positions at any entity in the investment company complex that is directly responsible for the operations or financial reporting of the investment company.

²⁸⁴ Independence Standards Board, "Employment with Audit Clients" *Independence Standard No. 3* (July 2000).