

the Board must conduct a special review of all of the firm's engagements subject to the rule at least once every three years. This special review should focus on the overall quality of the audit, and in particular, the independence and competence of the key personnel on the audit engagement teams. Additionally, accounting firms with fewer than five audit clients that are issuers and fewer than ten partners are exempt from the compensation requirements.

D. Small Entities Subject to the Rules

The rules affect smaller registrants and smaller accounting firms. Exchange Act Rule 0-10(a)²⁹⁵ and Securities Act Rule 157²⁹⁶ define a company to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that approximately 2,500 companies, other than investment companies, are small entities.

For purposes of the Investment Company Act, Rule 0-10²⁹⁷ defines a "small business" as an investment company complex²⁹⁸ with net assets of \$50 million or less as of the end of its most recent fiscal year. We estimate that approximately 225 investment companies meet this definition.

Our rules do not define "small business" or "small organization" for purposes of accounting firms. The Small Business Administration defines small business, for purposes of accounting firms, as those with under \$6 million in annual revenues. We have only limited data indicating revenues for accounting firms, and we cannot estimate the number of firms with less than \$6 million in revenues that practice before the Commission. We requested comment on the number of accounting firms with revenue under \$6 million. Advocacy provided information indicating that a great majority of the 51,645 accounting firms in the United States have less than \$6 million in revenue.²⁹⁹ Advocacy noted that the U.S. Census does not classify the firms according to revenue, but obtained average per-firm revenue through publicly available IRS tax return information. According to Advocacy, IRS data indicates that in 1998, there were 46,407 tax returns for accounting

firms organized as corporations.³⁰⁰ Advocacy concluded that, of the firms captured by the IRS data, 99.18% (46,025) would likely qualify as small businesses because they had less than \$3 million in receipts, and a further 318 corporate filers were reported to have an average of \$5.7 million in receipts, indicating that the majority of these firms also had less than \$6 million in revenues. Since fewer than 1,000 firms³⁰¹ provide audit services to issuers, it is uncertain how many of those firms qualify as small businesses.

E. Reporting, Recordkeeping and Other Compliance Requirements

1. Auditor Independence

The vast majority of registrants are audited by one of the four largest accounting firms, which clearly are not small entities. Nonetheless, changes in the auditor independence regulations may impose compliance requirements, recordkeeping and reporting requirements on smaller accounting firms and on any smaller registrant that engages, or would like to consider engaging, the auditor of an issuer's financial statements to perform non-audit services.

(a) *Non-audit services.* These auditor independence rules state that the performance of certain non-audit services will impair an auditor's independence. The rules, in some cases, redefine the limits of those non-audit services and add an additional item, "expert services," to the previous list of prohibited services. These changes could impact the competitive markets for these services. In particular, the Commission is withdrawing the specific exemption in the current rules that allows audit clients with less than \$200 million in total assets to engage the auditors of their financial statements to perform internal audit outsourcing services.³⁰² Under these rules, small issuers also are precluded from engaging the independent accountants to perform services in the categories of financial systems design and implementation services, appraisal and valuation services, actuarial services, and others, that could have been performed under the previous rules. Smaller registrants, therefore, may have to use a separate vendor for such services. Smaller accounting firms may lose one or more sources of revenue because they no

longer will be able to sell certain non-audit services to their audit clients.

According to the information available to the staff in 2000, however, 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.³⁰³ Based on the attention that non-audit services have received in the past year, the Commission staff believes that the number of smaller registrants purchasing non-audit services from their auditors, and the number of smaller accounting firms providing a significant amount of non-audit services to audit clients that are Commission registrants, might have decreased. Also, to the extent non-audit services are merely redistributed among the firms, there will be no net loss of revenue to public accounting firms as a whole.

(b) *Audit Committee Pre-Approval of Services.* Under the rules, all audit and non-audit services to be provided by the auditor of an issuer's financial statements must be pre-approved by the issuer's audit committee.³⁰⁴ The definition of audit committee in the Sarbanes-Oxley Act, which is cited in the rules, however, indicates that if no such committee exists, the entire board of directors of the issuer may perform this function.³⁰⁵ The rules, therefore, do not require a small company to form an audit committee.

There are reasons to believe that many smaller entities currently have audit committees.³⁰⁶ Any smaller entity that does not have such a committee and forms one to facilitate operation of the rules, however, will incur costs to establish such a committee and, if necessary, to recruit and retain the required number of independent

³⁰³ *Id.*; 65 FR at 43185.

³⁰⁴ In the case of investment companies, all non-audit services provided by the auditor to an entity in the investment company complex that relate to the operations or financial reporting of the investment company must be pre-approved by the audit committee of the investment company.

³⁰⁵ 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). 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, among other things, adds Section 3(a)(58) to the Exchange Act.

³⁰⁶ See, e.g., NACD, 2001-2002 Public Company Governance Survey (Nov. 2001).

²⁹⁵ 17 CFR 240.0-10(a).

²⁹⁶ 17 CFR 230.157.

²⁹⁷ 17 CFR 270.0-10.

²⁹⁸ The definition of a "small business" also includes a "unit investment trust" and a "business development company."

²⁹⁹ Advocacy cited recent U.S. Census Statistics. See, Bureau Of The Census, U.S. Department Of Commerce, "Statistics Of U.S. Business," 1998 (NAICS Code #541211).

³⁰⁰ See, IRS, "1998 Corporation Source Book Of Statistics Of Income, Income Tax Returns of Active Corporations with Accounting periods ended July 1998 Through June 1999," Minor Industry 541215 (1998).

³⁰¹ Data provided by the SEC Practice Section of the AICPA.

³⁰² 17 CFR 210.2-01(c)(4)(v)(A).