

directors. Smaller entities also may spend time and incur costs to document the audit committee's activities in the areas covered by the rules, including drafting and maintaining the audit committee's policies and procedures related to engaging the auditor to perform non-audit services. Moreover, small entities may incur costs in seeking the help of outside experts, particularly outside legal counsel, in drafting the audit committee's policies and procedures.

(c) *Rotation of Partners on the Audit Engagement.* Under the rules, certain partners may not serve on an audit engagement team for more than five or seven years, depending on the partner's involvement in the audit. Current professional requirements state that the lead partner should be replaced after serving in that capacity for seven years.³⁰⁷ The rules, therefore, require more partners to be rotated and the lead partner to be rotated more frequently.

Potential costs associated with the periodic replacement of partners include more frequent company-specific training because new partners joining the audit engagement team will need to learn the company's accounting and financial reporting procedures, controls and familiarize themselves with key personnel. The rules also may result in incremental costs related to some partners being required to relocate.

In response to concerns expressed by commenters, the final rules allow accounting firms with fewer than five audit clients and fewer than ten partners to be exempted from the rotation requirement.

(d) *One-Year Cooling Off Period.* The rules deem an accounting firm to be not independent with respect to an audit client if a former member of the audit engagement team begins employment in a "financial reporting oversight role" at that issuer if the individual had been a member of the audit engagement team within the one-year period preceding the initiation of the audit.³⁰⁸ A "financial reporting oversight role" is a role in which a person is in a position to or does influence the contents of

financial statements or anyone who prepares them.³⁰⁹ Such persons include directors, chief executive officers, chief financial officers, chief accounting officers, controllers, and others.

A smaller registrant may incur costs from a delay in 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 less efficient operations.

(e) *Compensation.* Under the rules, an accounting firm's independence will be deemed to be impaired if any audit partner receives compensation based on directly selling to an audit client services other than audit, review and attest services. Thus, accounting firms will have to discontinue compensating these individuals for "cross-selling" services.

Some smaller accounting firms may have a relatively small number of partners, available to serve each client. Such firms may not have personnel, other than the partner in charge of the smaller company's audit with sufficient expertise to market and provide non-audit services to that company. In recognition of the special issues associated with smaller firms, the final rules provide that accounting firms with fewer than five audit clients and fewer than ten partners may be exempted from the compensation rule.

2. Auditor Reports to Audit Committees

Under the rules, each public accounting firm registered with the Board that audits an issuer's financial statements must report to the issuer's audit committee (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, including the ramifications of the use of the alternative treatments and the treatment preferred by the accounting firm, (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 required reports need not be in writing, but must be provided to the audit committee before the auditor's report on the financial

statements is filed with the Commission.³¹⁰

GAAS currently require discussions between the auditors and the audit committee of significant unusual, controversial, or emerging accounting policies, of the process used by management to select certain estimates, and of disagreements with management over certain accounting matters. Further, audit committees generally are aware of management's letter making representations to the auditors, which the auditor uses in conducting the audit of the issuer's financial statements, and the auditor's letters to management on reportable conditions in internal controls and other matters. Also, due to enactment of Section 401 of the Sarbanes-Oxley Act, all material adjustments identified by the auditor should be reflected in the issuer's financial statements and, therefore, there should be no material "unadjusted differences." In the case of investment companies, we believe auditors already are reporting non-audit services provided to the investment company complex annually and some routinely provide more frequent updates at the request of the audit committee.

Because of these GAAS and legal provisions, we believe that adoption of the rules regarding auditor reports to audit committees will not significantly increase costs, including costs for smaller accounting firms and smaller registrants. Some costs may be incurred, however, to the extent communications are required before the auditor's report is filed with the Commission.

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

Currently, disclosure is required in proxy statements of the fees billed in the most recent fiscal year under the categories of audit fees, information systems design and implementation fees, and all other fees.³¹¹ The rules require disclosure of the fees billed in each of the two most recent years. The rules also add the categories of tax fees and audit-related fees but eliminate separate disclosure of information systems design and implementation from the current list of categories of fees. The rules also require disclosure of

³⁰⁷ 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>. In its comment letter, Advocacy stated its belief that there are approximately 460 audit firms in the United States providing audit services to 765 smaller reporting companies who are currently exempt from the AICPA audit partner rotation requirements.

³⁰⁸ In the case of investment companies, the cooling off period extends 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.

³⁰⁹ See, Rule 2-01(f)(3)(ii) of Regulation S-X.

³¹⁰ In the case of investment companies, the auditors are required to discuss these matters with the audit committee annually, with an update, if necessary.

³¹¹ In the case of investment companies, 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.