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SEC AMENDS AUDITOR INDEPENDENCE RULES

MARK S. BERGMAN

FEBRUARY 2001



In a continuing effort to improve disclosure relating to the functioning of corporate audit committees and to protect the integrity and reliability of public companies' financial statements, the Securities and Exchange Commission adopted amendments to the rules regarding auditor independence. The amendments modernize the Commission's rules for determining whether an auditor is independent in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients, and the scope of services provided by audit firms to their audit clients.

This memorandum summarizes the provisions of the new rules that require U.S. reporting companies that file proxy statements to make certain disclosures in proxy statements and information statements.

New Item 9(e) of Schedule 14A contains the disclosure that must be included in a proxy statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). The new disclosure is not required for companies reporting solely under Section 15(d) of the Exchange Act or to foreign private issuers (since they are not subject to the SEC's proxy rules).

The disclosure is required to be included in all proxy and information statements filed after February 5, 2001. The SEC did not specify where the disclosure should appear in the proxy statement. While the SEC suggests that the disclosure might appropriately accompany the disclosure required by Item 7(e) and Items 9(a-d) of Schedule 14A and could be included in the audit committee report, it reminds registrants that there is no safe harbor that would cover disclosures required by Item 9(e) but included in the audit committee report.

1. Disclosure of Fees

The new disclosure rules require registrants to aggregate and disclose:

- the aggregate fees paid for the annual audit and for the review of the company's quarterly financial statements for the most recent fiscal year, under a caption entitled "Audit Fees";
- the aggregate fees billed for information technology services rendered by the outside auditor during the last fiscal year, under the caption "Financial Information Systems Design and Implementation Fees"; and
- the aggregate fees billed for all other non-audit services, including fees for tax-related services, for the last fiscal year, under the caption "All Other Fees."

If there has been a change in accountants during the year, only fees paid to the accountant who renders an audit opinion on the most recent year's financial statements are required to be disclosed. Only fees relating to the financial statement audit and review services performed by the auditor that are customary under generally accepted auditing standards or that are customary for the purpose of rendering an opinion or review report on the financial statements should be included in the category of "Audit Fees." The SEC permits the various fees to be disclosed in tabular format.

Investment companies will be required to disclose a fund's audit fee and the aggregate fees billed for information technology and other non-audit services provided by the registrant's auditors to the registrant, its adviser and entities in a control relationship with the adviser that provide services to the registrant.

2. Audit Committee Disclosure

The registrant must disclose whether the audit committee considered whether the information technology services and other non-audit services provided by the outside auditor is compatible with maintaining such auditor's independence. The registrant is not required to disclose the conclusions of the audit committee deliberations. The SEC suggests that the audit committee's consideration of the following factors would be helpful in making this determination:

- The impact of the service on the effectiveness of the audit or the quality and timeliness of the financial reporting process.
- Whether the auditors would be auditing their own numbers.¹
- Whether the employees of the auditing firm would be assuming a management role or creating a mutuality of interest with the company's management.
- Whether the service is performed by specialists who also provide audit support.
- The size of the fees for non-audit services.

3. Leased Employees

If greater than 50% of the hours expended on the audit engagement were performed by personnel the outside auditor leased or otherwise acquired from another entity, the registrant must disclose the percentage of the hours spent by such leased or borrowed employees.

4. Other Proxy Disclosures

In addition to the disclosure required by the most recently adopted rules, annual proxy statements filed after December 15, 2000 must also include the following in accordance with previous SEC action (see Paul Weiss client memo dated December 1999):

- the report of the audit committee, including:
 - (i) whether the audit committee has reviewed and discussed the audited financial statements with management;

¹ For example, the SEC cautions that an auditor who provides a fairness opinion where it is reasonably likely that the results individually or in the aggregate would be material to the audit client's financial statements or where the results would be audited by the auditor would impair the auditor's independence.

- (ii) whether the audit committee has discussed with the independent auditors the matters required to be discussed by the Statement of Auditing Standards 61; and
- (iii) whether the audit committee received the written disclosures and letter from the independent auditors required by ISB Standard No. 1;
- disclosure regarding the independence of the members of the audit committee; and
- a copy of the audit committee's charter (at least once every three years).

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This memorandum provides only a general overview of the revised auditor independence rules. It is not intended to provide legal advice, and no legal or business decision should be based on its contents.

Mark S. Bergman is a partner in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison.

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