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HRO Alert

The Sarbanes-Oxley Act of 2002

Final Rules:
AUDITOR INDEPENDENCE

On January 28, 2003, the SEC released final rules to strengthen SEC requirements regarding auditor independence. These rules will impact your company's audit committee and its practices with respect to your auditor.[1]

These rules, issued under the Sarbanes-Oxley Act of 2002 (the "SO Act"), finalize and, in some cases, revise the SEC's proposed rules relating to auditor independence, which were released on December 2, 2002.

This HRO Alert summarizes the main provisions of the final rules. Most of these rules, which apply to U.S. public companies, foreign private issuers and registered investment companies, become effective on **May 6, 2003**. Some of the rules with respect to concurring audit partners become effective on **May 6, 2004**.

BACKGROUND

Pursuant to Title II of the SO Act, the SEC adopted a number of new rules designed to provide greater assurance to investors that independent auditors are performing their public responsibilities. Below we briefly describe the new obligations imposed on accounting firms in connection with rendering audit services. We provide greater detail on the aspects of the final rules that will directly affect your disclosure and audit committee responsibilities relating to your company's auditor.

CONFLICTS OF INTEREST RESULTING FROM EMPLOYMENT RELATIONSHIPS

The SO Act prohibits an accountant from performing an audit for a public company if an officer of the company, or a person in an equivalent position, was employed by the accounting firm and participated in an audit of that company during the preceding year. According to the existing rules, an accountant is not independent if the audit client employs one of the accounting firm's former employees and such employee has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies.

Under the final rules, an accountant will not be independent if the company employs (in a financial oversight position) certain former members of the accounting firm's audit engagement team who audited the company during the one-year period preceding the commencement of the audit procedures for the current fiscal period. The barred members of the audit engagement team are the lead partner, the concurring partner, and any other member of the accountant's audit engagement team who provided more than ten hours of audit, review or attest services for the company.

[1] The terms "auditor," "accountant" and "accounting firm" are intended to mean a registered public accounting firm, certified public accountant or public accountant. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

SERVICES OUTSIDE THE SCOPE OF THE PRACTICE OF AUDITORS

Consistent with the proposed rules relating to auditor independence, the final rules clarify and strengthen the SO Act's prohibitions against an auditor providing non-audit services contemporaneously with an audit. Under the final rules, an auditor is not independent if, at any point during the audit and professional engagement period, the auditor provides any of the following non-audit services to an audit client:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions;
- Human resources functions;
- Broker-dealer, investment adviser, or investment banking services;
- Legal services; and
- Expert services unrelated to the audit.

Tax services that do not fall within any of the prohibited categories are permitted, provided that they are pre-approved by the company's audit committee. The final rules do not govern non-audit services when provided to non-audit clients.

PARTNER ROTATION

The SO Act requires rotation of the lead audit partner and the audit partner responsible for reviewing the audit on a five-year basis in order for the accountant to continue to provide audit services to the company. The proposed rules contemplated expanding the partner rotation requirement to include all other partners on the audit engagement team. The final rules, however, limit the partner rotation to a smaller number of auditors than originally proposed. The SEC did this by applying the additional partner rotation requirement to "audit partners," a newly defined term that includes not only the lead and concurring partners, but also those partners on the engagement team who have responsibility for decision-making on significant matters or who maintain regular contact with management or the audit committee. The rotation requirement for the non-lead and non-concurring partners is every seven years.

The final rules also adopt an exception relating to small firm partner rotations. In that regard, any accounting firm with less than five audit clients that are issuers and less than ten partners are exempt from the rotation requirement, provided, the newly established Public Company Accounting Oversight Board conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence.

AUDIT COMMITTEE ADMINISTRATION OF THE ENGAGEMENT

The final rules require a public company's audit committee to pre-approve the engagement of an accountant to perform non-audit services and all audit, review and attest engagements required under the securities laws. Under the final rules, the engagement of an accountant to render such services must be either:

- Approved by the company's audit committee before the auditor is engaged by the company or its subsidiaries to render the service; or
- Entered into pursuant to pre-approval policies and procedures established by the company's audit committee, provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee's responsibilities to management.

The final rules include a de minimis exception for the pre-approval of non-audit services in instances where (i) the aggregate amount paid for such non-audit services does not exceed five percent of the total amount paid by the company to the auditor in the fiscal year in which the services are rendered; (ii) at the time of the engagement, such services were not recognized by the company to be non-audit services; and (iii) such services are brought to the attention of and approved by the audit committee or one or more designated audit committee representatives before the completion of the audit.

COMPENSATION

The SEC amended the auditor independence rules to end the practice of auditors being compensated by their firms for selling non-audit services to their audit clients. Generally, the final rules differ from the proposed rules by limiting the selling of non-audit services by auditors falling under the newly defined term "audit partner." Thus, the final rules deem that an accountant is not independent if, at any point during the audit and professional engagement period, any "audit partner" earns or receives compensation based on the procuring of engagements with that audit client to provide any services other than audit, review or attest services. Also, in contrast to the proposed rules, the final rules exempt from this compensation restriction any accounting firm with ten or fewer partners and five or fewer audit clients that are issuers.

COMMUNICATION WITH AUDIT COMMITTEE

The final rules also require an auditor that performs an audit required under the securities laws (i.e., in connection with a company's annual report, proxy statement, registration statement or other filing in which audit reports are included) to report certain information to the company's audit committee before the filing of such audit report with the SEC. Specifically, the auditor is required to report the following information to the audit committee:

- All critical accounting policies and practices to be used;
- All alternative treatments of financial information within Generally Accepted Accounting Principles ("GAAP") for policies and practices related to material items that have been discussed with the company's management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor; and
- Other material written communications between the auditor and the company's management.

Under the final rules, such communications with the audit committee do not have to be in writing; however, the SEC does suggest that both the accountant and audit committee document their communications with each other.

The final rules do not list specific topics that must be communicated to the audit committee by the auditor regarding critical accounting policies. However, the SEC stated that, at a minimum, such discussion should include the reasons why certain estimates or policies are or are not considered critical and how current and anticipated future events may impact those determinations. The SEC also instructed that the discussion regarding critical accounting policies should include an assessment of Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), including discussion of any modifications proposed by the auditor that were not included.

For communications relating to alternative accounting treatment, the final rules are intended to cover recognition, measurement and disclosure considerations related to accounting for both specific transactions and general accounting policies. Accordingly, the SEC indicated that it would be necessary for the auditor to discuss with the audit committee the following items in connection with both specific transactions and general accounting policies:

Specific Transactions	General Accounting Principles
• The underlying facts of the transaction; • The financial statement accounts impacted; • The applicability of existing corporate accounting policies to the transaction; • If the proposed accounting treatment of the transaction does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, an explanation of why it is not appropriate or applicable and the basis for selection of an alternative policy; • The alternatives available under GAAP that were discussed by management and the auditor and the reasons for not selecting those alternatives; and • If the accounting treatment selected is not the method preferred by the auditor, the reason why the auditor's preferred method was not selected by management.	• The initial selection of and changes in significant accounting policies; • The impact of management's judgments and accounting estimates; • The auditor's judgments about the quality of the company's accounting principles; • The range of alternatives available under GAAP that were discussed by management and the auditor and the reason for choosing the selected policy; • The reasons for change to any existing accounting policy; and • If the accounting policy selected is not the policy preferred by the auditor, the reason why the auditor considered one policy preferable and why that policy was not selected by management.

Finally, with respect to material written communications between the auditor and management, the final rules specifically identified the management letter and schedules of unadjusted differences as material written communications. Other written communications that the SEC stated it would anticipate to be material include the management representation letter, the reports on observations and recommendations on internal controls, schedules of material adjustments and reclassifications proposed (and a listing of adjustments and reclassifications not recorded, if any), the engagement letter and the independence letter.

EXPANDED DISCLOSURE

The final rules require a public company to present specific disclosures regarding the audit and non-audit services provided to the company by its auditor, as well as the fees paid by the company to the accountant for the past two fiscal years. The company also must disclose any policies and procedures developed by the company's audit committee concerning pre-approval of the auditor to perform both audit and non-audit services, as well as the percentage of fees that were pre-approved under the de minimis exception.

The final rules require these disclosures to be included in the company's annual report on Form 10-K and in its proxy or information statement. Accordingly, the company may incorporate the disclosure in its proxy statement by reference into its Form 10-K. Companies, including foreign private issuers, that are not required to file proxy statements must include these disclosures in their annual reports on Form 10-K, 10-KSB, 20-F or 40-F.

Auditors' Fees

The final rules amend the current requirements regarding disclosure of the professional fees paid by a company to its auditor. The company is required to disclose fees paid in the following categories:

- Audit fees;
- Audit-related fees;
- Tax fees; and
- All other fees.

"Audit fees" include those services necessary to complete the audit, sign the audit opinion and perform required quarterly reviews, as well as other services that only the auditor can reasonably provide, such as comfort letters, attest services, consents and assistance with SEC filings. In response to commenters' questions, the SEC clarified that "audit fees" also include all tax and other services required to fulfill the auditor's responsibilities under generally accepted auditing standards. "Audit-related fees" include employee benefit plan audits, acquisition due diligence, internal control reviews and consultation concerning reporting standards. "Tax fees" include tax compliance, consultation and planning, other than tax-related services falling into the "audit fees" category.

The company is obligated to describe each subcategory of services provided in the "audit-related fees," "tax fees" and "all other fees" categories. The SEC had not originally proposed requiring descriptions in the "tax fees" category. Disclosure is required for each of the two most recent fiscal years, instead of just the most recent fiscal year as under current rules.

The final rules eliminate disclosure of financial information technology consulting fees as a separate category, because under the rules and the SO Act, auditors are prohibited from providing most of these services to their audit clients. Instead, these fees now must be described as a subcategory of the "all other fees" category.

Audit Committee Pre-Approval Policies

The final rules also require a public company, including a foreign private issuer, to disclose and describe any policies and procedures developed by its audit committee concerning pre-approval of audit and non-audit services to be performed by its auditor. The company is required to "set out in detail the audit committee's policies and procedures for engaging the independent accountant to perform services other than audit, review and attest services." The SEC indicated that the policies and procedures should address auditor independence oversight functions and, if applicable, the specific processes that would permit and monitor activities meeting the de minimis exception to the pre-approval requirement. The company may choose whether to describe the relevant policies and procedures, or include a copy of the policies and procedures as part of its filing.

In addition, if it has relied on the de minimis exception to the pre-approval requirement, the company must disclose, by category, the percentage of the fees paid to the auditor for services provided under the de minimis exception. (For a discussion of the de minimis exception, see "Audit Committee Administration of the Engagement" above.) The SEC had proposed requiring disclosure of the percentage of fees in each of the "audit-related fees," "tax fees," and "all other fees" categories that were pre-approved by the company's audit committee, but narrowed the disclosure requirement in response to comments.

These required disclosures must be provided in the company's annual report or proxy statement for its first fiscal year ending after **December 15, 2003.**

HOW HRO CAN HELP

The final rules described in this HRO Alert will generally have the most significant impact on your company's auditor. The rules, however, also create new disclosure obligations for your company and additional oversight responsibilities for your audit committee. If you would like to discuss these rules and how they may affect your company, we encourage you to contact any of the persons listed in the margin of the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. Nor is it intended to address specific disclosure or compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding the rules described herein, please contact any of the persons listed in the margin of the first page of this HRO Alert.

2/14/03