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MEMORANDUM

April 22, 2003

TO: Clients and Friends

FROM: Graubard Miller

SUBJECT: New SEC Rules relating to Auditor Independence

The SEC has adopted rules implementing Title II of the Sarbanes-Oxley Act of 2002 ("Act"). These rule address auditor independence and are discussed in this memorandum.

Audit Committee Pre-Approval

The rules require that a company's audit committee pre-approve all audit and review engagements which are required under the securities laws. The rules also require committee pre-approval of non-audit services that will be rendered contemporaneously with audit services.

The required approval may be achieved pursuant to (i) a vote by the company's audit committee or (ii) a detailed pre-approval policy previously established by the audit committee. The audit committee also may delegate its authority to pre-approve audit and non-audit engagements to a single member (who must be an independent director).

For approval to be valid under a pre-approval policy, (i) such policy must have been established by the audit committee of the issuer, (ii) such policy must be detailed as to the particular service, (iii) the audit committee must be informed on a timely basis of each engagement under the policy, and (iv) such policy must not include delegation of the audit committee's responsibilities to management.

Prohibition on Certain Services

Notwithstanding the approval process described above, the rules prohibit auditors from providing certain non-audit services contemporaneously with audit services. Theses "prohibited services" include: (i) bookkeeping services, (ii) financial information systems design and implementation, (iii) appraisal or valuation services, (iv) fairness opinions or

contribution-in-kind reports, (v) actuarial services, (vi) management functions, (vii) human resources functions, (viii) broker-dealer, investment adviser or investment banking services, and (ix) expert services unrelated to the audit.

While most of these categories of services (other than expert services) were prohibited under prior rules, a number of exceptions to those prohibitions have been eliminated.

The rules provide that, until May 6, 2004, the non-audit services addressed therein will not be deemed to impair an accountant's independence provided that they were rendered pursuant to contracts that were in existence on May 6, 2003.

Communications with the Audit Committee

The rules require the auditor to communicate the following items to the audit committee prior to the filing of an audit report with the SEC:

- *Critical Accounting Policies:* These encompass both the policies and estimates that are most important to the audit client's results and condition and which require the most difficult, subjective or complex judgments by management.

- *Alternative Accounting Treatments*: These are other accounting treatments under GAAP that would be available for use by the company. The auditor must discuss the basis for the chosen approaches.

- *Other Written Material Communications*: These include written material communications that the auditor had with the company including management representation letters, schedules of unadjusted differences and engagement letters as well as other documents.

Partner Rotation

Lead and Concurring Audit Partners

The rules require that the "lead partner" and "concurring partner" of an auditor rotate out after serving in such roles for any five consecutive year period. The new rules also mandate a five-year "time-out" period thereafter, during which time such partners are prohibited from serving as lead partner or concurring partner on an audit.

The rules also require the rotation of audit partners other than the lead and concurring partners after seven years of performing certain services for audit clients, followed by a two-year "time-out" period.

Definitions

"Lead Partner and Concurring Partner"

The rules define "lead partner" as the "audit partner having primary responsibility for the audit or review" and "concurring partner" as "[t]he partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with GAAP and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the SEC or the Public Company Accounting Oversight Board" (the "Oversight Board").

"Audit Partner"

The term "audit partner" is newly defined in the rules as a partner (or person in an equivalent position) who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee.

"Audit partner" includes "lead" and "concurring" partners, as well as other audit engagement team partners who provide more than ten hours of audit, review or alteration services in connection with the annual or interim consolidated financial statements of an issuer. "Audit partner" also includes other audit engagement team partners who serve as the "lead partner" in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenue of the issuer's respective consolidated assets or revenues.

Partners assigned to "national office" duties (which can include technical accounting or auditing, whether at a local or national level, as well as centralized quality control functions) who may be consulted on specific accounting issues related to a client are not considered to be "audit partners" even though they may periodically consult on client matters.

"Audit Engagement Team"

"Audit engagement team" refers to all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client. Included within the audit engagement team would be "audit partners" (as separately defined in the rules) and all other persons who consult with other members of the engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

Exempt Firms

The rules exempt from the rotation requirements accounting firms with less than five audit clients that are issuers and less than ten partners, provided that the Oversight

Board conducts a review at least once every three years of each of the audit client engagements that would otherwise result in a lack of auditor independence.

Application to Issuers and Investment Companies

The rules concerning which partners must rotate, the applicable periods of rotation and "time-out" from the audit client will be applied in the same manner to investment companies as to other issuers. As applied to investment companies, a consecutive year of service for audit partners includes all fiscal year-end audits of investment companies in the same investment company complex that are performed in a continuous 12-month period.

Employment at Audit Client of Former Employees of Auditor

The Act prohibits a registered accounting firm from performing an audit for an issuer if the chief executive officer, controller, chief financial officer or chief accounting officer of the issuer was employed by that accounting firm and participated in any capacity in the audit of that issuer during the one-year period preceding the date of initiation of the audit.

Under the final rules implementing that provision, an accounting firm will not be permitted to audit an issuer if the lead partner, the concurring partner, or any other member of the audit engagement team who provided more than ten hours of audit, review or attestation services was employed in a "financial reporting oversight role" by the issuer within the specified one-year period. The term "financial reporting oversight role" refers to a person who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information that is included in filings with the SEC.

For purposes of this rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report is filed with the SEC. The audit engagement period for the current year is deemed to conclude on the date the current year's periodic annual report is filed with the SEC.

Audit Record Retention

Pursuant to Section 802 of the Act, the SEC has amended Regulation S-X to include new Rule 2-06, which governs retention of audit records. Rule 2-06 provides that "for a period of seven years after an accountant concludes an audit or review of an issuer's financial statements to which Section 10A of the Securities Exchange Act of 1934 (the "Exchange Act") applies, or of the financial statements of any investment company registered under Section 8 of the Investment Company Act of 1940, the accountant must retain records relevant to the audit or review."

According to the SEC, the availability of documents under this new rule "will assist in the oversight and quality of audits of an issuer's financial statements…and may provide critical evidence of financial reporting impropriety or deficiencies in the audit process."

Records That Must be Retained

The records that must be retained under the rule include "workpapers and other documents that form the basis of the audit or review and memoranda, correspondence, communications, other documents, and records (including electronic records), which:

- are created, sent or received in connection with the audit or review; and
- contain conclusions, opinions, analyses, or financial data related to the audit or review."

The rule separately defines "workpapers" as "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by the standards established or adopted by the SEC or by the Oversight Board." In its adopting release, the SEC further noted that financial information that the auditor examines on the issuer's premises, but that are not made part of the audit, would not be deemed to be received by the auditor, and need not be retained by the auditor under the new rules.

Rule 2-06 also requires the retention of records relevant to the audit or review, or contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions regarding that matter or the audit or review. The significance of a matter is to be determined "based on an objective analysis of the facts and circumstances."

Disclosure of Accounting Fees

Previously, companies who filed proxy statements were required to disclose the fees paid to their principal accountants in their proxy statement. The new rules expand the required disclosure from the most recent fiscal year to the two most recent fiscal years. In addition, the types of fees required to be disclosed have been expanded and reorganized. The new rules require disclosure of (i) audit fees, (ii) audit-related fees, (iii) tax fees and (iv) all other fees. The rules also require disclosure of the policies of the audit committee regarding pre-approval of audit and non-audit services. The disclosure must be included in either the company's annual report or in its proxy statement if it determines to incorporate such information into their annual filings. The foregoing disclosure will be required to be made in periodic annual filings for the first fiscal year ending after December 15, 2003.

Effective Dates

The effective date for the final auditor independence rules is May 6, 2003. However, pursuant to transition periods set forth in the final rules release, an auditor's independence will not be deemed impaired:

- by employment relationships that began prior to May 6, 2003;

- by compensation earned or received during the accounting firm's fiscal year that includes May 6, 2003;

- by the provision of non-audit services before May 6, 2004, so long as those services are provided pursuant to contracts in existence as of May 6, 2003;

- by the provision of services before May 6, 2003 that are not pre-approved by the audit committee;

- by a lead partner's years of service as such before May 6, 2003 (regardless of how long), until the first day of the issuer's fiscal year that begins after May 6, 2003;

- by a concurring partner's years of service as such before May 6, 2004 (regardless of how long), until the first day of the issuer's fiscal year that begins after May 6, 2004; and

- by an audit partner's years of service as such, other than a lead or concurring partner, prior to May 6, 2003.

Additional Information

If you have any questions, please call Brian Ross at (212) 818-8610 or Marci J. Frankenthaler at (212) 818-8892. We intend to provide updates to this memorandum and our previous memoranda regarding the implementation of the provisions of the Sarbanes-Oxley Act of 2002 as warranted at our website www.graubard.com. When visiting our website for updates, please review the section entitled "Articles."