



# Federal Register

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**Wednesday,  
November 27, 2002**

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**Part III**

## **Securities and Exchange Commission**

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**17 CFR Part 210**

**Retention of Records Relevant to Audits  
and Reviews; Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 210

[Release Nos. 33-8151; 34-46869; IC-25830; File No. S7-46-02]

RIN 3235-A174

### Retention of Records Relevant to Audits and Reviews

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** As directed by section 802 of the Sarbanes-Oxley Act of 2002, we are proposing rules requiring accounting firms to retain for five years certain records relevant to their audits and reviews of issuers' financial statements. Records to be retained would include an accounting firm's workpapers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review.

**DATES:** Comments should be received on or before December 27, 2002.

**ADDRESSES:** You should send three copies of your comments to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. You also may submit your comments electronically to the following address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please use only one method of delivery. All comment letters should refer to File No. S7-46-02; this file number should be included in the subject line if you use electronic mail. Comment letters will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102. We will post electronically-submitted comment letters on the Commission's Internet Web site (<http://www.sec.gov>). We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

**FOR FURTHER INFORMATION CONTACT:** Samuel L. Burke, Associate Chief Accountant, Robert E. Burns, Chief Counsel, or D. Douglas Alkema, Professional Accounting Fellow, at (202) 942-4400, Office of the Chief Accountant, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-1103.

**SUPPLEMENTARY INFORMATION:** We are proposing to add rule 2-06 to Regulation S-X.

### I. Executive Summary

As mandated by section 802 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or "the Act"),<sup>1</sup> we are proposing to amend Regulation S-X to require accountants who audit or review an issuer's financial statements to retain certain records relevant to that audit or review for a period of five years from the end of the fiscal year in which an audit or review was concluded. These records would 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. Records described in the proposed rules would be retained whether the conclusions, opinions, analyses, or financial data in the records would support or cast doubt on the final conclusions reached by the auditor.

### II. Discussion of Proposed Rule

Section 802 of the Sarbanes-Oxley Act<sup>2</sup> is intended to address the

<sup>1</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>2</sup> Section 802 of the Sarbanes-Oxley Act, among other things, adds sections 1519 and 1520 to Chapter 73 of Title 18 of the United States Code. Section 1519 states, among other things, that anyone who knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence an investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under the bankruptcy code, or in relation to or contemplation of any such matter or case, may be fined, imprisoned for not more than 20 years, or both.

Section 1520(a)(1) specifies that: "Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 applies, shall maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded." Section 1520(a)(2) directs the Commission to promulgate, by January 26, 2003:

"\* \* \* such rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by an accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies. The Commission may, from time to time, amend or supplement the rules and regulations that it is required to promulgate under this section, after adequate notice and an opportunity for comment, in order to ensure that such rules and regulations adequately comport with the purposes of this section."

destruction or fabrication of evidence and the preservation of "financial and audit records."<sup>3</sup> We are directed under that section to promulgate rules related to the retention of records relevant to the audits and reviews of financial statements that issuers file with the Commission.

Section 802 states that the record retention requirements should apply to audits of issuers of securities to which section 10A(a) of the Securities Exchange Act of 1934 ("Exchange Act") applies. The term "issuer" in this context is defined in section 10A(f) of the Exchange Act to include certain entities filing reports under that Act and entities that have filed and not withdrawn registration statements to sell securities under the Securities Act of 1933.<sup>4</sup> We also are proposing that the record retention requirements apply to any audit or review of the financial statements of any registered investment company.<sup>5</sup> We believe that it is

Section 1520 also provides that any person who knowingly and willfully violates subsection (a)(1), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), may be fined, imprisoned for not more than 10 years, or both. It further provides that nothing in section 1520 shall be deemed to diminish or relieve any person of any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying, any document.

<sup>3</sup> Floor statement by Senator Leahy, 148 Cong. Rec. S7418 (July 26, 2002).

<sup>4</sup> Section 802 states that the record retention requirement applies to "an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies." Section 10A(a) of the Securities Exchange Act of 1934 ("Exchange Act") states, "Each audit required pursuant to this title of the financial statements of an issuer by an independent public accountant shall include" designated procedures. Section 10A(f), which has been added to the Exchange Act by section 205(d) of the Sarbanes-Oxley Act, states: "As used in this section the term 'issuer' means an issuer (as defined in section 3 [of the Exchange Act]), the securities of which are registered under section 12, or that is required to file reports pursuant to section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), and that it has not withdrawn." Section 3(a)(8) of the Exchange Act, 15 U.S.C. 78c(a)(8), states that, with certain exceptions, an "issuer" is "any person who issues or proposes to issue any security\* \* \*."

Neither section 802 nor the proposed rules exempt auditors of foreign issuers' financial statements. Accordingly, the retention requirements would apply to domestic and foreign accounting firms conducting audits or reviews of foreign issuers' financial statements.

Because investment advisers and broker-dealers are not necessarily issuers, audits of their financial statements required for regulatory purposes would not be subject to the proposed rules. In other words, only the audits of the financial statements of investment advisers and broker-dealers meeting the definition of "issuer" in section 10A(f), or that are registered investment companies, would be subject to the retention requirements in the proposed rules.

<sup>5</sup> See section 8 of the Investment Company Act of 1940, 15 U.S.C. 80a-8.

important for these record retention requirements, like our other record retention requirements, to apply consistently with respect to all registered investment companies, regardless of whether they fall within the periodic reporting requirements of the Exchange Act.<sup>6</sup>

#### *Documents To Be Retained and Time of Retention*

Paragraph (a) of proposed rule 2-06 would identify the documents that must be retained and the time period for retaining those documents.<sup>7</sup> In both instances, we have followed the guidance in section 802.

The proposed rule would require that the auditor<sup>8</sup> retain workpapers and other documents that form the basis of the audit or review of an issuer's financial statements, and memoranda, correspondence, communications, other documents, and records (including electronic records) that meet two criteria. The two criteria are that the materials (1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review. The proposed rule, therefore, would require an auditor to retain any materials satisfying both criteria. Non-substantive materials that are not part of the workpapers, however, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions or analyses would not meet the second of these criteria and would not have to be retained.<sup>9</sup>

<sup>6</sup> Cf. rules 31a-1 and 31a-2 under the Investment Company Act of 1940, 17 CFR 270.31a-1 and 31a-2 (record-keeping and record-retention requirements for registered investment companies).

<sup>7</sup> The Commission's proposals are not intended to pre-empt or supersede any other federal or state record retention requirements.

<sup>8</sup> Proposed rule 2-06 uses the term "accountant," which is defined in rule 2-01(f)(1) of the Commission's auditor independence rules, 17 CFR 210.2-01(f)(1), to mean "a certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public or public accountant is affiliated." In a comparison release, the Commission is proposing to amend this definition to include the term "registered public accounting firm." We would apply the definition in rule 2-01(f)(1) to proposed rule 2-06. Because the definition would continue to reference certified public accountants and public accountants, the Commission could make the proposed rules effective before accounting firms register with the Public Company Accounting Oversight Board.

<sup>9</sup> Senator Leahy stated on the Senate floor, "Non-substantive materials, however, which are not relevant to the conclusions or opinions expressed (or not expressed), need not be included in such

The period for retention of these materials is five years after the end of the fiscal period in which an accountant audits or reviews an issuer's financial statements,<sup>10</sup> which is the period prescribed by section 802.<sup>11</sup>

Section 103 of the Sarbanes-Oxley Act directs the Public Company Accounting Oversight Board ("the Board") to require auditors to retain for seven years audit workpapers and other materials that support the auditor's conclusions in any audit report.<sup>12</sup> There may be fewer documents retained pursuant to section 103, which focuses more on workpapers that support the auditor's conclusions, than under section 802, which includes not only workpapers but also other documents that meet the criteria noted in this release. Many documents, however, may be covered by both retention requirements.

#### *Workpapers Defined*

Section 802 is intended to require the retention of more than what traditionally has been thought of as an auditor's "workpapers."<sup>13</sup> To clarify the distinction between workpapers and other materials that would be retained, paragraph (b) of the proposed rules would define the term "workpapers." The legislative history to this section states that the term is to be used as it is "widely understood" by the Commission and by the accounting profession.<sup>14</sup> We believe that the term is understood to refer to the documents

retention regulations." 148 Cong. Rec. S7419 (July 26, 2002).

<sup>10</sup> The retention period is not based on the fiscal period covered by the financial statements being audited or reviewed, but when the audit or review occurs. For example, if a company has a calendar year-end fiscal year, for an audit of year 2002 financial statements that concludes in February or March 2003, the records would be required to be retained until January 1, 2009.

<sup>11</sup> See Statement of Senator Leahy on the Senate floor: "[I]t is intended that the SEC promulgate rules and regulations that require the retention of such substantive material \* \* \* for such a period as is reasonable and necessary for effective enforcement of the securities laws and the criminal laws, most of which have a five-year statute of limitations." 148 Cong. Rec. S7419 (July 26, 2002).

<sup>12</sup> The Board is required under section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act to adopt an auditing standard that requires accounting firms registered with the Board to " \* \* \* maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report."

<sup>13</sup> Senator Leahy stated on the Senate floor that section 802 "requires the SEC to promulgate reasonable and necessary regulations \* \* \* regarding the retention of categories of electronic and non-electronic audit records, which contain opinions, conclusions, analysis or financial data, in addition to the actual work papers." 148 Cong. Rec. S7418 (July 26, 2002).

<sup>14</sup> Statement by Senator Leahy on the Senate floor, 148 Cong. Rec. S7418 (July 26, 2002).

required to be retained by generally accepted auditing standards ("GAAS").

GAAS does not use the specific term "workpapers"<sup>15</sup> but Statement on Auditing Standards No. 96, "Audit Documentation," states, in part:

The auditor should prepare and maintain audit documentation, the content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of the auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement.<sup>16</sup>

We have placed the body of this provision into paragraph (b) and stated that "workpapers" means "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the Commission or by the Public Company Accounting Oversight Board."<sup>17</sup> The proposed rule, therefore, recognizes that the Board, subject to Commission oversight, has the ability to review and change the nature and scope of the required documentation of procedures, evidence, and conclusions related to audits and reviews of financial statements.<sup>18</sup>

#### *Differences of Opinion*

SAS 96 states that audit documentation serves mainly to provide the principal support for the auditor's report and to aid the auditor in the conduct and supervision of the audit.<sup>19</sup> In order to ensure that the purposes of the Act are fulfilled, we have included in paragraph (c) of the proposed rules the specific requirement that the materials retained under paragraph (a) would include not only those that support an auditor's conclusions about the financial statements but also those materials that may "cast doubt" on

<sup>15</sup> American Institute of Certified Public Accountants ("AICPA"), Statement on Auditing Standards No. ("SAS") 96, "Audit Documentation," at footnote 1, however, acknowledges that: "Audit Documentation also may be referred to as *working papers*"; Codification of Statements on Auditing Standards ("AU") § 339.

<sup>16</sup> SAS 96, at ¶ 1; AU § 339.01. This paragraph also states: "The quality, type, and content of audit documentation are matters of the auditor's professional judgment." The proposed rule does not include this sentence, but instead notes that the Commission or the Board may reexamine these requirements in the auditing standards.

<sup>17</sup> Prior to the establishment or adoption of auditing standards by the Board, "workpapers" would continue to mean the documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement as required by GAAS.

<sup>18</sup> See section 103(a) of the Sarbanes-Oxley Act.

<sup>19</sup> SAS 96, at ¶ 3; AU § 339.03

those conclusions.<sup>20</sup> Paragraph (c) is intended to ensure the preservation of those records that reflect differing professional judgments and views (both within the accounting firm and between the firm and the issuer) and how those differences were resolved. To better communicate what we intend by “cast doubt” on the auditor’s conclusions, we have included in the proposed rule the example of documentation of differences of opinion concerning accounting and auditing issues.

The auditor in a variety of contexts may create materials related to differences of opinion. For example, SAS No. 22, “Planning and Supervision,” states in part:

The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his disagreement with the conclusions reached if, after appropriate consultation, he believes it necessary to disassociate himself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.<sup>21</sup>

An interpretation of this section issued by the AICPA’s Auditing Standards Board emphasizes the professional obligation on each person involved in an audit engagement to bring his or her concerns to the attention of others in the firm and, as appropriate, to document those concerns. This interpretation states:

Accordingly, each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm, disagreements or concerns the assistant might have with respect to accounting and auditing issues that he believes are of significance to the financial statements or auditor’s report, however those disagreements or concerns may have arisen. In addition, each assistant should have a right to document his disagreement if he

<sup>20</sup> Senator Leahy stated on the Senate floor: In light of the apparent massive document destruction by Andersen, and the company’s apparently misleading document retention policy, even in light of its prior SEC violations, it is intended that the SEC promulgate rules and regulations that require the retention of such substantive material, including material that casts doubt on the views expressed in the audit or review, for such a period as is reasonable and necessary for effective enforcement of the securities laws and the criminal laws, most of which have a five-year statute of limitations.

148 Cong. Rec. S7419 (July 26, 2002).

<sup>21</sup> SAS 22, ¶ 22 (as amended by SAS 47, 48 and 77); AU § 311.22. “Assistants,” in the context of the first sentence of the quoted paragraph, should be defined broadly and include other partners who are on the audit engagement team.

believes it is necessary to disassociate himself from the resolution of the matter.<sup>22</sup>

In addition, SAS 96 states that the documentation for an audit should include the findings or issues that in the auditor’s judgment are significant, the actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached.<sup>23</sup> For example, if a memorandum is prepared by a member of a large accounting firm’s national office that is critical of the accounting used by an audit client, or of a position taken by the partner in charge of the audit of those financial statements, that memorandum should be retained.<sup>24</sup> Another example would be documentation related to an auditor’s communications with an issuer’s audit committee about alternative disclosures and accounting methods used by the issuer that are not the disclosures or accounting preferred by the auditor.<sup>25</sup>

We believe that retaining the materials created under SAS 22 and SAS 96, as well as other materials that might cast doubt on the conclusions reflected in the auditor’s report, would be consistent with the letter and spirit of the Sarbanes-Oxley Act.

<sup>22</sup> “Planning and Supervision: Auditing Interpretations of Section 311,” AU § 9311.37. “Assistants,” in the context of this interpretation, should be defined broadly and include other partners who are on the audit engagement team.

<sup>23</sup> SAS 96, ¶ 9; AU § 339.09, which states: In addition, the auditor should document findings or issues that in his or her judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached.

*See also*, SAS 96, ¶ 6; AU § 339.06, which states: Audit documentation should be sufficient to (a) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained; (b) indicate the engagement team member(s) who performed and reviewed the work; and (c) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

<sup>24</sup> Such a memorandum might be prepared in connection with the consultation process that is part of an accounting firm’s quality controls. *See, e.g.*, Section 103(a)(2)(B)(i) of the Sarbanes-Oxley Act. Superseded drafts or auditor review notes that do not reflect a difference of opinion, however, would not have to be retained.

<sup>25</sup> Section 204 of the Sarbanes-Oxley Act adds section 10A(k) to the Exchange Act and requires auditors to report certain matters to audit committees, including: “(a) all critical accounting policies and practices to be used, (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and (3) other material written communications between the registered public accounting firm and the management of the issuer, such as the management letter or schedule of unadjusted differences.”

### Request for Comment

• Are the “workpapers” and other documents that would be required to be retained under this proposed rule sufficiently described? If not, what changes should be made to provide for greater clarity? Are there alternative definitions that would better implement section 802?

• Would auditors have to implement significant changes to their retention policies or internal control processes and procedures, as well as system upgrades, to ensure compliance with the proposed rule? If so, what types of changes most likely would be required? How can we minimize any required changes consistent with section 802?

• Would auditors circumvent the proposed record retention requirements by, for example, replacing written communications with oral communications? If so, what additional measures should be taken?

• Section 103 of the Sarbanes-Oxley Act directs the Public Company Accounting Oversight Board to adopt an auditing standard that requires each registered public accounting firm to retain for a period of not less than seven years audit workpapers and other information that support the conclusions in the auditor’s report. Should the retention period in the proposed rules be extended to seven years to coincide with the retention period in section 103? Why?

• Should the retention period be for some other appropriate period based on consideration of other factors, such as the utility of the records to investors, regulators or litigants, the cost of retaining the records, or the size of the accounting firm?

• Audits of the financial statements of many investment advisers and broker-dealers would not be subject to the proposed rules because they are not “issuers” of securities. Should the proposals be amended to apply the retention period to audits of the financial statements of these entities? Why?

• The proposed rules would incorporate the definition of “issuer” in new section 10A(f) of the Exchange Act? Should “issuer” be defined more broadly to include any issuer of securities with respect to which a registration statement or report is filed with the Commission? Why?

• Should there be a document retention requirement for issuers as well as auditors? If yes, what would be the scope and nature of that requirement? For example, should issuers be required to retain records that the auditor reviewed but did not include in the

audit workpapers? Should issuers be required to keep copies of all correspondence with the auditors and copies of documents provided to the auditors?

- Section 32(c) of the Investment Company Act of 1940 authorizes the Commission to adopt rules to require accountants and auditors to keep reports, work sheets, and other documents and papers relating to registered investment companies for such periods as the Commission may prescribe, and to make these documents and papers available for inspection by the Commission and its staff. Should we use our authority under this section to extend proposed rule 2–06 by requiring that audit workpapers and other documents required to be retained with respect to the audit or review of investment company financial statements be made available for inspection by the Commission and its staff?

- The proposed rules would apply to foreign auditors. Are there statutes, rules or standards in foreign jurisdictions that govern the retention of records by foreign auditors that are different from and potentially conflict with the requirements of the proposed rules? If so, how is the foreign law incompatible with the specific provisions of the proposed rules?

- Does the “cast doubt on the final conclusions reached by the auditor” provision in the proposed rules adequately capture the scope of the retention requirements under the Sarbanes-Oxley Act? Should the scope be narrower or broader? Would a different test be more appropriate, such as “significant differences in professional judgment,” or “differences of opinion on issues that are material to the issuer’s financial statements or to the auditor’s final conclusions regarding any audit or review”?

- Should the rules include other examples of materials that “cast doubt” on auditors’ conclusions? If so, what examples should be included?

### III. General Request for Comments

We invite any interested person wishing to submit written comments on the proposed rules to do so. We specifically request comments from investors, accounting firms and issuers. We solicit comment on each component of the proposal.

### IV. Paperwork Reduction Act

Certain provisions of the proposed rules contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”) (44 U.S.C. 3501 *et*

*seq.*), and the Commission has submitted them to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Compliance with the proposed requirements would be mandatory. The proposed rules would require that accounting firms retain certain records for five years. Retained information would be kept confidential unless or until made public during an enforcement, disciplinary or other legal or administrative proceeding.

The title for the collection of information is “Regulation S–X—Record Retention.” We are applying for a new OMB Control Number for this collection.

As mandated by section 802 of the Sarbanes-Oxley Act of 2002, we are proposing to amend Regulation S–X to require accountants who audit or review an issuer’s financial statements to retain certain records relevant to that audit or review for a period of five years from the end of the fiscal year in which an audit or review was concluded. The proposed rules do not require accounting firms to create any new records.

The records to be retained would 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. Records described in the proposed rules would be retained whether the conclusions, opinions, analyses, or financial data in the records would support or cast doubt on the final conclusions reached by the auditor. The required retention of audit and review records should discourage the destruction, and assist in the availability, of records that may be relevant to investigations conducted and litigation brought under the securities laws.

We estimate that approximately 850 accounting firms audit and review the financial statements of approximately 20,000 public companies and registered investment companies filing financial statements with the Commission.<sup>26</sup> Each

<sup>26</sup> These estimates are based on information in Commission databases. The number of public companies includes those filing annual reports and

firm currently is required to perform its audits and reviews in accordance with generally accepted auditing standards (“GAAS”), which require auditors to retain certain documentation of their work.<sup>27</sup> Accounting firms, therefore, currently make decisions about the retention of each record created during the audit or review. GAAS, however, currently does not require explicitly that auditors retain documents that may “cast doubt” on their opinions and GAAS does not set definite retention periods. As a result, the proposed rule might result in the retention of more records than currently required under GAAS, and might result in some accounting firms keeping those records for a longer period of time.

The Commission, through its experience in matters pertaining to accounting firms, believes that many accounting firms retain records of audits and reviews of the financial statements of current clients for five or more years. Once an issuer is no longer a client, some firms currently may dispose of those records before the expiration of the five-year period. It is important to note, however, that the proposed rules do not require the creation of any record, they require only that existing records be maintained for the prescribed time period. It also is important to note that decisions about the retention of records currently are made as a part of each audit or review.

We do not anticipate any significant increase in burden hours for accounting firms or issuers because the proposed rules do not require the creation of records, would not significantly increase procedures related to the review of documents, and minimal, if any, work would be associated with the retention of these records. The disposal of those records, which would occur in any event, merely would be delayed. In addition, because an already large and ever-increasing portion of the records required to be retained are kept electronically, we do not anticipate that the incremental increase in storage costs for documents would be significant for any firm or for any single audit client. To cover all increases in burden hours,

those filing registration statements to conduct initial public offerings. The same auditors also audit the financial statements of approximately 5,587 investment companies.

<sup>27</sup> See American Institute of Certified Public Accountants (“AICPA”), Statement on Auditing Standards No. (“SAS”) 96, “Audit Documentation”; Codification of Statements on Auditing Standards (“AU”) 339. GAAS does not specify a required retention period. The documents to be retained under SAS 96 include those indicating the auditing procedures applied, the evidence obtained during the audit, and the conclusions reached by the auditor in the engagement.

we estimate that, on average, the incremental burden on firms would be no more than one hour for each public company audit client, or approximately 15,000 hours.<sup>28</sup>

Pursuant to 44 U.S.C. 3506(c)(2)(B), we solicit comments to: (1) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (4) evaluate whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-46-02. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-46-02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

## V. Cost—Benefit Analysis

The record retention requirements that we propose would implement a congressional mandate. We recognize that any implementation of the Sarbanes-Oxley Act likely will result in

<sup>28</sup> This burden accounts for incidental reading and implementation of the proposed rule. Fifteen thousand burden hours should be sufficient to cover the audits and reviews of not only public companies but also registered investment companies. Because of the nature and scope of the audits of investment companies, there would be an even smaller and insignificant incremental burden imposed on those audits than on the audits of public companies.

costs as well as benefits and will have an effect on the economy.

We are sensitive to the costs and benefits imposed by our rules, and we have identified certain costs and benefits of these proposals. We request comments on all aspects of this cost-benefit analysis, including the identification of any additional costs or benefits. We encourage commenters to identify and supply relevant data concerning the costs or benefits of the proposed rules.

### A. Background

Under section 802 of the Sarbanes-Oxley Act, accountants who audit or review an issuer's financial statements must retain certain records relevant to that audit or review for a period of five years from the end of the fiscal year in which an audit or review was concluded. The proposed rules would implement this provision and indicate the records to be retained, but they do not require accounting firms to create any new records.

The records to be retained would 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. Records described in the proposed rules would be retained whether the conclusions, opinions, analyses, or financial data in the records would support or cast doubt on the final conclusions reached by the auditor. The required retention of audit and review records should discourage the destruction, and assist in the availability, of records that may be relevant to investigations conducted under the securities laws.

### B. Potential Benefits of the Proposed Rules

The proposed rules would require that certain records relevant to the audit and review of an issuer's financial statements be retained for five years. To the extent that the proposals increase the availability of documents beyond current professional practices, the proposed rules may benefit investigations and litigation conducted by the Commission and others. Increased retention of these records may provide important evidence of financial reporting improprieties or deficiencies in the audit process.

One of the most important factors in the successful operation of our

securities markets is the trust that investors have in the reliability of the information used to make voting and investment decisions. In addition to providing materials for investigations, the availability of the documents subject to the proposed rules might facilitate greater oversight of audits and improved audit quality, which, in turn, ultimately could increase investor confidence in the reliability of reported financial information.

### C. Potential Costs of the Proposal

We estimate that approximately 850 accounting firms audit and review the financial statements of approximately 20,000 public companies and registered investment companies filing financial statements with the Commission.<sup>29</sup> Each firm currently is required to perform its audits and reviews in accordance with generally accepted auditing standards ("GAAS"), which require auditors to retain certain documentation of their work.<sup>30</sup> Accounting firms, therefore, currently make decisions about the retention of each record created during the audit or review. GAAS, however, does not require explicitly that auditors retain documents that may "cast doubt" on their opinions and GAAS does not set definite retention periods. As a result, the proposed rule might result in the retention of more records than currently required under GAAS, and might result in some accounting firms keeping those records for a longer period of time.

The Commission, through its experience in matters pertaining to accounting firms, believes that many accounting firms retain records of audits and reviews of the financial statements of current clients for five or more years. Once an issuer is no longer a client, some firms currently may dispose of those records before the expiration of the proposed five-year period. It is important to note, however, that the proposed rules do not require the creation of any record; they require only that existing records be maintained for the prescribed time period. It also is important to note that decisions about the retention of records currently are made as a part of each audit or review.

<sup>29</sup> These estimates are based on information in Commission databases. The number of public companies includes those filing annual reports and those filing to conduct an initial public offering. The same auditors also audit the financial statements of approximately 5,587 investment companies.

<sup>30</sup> See American Institute of Certified Public Accountants ("AICPA"), Statement on Auditing Standards No. ("SAS") 96, "Audit Documentation"; Codification of Statements on Auditing Standards ("AU") 339.

We do not anticipate any significant increase in costs for accounting firms or issuers because the proposed rules do not require the creation of records, would not significantly increase procedures related to the review of documents, and minimal, if any, work would be associated with the retention of these records. The disposal of those records, which would occur in any event, merely would be delayed. In addition, because an already large and ever-increasing portion of the records required to be retained are kept electronically, we do not anticipate that the incremental increase in storage costs for documents would be significant for any firm or for any single audit client.

For purposes of the Paperwork Reduction Act, we estimated the total burden to be 15,000 burden hours. Assuming an accounting firm's average cost of in-house staff is \$110 per hour,<sup>31</sup> the total cost would be \$1,650,000.

#### D. Request for Comments

As noted above, we request comments on all aspects of this cost-benefit analysis, including the identification of any additional costs or benefits. We encourage commenters to identify and supply relevant data concerning the costs or benefits of the proposed amendments. We request comments, including supporting data, on the magnitude of the costs and benefits mentioned in this section.

- Are there any other costs or benefits that we have not identified? For example, would the cost of audits increase? Please describe any such costs and provide relevant data.

- Are there additional costs related to the proposed rules? If there are, please identify them and provide supporting data.

- Are there measures that the Commission should take, such as encouraging accounting firms to keep more records electronically, to lower storage costs?

- We request comments on the reasonableness of the burden hours, cost estimates, and underlying assumptions related to the proposed disclosures.

<sup>31</sup> We estimate that associates would perform three-fourths of the required work, with a partner performing about one-fourth of the work. We also estimate that, on average, an associate's annual salary would be approximately \$125,000 and a partner's annual compensation would be approximately \$500,000. Based on these amounts, the in-house cost of an associate's time would be approximately \$65 per hour, and the in-house cost of a partner's time would be approximately \$250 per hour. The average hourly rate, therefore, would be about \$110 per hour  $((3 \times \$65) + \$250) / 4$ .

## VI. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>32</sup> the Commission is requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commentators should provide empirical data to support their views.

Section 23(a)(2) of the Exchange Act<sup>33</sup> requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. In addition, Section 2(b) of the Securities Act of 1933,<sup>34</sup> Section 3(f) of the Exchange Act,<sup>35</sup> and Section 2(c) of the Investment Company Act<sup>36</sup> require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.

We believe that the proposed rules would not have an adverse impact on competition. To the extent the proposed rules would increase the quality of audits and the efficiency of enforcement and disciplinary proceedings, there might be an increase in investor confidence in the efficacy of the audit process and the efficiency of the securities markets.

We request comment on the anti-competitive effects of the proposals.

The possible effects of our rule proposals on efficiency, competition, and capital formation are difficult to quantify. We request comment on these matters in connection with our proposed rules.

## VII. Initial Regulatory Flexibility Act Analysis

This Initial Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to proposed revisions to Regulation S–X. The proposals would require the retention of certain audit and review documentation.

### A. Reasons for the Proposed Action

The proposed rules generally carry out a congressional mandate. The proposed rules, in general, would prohibit destruction for five years of certain records related to the audit or

review of an issuer's financial statements.<sup>37</sup> The proposed rules would not require accounting firms to create any new records.

### B. Objectives

Our objectives are to implement section 802 of the Sarbanes-Oxley Act in order to increase investor confidence in the audit process and in the reliability of reported financial information. This would be accomplished by defining the records to be retained related to an audit or review of an issuer's financial statements. Having these records available should enhance oversight of corporate reporting and of the performance of auditors and facilitate the enforcement of the securities laws.

### C. Legal Basis

We are proposing amendments to Regulation S–X under the authority set forth in sections 3(a) and 802 of the Sarbanes-Oxley Act, and Schedule A and Sections 7, 8, 10, 19 and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, Sections 5, 10, 14 and 20 of the Public Utility Holding Company Act of 1935, and Sections 8, 30, 31, 32(c) and 38 of the Investment Company Act of 1940.

### D. Small Entities Subject to the Proposed Rules

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.<sup>38</sup> 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 request comment on the number of accounting firms with revenue under \$6 million that audit issuers' financial statements.

### E. Reporting, Recordkeeping and Other Compliance Requirements

Under the proposed rules,<sup>39</sup> accountants who audit or review an issuer's financial statements must retain certain records relevant to that audit or review for a period of five years from the end of the fiscal year in which an audit or review was concluded. These records would include workpapers and other documents that form the basis of the audit or review and memoranda, correspondence, communications, other

<sup>32</sup> Pub. L. No. 104–121, tit. II, 110 Stat. 857 (1996).

<sup>33</sup> 15 U.S.C. 78w(a)(2).

<sup>34</sup> 15 U.S.C. 77b(b).

<sup>35</sup> 15 U.S.C. 78c(f).

<sup>36</sup> 15 U.S.C. 80a–2(c).

<sup>37</sup> See section 802 of the Sarbanes-Oxley Act.

<sup>38</sup> 13 CFR 121.201.

<sup>39</sup> See section 802 of the Sarbanes-Oxley Act of 2002.

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. Records described in the proposed rules would be retained whether the conclusions, opinions, analyses, or financial data in the records would support or cast doubt on the final conclusions reached by the auditor. The required retention of audit and review records should discourage the destruction, and assist in the availability, of records that may be relevant to investigations conducted under the securities laws.

The Commission, through its experience in matters pertaining to accounting firms, believes that many accounting firms retain records of audits and reviews of the financial statements of current clients for longer periods of time than for former clients.

We do not anticipate any significant increase in costs for small accounting firms or small issuers because the proposed rules do not require the creation of records, would not significantly increase procedures related to the review of documents, and minimal, if any, work would be associated with the retention of these records. The disposal of those records, which would occur in any event, merely would be delayed. In addition, because an already large and ever-increasing portion of the records required to be retained are kept electronically, we do not anticipate that the incremental increase in storage costs for documents would be significant for any firm or for any single audit client.

#### *F. Duplicative, Overlapping or Conflicting Federal Rules*

The Commission is not aware of any current rules that duplicate, overlap, or conflict with the proposed rules. The proposed rules contemplate that the Board will define "workpapers," as required in section 103 of the Sarbanes-Oxley Act. Our proposal is designed to not conflict with the Board's rule.

#### *G. Significant Alternatives*

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

1. The establishment of differing compliance or reporting requirements or timetables that take into account the resources of small entities;

2. The clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities;

3. The use of performance rather than design standards; and

4. An exemption from coverage of the proposed amendments, or any part thereof, for small entities.

The Sarbanes-Oxley Act provides the basis for the requirements and timetables for the proposed record retention rules. The proposed rules are designed to require the retention of those records necessary for oversight of the audit process, to enhance the reliability and credibility of financial statements for all public companies, and to facilitate enforcement of the securities laws.

We considered not applying the proposals to small accounting firms. We believe, however, that investors would benefit if accountants subject to the proposed record retention rules, regardless of their size, audit all companies.

Currently, we do not believe that it is feasible to further clarify, consolidate, or simplify the proposed rules for small entities. We invite comments, however, on whether the requirements could be simplified or clarified for small accounting firms.

#### *H. Solicitation of Comments*

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. Specifically, we request comments regarding the number of small entities that may be affected by the proposed rules, and the existence or nature of the potential impact on those small entities. We also seek comments on how to quantify the number of small accounting firms that would be affected by the proposals, how to quantify the impact of the proposed rules on those firms, and how to lower the cost of record retention for small accounting firms.

Commenters are requested to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposed rules.

#### **VIII. Codification Update**

The Commission proposes to amend the "Codification of Financial Reporting Policies" announced in Financial Reporting Release No. 1 (April 15, 1982):

By amending section 602 to add a new discussion at the end of that section under the Financial Reporting Release Number (FR-XX) assigned to the adopting release and including the text in the adopting release that discusses the final rules, which, if the proposals are adopted, would be substantially similar to Section II of this release.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

#### **IX. Statutory Bases and Text of Proposed Amendments**

We are proposing amendments to Regulation S-X under the authority set forth in sections 3(a) and 802 of the Sarbanes-Oxley Act, and Schedule A and Sections 7, 8, 10, 19 and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23 and 36 of the Exchange Act, Sections 5, 10, 14 and 20 of the Public Utility Holding Company Act of 1935, Sections 8, 30, 31, 32 and 38 of the Investment Company Act of 1940.

#### **List of Subjects in 17 CFR Part 210**

Accountants, Accounting.

#### **Text of Proposed Amendments**

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

1. The authority citation for Part 210 is revised to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77aa(25), 77aa(26), 78j-1, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), unless otherwise noted.

2. By adding § 210.2-06 to read as follows:

#### **§ 210.2-06 Retention of audit and review records.**

(a) For a period of five years after the end of the fiscal period in which an accountant concludes an audit or review of an issuer's financial statements to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies, or of the financial statements of any investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), the accountant shall retain 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:



(1) Are created, sent or received in connection with the audit or review, and

(2) Contain conclusions, opinions, analyses, or financial data related to the audit or review.

(b) For the purposes of paragraph (a) of this section, “workpapers” means documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards

established or adopted by the Commission or by the Public Company Accounting Oversight Board.

(c) Materials described in paragraph (a) of this section shall be retained whether the conclusions, opinions, analyses, or financial data in the materials support or cast doubt on the final conclusions reached by the auditor. For example, such materials shall include documentation of differences of opinion concerning accounting and auditing issues.

(d) For the purposes of paragraph (a) of this section, the term “issuer” means an issuer as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)).

Dated: November 21, 2002.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

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