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SEC Proposes Rules Strengthening Its Requirements Regarding Auditor Independence

The SEC has proposed new rules to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. The new rules would:

- revise the SEC's regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence;
- require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements;
- prohibit partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years and from returning to provide audit services to the same issuer within five years;
- prohibit an accounting firm from auditing an audit client's financial statements if certain members of management of that client had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures;
- require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and
- require additional disclosures to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.

In addition, under the proposed rules, an accountant would not be independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review and attest services.

The proposed rules would apply to both U.S. and foreign audit firms. In proposing these rules, the SEC stated that it was cognizant of the Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence issued by the International Organization of Securities Commissions in October 2002.

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The proposed rules are subject to a comment period ending on January 13, 2003. The Act requires the SEC to adopt final rules no later than January 26, 2003. Since the SEC is proposing changes which go beyond the provisions of the Act, it is soliciting comments on the appropriate timing for the implementation of the final rules in order to allow for an orderly transition.

I. Background

The Sarbanes-Oxley Act of 2002 (the "Act") requires the SEC to adopt rules, under which certain non-audit services would be prohibited, conflict of interest standards would be strengthened, auditor partner rotation and second partner review requirements would be strengthened, and the relationship between the independent auditor and the audit committee would be clarified and enhanced.

The proposed rules focus on key aspects of auditor independence:

- the provision of certain non-audit services and the unique ability of the audit committee to insulate the auditor from the pressures that may be exerted by management,
- the potential conflict of interest that can be created when a former member of the audit engagement team accepts a key management position with the audit client, and
- the need for effective communications between the auditor and audit committee.

The proposed rules also address the possibility of any partner, principal or shareholder who is a member of the audit engagement team being unduly influenced by financial incentives to sell non-audit services to the audit client.

II. Discussion of the Proposed Rules

A. Conflicts of Interest Resulting from Employment Relationships

Under the SEC's existing rules, a firm is not deemed to be independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm accepts employment with a client if he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. This requirement remains unchanged.

The proposed rules add a "cooling off" period that provides that the employment of audit engagement team members of an accounting firm in a financial reporting oversight role at an audit client within one year prior to the commencement of procedures for the current audit engagement would cause the accounting firm not to be independent with respect to that registrant. The proposed rules would apply to employment relationships entered into between audit engagement team members and their audit clients.

The Act specifies that the cooling off period must be one year. Under the proposed rules, the prohibition would commence one year prior to the earlier of either when the accountant began the current fiscal year's audit or when the accountant began review procedures necessary to conduct a timely review of the registrant's quarterly financial information associated with the current fiscal year.

The proposed rules define "financial reporting oversight role" as a role in which an individual has direct responsibility or oversight of those who prepare the registrant's financial statements and

related information (*e.g.*, management discussion and analysis), which will be included in a registrant's document filed with the SEC.

B. Service Outside the Scope of the Practice of Auditors

Section 201(a) of the Act amends Section 10A of the Securities Exchange Act of 1934 to provide that it shall be unlawful for a registered public accounting firm that performs an audit of an issuer's financial statements (and any person associated with such a firm) to provide to that issuer, contemporaneously with the audit, any non-audit service, including specified services set forth in the Act. There is an exception, however, for "any non-audit service, including tax services, that is not described" as a prohibited service, but only if the service has been pre-approved by the issuer's audit committee.

The non-audit services specified in the Act and the proposed rules relating to them are discussed below. According to the SEC's proposal, the rules are based on the principles that a company's auditors should not:

- audit their own work;
- function as part of management or an employee; and
- act as an advocate for their client.

(1) Bookkeeping or other services related to the audit client's accounting records or financial statements of the audit client.

Under the proposed rules, an auditor's independence is impaired if the auditor provides bookkeeping services to an audit client. Under the proposed rules, an accountant is not independent of an audit client if the accountant provides any service, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements, including:

- maintaining or preparing the audit client's accounting records;
- preparing the audit client's financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC; or
- preparing or originating source data underlying the audit client's financial statements.

The services described above are consistent with the existing definition of bookkeeping or other services. The proposed rules continue the existing prohibition on bookkeeping, but eliminate the limited situations where these services may be provided under the current rules.

Consistent with existing rules, the independence of accountants that prepare statutory financial statements that are not filed with the SEC for foreign companies would be impaired if those statements form the basis of the financial statements that are filed with the SEC. Under these circumstances, an auditor or accounting firm that has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant financial statements that were converted to comply with U.S. generally accepted accounting principles ("GAAP").

(2) Financial information systems design and implementation.

Under the proposed rules, an accountant is not independent of an audit client if the accountant:

- directly or indirectly, operates, or supervises the operation of, the audit client's information system or manages the audit client's local area network; and

- designs or implements a hardware or software system that aggregates source data underlying the financial statements or generates information that is "significant" to the audit client's financial statements or other financial information systems taken as a whole.

According to the proposing release, "significant" to the financial statements taken as a whole refers to information that is reasonably likely to be material to the financial statements of the audit client.

Consistent with existing rules, the proposed rules do not preclude an audit firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records so long as those services are pre-approved by the audit committee.

(3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.

Under the proposed rules, an accountant is not independent of an audit client if the accountant provides any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements.

Appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. They include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction.

The proposed rules do not prohibit an accounting firm from providing these types of services for non-financial reporting purposes (*e.g.*, transfer pricing studies, cost segregation studies). The proposed rules also do not limit an accounting firm from utilizing its own valuation specialist to review the work done by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements.

(4) Actuarial services.

Under the proposed rules, an accountant is not independent of an audit client if the accountant provides any advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client, where it is reasonably likely that the results of these services will be subject to audit procedures during an audit of the audit client's financial statements.

The proposed rules provide that the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities.

The proposed rules prohibiting actuarial services are significantly broader than the current rules, which generally bar auditors only from providing actuarial services related to insurance company policy reserves and related accounts.

(5) Internal audit outsourcing services.

Under the proposed rules, an auditor is not independent of an audit client when the auditor performs any internal audit services related to the internal accounting controls, financial systems or financial statements, for an audit client. This does not include nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function. It also does not include operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

Existing SEC independence rules contain an exception for small businesses, identified as those with assets totaling less than $200 million. However, the proposed rules contain no similar exception because, regardless of the entity's size, the Act appears to view the auditor as being in a position of auditing his or her own work if these services are provided.

(6) Management functions.

Under the proposed rules, an accountant is not independent of an audit client if the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. This is consistent with existing independence rules.

The SEC noted in its proposing release that so long as the auditor does not act as an employee or perform management functions, the auditor could provide services in connection with the assessment of internal accounting and risk management controls as well as recommendations for improvements and not impair his or her independence. Accordingly, the proposed rules continue to allow auditors to assess the effectiveness of internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls. However, designing and implementing internal accounting and risk management controls would be considered to impair the auditor's independence because the auditor is placed in the role of management.

(7) Human resources.

Under the proposed rules, an accountant is not independent of an audit client if the accountant:

- searches for or seeking out prospective candidates for managerial, executive, or director positions;
- advises an audit client about the design of its management or organization structure;
- engages in psychological testing, or other formal testing or evaluation programs;
- undertakes reference checks of prospective candidates for an executive or director position;

- acts as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

- recommends, or advises the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

The proposed rules in this area are substantially consistent with existing independence rules.

(8) Broker-dealer, investment adviser, or investment banking services.

Under the proposed rules, an auditor is deemed to lack independence when acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

The proposed rules are substantially the same as the SEC's existing rules relating to the provision of these types of services to audit clients. However, the proposed rules expand the current independence rules by adding prohibitions on serving as an unregistered broker-dealer.

The proposed rules are not meant to change the SEC's current position that an audit firm's broker-dealer division can cover an industry which includes an audit client when performing analyst functions. However, analysis of a specific audit client's stock places the auditor in the position of acting as an advocate for the client and would cause the auditor to lack independence.

(9) Legal services.

Under the proposed rules, an accountant is not independent of an audit client if the accountant provides any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

The SEC acknowledged in its proposing release that there may be implications for some foreign registrants from this proposal. For example, in some jurisdictions it is mandatory that someone licensed to practice law perform tax work, and an accounting firm providing such services, therefore, would be deemed to be providing legal services. Accordingly, the SEC has asked for comments on the implications of this proposal for foreign private issuers

(10) Expert services unrelated to the audit.

Under the proposed rules, an accountant is not independent of an audit client if the accountant provides expert opinions for an audit client in connection with legal, administrative, or regulatory proceedings or acts as an advocate for an audit client in such proceedings. This is different from existing rules under which an auditor was not deemed to lack independence for providing expert services to an audit client.

The proposed prohibition on the provision of expert services would include providing consultation and other services to an audit client's legal counsel in connection with litigation, administrative or regulatory proceedings. The prohibition on providing "expert" services included in

this rule proposal covers services that result in the accounting firm's specialized knowledge, experience and expertise being used to support the contentions of the audit client in various adversarial proceedings. Therefore, under the proposed rules, an auditor's independence would be impaired if the auditor were engaged by the audit client's legal counsel to provide expert witness or other services, including accounting advice, opinions or forensic accounting services, in connection with the client's participation in a legal, administrative, or regulatory proceeding.

The proposed rules would not prohibit an auditor from assisting the audit committee in fulfilling its responsibilities in connection with the financial reporting process. For example, Section 301 of the Act stipulates that each audit committee has the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. The SEC noted in the proposing release that it believed it was important that auditors be allowed to assist the audit committee in its capacity as investors' representatives. In this regard, the proposed rules would not prevent the auditors from assisting an audit committee in carrying out an investigation of a potential accounting impropriety, so long as the auditor does not take on the role of an advocate in the investigation. The proposed rules also would not prohibit an auditor from testifying as a fact witness to its audit work for a particular audit client. An accounting firm that, after receiving appropriate authorization from an audit client's audit committee, had prepared an audit client's tax returns, also could appear as a fact witness in tax court to explain how the returns were prepared.

(11) Tax services.

Tax services are not included among the non-audit services prohibited by the Act. According to the proposing release, the proposed rules are not intended to prohibit an accounting firm from providing tax services to its audit clients when those services have been pre-approved by the client's audit committee. While the proposing release did not define "tax services," it acknowledged that tax services can include a range of activities including the preparation of tax returns, tax compliance, tax planning, tax recovery, and other tax-related services. In addition, many engagements will require that an auditor review the tax accrual that is included in the financial statements. Reviewing tax accruals is part of audit services and is not, in and of itself, deemed to be a tax compliance service.

Classifying a service as a "tax service" however, does not mean that the service may not be within one of the categories of prohibited services or may not result in an impairment of independence under the proposed rules. The accounting firm and the registrant's audit committee should consider, for example, whether the proposed non-audit service is an allowable tax service or constitutes a prohibited legal service or expert service.

C. Partner Rotation

Section 203 of the Act requires rotation of the lead (or coordinating) audit partners having primary responsibility for the audit and the audit partner responsible for reviewing the audit on a five-year basis in order for a registered public accounting firm (as defined in the Act) to continue to provide audit services for an issuer.

The proposed rules go beyond the requirements specified by the Act with respect to determining which partners, principals and shareholders should be covered and require the rotation of:

- the lead partner, the concurring review partner, the client service partner, and other "line" partners directly involved in the performance of the audit;

- tax partners who perform significant services related to the audit engagement, to the extent that the services they provide are a necessary part of the accounting firm's ability to complete the audit;

- partners who serve on the engagement team that conducts the timely review of the registrant's interim financial information;

- partners who serve on the team that conducts the attest engagement on management's report on the registrant's internal controls (as required under Section 403 of the Act and the SEC's proposed rules); and

- partners who perform audit, review or attestation services to an investment company if he or she had performed such services for any entity within the investment company complex (as defined in rule 2-01(f)(14) of Regulation S-X) during the previous five consecutive years.

The proposed rules do not require the rotation of partners performing national office duties who may be consulted on specific accounting issues or partners who only provides tax services for the registrant. The proposed rules also do not require that all of the partners be rotated at the same time.

D. Audit Committee Administration of the Engagement

The proposed rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attestation engagements required under the securities laws. The proposals require that either:

- before the accountant is engaged by the audit client to provide services other than audit, review or attestation services, the audit client's audit committee expressly approve the particular engagement; or

- any such engagement be entered into pursuant to detailed pre-approval policies and procedures established by the audit committee and the audit committee be informed on a timely basis of each service.

As provided in the Act, the proposed rules recognize audit services to be broader than those services required to perform an audit pursuant to generally accepted auditing standards. For example, the Act identified services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services. In addition, statutory audits required by some domestic and foreign jurisdictions are considered to be audit services under the proposed rules. The proposed rules require that the audit committee pre-approve all such services. The audit committee is permitted to approve broadly the provision of audit, review and attestation services by the auditor to the issuer and its subsidiaries.

The audit committee would have the sole authority to pre-approve the engagement of the company's independent accountant to expressly perform particular non-audit services. In addition, the audit committee could establish policies and procedures, provided they are detailed as to the particular service and designed to safeguard the continued independence of the auditor. In accordance with the Act, one audit committee member is permitted to pre-approve the service.

The proposed rules require audit committee pre-approval of the non-audit services provided to an investment company issuer, as well as of the non-audit services provided to the investment adviser of an investment company issuer and any entity controlling, controlled by, or under common

control with the investment adviser that provides services to the investment company. Under the proposed rules, the investment company's audit committee would be able to establish policies and procedures for pre-approving non-audit services provided not only to the investment company issuer, but also its investment adviser and related entities that provide services to the fund.

E. Compensation

The proposed rules amend the auditor independence rules to address the practice of auditors being compensated by their firms for selling non-audit services to their audit clients. The proposed rules provide that an accountant is not independent if, at any point during the audit and professional engagement period, any partner, principal or shareholder of the accounting firm who is a member of the audit engagement team earns or receives compensation based on the performance of, or procuring of, engagements with that audit client, to provide any services, other than audit, review, or attest services.

"Compensation," as used in the proposed rule, includes any form of income or monetary benefit distributed to the partner, principal or shareholder. Compensation would be based on the performance or sale of non-audit services if the partner, principal, or shareholder were financially rewarded in any way for the performance or sale of such services.

F. Communication with Audit Committees

Section 204 of the Act directed the SEC to issue rules requiring timely reporting of specific information by auditors to audit committees. The proposed rules amend Regulation S-X to require each public accounting firm registered with the Public Company Accounting Oversight Board that audits an issuer's financial statements to report to the issuer's or registered investment company's audit committee, prior to the filing of such financial statements with the SEC:

- all critical accounting policies and practices used by the issuer or registered investment company;
- all alternative accounting treatments of financial information within generally accepted accounting principles that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and
- other material written communications between the accounting firm and management of the issuer or registered investment company.

These are discussed in more detail below.

(1) Critical accounting policies.

The proposed rules require communication by auditors to audit committees of all critical accounting policies and practices. This communication can be oral or written.

In December 2001, the SEC issued cautionary advice regarding disclosure of those accounting policies that management believes are most critical to the preparation of the issuer's financial statements. The cautionary advice indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. As part of that cautionary advice,

the SEC stated that audit committees should review the selection, application and disclosure of critical accounting policies prior to finalizing and filing annual reports. In addition, the SEC stated that, consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.

In May 2002, the SEC proposed rules to require disclosures that would enhance investors' understanding of the application of companies' critical accounting policies. The May 2002 proposed rules covered (1) accounting estimates a company makes in applying its accounting policies and (2) the initial adoption by a company of an accounting policy that has a material impact on its financial presentation.

In the current proposing release, the SEC suggested that auditors should consider referring to the December 2001 cautionary guidance as well as the May 2002 proposed rules as guides to determining the types of matters that should be communicated to the audit committee under the proposed rules. The proposed rules do not require that those discussions follow a specific form or manner, but the SEC suggested that it expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why certain estimates or policies are or are not considered critical and how current and anticipated future events impact those determinations. In addition, the SEC stated that it anticipates that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the auditors that were not included.

(2) Alternative accounting treatments.

The proposed rules require communication, either orally or in writing, by auditors to audit committees of alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm. The proposed rules are intended to cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

In the proposing release, the SEC stated that it believes that communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the auditors should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not the preferred method in the auditor's opinion, the SEC stated that it would expect that the reasons why the auditor's preferred method was not selected by management also would be discussed.

Communications regarding general accounting policies would focus on the initial selection of and changes in significant accounting policies, as required by AU § 380, and would include the impact of management's judgments and accounting estimates, as well as the auditor's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies would include the range of alternatives available under GAAP that were discussed by management and the auditors along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change would also be communicated. If the accounting policy selected is not the auditor's preferred policy, then the SEC would expect the discussions to

include the reasons why the auditor considered one policy to be preferred but that policy was not selected by management.

The SEC does not consider the separate discussion of critical accounting policies and estimates to be a substitute for communications regarding general accounting policies because the discussion about critical accounting policies and estimates might not encompass any new or changed general accounting policies and estimates.

(3) Other material written communications.

The proposed rules attempt to clarify the substance of information that would be provided by auditors to audit committees to facilitate auditor and management oversight by those committees.

The Act specifically cites the management letter and schedules of unadjusted differences as examples of material written communications to be provided to audit committees. Examples of additional written communications that the SEC suggested that it expected would be considered material to an issuer include:

- management representation letters;
- 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;
- engagement letters; and
- independence letters.

These examples are not exhaustive, and the SEC encouraged auditors to critically consider what additional written communications should be provided to audit committees.

(4) Timing of communications.

The Act requires that the communications discussed above should be timely reported to the audit committee. For purposes of the requirements of this provision, the proposed rules specify that the proposed communications between the auditor and the audit committee must occur prior to the filing of the audit report with the SEC pursuant to applicable securities laws. As a result, these discussions will occur, at a minimum, during the annual audit, but could occur as frequently as quarterly or more often on a real-time basis.

G. Expanded Disclosure

(1) Principal accountants' fees.

The proxy disclosure rules currently require that a registrant disclose the professional fees it paid to its principal independent accountant in the most recent fiscal year. Under the proposed rules, both the types of fees that must be detailed and the years of service that are covered by the disclosure will be changed.

Under the proposed rules, the disclosed categories of professional fees paid for audit and non-audit services would be:

- Audit fees, which would include fees paid to the principal accountant for services necessary to perform an audit or review in accordance with generally accepted auditing standards, and may also include services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attestation services, consents and assistance with and review of documents filed with the SEC.

- Audit-related fees, which would include assurance and related services that are traditionally performed by the independent accountant, such as, employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with proposed or consummated acquisitions, internal control reviews, consultation concerning financial accounting and reporting standards.

- Tax fees, which would include all services performed by professional staff in the independent accountant's tax division, including fees for tax compliance, consultation and planning.

- All other fees, which would include certain accounting, audit, assurance and related services that accountants must perform for their audit clients, as well as fees for financial information systems implementation and design.

The proposed rules require disclosure of these fees for each of the two most recent fiscal years, rather than just the most recent fiscal year as currently required. In addition, registrants will be required to describe in subcategories the nature of the services provided that are categorized as audit-related fees and all other fees. The proposed rules also include disclosure requirements related to audit committee pre-approval policies and procedures for audit and non-audit services provided by an independent public accountant as well as the percentage of fees that were pre-approved.

The disclosure of the percentage of audit services that are not provided by permanent, full-time employees of the independent public accounting firm, if more than 50%, remains unchanged from existing rules.

(2) Audit committee actions.

The proposed rules require that registrants filing proxy statements disclose any policies and procedures developed by the audit committee of the board of directors concerning pre-approval of the independent accountant to perform both audit and non-audit services.

The proposed disclosure would set out in detail the audit committee's policies and procedures for engaging the independent accountant to perform services other than audit, review and attestation services. The SEC stated that it expects registrants to provide clear, concise and understandable descriptions of the policies and procedures. Alternatively, registrants could include a copy of those policies and procedures with the proxy statement delivered to investors and filed with the SEC. Either method should allow shareholders to obtain a complete and accurate understanding of the audit committee's policies and procedures.

In addition, the SEC expects the policies and procedures to address auditor independence oversight functions. Additionally, these procedures should describe, if applicable, the specific processes in place that permit and monitor activities meeting the *de minimis* exception. The disclosure should also discuss what percentage of the fees reported in each of the "audit-related fees," "tax fees," and "all other fees" categories were pre-approved by the audit committee pursuant to the policies and procedures instituted by the audit committee.

(3) Location of disclosure.

Under the proposed rules, the new disclosure will be required to be included in a company's annual report, as well as in a company's proxy statement on Schedule 14A or information statement on Schedule 14C. Because the information is proposed to be included in Part III of annual reports on Forms 10-K and 10-KSB, domestic companies would be able to incorporate the required disclosures from the proxy or information statement into the annual report. Registrants that do not issue proxy statements would be required to include appropriate disclosures in their annual filing included in Form 10-K, Form 10-KSB, 20-F, Form 40-F and proposed Form N-CSR as appropriate. Asset-backed issuers and unit investment trusts are exempt from these disclosure requirements under the proposed rules.

The proposed rules require parallel disclosure for registered management investment companies in annual reports on proposed Form N-CSR. Like operating companies, registered management investment companies would also be required to include this information in proxy or information statements that relate to the election of directors, or the election, approval, or ratification of an independent public accountant. In addition, the disclosure regarding audit committee pre-approval policies and procedures for audit and non-audit services and professional fees billed by auditors should also be required in annual reports on proposed Form N-CSR
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This memorandum provides only a general overview of the SEC's proposed rules regarding auditor independence. It is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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