MCLE ON THE WEB

($15 PER CREDIT HOUR)
TEST # 39
1 HOUR CREDIT

To earn one hour of MCLE credit, read the substantive material, then download the test, answer the questions and follow the directions to submit for credit

Implementing The Sarbanes-Oxley Act

SEC adopts final rules on auditor independence, a key step in restoring public confidence in the economy

By BRIAN J. KAHLE and JULIE E. MCGUIRE

After 2001's economic downturn was worsened by numerous Enron-type scandals, Congress passed the Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 et seq., (the "Act"). The Act was signed into law by President Bush on July 30, 2002, and as a result, the U.S. Securities and Exchange Commission ("SEC"), the agency charged with promulgating rules and regulations to implement the Act, has experienced the most extensive rulemaking period in its 70-year history.

On Jan. 22, 2003, the SEC voted to adopt final rules to implement Title II of the Act: "auditor independence." Published in the Federal Register (Securities and Exchange Commis-sion, 68 Fed. Reg. 6006 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274)) on Feb. 5, 2003, the rules became effective on May 6. The issue of auditor independence is regarded by some commentators as the focal point of the legislation and the most important step toward restoring public confidence in the economy. This issue also is arguably the most controversial. What follows is an overview of the highlights of these new rule provisions.

The Sarbanes-Oxley Act applies only to registered public accounting firms alone and does not seek to regulate those small and medium-sized accounting firms that do not perform audits of public companies. A "registered public accounting firm," defined in Section 2 of the Act, is a public accounting firm that must be registered with the newly formed Public Company Accounting Oversight Board ("Oversight Board") before it is able to provide auditing services to a public company registered with the SEC. (See, 15 U.S.C. § 7201(12) (2003).)

Generally, then, the rules discussed here apply only to those accounting firms that perform audits for publicly traded companies. (However, this article still has relevance to non-registered firms since they will be required to look to state and other regulatory authorities that will likely be adopting regulations similar to those discussed here.)

A violation by any person of the Act or the auditor independence rules discussed here will subject the person to the same penalties as would a violation of the Securities Exchange Act of 1934 and related SEC rules. (See, 15 U.S.C. § 7202(b)(1) (2003); 17 C.F.R. § 240.10A-2 (effective May 6, 2003).) This could include civil penalties, criminal penalties or both. (See, e.g., 15 U.S.C. § 78u (2003); 18 U.S.C. § 1341 (2003).)

The SEC rules on audit independence can be organized into five key areas:

A. Prohibited non-audit services;
B. Audit committee pre-approval of services;
C. Partner rotation;
D. Conflict of interest; and
E. Increased communication and disclosure.

Prohibited non-audit services

Congress enumerated in Section 201 of the Act nine non-audit services that are prohibited from being contemporaneously performed for a public company client by any registered public accounting firm that is also serving as auditor of the client. (See, 15 U.S.C. § 78j-1(g) (2003).)

The SEC rules do not prohibit a firm from providing non-audit services to clients they are not auditing. The prohibited non-audit services are:

1. BOOKKEEPING. Generally, all bookkeeping services, such as maintaining accounting records, preparing financial statements or preparing source data, are prohibited from being performed by an auditing firm.

2. FINANCIAL INFORMATION SYSTEM DESIGN OR IMPLEMENTATION. An accounting firm may not provide any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements. (Id. at 6011 (to be codified at 17 C.F.R. § 210.2-01(c)(4)(ii)).)

3. APPRAISAL AND VALUATION SERVICES. Generally, an accounting firm is prohibited from performing services of appraising or valuing assets or liabilities or performing services involving a fairness opinion or contribution-in-kind

report for an audit client, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures. (Id. at 6012 (to be codified at 17 C.F.R. § 210.2-01(c)(4)(iii)).)

4. ACTUARIAL SERVICES. An accounting firm is prohibited from providing to an audit client any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements for the audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures. (Id. at 6012-6013 (to be codified at 17 C.F.R. § 210.2-01(c)(4)(iv)).)

5. INTERNAL AUDIT OUTSOURCING. The SEC now prohibits an accounting firm from providing to their audit client any internal audit service that has been outsourced by the audit client and that relates to the audit client's internal accounting controls, financial systems or financial statements. (Id. (to be codified at 17 C.F.R. § 210.2-01(c)(4)(v)).)

6. MANAGEMENT AND HUMAN RESOURCES FUNCTIONS. An accountant is prohibited from acting as a director, officer or employee of an audit client or performing any decision-making, supervisory or ongoing monitoring function for the audit client. (68 Fed. Reg. 6006, 6013-6014 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(4)(vi)).) The rules also prohibit an accounting firm from searching for employee candidates, performing reference checks of candidates, engaging in testing or evaluation programs or recommending a specific candidate for a specific job. (Id. at 6014 (to be codified at 17 C.F.R. § 210.2-01(c)(4)(vii)).)

7. INVESTMENT ADVISING SERVICES. It is impermissible for an accounting firm to perform brokerage, investment advising or investment banking services for an audit client.

8. LEGAL SERVICES. An accounting firm is prohibited from providing to an audit client any service that could only be provided by someone licensed to practice law in the jurisdiction in which the service is provided. (Id. at 6015 (to be codified at 17 C.F.R. § 210.2-01(c)(4)(ix)).) Impor-tantly, because some countries have regulations requiring a license to practice law in order to do tax work, this restriction on legal practice does not prohibit foreign accounting firms that are so regulated from providing accounting services that an American accounting firm could provide under these rules. (See, 68 Fed. Reg. 6006, 6015 (Feb. 5, 2003).)

9. EXPERT SERVICES. Expert services are those where an accounting firm's specialized knowledge and expertise are used to support the audit client's positions in an adversarial proceeding. An accountant is prohibited from providing expert opinions to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation or administrative and regulatory proceedings.

Tax Services Exception

An accounting firm is permitted to provide tax services such as tax compliance, tax planning and tax advice to audit clients; doing so is not deemed a violation of auditor independence. It should be noted that such permitted services cannot be performed without pre-approval by the audit committee. Further, such tax services could be a violation of other SEC rules on auditor independence, where, for example, the firm represents the audit client before tax court or federal court of claims. (See, 68 Fed. Reg. 6006, 6016-6017 (Feb. 5, 2003).)

Audit committee pre-approval of services

An audit committee is defined in Section 2 of the Act as a committee established by and among the board of directors of a publicly traded client for the purpose of overseeing the accounting and financial reporting processes of the client and audits of the financial statements of the client. If no such committee of the board exists, the committee is deemed to be the entire board of directors of the client. (See, 15 U.S.C. § 7201(3)(A) and (B) (2003).)

In order for a registered firm to provide audit or permitted non-audit services to a public company, the audit committee of the company must give prior approval pursuant to Section 202 of the Act. The rules require that the audit committee pre-approve all permissible non-audit services and all audit, review or attest engagements. (See, Fed. Reg. 6006, 6022 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(7).) The rules provide a de minimis exception for certain non-audit related services. (Id. at 6022-6023 (to be codified at 17 C.F.R. § 210.2-01(c)(7)(i)(C)).)

Partner rotation

An audit engagement team is defined as all partners and professional employees participating in an audit, review or attestation engagement of an audit client. To preserve independence and maintain quality of audit services, Congress included in Section 203 of the Act a requirement that audit partners "rotate off" of a particular client engagement after a specific period of time. (See, 15 U.S.C. § 78j-1(j) (2003).)

In developing rules on partner rotation, the rule has classified partners into different levels and established rules for each level of partner. The lead and concurring partners are required to rotate after five years, and then are subject to a five-year "time out" period when they cannot perform services for that audit client. (68 Fed. Reg. 6006, 6018-6019 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(6)(i)(B)(1)).)

Other audit partners are required to rotate after no more than seven years and be subject to a two-year time out period. (Id. (to be codified at 17 C.F.R. § 210.2-01(c)(6)(i)(B)(2)).)

Small firm exception

In response to a significant number of comments, the SEC adopted a small firm exception from the partner rotation rules. (See, 68 Fed. Reg. 6006, 6020 n. 143 (Feb. 5, 2003).) Audit firms that have fewer than five audit clients that are public companies, and have fewer than 10 partners, are exempted from partner rotation rules. These firms still must be subject to a full review by the board at least once every three years, however. (68 Fed. Reg. 6006, 6020 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(6)(ii)).)

Conflicts of interest

Section 206 of the Act sets forth a conflict of interest rule whereby a one-year cooling off period is required before a member of the audit engagement team can begin working for the audit client in certain key positions. (See, 15 U.S.C. § 78j-1(l) (2003).)

Generally, the rule provides that when the lead partner, concurring partner, or any other member of the audit engagement team who provides more than 10 hours of audit, review or attest services for the client accepts a position with the audit client in a financial reporting oversight role within one year after they provided such services to the client, the accounting firm is not independent. (68 Fed. Reg. 6006, 6007-6008 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01(c)(2)(iii)).)

The SEC has addressed conflicts of interest arising where an audit partner receives compensation based on the act of selling non-audit services to the client. It has adopted the rule that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with the audit client to provide any products or services other than audit, review or attest services. (Id. at 6024-6025 (to be codified at 17 C.F.R. § 210.2-01(c)(8)).)

Increased communication and disclosure

TO AUDIT COMMITTEES. Section 204 requires the SEC to issue rules requiring timely reporting of specific information to audit committees in order to assist the committee in overseeing both management and the accountants. (See, 15 U.S.C. § 78j-1(k)(2003).) The SEC has added substance to this rule by requiring disclosures for three types of information that must occur prior to the filing of the audit report with the SEC.

First, firms are required to disclose to audit committees all critical accounting policies and practices. (68 Fed. Reg. 6006, 6027-6028 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-07(a)(1)).)

Second, accounting firms are also required to communicate to the audit committee, either orally or in writing, all alternative treatments within generally accepted accounting principles ("GAAP") for policies and practices related to material items that have been discussed with management. This includes discussions of the ramifications of the use of such alternative treatments and the treatment preferred by the accounting firm. (68 Fed. Reg. 6006, 6028 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-07(a)(2)).)

Third, the SEC also requires disclosure to the committee of material written communications, such as management representation letters, engagement letters, independence letters, reports on internal controls and schedules of unadjusted audit differences. (Id. at 6029 (to be codified at 17 C.F.R. § 210.2-07(a)(3)).)

TO INVESTING PUBLIC. Beyond the disclosures to audit committees, the new rule requires that additional information be provided to the public as well. Public companies must disclose fees paid to their independent accountant(s) for: (1) audit fees, (2) audit-related fees, (3) tax fees and (4) all other fees. Further, the company must disclose a description of the type of services being provided.

Disclosure must also be made of the audit committee's pre-approval policies and procedures, if any. These disclosures are to be provided both in the company's annual report and in their proxy statement, so that all investors have equal information. The information must be included for the two most recent fiscal years of the company. (Id. at 6030 (to be codified at 17 C.F.R. § 240.14a-101 Schedule 14A at Item 9(e)).)

Conclusion

This article has sought to provide an overview of the final auditor independence rules. These rules were the subject of significant debate during the rulemaking process and will surely be subject to further criticism as they begin to be implemented.

However, public companies and registered public accounting firms will likely take very seriously these rules, in view of the Act's harsh criminal penalties.

Whether they will prove effective and worth the burden will be determined in the years, and hopefully bull markets, to come.

■ *Brian J. Kahle is a law clerk and Julie E. McGuire is a shareholder in Hull McGuire PC. The firm has offices in Pittsburgh, Washington, D.C., and San Diego and practices in the areas of international law, taxation, transactions, intellectual property, litigation, employment practices, environmental and legislative.*

Test
1 Hour MCLE Credit

1. The Securities and Exchange Commission ("SEC") recently promulgated rules concerning "auditor independence" to implement the Sarbanes-Oxley Act.

2. The auditor independence rules issued by the SEC generally apply only to accounting firms that provide auditing services to publicly traded companies registered with the SEC.

3. Violation of the auditor independence rules will never subject a person to criminal penalties.

4. As part of the Sarbanes-Oxley Act, Congress prohibited accounting firms from performing certain non-audit services if that firm is also performing audit services for the same publicly traded client.

5. The SEC rules do not prohibit a firm from providing non-audit services to clients they are not auditing.

6. Under the new rules, it will be common for an accounting firm that audits a publicly traded company to also perform bookkeeping services for that publicly traded company, such as maintaining accounting records and preparing financial statements.

7. Under the new rules, it will be common for an accounting firm that audits a publicly traded company to also perform human resources services for that publicly traded company, such as searching for employee candidates, performing reference checks of candidates, engaging in testing or evaluation programs, or recommending a specific candidate for a specific job.

8. Under the new rules, an accountant is generally prohibited from providing expert opinions to a publicly traded audit client, or a legal representative of that audit client, for the purpose of advocating that audit client's interests in litigation or administrative and regulatory proceedings.

9. An accounting firm is never permitted to provide tax services such as tax compliance, tax planning and tax advice to audit clients; doing so is deemed a per se violation of auditor independence.

10. The rules require that the audit committee of a publicly traded company's board of directors pre-approve all permissible non-audit services and all audit, review or attest engagements.

11. To preserve independence and maintain quality of audit services, Congress included in the Sarbanes-Oxley Act a requirement that in the case of publicly traded clients, audit partners "rotate off" of a particular client engagement after a specific period of time.

12. In developing rules on partner rotation, the SEC auditor independence rules have classified partners into different levels and established rules for each level of partner.

13. The partner rotation rules require that lead and concurring partners are required to rotate after 10 years, and then are subject to a five-year "time out" period where they cannot perform services for that publicly traded audit client.

14. Audit firms that have fewer than five audit clients that are public companies, and have fewer than 10 partners, are exempted from partner rotation rules.

15. In addition to the partner rotation rules, the Sarbanes-Oxley Act includes a conflict of interest prohibition whereby a three-year cooling off period is required before a member of the audit engagement team can begin working for a publicly traded audit client in certain key positions without risking a loss of independence.

16. The new rules require that all critical accounting policies and practices be disclosed to audit committees of publicly traded companies.

17. The new rules require that all alternative treatments within generally accepted accounting principles ("GAAP") for policies and practices related to material items that have been discussed with management be disclosed to audit committees of publicly traded companies, either orally or in writing. This includes discussions of the ramifications of the use of such alternative treatments and the treatment preferred by the accounting firm.

18. The new rules require that material written communications, such as management representation letters, engagement letters, independence letters, reports on internal controls, and schedules of unadjusted audit differences be disclosed to audit committees of publicly traded companies.

19. Beyond the disclosures to audit committees, the new rules require that additional information be provided to the public as well. Public companies must disclose fees paid to their independent accountant(s) for: (1) audit fees, (2) audit-related fees, (3) tax fees and (4) all other fees.

20. The auditor independence rules were the subject of significant debate during the rulemaking process and will surely be subject to further criticism as they begin to be implemented.

Certification

■ This activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

■ The State Bar of California certifies that this activity conforms to the standards for approved education activities prescribed by the rules and regulations of the State Bar of California governing minimum continuing legal education.

MCLE ON THE WEB

TEST #39 — Implementing The Sarbanes-Oxley Act

1 HOUR CREDIT

- Print the answer form only and answer the test questions.
- Mail only form and check for $15 to:

MCLE ON THE WEB — CBJ
The State Bar of California
180 Howard Streeet
San Francisco, CA 94105

- Make checks payable to State Bar of California.
- A CLE certificate will be mailed to you within eight weeks.

____
Name

____
Law Firm/Organization

____
Address

____
State/Zip

____
State Bar Number (Required)

1.	True____	False____	11.	True____	False____
2.	True____	False____	12.	True____	False____
3.	True____	False____	13.	True____	False____
4.	True____	False____	14.	True____	False____
5.	True____	False____	15.	True____	False____
6.	True____	False____	16.	True____	False____
7.	True____	False____	17.	True____	False____
8.	True____	False____	18.	True____	False____
9.	True____	False____	19.	True____	False____
10.	True____	False____	20.	True____	False____