



# SEC ISSUES NEW RULES

## *IMPACT OF THE SARBANES-OXLEY ACT AND OTHER FINAL RULES ON ACCOUNTING FIRMS AND PUBLIC COMPANIES*

***Spearheaded by the Sarbanes-Oxley Act and the need to strengthen the independence rules for auditors, the SEC has issued new rules that affect public companies and the services their auditors provide.***

### **Registration of Accounting Firms**

All accounting firms wishing to perform audits for public companies must register with the Public Company Accounting Oversight Board (Board). The registration period will not commence until the Securities and Exchange Commission (SEC) determines that the Board is functioning, which is expected to occur in or about April 2003. From that point, accounting firms will have 180 days to register with, and be approved by, the Board.

The registration process is expected to require the following information from accounting firms.

- Names of SEC reporting clients.
- Amount of fees received from such clients.
- Names and license numbers of members of the accounting firm that participate in those audits.
- Information on any disciplinary proceedings against the accounting firm and any disagreements with audit clients.

Accounting firms must agree to cooperate and comply with any Board requests for testimony or documents.

Annual reports updating the information provided in the original registration filing will also be required. The registration filings and annual updates will be available for public viewing.

The Board will assess fees to accounting firms to recover the costs of processing and reviewing applications and annual updated reports.

**Foreign accounting firms who perform audits of SEC registered companies, including significant subsidiaries of SEC registered companies, are expected to be required to follow all the registration requirements. The SEC is currently considering a registration plan submitted by the Board.**

Each registered accounting firm will be subject to periodic inspections of its audit and quality control procedures by the Board. For firms auditing more than 100 SEC clients, the inspection by the Board will occur annually. For firms with less than 100 SEC clients, the inspection will occur at least once every three years.

Final rules on the registration process are expected to be issued once the SEC determines that the Board is functioning.

### **Records Retention**

The recently issued SEC rules require accounting firms to retain for **seven years** from the time the auditor concludes the audit or review service certain records relevant to audits and reviews of SEC clients. The records to be retained include workpapers and other documents that contain conclusions, opinions, analysis, or any other data

related to the audit or review, including documents containing any areas whereby differences in opinions occurred over accounting or audit issues. The compliance date for these rules is October 31, 2003.

### **Partner Rotation**

The new rules require that both the lead and concurring partners rotate off SEC clients after five years of service and be subject to a five-year time-out period after rotation. Additionally, certain other "significant" partners would be subject to a seven-year rotation requirement with a two-year time-out period. Significant audit partners include partners, other than the lead and concurring partners, that perform audit and consulting services for SEC related clients and all lead partners on subsidiaries of an SEC registered company whose assets or revenues constitute 20% or more of the registered company's assets or revenues.

**Lead partner:** The rotation rules for the lead partner include a look-back provision for time previously served and is effective at the end of the first fiscal year after the effective date of the rules. Assuming the rules are effective in 2003, as expected, lead partners for calendar year clients who served as partners for four or more previous years, would need to rotate off after the December 31, 2003 audit.

**Concurring partner:** Concurring partner rotation requirement also includes a look back provision for time previously served; however, the rules are not effective until the end of the second fiscal year after the effective date of the rules (i.e., the concurring partner may initially get to stay on for one more year than the lead partner.)

**Other partners:** For all other partners, the rotation rules are in effect as of the beginning of the first fiscal year after the effective date of these rules. However, in determining time served, that first fiscal year will constitute the first year of service, without consideration to prior time served.

**Exemption:** Accounting firms with less than five SEC clients and fewer than ten partners will be exempt from the rotation requirements provided that audit workpapers for each of their SEC clients are reviewed by the Board at least every three years

**Non-US accounting firms:** For all partners of foreign (non-U.S.) accounting firms who are subject to rotation requirements, the rules are similar to those of the "other partners" described above. Thus for a lead partner in a foreign (non-

U.S.) accounting firm serving a calendar year client, 2004 would most likely constitute the first of the seven-year rotation period, without regard to time previously served.

### **Employment by Clients**

Under Section 206 of the Sarbanes-Oxley Act, an audit firm is precluded from performing the audit of an SEC-registered client if the lead or concurring partner (regardless of number of service hours) or any member of the audit engagement team who provided more than ten hours of audit, review or attest services during the annual audit is employed by that client within a one-year "cooling off" period. This applies to employment as the client's chief executive officer, controller, chief financial officer or any equivalent position.

For purposes of this rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report (e.g., Form 10-K, 10-KSB, 20-F or 40-F) is filed with the SEC. The audit engagement period for the current year is deemed to conclude the day the current year's periodic annual report (for example, Form 10-K, 10-KSB, 20-F or 40-F) is filed with the SEC.

### **Internal Control Reporting**

The SEC will adopt rules requiring each company with public reporting requirements, to include in its annual filings, a report on internal control that:

- (1) states management's responsibility for maintaining adequate internal controls for financial reporting, and
- (2) contains management assessment of the effectiveness of such controls.

The company's audit firm would be required to attest to, and report on, management's assessment in accordance with standards to be issued by the Board.

### **Non-GAAP Financial Information**

Section 401(b) of the Sarbanes-Oxley Act requires that any public disclosure or release of "pro forma financial information" by a public company be presented in a manner that:

- (1) does not contain an untrue statement of a material fact or an omission of a material fact necessary in order to make the "pro forma

financial information,” in light of the circumstances under which it is presented, not misleading, **and**

- (2) reconciles the “pro forma financial information” presented with the financial condition and results of operations of the company under generally accepted accounting principles (GAAP).

### **Audit Committees**

The new rules surrounding the enhanced responsibilities of audit committees includes the requirement that all audit and permissible non-audit services be approved by the audit committee.

Additionally, the new rules explain the definition of an “audit committee financial expert”. Under the new rules the audit committee’s financial expert must have certain attributes including: an understanding of financial statements and generally accepted accounting principles; the ability to assess the application of accounting policies; experience in preparing or analyzing financial statements; an understanding of internal controls, and an understanding of the audit committee functions.

The rules also require the accounting firm to report, prior to the filing of its audit report with the SEC, to the audit committee:

- (1) all critical accounting policies and practices used by the company;
- (2) all material 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; **and**
- (3) other material written communications between the accounting firm and management.

Each audit committee member must be a member of the Board of Directors and be independent. The independence rules require that the audit committee member cannot accept any consulting, advisory or compensatory fee from the company, nor can the member be an affiliate or owner of the company.

The Sarbanes-Oxley Act does **not** mandate the establishment of an audit committee for each public company. If a public company has no audit

committee, the entire Board of Directors is defined as the “audit committee”. However, companies whose stock trades on national exchanges must follow the audit committee rules of such exchanges.

### **Accelerated Filing Requirements**

Most public companies with a public float of **at least \$75 million** will be subject to accelerated filing requirements for their quarterly 10Q’s and annual 10K filings. The accelerated filing dates will be phased in over three years.

**10K:** The annual 10K filing requirements will remain at 90 days for one year, change from 90 days to 75 days in the second year and 60 days in the third.

**10Q:** The quarterly 10Q filings will remain at 45 days in one year and change to 40 days in year two, and 35 days in year three.

**For calendar year public companies, the December 31, 2002 year-end filing requirements remain at 90 days, while the December 31, 2003 10K filing requirements will be accelerated to 75 days. For these calendar year companies, the accelerated 10Q filing requirement will not take effect until 2004.**

Companies eligible to file 10-QSB’s and 10-KSB’s, otherwise known as “small business” are **NOT** subject to the accelerated filing rules.

### **Compensation**

The new rule provides 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 that partner procuring engagements with the audit client to provide any services other than audit, review or attest services.

### **Restriction on Non-Audit Services**

The Sarbanes-Oxley Act imposed restrictions on the nature of the services accounting firms can provide to SEC clients while serving as their auditors. Some of the restricted services include:

**Bookkeeping:** Bookkeeping or other services related to the accounting records or financial services of the audit client are prohibited.

**Financial Information System Design:** The rules prohibit the accounting firm from providing 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 any audit of the client's financial statements. The rules will not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

**Appraisal or Valuation Services:** The rules prohibit the accountant from providing appraisal or valuation services, fairness opinions, or contribution-in-kind reports unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during any audit of the client's financial statements.

**Actuarial Services:** The rules prohibit an accountant from providing to an audit client any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during any audit of the client's financial statements. The accountants, however, may assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.

**Internal Audit Outsourcing:** The rules prohibit the accountant from providing any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems or financial statements unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during any audit of the client's financial statements. **During the conduct of the audit or when providing attest services related to internal controls, the auditor may continue to evaluate the company's internal controls and, as a result, may make recommendations to the audit client for improvements to the controls.**

**Management** The final rules prohibit the accountant from acting 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.

**Human Resources Services:** The rules also provide that an accountant's independence is impaired with respect to an audit client when the

accountant seeks out prospective candidates for managerial, executive or director positions; acts as negotiator on the audit client's behalf; or undertakes reference checks of prospective candidates. Under the rule, an accountant's independence will also be impaired when the accountant engages in psychological testing or other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

**Broker-Dealer, Investment Adviser, or investment Banking Services:** Acting as a broker-dealer, promoter or underwriter on behalf of an audit client and similar activities are prohibited as such services will impair the accountant's independence.

**Legal Services:** An accountant is prohibited from providing to an audit client any service that could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

**Expert Services Unrelated to the Audit:** The rules prohibit an accountant from providing expert opinions or other expert services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interest in litigation or in a regulatory or administrative proceeding or investigation. An accountant's independence will not be impaired, however, by an accountant providing factual accounts or testimony or explaining the positions taken or conclusions reached during the performance of any service by the accountant.

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*Items in this publication should not be considered official statements of position, nor advice for individuals or organizations without consulting a professional advisor. If you have any questions or would like to discuss any of these matters in more detail, please feel free to contact John Baldante or John Haslbauer at PKF New York.*

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