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AICPA SPECIAL COMMITTEE ON STATE REGULATION

AN OVERVIEW OF STATE ISSUES RELATED TO THE SARBANES-OXLEY ACT

A Reasoned Approach to Reform

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Background

Founded in 1887, the American Institute of Certified Public Accountants (AICPA) is the national professional organization representing more than 330,000 member CPAs in business and industry, public practice, government and education. Its staff, which supports the membership and its activities, is divided among the national headquarters in New York City and offices in Washington, D.C., Jersey City, N.J and Lewisville, TX.

The AICPA's mission is to provide members with the resources, information and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients. In fulfilling its mission, the AICPA works with state CPA organizations and gives priority to those areas where public reliance on CPA skills is most significant.

To achieve this mission, the AICPA engages in many activities, including:

- Advocacy
  Representing the profession nationally before government, rule-making, standard-setting, legislative and regulatory bodies, state CPA societies and other professional organizations;

- Certification and Licensing
  Seeking the highest possible level of uniform certification and licensing standards, preparing and administering the Uniform CPA Examination and promoting and protecting the CPA designation;

- Communications
  Restoring public trust in the CPA profession, promoting public awareness of the integrity, objectivity, competence, and professionalism of CPAs and providing information, educational guidance and technical assistance to members;

- Recruitment and Education
  Encouraging highly qualified individuals to become CPAs and supporting the development of outstanding academic programs;

- Standards and Performance
  Establishing U.S. private auditing and professional ethical standards, assisting members in continually improving their professional conduct, performance and expertise and monitoring performance to ensure compliance with current standards and requirements.

Major Initiatives

The AICPA has developed many initiatives to implement this mission. Ongoing programs include:

- The Anti-fraud and Corporate Responsibility Program
  The AICPA's number one priority is to rebuild the confidence of investors in our capital markets, reestablish audited financial statements as a clear picture window into corporate America and reduce the incidence of financial fraud. The AICPA is working to achieve these goals through its new, multi-faceted Anti-fraud and Corporate Responsibility Program launched in September 2002 when AICPA President and CEO Barry C. Melancon announced eight initiatives designed to restore investor confidence and strengthen audit quality. Already underway, the program has issued clarified and focused auditing guidance to CPAs, is establishing a new institute to study how to prevent fraud, has developed a free training program to help the business community educate employees about fraud prevention, and has established a new resource center at www.aicpa.org/antifraud providing news, tools and information in fraud prevention, detection and investigation.

- Sarbanes-Oxley Act of 2002 Implementation
  The AICPA strongly supports the goals of the Sarbanes-Oxley Act and considers the law an important part of restoring investor confidence. The Institute places high priority on implementing Sarbanes-Oxley and educating and providing guidance to directly impacted members on relevant actions taken by the SEC and other bodies, including the Public Company Accounting Oversight Board (PCAOB). The AICPA has responded or is in the process of responding with comment letters to proposed rules issued by the SEC and will work to implement these rules once they are issued. In addition, the AICPA will continue to share its expertise and experience with bodies drafting rules implementing the law and to communicate developments to its members. A new Web site at http://www.aicpa.org/Sarbanes/index.asp keeps members and the public up to date.

- Enhanced Business Reporting Model
  The AICPA has strongly advocated in testimony before Congress, in communications to members and in other public statements an enhanced business reporting model. Achieving more transparent financial reporting is central to ensuring fair markets and restoring investor confidence. To move toward an improved model, the AICPA will continue to work with the Financial Accounting Standards Board. The AICPA and Canadian Institute of Chartered Accountants also have developed the Value Measurement and Reporting Collaborative to bring together stakeholders in the financial reporting process from around the world to determine the best methodologies for value measurements and business reporting.

- Enhanced Discipline
  The AICPA holds its members to the highest professional standards. It is intolerant of those who break the rules, and it is committed to retaining and reinforcing the public's trust, our most valuable asset. The AICPA's Professional Ethics Executive Committee

(PEEC) is working to strengthen this disciplinary process with a focus on greater transparency and public protection.

- Computer-based Uniform CPA Examination
  To keep up with new business demands and emerging technologies, the Uniform CPA Examination is moving to a computer-based format and the content is being revised. The new exam focuses on the realities of today's CPA work environment and the knowledge and skills required at the entry level. It incorporates increased emphasis on information technology and general business knowledge with a broadened scope in the audit area and more skills testing. The first computerized CPA exam will be administered in April 2004.

- Student Recruitment Campaign
  In 2000, the AICPA launched a five-year student recruitment campaign aimed at attracting talented, young students to the CPA profession. Focusing on 16-22 year olds in high school and on college campuses, the campaign reaches students through Web-based interactive games and promotions as well as e-mail, direct mail and other advertising and communications vehicles. Students have flocked to the Web site at www.StartHereGoPlaces.com. Already the campaign is a great success reaching more than 8.5 million high school juniors and seniors and 1.2 million college students.

Governance

The AICPA's mission is carried out through the work of approximately 2,000 member volunteers serving on the Institute's governing Council, Board of Directors, and its nearly 200 committees, subcommittees, panels, and task forces.

The AICPA Board of Directors acts as the executive committee for the governing Council, which determines AICPA programs and establishes general policies. The Council, with 265 members, is made up of elected and appointed members from each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Guam.

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A Reasoned Approach to Reform - White Paper

In 2002 Corporate governance, Wall Street and auditing reform regarding public companies were at the forefront of Congressional activity. The American Institute of Certified Public Accountants (AICPA) and the State CPA Societies have actively participated in and supported the reforms that have been adopted at the federal level.

At the local level, several state legislators, regulators, and other elected or appointed officials are seeking to duplicate many of the provisions of the federal law into state laws and regulations. While some measures may have merit and could possibly be supported, some of what is being discussed is overreaching and simply should not apply to CPAs and CPA firms that do not provide audits to publicly traded companies.

This paper sets forth justification for States to seek and support a reasoned approach to considering changes that fit within a uniform regulatory format for the CPA profession.

Federal Regulation: Sarbanes-Oxley Act of 2002

The President, Congress and regulators moved swiftly to adopt sweeping corporate governance reforms in light of the financial and accounting scandals. Congress passed, and President Bush signed, the Sarbanes-Oxley Act of 2002 (the Act) providing unprecedented new requirements for auditors of public companies, corporations and Wall Street.

The federal statute and proposed rules from the Securities and Exchange Commission (SEC) provided for new and stringent requirements including: tightened requirements for boards of directors of public companies; greater corporate governance requirements for public companies; additional disclosure of events that affect a company's finances; and, certification by CFOs and CEOs of the accuracy of financial disclosures.

The Act also enhances auditor independence through a number of provisions. The company's audit committee must approve non-audit services provided to a public company in advance. A company's auditors are prohibited from offering certain non-audit services to the company including: bookkeeping or other services related to financial statements; financial information systems design and implementation; appraisal or valuation services; internal audit outsourcing and other services.

Auditors of a public company are required to report to its audit committee all critical accounting policies to be used by the company, alternative treatments that have been discussed with senior management, the auditor's preference, and any management letters between the auditors and senior management. In addition, an accounting firm cannot perform an audit of a public company if a senior executive officer of the company was employed by the accounting firm and participated in any capacity in the audit of the company during the one-year period prior to the current audit.

The Act also provides for establishment of the Public Company Accounting Oversight Board (PCAOB), which is charged with the power to regulate the accounting profession, adopt auditing standards and discipline auditors. The SEC will have oversight responsibilities with respect to the PCAOB.

The accounting profession believes that these provisions are appropriate for SEC registrants and their auditors and will contribute to the protection of the public interest. The profession is also committed to working with regulators and legislators to implement the Act at the federal level. However, the extension of these provisions to smaller, non-SEC registrants and their CPA firms raises a number of issues that do not contribute to the public interest and may in fact be harmful to small business. It is important we allow ample time for the implementation of these provisions and give the new Board time to work. To understand why we hold these positions, it is necessary to better understand the role of state regulation and the importance of enhancing, not detracting, from uniformity.

State Regulation

The modern public accounting profession originated in Great Britain during the latter half of the nineteenth century. In 1896 the New York state legislature passed the first law creating the title "certified public accountant," thereby setting the pattern for state government regulation of the public accounting profession in the United States.

As with other professions, the public accounting profession is built upon a state statutory foundation providing for the examination and licensing of members of the profession, and for the regulation of their professional conduct. All CPAs are examined, licensed, and regulated under the state accountancy laws, and there is such a law in every American jurisdiction.

A model bill to regulate the practice of public accountancy was first published in 1916 by the American Institute of Accountants, the predecessor of the American Institute of Certified Public Accountants (AICPA), the national membership organization of certified public accountants. In 1984, the AICPA and the National Association of State Boards of Accountancy (NASBA) published the first joint model bill, later renamed the Uniform Accountancy Act (UAA). Ultimately, a substantial majority of the state accountancy laws followed, in their principal provisions, the example provided by earlier model accountancy bills and the Uniform Act.

The Uniform Accountancy Act seeks to eliminate differing requirements for CPA certification, reciprocity, temporary practice, and other aspects of state accountancy legislation in the 54 American licensing jurisdictions (the 50 states, Puerto Rico, the District of Columbia, the U.S. Virgin Islands, and Guam). Uniform state accountancy laws should also foster interstate and international accounting practices as many companies and organizations which depend on a CPA's professional services conduct business across state and national borders. For example, if a state chooses to adopt one provision of Sarbanes-Oxley and another state does not adopt that same provision, companies will find it more difficult to conduct business in multiple jurisdictions. Further, the compliance and monitoring of the accounting profession also becomes more challenging. These complexities hold true for provisions such as peer review, mandatory auditor rotation, and independence of audit committees and do little to serve the public interest.

Economic Impact

Freedom of Choice

A cornerstone of the U.S. free enterprise system is "freedom of choice." Consumers are free to choose what they wish to purchase and from whom. This simple concept is the powerful engine that drives our free market economy. At the same time, there is an appropriate role for government oversight in the free market process to assure that the consuming public is not being misled or defrauded by unethical business practices. Government intervention into that free market process, however, should be as limited as possible. Laws and regulations that impede the free enterprise system and the ability of consumers to make choices should only be introduced where there is potential for severe harm to the public.

Restricting services that CPA firms can provide to all types of clients in essence restricts the freedom of choice that these consumers have to select a service provider. Government intervention into this consumer process should not be done lightly. These types of restrictions may appropriately apply to larger public companies where the events of 2002 indicated a need for greater government intervention. In this situation, the owners (shareholders) are removed from the day-to-day operations of the company and many have limited sophistication and knowledge of business practices and access to the financial records of the company. Implementing regulations to try to help protect the public in this case makes sense.

However, this same logic does not apply to non-public companies; there has been no demonstrated problem of harm to the public created by private companies utilizing CPA firms to provide an array of services, including audits. Because there are vast differences between public and private companies, especially as they relate to public interest concerns, the level of government intervention and protection measures applied to non-public companies should not be the same as that for public companies.

Non-public companies should be allowed to choose whom they want to perform necessary services. If they have developed a long-term relationship with a CPA firm, the government should not intervene in that relationship and force them to choose another CPA firm or other service provider. Having the government make these types of consumer choices is inappropriate and runs counter to the spirit of free enterprise. In the long run, it could cause more harm than any good it would produce for the public.

Increasing Costs for Business

Certain state-based reform measures would undoubtedly increase the costs for businesses to operate, with no compensating benefit. Some examples are:

- Subjecting private companies to the types of governance requirements contained in the Sarbanes-Oxley Act will raise their costs of operation. Private companies will have to recruit and pay outside individuals to serve on a board and audit committee in order to comply, which they currently do not have to do. Since there are no outside investors or shareholders these additional costs will serve no useful purpose. The types of outsiders

who rely on the financial statements of private companies usually possess a level of sophistication and expertise beyond an uninformed individual shareholder/investor and do not need additional government regulations of this type to help protect them.

- Placing restrictions on the delivery or scope of services CPA firms can provide to their small private business clients will force those businesses to go to other service providers for needed services beyond the audit. This will increase costs for these businesses as any "economy of scale" will be lost and it may also possibly reduce the quality of service they receive as their CPA audit firm probably has a greater understanding of their business. The added cost may inhibit the company from seeking the additional services. This would have an adverse impact on the company's ability to compete, and possibly survive. In some smaller communities, it may be difficult for businesses to even find another suitable service provider within a reasonable geographic distance.

- Requiring audit partner rotation for audits of private companies will likely increase the audit fees charged to these businesses. Auditor rotation will reduce the number of CPA firms performing audits, as some smaller firms will not have the necessary numbers of partners in the firm to comply with this type of requirement. A reduction in the number of firms performing audits will lead to an increase in audit fees, as competition will be reduced. Some audit firms are projecting that the expenses involved in complying with the provisions of the Act could necessitate an increase in fees for public company audits (in the range of 20-30 percent). Smaller, private businesses could likewise anticipate increases in costs if similar requirements are imposed on the firms that they use for providing these types of audit services.

Costs Associated with Sarbanes-Oxley

From the time that details of the various provisions of the Sarbanes-Oxley Act were made clear, public companies began to estimate the costs of compliance and by now have begun to take actions and spend dollars to ensure that compliance. Results of surveys conducted by the Financial Executives International (FEI) and the AICPA are consistent with quotes appearing in numerous articles about this topic. This information makes clear that public companies anticipate spending anywhere from hundreds of thousands to millions of dollars, depending on their size and complexity, to comply not only with Section 404 (Management Assessment of Internal Controls) but also with other provisions of Sarbanes-Oxley.

These expenses will likely be spent on increased technology, consulting, legal and audit fees, as well as higher premiums for directors and officers' liability insurance. The AICPA estimates that companies expect to spend an average of 32% more on internal audit and 16% on information systems while the FEI survey respondents estimate the average dollars in consulting costs related to Sarbanes-Oxley compliance at $480,000.

While we recognize that these increased costs to public companies may be entirely appropriate given the benefits the Sarbanes-Oxley provisions provide to the investing public, careful consideration should be given to the relative costs and benefits before imposing such provisions in the private company, non-issuer environment.

Creating a Negative Business Climate

State legislators and regulators should use caution in the implementation of new financial and governance requirements on businesses in their state. Otherwise, they may create a negative business climate that deters new companies from locating there and encourages existing businesses to leave.

Any of the public's reduced confidence in capital markets or the accounting profession is a result of actions affecting publicly held companies, their management, their auditors, their attorneys, securities analysts and the underwriters of public securities. There has been no corresponding crisis of confidence in the thousands of CPAs who serve their private company clients, the small businesses that generate most of the new jobs in this country. Therefore, it is important to distinguish between these two different universes when contemplating new legislation or regulation.

States enacting reforms modeled after the Sarbanes-Oxley Act may unintentionally harm private businesses by driving up their costs of operations (without any apparent commensurate benefit to the public), thereby increasing prices for consumers. Such action could also reduce the size of the state's business community as companies seek to locate to more favorable states. Finally, a reduction in tax revenue from the business sector could impact a state's ability to deliver needed services to its citizens.

Uniformity of Regulation

In today's world, business is conducted on a national and often global basis. Even small businesses are using the power of the Internet and other technology to market their products and services beyond the community where they are physically located. And consumers use the power of this same technology to make their purchases in order to obtain the best price and quality possible within the free market system.

Investors do not limit their purchases to companies located only within their state of residence. Therefore, to provide meaningful protection to the public, a uniform approach to business regulation across all states makes the most sense. Otherwise, states are only creating additional costs of regulation and compliance for the business providers without really providing the level of protection they are seeking for the public.

State legislators should consider this factor as they approach any reform proposals. If they implement unique reform proposals that apply only to businesses that operate in their state, they may create a business climate that deters investment and job production.

A Reasoned Approach

State legislators and regulators are strongly encouraged to take a reasoned approach to reform for several reasons. First, the federal government has addressed the highest risk to the investing public (publicly traded companies and their auditors) by adopting the Sarbanes-Oxley Act. All firms auditing publicly traded companies must comply with the new law and subsequent regulations. Although the PCAOB is in its beginning phase of operation, these reforms and those yet to be defined constitute the most sweeping changes since the 1933 and 1934 Securities Acts. In fact, it would be premature for states to institute any reform before the effectiveness of the federal reforms is evaluated.

Second, Sarbanes-Oxley was not intended to be a template for state regulation. Rather, the Act was designed as a comprehensive bill that specifically relates to publicly traded companies.

Furthermore, one of the authors of the bill, U.S. Senator Sarbanes, said from the Senate floor on July 8, 2002, "This bill applies only to public companies that are required to report to the SEC. It says plainly that State regulatory authorities should make independent determinations of the proper standards and should not presume that the bill's standards apply to small- and medium-sized accounting firms that do not audit public companies."

Private companies do not have the same responsibilities for financial disclosure to the investing public. Therefore, to impose the same restrictions would be burdensome, costly, and impractical.

The AICPA and NASBA will undertake a reasoned approach to examining the merits of all of the issues and consider which ones meet the public interest. Proactive and premature legislation or regulation by well-meaning state legislators and regulators will do little to protect the public good if they embrace efforts to “out do” every other state. In fact, such actions will tend to politicize the process and destroy the uniformity goals so desperately needed by the profession and the clients and public they serve.

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Complexity of the Issues - White Paper

The Complexity of Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 is a complex, comprehensive law that covers a broad scope of corporate responsibility issues for public companies. Included in the Act are provisions addressing certification and disclosure of public reports, independence of audit committees, executive compensation and insider transaction rules. The Act also covers analyst conflicts of interest, rules of professional responsibility for attorneys, and a new model for the regulation of the accounting profession. The Act clearly applies to a broad stakeholder group.

Given the passage by Congress of Sarbanes-Oxley, many state legislators and regulators are considering the adoption of some or all of the provisions of the Act and making them applicable at the state level for private companies and their auditors. However, in doing so, the states risk enacting provisions that are both unworkable from a practical standpoint and unnecessary from a risk perspective. This paper seeks to explore the complexity involved in applying Sarbanes-Oxley to private companies and their auditors at the state level as well as a reasoned approach to reform as it relates to these companies.

The Importance of Uniformity

The Uniform Accountancy Act (UAA), the model licensing law for state regulation within the profession, provides the fundamental principles that should govern the regulation of Certified Public Accountants. These fundamental principles express the legislative policies of the American Institute of Certified Public Accountants and National Association of State Boards of Accountancy. The UAA seeks to protect the public while providing flexibility and choice to both the public and licensees. Interstate uniformity of professional standards provides equality among states, ease of movement and monitoring among licensees, and responds to a marketplace that transacts business across state borders. If states enact different provisions from Sarbanes-Oxley to varying degrees, the resulting complexity would significantly hinder compliance, monitoring and interstate business.

For example, should one state enact the Sarbanes-Oxley restrictions on the scope of services that auditors can provide to their private company clients while other states do not, issues will arise with companies that have operations in multiple states. Further, differing state-based restrictions may make it attractive for private companies to locate their businesses in the states that do not impose unreasonable demands, creating trade barriers and economic disadvantages. Similar adverse consequences would likely follow the extension to non-public companies of such provisions as peer review, mandatory auditor rotation, and independence of audit committees. The challenges that would arise for privately held companies, especially smaller entities, are hard to justify since extending the provisions would not create any benefit to the public.

Further Restrictions Unnecessary For Private Companies

The Sarbanes-Oxley Act has succeeded in addressing at the federal level the highest areas of public risk. Any additional legislation or regulation at the state level must be justified in terms of identifying the public harm it is aimed at mitigating. The introduction to the UAA states that statutory regulation of CPAs is justified ***only by consideration of the public interest.*** Further, the public interest must be substantially at risk, as any regulation would involve restrictions on who can perform certain services and how they are performed.

A strong assertion can be made that current accounting regulation of private companies protects the public adequately and there is no need for additional restrictions. As with other professions, the accounting profession is built upon a statutory foundation, providing for examination and licensing of members of the profession and for the regulation of their professional conduct. The rules of professional conduct require a CPA to be independent in the performance of any audit and thereby prohibits a CPA from performing management functions or auditing his or her own work, whether it is an audit of a public company or a private company or entity. All auditors are examined, licensed and their professional conduct is regulated under state accountancy laws. There is such a law in every American jurisdiction.

Third Party Distinction between Public and Private Entities

The central element in assessing the public welfare risk is identifying a high level of third party reliance on financial information. A third party who is not able to determine the reliability of a particular practitioner or the financial reports coming from that practitioner must be protected from incompetence or misconduct. The Sarbanes-Oxley Act protects such third party investors of public companies, who can rely *only* on financial reports to make investment decisions. Yet, the financial statements of private companies, who also provide information to third party stakeholders, do not carry a similar risk.

Bankers, insurance companies and private equity investors are examples of third parties that rely on the audits of privately held companies. However, these relationships differ strongly from third party investors of publicly traded companies. In the privately held company scenario, the third party is highly familiar with the operations and strategy of the company being audited. In most cases, the third party is also knowledgeable about the auditor performing the audit. These direct relationships allow the third party stakeholder of private companies to obtain a comfort level rarely accessible to a public company investor.

Public Interest Entities

Given the foregoing discussion of third party reliance on financial statements, one must consider a hybrid of the public and private company scenario -- a private entity that has a public-interest component. The International Federation of Accountants (IFAC) has described this type of entity as a *public interest entity*. In so describing, IFAC attempts to classify those entities having a significant public interest as a result of their business, their size, corporate status, or wide range of stakeholders. Such businesses may warrant having the same principles and safeguards of independence applied to them as would be applied in the audit of a publicly traded company.

The largest challenge associated with the regulation of private interest entities is identifying them. Defining this group creates tremendous complexities, as there would be a need to calculate the extent of potential public harm using a large number of factors including the nature of the entity, its size, and its stakeholder group. Based on each state's assessment, different types of organizations could by classified as public interest entities including charitable organizations, volunteer organizations, professional or trade organizations, religious institutions, hospitals, colleges or universities and labor unions. Depending upon definitions, one could easily see tens of thousands of entities qualifying and subsequently being subjected to additional legislative or regulatory requirements for a financial statement audit. The issue becomes even more complex if states use separate definitional criteria for different rules of independence.

Again, it is helpful to return to the question of need. Rules and regulations already exist today to protect the public from private entities that operate in public interest spaces. SEC rules, the General Accounting Office policies and Yellow Book rules apply to all entities that receive federal funds in excess of a pre-determined threshold. In addition, many other legislative and regulatory bodies such as banking regulators, governmental auditors, and securities regulators put in place regulation for certain types of entities that affect the public. These rules have been promulgated through a representative process with public input and have adequately protected stakeholder interest when required.

Considerations for a Reasoned Approach

Applying piecemeal restrictions from Sarbanes-Oxley to private company financial reporting at the state level creates unnecessary complexity and severely threatens uniformity for the accounting profession. This uniformity is necessary to ensure equality among states and guarantee flexibility for private companies and their accounting firms. Uniformity enables higher quality monitoring and compliance of the profession and fosters interstate business.

The auditing of private companies at the state level is adequately regulated. Third party stakeholders of privately held companies have direct access to the companies in which they invest and to their auditors. This relationship allows them to make knowledgeable decisions about their investments and achieve a comfort level with those decisions that is not readily enjoyed by the average public company investor. Further, most public interest entities operate under the eye of the appropriate regulatory agency whose additional restrictions apply to protect the public interest. The classification of additional public interest entities would be a burdensome and complex task that would also harm uniformity across states.

In a reasoned approach to changes in state laws due to the enactment of Sarbanes-Oxley, strong consideration should be given to the fact that the high-risk area of public company financial reporting has been addressed at the federal level. Regardless of the state in which they are practicing, audit firms performing public company audits must abide by this federal law. The application of Sarbanes-Oxley for privately held companies at the state level would create additional complexity that is not in the best interest of the public. Further restrictions for private organizations and their auditors who have not exhibited any potential for high public risk are unnecessary and would ultimately be unworkable.

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Audit Partner Rotation - Issue Brief

In response to the wave of corporate crises, the Sarbanes-Oxley Act includes a provision regarding mandatory audit partner rotation for firms auditing public companies. This should not be confused with audit firm rotation and it is important to make the distinction. The Act requires the lead audit partner and audit review partner (or concurring reviewer) to be rotated every five years on all public company audits. The Act requires a concurring review of all audits of issuers (as defined in the Act). The focus of this document is audit partner rotation. However, it also discusses the circumstances in which audit partner rotation can be tantamount to audit firm rotation.

A Reasoned Approach

A reasoned, logical approach should be taken in considering imposing mandatory audit partner rotation at the state level. On January 28, 2003 the SEC adopted rules to effectuate the statutory requirement of audit partner rotation found in Sec. 203 of the Sarbanes-Oxley Act. In addition to the five-year rotation requirement of the lead and concurring audit partners, the rules also mandate a five-year "timeout" period after rotation. The rules, as adopted, specify that certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year "timeout" period. The rule provides an alternative for firms with fewer than five public audit clients *and* fewer than ten partners. The alternative requires the Public Company Accounting Oversight Board (PCAOB) to review all of the firm's engagements subject to the rule at least once every three years. Further, the Sarbanes-Oxley Act requires the Government Accounting Office (GAO) to conduct a study of the effectiveness and implications of audit firm rotation.

In a reasoned approach at the state level, it would not be logical to attempt to replicate what has already been done at the federal level regarding audit partner rotation. It would also be logical to await the results of the GAO study regarding audit firm rotation before taking any action on that issue. The following is a discussion of several factors to consider which may provide a broader understanding of the implications of mandating audit partner rotation for firms auditing nonpublic entities.

Audit Practice Considerations and the Public Interest

As noted above, the Sarbanes-Oxley Act requires the lead audit partner and audit review partner (or concurring reviewer) to be rotated every five years on all public company audits. Generally Accepted Auditing Standards, which apply to SEC and non-SEC engagements alike, do not require a concurring partner review. If the concurring partner review requirement were enacted for all engagements, sole practitioners would have to either give up their audit practice or outsource the concurring review function to another firm.

In addition, for sole practitioners and small firms with a limited number of audit partners, adopting a mandatory audit partner rotation requirement would be tantamount to firm rotation. They could not meet the rotation requirement and would therefore have to give up the audit to

another firm. Because smaller audit firms would need to employ more professionals to meet the audit partner rotation mandate, many firms could cease providing audit services, thus eliminating competition and the cost and quality benefits associated with competition. Small businesses that employ these firms would be at a disadvantage either as a result of potentially higher costs of audit services (due to a reduced supply of auditors) or their total inability to engage an auditor because local firms may opt to eliminate audit services from their practices.

Limiting the number of firms performing audits or imposing rules that inadvertently cause firm rotation is not in the public interest.

Audit Quality

It is clear that Congress believed that audit partner rotation was an important element to achieving a fresh look at the engagement for the audits of public companies. In developing regulations pertaining to Sarbanes-Oxley, the SEC acknowledged that its partner rotation requirements needed to strike a balance between the need to achieve a fresh look at the engagement and a need for the audit engagement team to be composed of competent accountants. While audit partner rotation was mandated in Sarbanes-Oxley, there is no evidence that audit partner rotation will guarantee better audits.

In fact, regarding the issue of firm rotation there are existing independent studies that conclude that audit firm rotation reduces audit quality and that the costs far outweigh the benefits. Research conducted separately by the Public Oversight Board, the Commission on Auditors' Responsibilities, and the National Commission on Fraudulent Financial Reporting found that audit failures are three times more likely in the first two years of a client/auditor relationship, and that there is a positive relationship between audit firm tenure and auditor competence. There is a substantial body of academic literature that indicates the direct relationship between the length of auditor tenure and the increased discovery of material financial statement errors.

Knowledge of the client, its business and the environment it operates in is essential to audit quality. Without these, audit quality would decrease. It is clearly in the public's interest to keep the most qualified partner on the job.

Market and Economic Impact

Requiring audit partner rotation for non-public companies could also have a direct impact on the cost of doing business, creating a more time consuming, less efficient, and therefore, more costly process for businesses. For instance, the periodic re-training of new auditors on the company's policies and procedures can also be very costly, thus adding to the cost of the audit. In fact, there are efficiencies gained over the long term by the audit team that can and many times do lead to cost savings.

In its January 13, 2003 comment letter to the SEC on Strengthening the Commission's Requirements Regarding Auditor Independence, the U.S. Small Business Administration's ("SBA") Office of Advocacy stated that "initial cost for new firms would rise, due to the need to familiarize auditors with the client firm's industry and business practices." Their comment letter

indicated they believed this increased cost to the auditing firm would result in increased cost to the audit consumer.

Statistics indicate that only a relative few firms currently bid on audit requests now. If mandatory audit partner rotation causes some firms to stop performing audits there will be even fewer firms bidding on audit requests. This consolidation of the market and therefore loss of competition will likely cause audit fees to increase.

The potential reduction of firms performing audit services and the resulting increase in costs to small business by mandatory audit partner rotation is not in the public interest.

Addressing Investor Risk

Clients in the non-public business environment believe their current audit partner knows their business the best and can provide the best service. The Sarbanes-Oxley Act was passed largely to protect public stakeholders, who have little direct contact with their company investments or management and are principally passive investors. Many of these stakeholders have a limited level of financial sophistication and little or no knowledge of the day-to-day operations or business practices at the organizations where they place their money. They need protection. In that environment, audit partner rotation makes sense.

Conclusion

In the non-public company environment the public is best served by not imposing regulations, such as mandatory audit partner rotation that has the potential to limit choices, decrease competition and thereby drive up costs. While the Small Business Administration's comment letter to the SEC on Strengthening the Commission's Requirements Regarding Auditor Independence focused on the need for a small firm exemption to public company audit partner rotation requirements, its comments can likewise apply to small firm audit partners of nonpublic entities.

> "Advocacy is concerned that small issuers retaining the services of currently exempt small audit firms who decline to offer audit services to them may be forced to engage the services of a larger audit firm. Advocacy believes that this could result in significantly increased audit costs to audit consumers in two ways. First, initial costs for new firms would rise, due to the need to familiarize auditors with the client firm's industry and business practices. Second, due to the effective elimination of smaller firms from the competitive market for audit services and the consolidation of the market, larger audit firms may gain some power over price, causing audit prices to rise."

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Peer Review for Non-SEC Firms - Issue Brief

The AICPA Peer Review Program (PRP) seeks to achieve quality in the performance of accounting and auditing engagements of firms that do not audit publicly traded companies through education and remedial corrective measures. This paper describes the non-public company peer review program as 1) a membership requirement for AICPA members and their firms, and 2) as the state requirement for CPA/Firm license renewal, in the jurisdictions with a mandatory requirement.

The AICPA Peer Review Board (PRB), which oversees this national program, is currently considering several critical enhancements to the Peer Review process, seeking input from the state boards of accountancy to address their needs. While the PRB evaluates the Peer Review process, the newly formed Public Company Accounting Oversight Board (PCAOB) will begin determining its role in monitoring the profession's auditing of publicly traded companies.

A reasoned approach would suggest that any decisions concerning changes to peer review at the state level in response to recent financial reforms be deferred until the PRB makes its formal recommendations and the PCAOB responsibilities relating to professional oversight of publicly traded companies are formalized.

History of Peer Review

The AICPA PRP was put in place to monitor the profession and establish a layer of public protection to improve firms' accounting and auditing practices by identifying CPA firms that have inadequate systems of quality control, detecting non-performance in accordance with professional standards in all material respects and imposing remedial action to correct deficiencies.

Currently, the approved practice-monitoring program for firms that do not audit publicly traded companies is the AICPA's PRP (the AICPA's SEC Practice Section Peer Review Program exists for members of SECPS, and will not be discussed in this paper). The PRP requires a peer review of the firm's accounting and auditing practice every three years.

Since its inception, the program has been amended several times to expand its reach and strengthen its effectiveness. The PRP continues to evolve in response to changing market needs.

1977 - Voluntary AICPA peer review program established.

1988 - AICPA bylaw approved requiring all AICPA members active in the practice of public accounting to be associated with a firm that is enrolled in an AICPA-approved practice-monitoring program.

2000 - AICPA bylaw amendment approved requiring *individual* CPAs to enroll in an Institute-approved practice-monitoring program if they perform compilation services in firms or

organizations not eligible to enroll in such a program.

2001 - AICPA Standards for Performing and Reporting on Peer Reviews revised to include three different tiers of peer reviews – System, Engagement and Report Reviews discussed below.

Going forward, the AICPA is committed to developing a program to assist firms required to register with and be inspected by the PCAOB in having a peer review of their non-SEC practice in order to meet their state licensing and other regulatory requirements.

Furthermore, at the state level, the AICPA supports peer review as a requirement for re-licensure and works closely with the states to establish Peer Review Programs. The AICPA and the National Association of State Boards of Accountancy (NASBA) have worked in conjunction to develop language contained in the Uniform Accountancy Act Statute (UAA) to promote peer review.

Objectives of Peer Review

Firms that perform engagements under the Statements on Auditing Standards (SASs), Government Auditing Standards (Yellow Book) and/or examinations of prospective financial information under the Statements on Standards for Attestation Engagements (SSAEs) must have a System Review, which periodically evaluates their system of quality control by independent peers. These reviews are system and compliance oriented with the current objectives of evaluating whether:

1. The reviewed firm's system of quality control for its accounting and auditing practice has been designed to meet the requirements of the Quality Control Standards established by the AICPA; and

2. The reviewed firm's quality control policies and procedures are being complied with to provide the firm with reasonable assurance of complying with professional standards.

Firms that perform compilations (except as noted below) or review services under Statements on Standards for Accounting and Review Services ("SSARS") and/or services under the SSAEs not included in system reviews must have an Engagement Review. The objectives of an engagement review are to provide the peer reviewer with a reasonable basis for expressing limited assurance that:

1. The financial statements or information, and the related accountant's report on the accounting and review engagements and attestation engagements reviewed, conform in all material respects with the requirements of professional standards; and

2. The reviewed firm's documentation conforms with the requirements of SSARS and the SSAEs applicable to those engagements in all material respects.

Firms that only perform compilation engagements under SSARS where the firm has compiled financial statements that omit substantially all disclosures have peer reviews called Report

Reviews. The objective of a report review is to enable the reviewed firm to improve the overall quality of its compilations that omit substantially all disclosures. The reviewer provides comments and recommendations based on whether the submitted financial statements and related accountant's reports conform with the requirements of professional standards in all material respects.

The remainder of this paper will focus on System Reviews.

Peer Review Engagement Selection

In a System Review, all accounting and auditing engagements covered by Statements on Auditing Standards (SASs), Governmental Auditing Standards (Yellow Book), Statements on Standards for Accounting and Review Services (SSARS), and the Statements on Standards for Attestation Engagements (SSAEs) performed by a firm are subject to selection for peer review. Engagements subject to litigation may be omitted, but are subject to the disciplinary and enforcement processes of the AICPA Professional Ethics Division. Engagements are selected for review based on a risk assessment, which heavily weighs high-risk engagements. However, as a part of the selection process, a peer reviewer must select at least one governmental audit, one employee benefit plan audit, and one depository institution audit if certain dollar thresholds are met.

Peer Review Acceptance

The acceptance of a firm's peer review includes a (a) technical review by a CPA who is independent of the reviewed firm and the peer review team, and (b) consideration of the peer review documents by an independent committee of experts in accounting, auditing and peer review that are currently in practice. Peer review documents often include comments issued by the peer reviewer on the firm's system of quality control and recommendations for improvement for that system. The independent peer review committee may require that a firm in need of improvement complete remedial and educational follow-up actions as a condition of acceptance. These actions may include, but are not limited to, revisits to the firm by the peer reviewer, pre-issuance and post-issuance reviews of engagements including working papers, and participation in CPE and accelerated peer reviews. This entire process results in improvements in a firm's system of quality control and enhancements to audit quality.

Peer Review Administration and Oversight

The peer review process includes rigorous checks and balances through the administration and oversight of the process. The Program is administered by 41 administering entities for the 54 jurisdictions and is overseen by the PRB and its staff to ensure consistent application of the peer review standards and guidance throughout the nation. The PRB's oversight program requires that each administering entity have its own formal oversight process. Visitation of each of the 41 administering entities, which often includes recommendations for improvements in administering peer reviews, must occur every other year.

During its oversight review, the PRB reviews the administrative and technical review, peer review committee acceptance and, internal oversight processes, and performs detailed reviews of peer reviewers' working papers and documents. Certain aspects of oversight are also performed annually on every administering entity.

Disciplinary Process

A disciplinary process is incorporated within the peer review program for any firm that refuses to cooperate, fails to correct material deficiencies, or is found to be so seriously deficient in its performance that education and remedial corrective actions are not adequate.

The AICPA PRB may decide, pursuant to due process, to appoint a hearing panel to consider whether the firm's enrollment in the Program should be terminated or whether other actions should be taken.

The public is notified of firms that are terminated from the program via *The CPA Letter* and the AICPA website. State boards are notified of a firm's termination from the program via direct notification.

A separate disciplinary process exists for peer reviewers and administering entities in the event that performance issues arise at that level.

In addition to the measures above, the AICPA may ultimately revoke the membership of an individual who fails to fully comply. Because state boards of accountancy grant the license to practice, they (not the AICPA) have the right to revoke a CPA's license to practice public accountancy.

Re-Evaluation of AICPA Peer Review Process

Early in 2001, the PRB began to re-evaluate and recommend improvements in the performance, reporting and administration of system reviews. Over 1,000 surveys were sent to state boards of accountancy, peer review committee chairs, technical reviewers, administrators and firms that recently had system reviews to gain feedback and assess the strengths and weaknesses of the current peer review process. Although this process was started prior to the enactment of the Sarbanes-Oxley Act, the PRB is considering the Act to determine the appropriateness of its inspection provisions in a non-SEC environment. Recommendations of the Public Oversight Board Panel on Audit Effectiveness are also being considered.

Preliminary recommendations, which are outlined below, are expected to enhance the peer review's current approach to focus more closely on higher risk areas that are of a greater public interest. The preliminary recommendations also seek to make the peer review report more informative and comprehensible to enhance its usefulness.

Preliminary Recommendations of PRB

Amendments to the objectives and performance of peer review to minimize the expectation gap

- Opining on a firm's "fitness" to audit in addition to evaluating the firm's system of quality control. The Peer Review report should state:

  - In our opinion, (*Name of Firm*) has demonstrated competencies necessary to perform accounting and auditing engagements in accordance with professional standards in all material respects.

- Enhancements to the risk-based approach to performing peer reviews, such as:

  - Focusing on higher risk areas of engagements that are of a greater public interest.

  - Selecting engagement(s) on a surprise basis.

  - More guidance on how to document the risk based approach.

  - More judgment for team captains to determine sample size, in addition to better utilizing the results of the firm's internal monitoring process.

Transparency

- Enhanced reporting on the results of peer review in a manner that is more understandable and useful.

- Exploring ways to make the results of peer review more readily available to users of peer review reports.

- Currently, approximately 11,000 of the 16,000 firms that have System Reviews already make some aspects of their peer review available to the public, through membership in PCPS, via state board required remittance, or Yellow Book requirements.

Peer reviewer performance and oversight

- Enhancing measures to ensure team captains are performing peer reviews in accordance with minimum standards requirements. For example, enhanced oversight could require that every team captain would be subject to oversight every pre-determined number of years.

- Establishing additional methods to ensure that the most qualified reviewers and team members are a part of the PRP.

PRB oversight of administering entities

- Establishing additional methods to ensure administering entities' staff, technical reviewers, committee members, and all others involved in the administration of PRP comply with the Standards and other guidance established by the AICPA Peer Review Board.

These preliminary recommendations were exposed for public comment by the Peer Review Board in May 2003 with the comment period ending in August 2003. Any enhancements adopted will result in amended Peer Review Standards and related guidance with an effective date of January 2005. The effective date will give the Peer Review Board sufficient time to develop an effective education and migration strategy for peer reviewers, technical reviews, committee members and administrators, as well as the revision of peer review courses, program materials and computer programs.

State Licensing Requirement

The AICPA promotes the concept of peer review at the state level and supports states that have enacted programs. The AICPA believes that states should recognize equivalent reviews, such as those performed as part of the AICPA programs, as sufficient to satisfy a state licensing requirement. The AICPA/NASBA Uniform Accountancy Act (UAA) contains a peer review section that was modified based on the recommendations of the AICPA/NASBA Joint Committee on Regulation of the Profession. UAA section 7(h) requires that firms performing the attest function undergo a peer review every three years. For more information on this model requirement, consult section 7(h) of the UAA.

Additionally, Section 7 (h)(3) requires that peer reviews be subject to oversight by an oversight body established or sanctioned by the Board. The oversight body shall periodically report to the Board on the effectiveness of the review program and provide a list of firms that have participated.

The UAA, Third Edition, Revised – 1999, extends peer review to individuals performing compilation services outside of a licensed CPA firm. This requirement conforms to the related change in the UAA, removing compilations from the definition of "attest services," thereby allowing licensees to perform SSARS compilations outside of a CPA firm.

Currently, thirty-five states have provisions within their accountancy statutes and/or regulations that provide for some form of monitoring program as part of the re-licensure process.

Conclusion

The AICPA PRP is dedicated to enhancing the quality of accounting, auditing and attestation services performed by AICPA members in public practice. State boards that embrace the peer review process as a requirement for re-licensure add a critical layer of protection against professional deficiencies or misconduct. The AICPA PRB has been committed to enhancing the program continuously to allow for greater transparency and higher quality reviews. States

considering changes to their peer review programs could best serve their constituents by first understanding these enhancements, as well as the new environment under which all businesses will be operating, before making any decisions at the state level.

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Professional Ethics — Issues Brief

Recent corporate scandals and the passage of the Sarbanes-Oxley Act of 2002 have prompted a renewed focus on ethics in corporate America. As a result, several state legislators and regulators have been studying what they might need to do to ensure ethical behavior of CPAs as they carry out their public interest mandate. A reasoned approach dictates that those studying such actions should begin with an understanding of the American Institute of Certified Accountant's (AICPA) *Code of Professional Conduct* and the processes that exist to interpret the Code, set ethics standards and ensure compliance with such standards through the AICPA's disciplinary process. It is also important that those contemplating such actions should understand changes that have been made and those being proposed to enhance the Code and the ethics enforcement process, thereby strengthening the ethical mandate of AICPA members. This paper is intended to be a resource to achieve that understanding.

The AICPA supports a reasoned approach to reform that fits within a uniform regulatory format for the CPA profession. Enhancing uniformity of state accounting laws is vital in order to minimize any adverse economic impact on businesses, practitioners and the public alike. Interstate uniformity of professional conduct rules is also necessary to avoid confusion among practitioners with regard to their requirements.

The AICPA's Code of Professional Conduct

The *Code of Professional Conduct* of the American Institute of Certified Public Accountants (AICPA) consists of two sections — (1) the Principles and (2) the Rules. The Principles provide the framework for the Rules, which govern the performance of professional services by members. The Council of the AICPA is authorized to designate bodies to promulgate technical standards under the Rules, and the bylaws require adherence to those Rules and standards.

The Code was adopted by the membership to provide guidance and rules to all members — those in public practice, industry, government, and education — in the performance of their professional responsibilities.

The Principles, which are spelled out in Section 50 of the Code, call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage. The Principles required for AICPA membership are summarized as follows:

Article I: Responsibilities

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

Article II: The Public Interest

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

Article III: Integrity
To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

Article IV: Objectivity and Independence
A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

Article V: Due Care
A member should observe the profession's technical and ethical standards; strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

Article VI: Scope and Nature of Services
A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

Other Guidance

Interpretations of Rules of Conduct consist of interpretations which have been adopted, after exposure to state CPA societies, state boards of accountancy, practice units and other interested parties, by the professional ethics division's executive committee to provide guidelines as to the scope and application of the Rules but are not intended to limit such scope or application. A member who departs from such guidelines shall have the burden of justifying such departure in any disciplinary hearing.

Ethics Rulings consist of formal rulings made by the professional ethics division's executive committee after exposure to state CPA societies, state boards of accountancy, practice units and other interested parties. These rulings summarize the application of the Rules and Interpretations to a particular set of factual circumstances. Members who depart from such rulings in similar circumstances will be requested to justify such departures.

For the complete text of the Code visit the AICPA Web site at:
http://65.242.185.106/about/code/index.htm.

The AICPA Professional Ethics Executive Committee

The AICPA's Professional Ethics Executive Committee (the Committee) is the senior technical committee charged with overseeing the entire ethics process for the AICPA and its membership. The structure includes the AICPA Professional Ethics Division and two subcommittees. The Committee helps the AICPA carry out key aspects of its overall mission, namely to promote public awareness and confidence in the integrity, objectivity, competence and professionalism of its members; establish and enforce professional ethics standards for the profession; assist members in continually improving their professional conduct and performance; and monitor such performance by enforcing current standards.

In addition to interpreting the Code and setting standards, the Committee also is responsible for the Joint Ethics Enforcement Program (JEEP) — an AICPA/state CPA society program for ethics enforcement that has existed since the early 1970s. The program's objectives are to provide (1) a single investigation and action with respect to a person who is a member of both the AICPA and the society; (2) nationwide uniformity in codes of conduct, as well as in their enforcement and implementation.

The Committee is composed of 20 members, including at least one representative of a state board or the National Association of State Boards of Accountancy (NASBA), as well as three non-CPA members representing the public. The Chair of the AICPA Board of Directors appoints the members for a one-year term. This year, a past NASBA board member was appointed to the Committee, and in the upcoming year, two state board/NASBA representatives will serve on the Committee.

The Chair of the NASBA Ethics Committee is invited to attend all open AICPA Committee meetings, which are held quarterly for two days. State boards are advised in advance of all Committee meetings by e-mail and other alerts, with the offer of participation via teleconference. State boards also receive a summary of the minutes of all open Committee meetings, as well as the quarterly newsletter *Ethically Speaking*, which highlights the latest developments in ethics activities.

A full summary of the Committee's role and programs is available at: http://www.aicpa.org/download/ethics/Ethics-Committee-Fact-Sheet.pdf.

Modernization of Independence Rules

In late 2001, the Committee embarked on a three-year program to modernize the Code in order to ensure its continued effectiveness in protecting the public interest by promoting the independence of AICPA members. Phase One dealt with independence rules related to financial interests, and family and business relationships. Phase Two focused on nonattest services rules.

In November 2001, the Committee adopted significant revisions to its independence rules in the areas of financial interests, and family and business relationships. These new rules, which substantially mirror those of the Securities and Exchange Commission (SEC), achieve what is commonly referred to as an "engagement team-based approach" to independence. Rules recently adopted by the General Accounting Office (GAO) and the International Federation of Accountants (IFAC) are consistent with the Institute's new rules in these areas. In essence, the U.S. and international rules for independence dealing with financial interests, and family and business relationships — those applying to auditors of public, private, governmental, and non-profit entities — are finally uniform and represent a huge step forward for the profession.

Input from State Boards

From the outset, the Committee recognized the importance of the state boards' involvement in the modernization process and the need to synchronize their rules with the new national standards in order to ensure harmonization for all U.S. practitioners.

Accordingly, throughout the process the Committee invited representatives from the states to participate in its standard-setting deliberations. Members of the Committee met with representatives of state boards expressing interest in modernizing their rules, either by adopting AICPA rules or incorporating them by reference. Prior to adopting the final standard, representatives of the AICPA Ethics Division visited numerous state boards to obtain feedback on the proposal and actively solicited comments from state boards on the exposure draft. All comments were given careful consideration by the Committee, which issued a white paper on the rules explaining the disposition of the comments received.

On December 4, 2001, shortly after the new rules were adopted, then former NASBA Vice-Chair K. Michael Conaway and representatives of the AICPA Committee participated in a live, interactive Web conference entitled, *Modernization of the Profession's Independence Rules*. The conference, sponsored by the Committee, addressed live e-mail questions on the new AICPA rules, the impact of modernized and harmonized rules on practitioners and the public, as well as state-related issues. The conference attracted roughly 84 participants representing CPA societies, state boards and AICPA members. A VHS recording of the event was also made available to state boards. Since early 2002, numerous states have moved to adopt or incorporate new rules on independence.

Modernization of Nonattest Services Rules

In late 2001, the Committee embarked on Phase 2 of its modernization project, which involved a reexamination of Interpretation 101-3, *Performance of Other Services*, and Interpretation 101-13, *Extended Audit Services*. The reevaluation was launched to ensure continued independence when a member renders nonattest services to an attest client.

On March 19, 2003, the Committee issued an Exposure Draft of the *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*, which contained several changes to independence rules governing nonattest services, loans, and leases. In June 2003, the Committee adopted several nonattest rule revisions, which take effect on December 31, 2003.

The revisions require members to:

- Comply with regulations of certain regulatory bodies, such as the state boards of accountancy, SEC, GAO, and Department of Labor, when performing services for attest clients that are governed by such regulators' independence rules;
- Assess the client's willingness and ability to oversee permitted nonattest services; and
- Document various aspects of the permitted nonattest services engagement (objective and nature of the services, client's acceptance of its responsibilities, member's responsibilities, and any limitations of the engagement) prior to performing nonattest services.

In addition, the Committee adopted more restrictive rules for certain services:

- Performing appraisal, valuation and actuarial services would impair independence if the results of the service would be material to the client's financial statements and the services involve a significant degree of subjectivity. Actuarial valuations of a client's pension or postretirement benefit plan liabilities and liabilities performed for non-financial statement

purposes (e.g., estate and gift tax-related valuations) are permitted provided all of the interpretation's other requirements are met.

- Performing certain financial information systems design and implementation services would impair independence, for example, when a member creates or makes more than insignificant modifications to the source code underlying a client's financial reporting system. Members also are precluded from operating a client's local area network (LAN) since that activity is considered to be a management function.

Members who have pending agreements subject to the new rules have until December 31, 2004 to complete such services. The final nonattest rules are available on the AICPA Web site at: http://65.242.185.106/download/ethics/interp_revisions_jun03.pdf.

The Committee continues to reevaluate its rules on nonattest services and will consider additional nonattest services not yet reviewed by the Committee, such as litigation support services and executive/employee search services.

Outreach to State Boards

Representatives of various state boards, NASBA and other experts assisted in the review and participated in four task forces that were assigned to examine the general standards and specific nonattest services. The Committee also held a Web conference in April 2003 to discuss proposed changes and solicit feedback from representatives of state boards and others.

Enhanced Ethics Enforcement

In mid-2001, well before the media focused on Enron and its independent auditors, the Committee had established a task force to evaluate the AICPA's disciplinary process and develop recommendations for improvement. In May and October 2002, representatives of the Committee presented the AICPA Council with several proposals aimed at strengthening ethics enforcement to help restore public and regulator confidence in the profession.

Based on the Council's response, the Committee implemented a more transparent system, making it easier for observers to determine what sanctions, if any, the AICPA had imposed on a member. For example, to make it simple for readers to trace an AICPA action to a publicly reported matter, the Committee will add — to notices it publishes of disciplinary actions against members — information that already is a matter of public record, such as the number of the SEC's accounting and auditing enforcement release, where applicable. And from now on, all members whose names are published in *The CPA Letter* as a result of an AICPA disciplinary action also will be named in the national edition of *The Wall Street Journal* on a periodic basis.

At the Council's 2003 spring meeting, the Committee presented three more enforcement-related proposals. One proposal for an admonishment sanction, which required approval by the Council only, is already in effect. The two other proposals, which would allow for automatic sanctions by the Committee and greater public disclosure of its investigations, will be decided in a member referendum. The proposals are meant to ensure that the AICPA, as advocate for the integrity of the

nation's CPAs, has the greatest flexibility and ability to act in the public's interest whenever a member violates the profession's code of ethics and conduct.

Admonishment Sanction

This sanction enables the Committee to publicly admonish an AICPA member who has violated the Code when other sanctions — whether more restrictive (suspension of membership) or less so (issuance of a private letter of required corrective action) — are inappropriate. Adoption of this proposal aligns the Institute's approach to discipline with that of other bodies, including the joint trial board and state and federal regulators.

Automatic Sanction

This proposal would establish an ethics enforcement policy allowing the Committee to automatically sanction without an investigation an AICPA member who has been disciplined by a government agency or other organization authorized to regulate accountants, and whom the Committee and AICPA Board have approved. Examples of disciplinary bodies under consideration are the IRS, SEC and Public Company Accounting Oversight Board (PCAOB). State boards of accountancy are already recognized under AICPA bylaws as an approved disciplinary body; however, the proposal would broaden the AICPA's ability to automatically sanction a member who has been disciplined by a state board.

The process would work as follows: As is the case today, if a State Board of Accountancy suspends, revokes or cancels a member's certificate or license to practice public accounting, the AICPA would automatically suspend or terminate the member's AICPA membership accordingly. However, if a State Board of Accountancy metes out any other public disciplinary or remedial sanction or penalty (e.g., censure/admonishment, monetary penalty, cease and desist), currently the Committee must conduct its own investigation and determine the appropriate sanctions. Under the proposed amendment, this additional investigation would be avoided because the member would be automatically disciplined in a manner commensurate with the state board action. The proposal requires the Committee to develop — and the AICPA Board of Directors to approve — specific sanctioning guidelines for this purpose.

The proposed automatic sanction under section 7.3 of the bylaws is designed to protect the CPA hallmark and members in good standing by making the AICPA's enforcement process timelier while ensuring that members under investigation have an opportunity to present a defense.

Enhanced Transparency

This proposal would establish a policy that allows the Committee — subject to the Council's review and approval — to provide the public with more relevant and useful disclosure about matters it has investigated. The proposal also would allow the Committee to disclose the results of an investigation to an individual or body filing a complaint with the AICPA. All sanctions currently imposed by the Committee that result in admonishment, suspension or expulsion are published in *The CPA Letter*, on the AICPA Web site (http://www.aicpa.org/) and — beginning fall 2003 — periodically in *The Wall Street Journal*.

Currently, remedial actions taken against AICPA members and matters that are closed with no finding, or with a finding of no violation, are not published or disclosed except to certain government agencies that had referred such matters to the professional ethics division. Individuals who filed complaints against AICPA members found this nondisclosure policy frustrating. While complainants were informed *when* an investigation had concluded, they were not advised as to *how* the matter was resolved.

The proposal before the membership would allow the Committee to disclose investigation results to people who filed formal complaints with the AICPA. Those who choose to file complaints should be able to find out the results of the investigation. Providing the public with more relevant and useful information about ethics investigations and disclosure of the results to a complainant is both in the public interest and will help to enhance the credibility of the enforcement process.

The Institute has created a special spotlight section on its Web site (http://www.aicpa.org/enforcement/) that contains the proposals in their entirety, along with answers to key questions and an overview of the ethics enforcement process.

Other Current Projects

Creating a Conceptual Framework for Independence

In April 2002, the Committee formed a task force to develop a conceptual framework that would underlie the AICPA's independence rules. The intended purpose of the framework is to aid the Committee in its future standard-setting activities by articulating the components and steps of a risk-based approach to analyzing independence matters. For example, it sets out the types of broad threats to independence (such as self-review or familiarity) and the types of independence safeguards (i.e., controls, restrictions, or outright prohibitions) that the Committee will need to focus on when developing new independence rules or revising existing ones. The framework does not, however, establish new independence rules, and is not intended to replace the existing set of rules.

The conceptual framework is written in a plain and concise style, including a definition of key terms (such as "independence," "threats," and "safeguards") and provides illustrative examples of threats and safeguards. It also embraces the notion of "independence in appearance" by incorporating the concept of a reasonably informed observer.

At its June 2003 meeting, the Committee agreed on a working draft of the framework, which has been disseminated to state accountancy boards and CPA societies for their feedback. Once this feedback is obtained, the Committee expects to begin using the framework in its standard-setting activities. Between obtaining state feedback on the framework and applying the concepts when setting standards over the next committee year (October 2003-04) the Committee will "test" the working draft to determine whether it enhances the current rulemaking process.

Significant Clients and Member Objectivity

In May 2002, the Committee began a project to identify the policies and procedures that are being applied by accounting firms that, in the Committee's view, effectively mitigate potential threats to objectivity that could arise when members provide services to "significant" attest clients (measured in terms of fees, status, or other factors). In an effort to provide helpful guidance to members, the Committee has explored communicating its findings through the following vehicles:

- *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*. The Committee provided the Auditing Standard Board's Joint Quality Control Standards Task Force with input derived from this project so that the Task Force may consider it when revising the Guide.
- AICPA *Independence Risk Alert*. The Alert would address various independence and objectivity-related topics, including significant clients.

The Committee will continue to work towards delivering guidance in this area.

Ethics Resources and Tools

The AICPA Ethics Division has developed a "one-stop shop" on the Institute's Web site that offers numerous resources and tools to promote greater awareness of the ethical standards contained in the Code, as well as to provide updates on developments in the ongoing standards-setting process, including the proposals summarized above. The Web site at: http://www.aicpa.org/members/div/ethics/index.htm provides links to the following ethics-related educational materials offered by the Institute:

- *Ethically Speaking* newsletter
- Ethics and independence CPE courses
- *Plain English Guide to Independence*
- Ethics Decision Tree and Case Study for Members in Business & Industry

Ethics Hotline

The staff of the AICPA's Professional Ethics Division continues to field questions on a broad range of independence and ethics matters through the Division's Ethics Hotline. For many years, the Division has offered the hotline as a free service to AICPA members and others to promote compliance with the ethical standards contained in the *AICPA Code of Professional Conduct*, and to promote an understanding and appreciation for independence and ethics rules in general.

The Hotline staff receives approximately 5,000 queries annually via telephone, regular and electronic mail, and facsimile. To discuss an independence or ethics question with a member of the hotline staff, call (888) 777-7077, send an E-mail to ethics@aicpa.org or fax to (201) 938-3367.

Conclusion

The AICPA recognizes that recent corporate scandals and the passage of the Sarbanes-Oxley Act have provided a new opportunity to focus on ethics in corporate America. As a result, some state legislators and regulators have been examining how to ensure ethical behavior of CPAs as they carry out their public interest mandate.

We further acknowledge the mandate of these state officials in carrying out their public protection duties, and support the efforts that take a reasoned approach in considering such actions. A reasoned approach recognizes the existence of the AICPA's *Code of Professional Conduct* and the processes that exist to interpret the Code, set ethics standards and ensure compliance with such standards through the AICPA's disciplinary process. It is also important to recognize the changes that have been made and those being proposed to enhance the Code and the ethics enforcement process, thereby strengthening the ethical mandate of AICPA members.

Moreover, in order to ensure uniformity, state regulators, legislators and executive branch officials should consider the importance of providing uniform practice and ethical standards, for the high percentage of CPAs that serve clients and their employers across state lines. Nearly 25 states currently reference the AICPA's *Code of Professional Conduct*. All states are encouraged to reference the Code, rather than write new rules that may undermine the uniformity goals so desperately needed by the profession, their clients and the public they serve.

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Scope Of Services - Issues Brief

The scope of services that a public accounting firm registered with the Public Company Accounting Oversight Board can provide to issuers, as defined in the Sarbanes-Oxley Act of 2002, was addressed in Title II of the Act, classifying eight specific services as unlawful, including:

1. Bookkeeping
2. Information systems design and implementation
3. Appraisals or valuation services
4. Actuarial services
5. Internal audits
6. Management and human resource functions
7. Broker or dealer, investment advisor, or investment banking services
8. Legal services and expert services unrelated to the audit

In addition to these eight, there exists a catchall category authorizing the Public Company Accounting Oversight Board (PCAOB) to prohibit by regulation any additional services it deems inappropriate. Further, other non-audit services, including tax services, require pre-approval by the audit committee.

Section 209 of the Sarbanes-Oxley Act allows state regulators to make “an independent determination of the proper standards applicable” in supervising *non-registered* accounting firms. Standards applied by the PCAOB “should not be presumed to be applicable” for small and medium sized firms.

One of the authors of the bill, U.S. Senator Sarbanes, said from the Senate floor on July 8, 2002, "This bill applies only to public companies that are required to report to the SEC. It says plainly that State regulatory authorities should make independent determinations of the proper standards and should not presume that the bill's standards apply to small- and medium-sized accounting firms that do not audit public companies."

To effectively determine the applicability of the scope of services standard at the state level, it is important to understand the implications of such restrictions on small private companies and their auditors. This document highlights several such issues for consideration.

Private vs. Public Investors

The Sarbanes-Oxley Act was passed largely to protect public stakeholders, who have little direct contact with the company they invest in or its management and are principally passive investors. Many of these investors own shares of these companies through investments in their employers' retirement plans and many also have a limited level of financial sophistication and little or no knowledge of the day-to-day operations or business practices at the organizations in which they place their money. They need an enhanced level of protection.

Yet, the "public" is not at risk when a private company, in which they have no investment, utilizes its CPA firm to perform non-audit services. At private companies, stakeholders include the owner/operators, banks and lenders, and possibly a small group of investors, all presumably financially savvy and having enough direct contact with company management to be able to understand managements' and the auditor's actions.

In this scenario, the user of the financial statement is less in need of protection and more in need of information and financial transparency in order to make business decisions.   Thus, the level of government intervention and protection measures applied to non-public companies need not be the same as for public companies. Having the government make these types of choices could jeopardize the spirit of free enterprise.

Audit Quality Enhanced By Deeper Relationships

Most users of financial statements in the private company environment believe their CPA firm can provide a better quality audit if they provide multiple business services. Involvement in appropriate aspects of a company's business enhances the auditor's knowledge of the company. In an era of increasing complexity of systems and business models, an auditor's strong understanding of its clients' businesses better positions that CPA to identify risk factors and critical issues. Bank officers, who are primary users of financial statements, agree. Research among smaller banks shows that they value the performance of the non-audit services performed by the auditors of private companies.

Reliance on the CPA for Critical Business Services

Most private companies maintain long, value-added relationships with the CPA firm that conducts their audits. In fact, research has shown that the CPA is often considered a private company's most trusted business advisor. Private companies often rely on their CPA firm to provide other critical business services outside the audit including tax compliance and planning, general business consulting, and assistance when hiring accounting personnel.

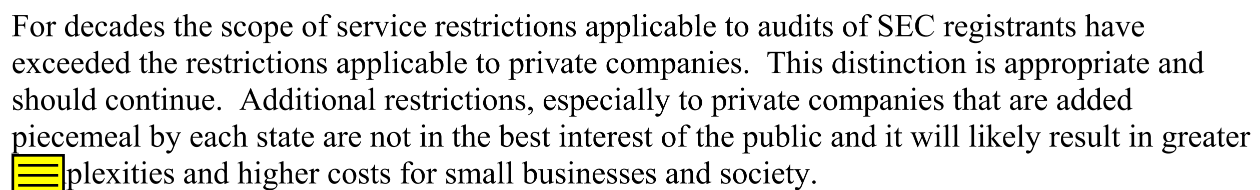
Placing unreasonable restrictions regarding which of these services CPA firms can provide to their private company clients would increase costs for these companies, which would now need to engage multiple service providers for services needed beyond the audit. The synergies enjoyed by using a single firm for multiple services would be lost altogether. Further, the additional burden of keeping multiple firms informed of the affairs of the company could dissuade smaller businesses from obtaining the services they need to improve their systems. Companies would be faced with a continuous dilemma as to whether to retain their audit firm or change auditors in order to use them for some other project. In some smaller communities, it may be difficult for businesses to even find another suitable service provider within a reasonable geographic distance.

Current Restrictions Provide Uniformity

Professional ethics already prohibit an auditor from performing management duties and include a significant number of restrictions and safeguards to protect auditor independence when

performing non-audit services. The AICPA *Code of Professional Conduct* provides numerous examples of services that would be inappropriate for auditors to perform on behalf of their clients and also sets forth the responsibilities of client management that must be in place for the auditor to accept such engagements. If each state selects a different set of restrictions, tremendous complexities would be created and compliance would suffer. Further, differing state-based restrictions may make it attractive for private companies to locate their businesses in the states that do not impose unreasonable demands, creating trade barriers and economic disadvantages. The AICPA, in conjunction with the state boards of accountancy and NASBA, is in the process of reviewing its rules on non-audit services to determine their appropriateness. It is anticipated that regulators will also provide input to help insure uniformity across states. In any case, it would be premature for states to institute any change prior to the PCAOB's implementation process and further definition by the SEC of the broad prohibitions contained in Sarbanes-Oxley Act.

<u>Conclusion</u>



For decades the scope of service restrictions applicable to audits of SEC registrants have exceeded the restrictions applicable to private companies. This distinction is appropriate and should continue. Additional restrictions, especially to private companies that are added piecemeal by each state are not in the best interest of the public and it will likely result in greater complexities and higher costs for small businesses and society.

When the auditor provides multiple services to a private company, within restrictions provided in the profession's *Code of Professional Conduct* that company enjoys the synergies of a multifaceted relationship and the quality of the audit is improved. Regulators continue to work with the profession to ensure that scope of services restrictions are appropriate and protect the public interest. The states have an opportunity to protect the interest of their small privately held companies by allowing the valuable relationships between these companies and their auditors to continue in accordance with the Code uniformly nationwide.

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State Board of Accountancy Composition - Issues Brief

In the wake of the Enron collapse, the National Association of State Public Interest Research Groups (PIRG) has recommended a series of reforms to states' regulation of the accounting profession, including calling for a majority of the members of each State Board of Accountancy to "be selected from the public to represent the interests of shareholders, investors, pension beneficiaries and future retirees." As states consider this recommendation and others, the following paper outlines the implications of such action and provides a general description of the roles of state boards of accountancy and the current regulatory process of the accounting profession.

As part of PIRG's mission to "encourage a fair marketplace for consumers," in June 2002, the organization published "In the Wake of Enron: A Survey of State Accounting Board Membership and the Need for Reform." The report studied potential conflicts of interest at the state level and national oversight of the accounting profession. Included in the report was the recommendation that state boards of accountancy be comprised of at least a majority of non-CPAs. However, the PIRG report did acknowledge that reducing the number of CPAs on the state boards of accountancy would impair the board's ability to fulfill its primary responsibility: to inspect and discipline members of the profession and set professional standards.

Roles of State Boards of Accountancy

State Boards of Accountancy certify public accountants through a process that involves educational requirements, a uniform CPA examination, practical experience requirements, with continuing professional education requirements and a process of reviewing the practice on an ongoing basis. The state boards also have a statutory responsibility to protect the public and do so by investigating complaints and violations of state laws and regulations against licensees and taking appropriate disciplinary action including suspension or revocation of a CPA's license.

Members of State Boards of Accountancy are generally appointed by the Governor and ratified by a legislative body. Composition of the boards is set by state statute. The legislatures must approve the budget and thus oversee its activities.

State Board Composition

All of the functions performed by the Board of Accountancy require experts completely steeped in the technical issues confronting the profession and the application of auditing principles to real-life situations. In nearly every state, these tasks are performed by the CPA Accountancy Board members - volunteers who have many years of experience, are able to apply auditing principles to real-life situations, and operate an accounting practice concurrent with service on the board thereby being completely steeped in the technical issues confronting the accounting profession. These members have the expertise and practical knowledge to effectively enforce the laws of the state.

To attempt to capture this level of expertise as staff would be cost-prohibitive, assuming this caliber of professional agrees to give up his or her accounting practice to work for the state board in a full-time position.

Board Member Competencies

In light of the technical nature of much of the board of accountancy's responsibilities, a majority of the board should be certificate holders. Moreover, any members of the board not having such qualifications should have professional or practical experience in the use of accounting services and financial statements, thus being qualified to make judgments about the qualifications and conduct of persons and firms subject to accountancy regulations. For example, as the AICPA has proposed for members of corporate audit committees, this type of experience would be defined as having broad knowledge and experience in generally accepted accounting principles and financial reporting, for example as the CEO, a CFO, controller or auditor of a company.

As with other professional-licensing boards, the responsibilities of the board require members with thorough knowledge of the profession. Hiring such high quality, experienced professionals is likely to be costly and, given their level of expertise, they are likely to be on various boards of directors and receiving compensation for that service. State accountancy boards would need to offer commensurate compensation in order to attract their talent. Further, the demand on these professionals' time could likely be more significant than in the past given the recent increased focus on enforcement.

While we do not believe public interest is served by having a board with a majority of non-CPAs, we believe there should be public representation on all boards, and that these public members should be successful business people who have a broad perspective of all aspects of owning and operating a business. S/he needs to know how to ask questions to find out what s/he does not know and how to elicit information helpful to the discussion at hand. S/he needs to have a quick mind to follow discussions about topics in which s/he may not have first hand knowledge. His/her reputation has to be above reproach. In short, s/he has to be the individual who every other group is already pulling on for his/her time and attention and many licensing jurisdictions find it difficult to attract those individuals. Failure to provide a qualified accountancy board would lead to ineffective board meetings, inconsistent decisions regarding issues brought before the board and inefficient use of resources due to the extra amount of time and energy to educate board members on the issues.

In March 2003, the National Association of State Boards of Accountancy (NASBA) Regulatory Structures Committee prepared a paper entitled "Discussion Memorandum: State Board Composition" to provide guidance and background for state boards of accountancy or other interested parties that are reviewing the composition of their state boards. After surveying public members from six states, the results were that most public members support the requirement for a majority of board members possessing accounting expertise to properly address technical and disciplinary matters.

Historical Background and Overview

Governance of the Accounting Profession

In addition to the State Board of Accountancy's role in governance of the accounting profession, there are a number of other bodies involved in the regulatory process, including: the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB) and the American Institute of Certified Public Accountants (AICPA).

The Sarbanes-Oxley Act of 2002 created the PCAOB to oversee public audits and the accountants who perform them. The PCAOB is under the oversight of the SEC and can set standards and enforce them with disciplinary actions and sanctions. CPA firms registered with the PCAOB are subject to quality audits (annually for firms that audit more than 100 issuers, every three years for other firms), investigations and related actions.

The AICPA bodies involved in the monitoring and disciplining of auditors include the Professional Ethics Division, the Joint Trial Board and the Peer Review Board. The Professional Ethics Division and the Joint Trial Board enforce technical and ethical standards by investigating and adjudicating disciplinary charges against auditors. The Peer Review Board administers a quality monitoring program for firms that perform audits, reviews, compilations and attestation engagements. Unlike the SEC and the state boards of accountancy, AICPA bodies do not have subpoena power; their disciplinary authority extends only to a CPA's membership rights in the AICPA or a state society of CPAs, and their disciplinary hearings are deferred while litigation or regulatory proceedings are in process. These bodies have not shared investigations or information with the state boards of accountancy until they are made public through membership publications.

The oversight system put into place over many decades has generally responded quickly and effectively to deal with problems in the financial markets:

- Congress has enacted a comprehensive reform of corporate governance and accounting practices, directing the SEC to assume responsibilities for oversight and regulation.
- The New York Stock Exchange and NASDAQ have promulgated tighter standards for listed companies.
- Industry associations and major companies have taken voluntary steps to improve controls and disclosure and to eliminate perceived conflicts of interest.

The system is demonstrating the ability and commitment to correct abuses and carry out reform. There has not been enough time to determine if the deterrent effects of judicial actions and strengthening of both national laws and business regulations have been sufficient. It is premature to make a judgment as to the need for action at the state level.

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About the Special Committee on State Regulation

In October 2002, AICPA Chair James G. Castellano established a high-level volunteer group to respond to the possible implications of the Sarbanes-Oxley Act at the state level and to make recommendations to the AICPA Board of Directors and to provide guidance to state CPA societies.

The AICPA Special Committee on State Regulation convened its first meeting in November 2002, chaired by former AICPA Chair Kathy G. Eddy of West Virginia. Additional members of the Committee include representatives from government, business and industry, public practice, state boards of accountancy and state CPA societies.

The Committee provides input to the AICPA and assists states with addressing the state issues and implications associated with the passage of the Sarbanes-Oxley Act. The Committee recommends positions to the AICPA Board of Directors on the issues. It also drafts and reviews materials to communicate the issues and the positions taken to states, the AICPA and State Society members. Additionally, where appropriate, the Committee assists states with state legislative and regulatory activities.

Furthermore, the Special Committee shares its findings and recommendations through various methods, including AICPA and state society publications, a special web site section and e-mail bulletins.

The members of the AICPA Special Committee on State Regulation are:

- Kathy Eddy, Chair – McDonough, Eddy, Parsons & Baylous - West Virginia
- Ernie Almonte, The Office of the Auditor General - Rhode Island
- Bill Balhoff, Postlethwaite & Netterville - Louisiana
- Neal Harte, The Audit Committee Support Group & Adjunct Professor, Boston College-Massachusetts
- Cindie Hubiak, Arizona Society of CPAs - Arizona
- Carlos Johnson, Oppenheim, A Division of BOSC Inc. - Oklahoma
- Mike Mares, Witt, Mares & Co., PLC - Virginia
- Mike Mountjoy, Carpenter, Mountjoy & Bressler, PSC - Kentucky
- Ron Rotaru, Accountancy Board of Ohio - Ohio
- Hal Schultz, PricewaterhouseCoopers LLP – California
- John Sharbaugh, Texas Society of CPAs - Texas
- Alan Steiger – A-dec, Oregon
- Buddy Turman, Florida Institute of CPAs - Florida