

ASSESSING THE IMPACT

The Significance of the
Sarbanes-Oxley Act of 2002 for State
Regulation of the Accounting Profession



Background Materials for the
2003 Regional Meetings of the
National Association of State Boards of Accountancy

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INTRODUCTION

This paper was developed as a resource guide for participants at the June 2003 Regional Meetings of the National Association of State Boards of Accountancy. The short summaries give brief overviews of the topics to be considered and are coupled with discussion questions and references to source documents.

Following the Enron and WorldCom disasters, the U.S. Congress passed Public Law 107-204 (the “Public Company Accounting Reform and Investor Protection Act of 2002,” which is known as the “Sarbanes-Oxley Act of 2002”). The Act can be found on the Library of Congress’ Web site <http://thomas.loc.gov/>.

As mandated by Sarbanes-Oxley, the Securities and Exchange Commission set about establishing rules that implement the Act’s requirements. These can be found on the SEC’s Web site <http://www.sec.gov/>. In particular, accountancy boards are concerned with the rules implementing Section II of the Act. The discussion of these can be found on the SEC site under the title “Final Rule: Strengthening the Commission’s Requirements Regarding Auditing Independence.”

The creation of the Public Company Accounting Oversight Board (PCAOB) was one of the mandates of the Sarbanes-Oxley Act. In March 2003, the PCAOB began issuing its proposed rules for registration of auditing firms and SEC registrants. They can be found on the SEC’s Web site as well. At this writing, the rules are not yet on the PCAOB’s site, but are anticipated to be there shortly <http://www.pcaobus.org/>. PCAOB rules have to be exposed for comment before being finalized, then after the comments are considered and the PCAOB finalizes its rules, they are to be sent to the SEC for approval. Following another exposure period, the SEC will approve the rules the PCAOB will use.

Besides checking these sites for original documents, summaries of the Sarbanes-Oxley Act’s provisions, as well as a regularly updated listing of state legislation related to Sarbanes-Oxley can be found on the American Institute of Certified Public Accountants’ Web site <http://www.aicpa.org/>. Another Web site with a summary of the provisions from an international practice vantage point can be found on the Deloitte Touche Web site <http://www.iasplus.com/>.

Of particular significance to the state boards, and to the Regional Meetings, is Sarbanes-Oxley Act **Sec. 209: Consideration by Appropriate State Regulatory Authorities:**

“In supervising nonregistered public accounting firms and other associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of accounting firms they supervise and the size and nature of the business of the clients of those firms. The standards applied by the Board under this Act should not be presumed to be applicable for purposes of this section for small and medium sized nonregistered public accounting firms.”

Scope of Services

Under the provisions of the Sarbanes-Oxley Act (SOX) and its related rules, auditors of public companies are prohibited from providing certain non-audit services concurrent with the time they serve as the company's auditor. The non-audit services that are prohibited, with exceptions possible on a case-by-case basis by the Public Company Accounting Oversight Board (PCAOB), include the following:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; or
- Any other service that the PCAOB determines, by regulation, is impermissible.

The auditor if pre-approved by the audit committee may provide other non-audit services, including tax services. Audit committees must periodically disclose what non-audit services have been approved. This disclosure requirement is waived if:

- The non-audit services amount to five percent or less of the total fees paid during fiscal year when the non-audit services are performed by the auditor;
- Such services were not recognized by the company at the time of the engagement to be non-audit services; and
- Such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

The audit committee can delegate authority to one or more members of the committee to pre-approve non-audit services; however, any non-audit services approved must be reported to the audit committee by the delegate(s).

Why Prohibit Non-Audit Services?

For many years a number of CPAs, educators, investors, regulators and others have been concerned that the rising amount of fees for non-audit services provided by auditors increased the risk that their independence and objectivity would be challenged. In response to such assertions, others, equally qualified and armed with studies with opposite conclusions, contended that there was not an inherent conflict between firms providing both audit and non-audit services to the same clients. They argued that it was necessary to be a one-stop shop in order to maintain client relationships and the CPAs' position in the marketplace.

SOX does not define "independence" in Section 201, but accepts the definition contained in the AICPA Code of Conduct. The Code provisions are also reflected in the accountancy laws of the various states.

The Code defines the basic principle of independence as:

- ✓ A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

Generally accepted auditing standards require:

- ✓ In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.

SOX builds its provisions and rules on the notion of independence contained in the Code and GAAS. From that foundation, SOX holds that to protect the interest of the investor in the regulated capital market it is essential that auditors meet the threshold standard of independence without question. The Congress and President of the United States have clearly determined that to protect the public interest in these matters that opportunity for an auditor to provide non-audit services to a public company must be limited and not include the specific services listed.

SEC Implementation of SOX

The SEC moved to implement the provisions of SOX by adopting rules to strengthen auditor independence and require additional disclosures to investors about the services provided to issuers by the independent accountant by adopting the “Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence” in January 2003.

The SEC took its mandate to enhance auditor independence very seriously by expressing their high regard for auditor independence in the Final Rule as follows:

“The Commission’s principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditors independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client.”

That statement provides the basic conceptual framework of the SEC regarding the provisions of the Final Rule. The Final Rule addresses each of the non-audit services prohibited by SOX and points out that many, if not most, of the prohibited non-audit services were already prohibited under existing SEC rules; however, those rules had been adopted over time and had exceptions and exemptions from the prohibitions. In keeping with the SEC’s stated three principles concerning auditor independence, all the previously prohibited non-audit services were carried over to the Final Rule and most, if not all, of the previous exceptions and exemptions were eliminated.

The Final Rule considers tax services to be unique among the non-audit services. It acknowledges that auditors have historically provided tax services, and that the IRS vigorously oversees compliance with tax laws and regulations. For these reasons the Final Rule allows tax practice to continue. However, the SEC suggests that auditors be mindful of the three basic principles of auditor independence when providing tax services. The Final Rule states that, while it is acceptable for auditors to provide traditional tax services to audit clients, some tax services will be prohibited on a facts and circumstances basis because they do impair independence. Therefore, the Final Rule warns against audit committees and auditors labeling as “acceptable” tax services activities that are in fact advocacy services – such as representing clients in tax court, district court or the federal court of claims.

The Final Rule identifies a number of non-audit services that auditors can provide to their audit client that are not prohibited, and, in fact, are encouraged. When describing what non-audit services are permitted, it notes that results of these services do not become part of the evidence examined by auditors when auditing the financial statement of the client and registrant. Examples of these permitted services:

1. Hardware and software consulting in areas that do not become part of the financial statement process.
2. Appraisal or valuation services relating to non-financial reporting such as transfer pricing, cost segregation studies and other tax-only valuations.
3. Using valuation specialists to review the valuation work provided by the client or the client specialist.
4. Services such as “agreed upon procedures” are permitted since management takes responsibility for the scope and assertions of such engagements.
5. Internal control reviews, assessments and tests necessary to perform the audit of the client’s financial statements, as well as the recommendations for improvements that may result from such audit procedures.
6. Undertaking as an expert special studies, fact-finding, or forensic work that results in the issuance of a report to the audit client. The SEC feels such services will improve the client’s internal controls.
7. Auditors are also not prohibited from assisting the audit committee in fulfilling its responsibilities.

Worthy of note is the prohibition against legal services being provided by the auditor. The previous rule deemed the auditor to lack independence when they provided legal services to the audit client. The Final Rule is “...prohibited from providing to an audit client any service that, under the circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.”

Should Service Prohibitions Be Enacted by States?

In response to the federal SOX action to protect the public interest by prohibiting certain non-audit services being provided by the auditor of a public company, state boards of accountancy are being challenged by organizations and individuals to reexamine the way boards of accountancy regulate the practice of accountancy. As part of the reexamination, boards of accountancy should consider if their state needs to adopt similar non-audit service prohibitions that would apply to all licensed accountants.

DISCUSSION QUESTIONS

1. How important is it to have uniform regulations governing the practice of accountancy?
2. Does it matter if a state board and governmental agencies requiring audited financial information have different rules on the same subject?
3. If a licensee violates a practice rule of a governmental agency that is not a rule of the board of accountancy, should the board of accountancy take any action?

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“Commission Adopts Rules Strengthening Auditor Independence” (On line) (U.S. Securities and Exchange Commission On Line, accessed April 7, 2003) available from: <http://www.sec.gov/news/press/2003-9.htm> complete press release describing how the SEC adopted rules to fulfill the mandate of Title II of the Sarbanes-Oxley Act of 2002, strengthen auditor independence and require additional disclosures to investors about the services provided to issuers by the independent accountant.

“Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence – Section B. Scope of Services Provided by Auditors” (U.S. Securities and Exchange Commission On line, accessed April 7, 2003) available from: <http://www.sec.gov/rules/final/33-8183.htm>

“A Closer Look at the Sarbanes-Oxley Act of 2002” – *California CPA Magazine* – September 2002, Pages 20 to 23 available on line at: <http://www.calcpa.org> The article states that “... to protect the public, Congress passed and President Bush signed the Sarbanes-Oxley Act of 2002 in July (2002).” The article provides “...a summary of the major provisions of the Sarbanes-Oxley Act, adapted from materials provided by the AICPA.”

“How the Sarbanes-Oxley Act Has Redefined Auditor Independence” by A. Christine David, CPA, a manager of litigation consulting and forensic accounting – *California CPA Magazine* – October 2002, Pages 14 to 16 available on line at: <http://www.calcpa.org> The article states how “...the accounting profession finds itself at the receiving end of the most uncompromising rules thus far on auditor independence, designed by federal legislators to ensure that the ‘independent auditor’ is truly independent... and how non-audit services provided to audit clients impact the independence of the auditor.”

“Seizing Upon Sarbanes-Oxley” by Kelly Barron, a free-lance writer in Los Angeles – *California CPA Magazine* – March/April 2003, Pages 12 to 15 available on line at: <http://www.calcpa.org> The article explains the “why” of Sarbanes-Oxley as being a necessary reform to prevent conflicts of interest –

perceived or actual – caused by auditors providing consulting services to their audit clients. The article cites “... a controversial study by Stanford Graduate School of Business faculty member Karen Nelson (that) reviewed the proxies of 3,000 companies in 2001 and found that more than half paid their auditors more for consulting than for audit services and that 95% of the firms purchased some non-audit services.”

Compensation - Fees and the Significant Client

The influence of compensation from a client on auditor independence is not directly addressed in the Sarbanes-Oxley Act. It is addressed indirectly by prohibiting specified non-audit services and requiring audit committee approval of all other services that exceed a specified fee level (Sec.201).

The issue is relevant to all types of auditing practices. Sole practitioners, small firms and the individual officers and practice partners of medium and large firms are all subject to the same fee-significant client impact on their independence.

The AICPA has been studying the issue for some time and is in the process of developing practice guidance, apart from ethics or auditing standards, intended to mitigate risks to independence when a client becomes significant.

It is generally agreed that when fees from a client reach some undefined level in relation to the auditor's total fee income, the appearance of independence is challenged and independence in fact may be compromised due to the dependence on the client. The threshold as a percentage of total fees is considered by some as ineffective and arbitrary.

Studies on this topic by academics, Congress (Metcalf and Moss and the Dingell subcommittees) and the AICPA (Cohen Commission, SECPS, Anderson Committee, Treadway Commission) have not resulted in conclusive evidence or standards.

The Independence Standards Board discussed requiring disclosure of fees but did not come to a conclusion.

“Now, recent cases and the comments of many critics strongly suggest that this critical independence is being subverted by fear of losing the client and future fees” (Lee Seidler March 6, 2002 Senate Committee testimony). With all the media attention and federal and state legislative activity, it is clear that the auditing profession's appearance of independence has been tarnished. In the view of many, true independence is difficult to maintain when the client pays

the fee. Former SEC Commissioner Arthur Levitt and representatives of investor groups have expressed their deep concern that auditor's independence has been compromised due to their reliance on the compensation from a client (*Take on the Street* by Arthur Levitt).

There have been suggestions from State Boards, members of the profession, and other interested parties that the auditor's compensation by types of services should be disclosed to the users of audited financial statements. This will allow the users to make their own judgments as to the independence of the auditor and the degree of confidence they have in the financial statements. It is the PCAOB's intention to have auditing firms disclose in their registration forms the annual fees received from issuers for audit services, other accounting services and non-audit services.

DISCUSSION QUESTIONS

1. Is there a need for further audit guidance or standards?
2. Should the Independence rules be changed in reference to fees?
3. Is it possible to quantify "significance" (percent of total firm/office/partner fees) as a guide?
4. Should there be disclosure of total compensation broken down by type of services:
 - A. In the auditor's report?
 - B. In footnotes to the financial statements?
 - C. By some other means?
5. Should a system be developed where the fee is not paid by the entity being audited? What about non-public clients?

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Audit Partner Rotation

The Sarbanes-Oxley Act of 2002, Section 203, requires that the lead audit or coordinating partner and the reviewing or concurring partner must rotate off the audit every five years for public companies. This Act does not apply to non-public entities. Section 207 mandates a General Accounting Office study on the potential effects of requiring the mandatory rotation of audit firms.

“We believe that the partner rotation requirements must strike a balance between the need to achieve a fresh look on the engagement and a need for the audit engagement team to be composed of competent accountants,” the SEC explained in issuing its final rule on auditor independence Section 210.2-01(c)(6)(i). The Commission expanded rotation to partners who had responsibility for decision-making on significant matters that affect the financial statements. However, accounting firms with less than five audit clients that are issuers and less than 10 partners are exempt from these rotations if the PCAOB conducts a review of each of those audit client engagements at least once every three years.

Public interest groups, such as U.S. Public Interest Research Group, have focused on the rotation of auditors for public companies and have not directly addressed the issue for non-public entities. Yet the state boards handle thousands of disciplinary cases each year; the greater majority involving non-public entities. In many cases the strict requirements of the Department of Labor, the GAO and other agencies are the standards on which those complaints are based.

The American Institute of CPAs supports Sarbanes-Oxley, Section 203, on the basis that it is consistent with the long-standing requirements of its SEC Practice Section for auditors of public companies. The Private Company Practice Section does not require rotation of partners for auditors of non-public entities. Similarly, the Institute’s report “A Reasoned Approach to Reform” does not support the mandatory rotation of audit partners for non-public entities, contending there is no public benefit, for the following reasons:

- There is no corresponding crisis of confidence in auditing of non-public companies (p.II.4.5).

- The third party reliance on financial statements is significantly different in the non-public environment (p.III.2), making rotation unnecessary.
- For the auditors of many non-public companies mandatory rotation is tantamount to firm rotation due to the non-existence or small number of partners (p.IV.1).
- Auditor rotation would force sole practitioners and many small firms to cease providing audit services (p.II.4).
- The cost to small businesses to obtain audit services would significantly increase (p.II.4).

Many states support the Sarbanes-Oxley Act's provisions for rotation of audit partners of public companies and are studying the need for similar rotation of auditors of non-public entities.

DISCUSSION QUESTIONS

1. Is there a corresponding crisis of confidence in the audits of non-public companies?
2. Is third party reliance on financial statements different in the non-public environment?
3. If there is a public interest need to rotate audit partners of non-public entities, is it of sufficient magnitude to justify the cost of mandated partner rotation for small businesses and their auditors that do not have sufficient depth of talent for rotation?
4. If there is not a significant threat to the public interest (protection) has the current crises pointed out a need for enhanced audit guidance, standards and ethics rules rather than audit partner rotation?

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Board Composition

The Sarbanes-Oxley Act may have set a standard for accountancy regulatory board composition by establishing a Public Company Accounting Oversight Board with a majority of non-licensees (three of five). Simply stated by then SEC Commissioner Harvey Pitt: “We oppose any regulatory system that is directly under the control of a profession it is designed to discipline.”

However, all State Boards have a majority of certificate holder members with the exception of California. According to a March 2003 paper by the NASBA Regulatory Structures Committee, even public members support the requirement for a majority of board members possessing accounting expertise to properly address technical and disciplinary matters. Licensee Board members claim the public’s interest far outweighs the profession’s interest when making their decisions. The study notes there is case law which affirms a board of accountancy with a majority of licensees does not have to retain an outside expert in the event of a disciplinary hearing and the Committee endorses the Uniform Accountancy Act’s provision cited in the following paragraph.

The UAA provides for a majority plus one that are holders of currently valid certificates, noting in the comments that in light of the technical nature of much of the Board’s responsibilities, it is desirable that an effective majority of the Board be certificate holders (UAA Section 4 (a)).

Public interest groups advocate public members on Boards and usually a majority, principally on the premise that certificate holders are unavoidably conflicted regardless of good intent (Center for Public Interest Law and U. S. Public Interest Research Group.)

Several state legislatures are considering legislation that if enacted will increase public representation on state Boards, in some instances establishing a majority. The most common rationale is that professional regulation without sufficient public participation has not proven to be effective in protecting the public.

DISCUSSION QUESTIONS

1. The profession's core values are founded on Independence, in both fact and appearance, and the standard of Objectivity. In carrying out the boards' role as regulators:
 - A. Are the boards more independent and objective with public member participation?
 - B. If yes to question A, to what extent is it in fact? In appearance?
 - C. How do the conclusions change if the *majority* of the board's members are public members?
 - D. If the boards reject a majority of public members, how do they convince the critics and the public that they are objective and independent?
 - E. If the number of public members on boards is increased (not a majority), will this satisfy their critics?
2. What is the impact on the quality of Board deliberations and decisions with public member participation assuming they are knowledgeable users of services?
 - A. If the Board majority are licensees?
 - B. If the Board majority are public members?
3. If majority public membership on Boards is mandated, how can the practical knowledge and expertise of the profession best be made available to the Board?
4. Is regulation more costly with public membership on Boards:
 - A. As minority members?
 - B. As majority members?
5. What qualifications should public members possess:
 - A. Should they have a background as users of public accounting services?

- B. Should they be representatives of consumer or public interest groups?

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Inspections of Registered Public Accounting Firms

Section 104 of the Sarbanes-Oxley Act requires the Public Company Accounting Oversight Board (PCAOB) to conduct inspections of all registered firms¹. Currently known as “peer” or “quality review,” this concept has been supported by the accounting profession for a number of years and is an accepted practice in many other professions as well.

Peer review programs were put into place to monitor the profession and enhance the protection of the public by identifying CPA firms that have inadequate systems of quality control, detecting non-performance in accordance with professional standards and imposing remedial action to correct deficiencies, and improving firms’ accounting and auditing practices. In 1977, the AICPA established a voluntary peer review program as an educational tool for its members. By 1988, many state boards of accountancy were requiring peer review for firm license renewal, and the AICPA approved a bylaw that required all members active in the practice of public accounting be associated with a firm that is enrolled in an approved practice monitoring program. Historically, the thrust of peer review programs has been to rectify deficiencies through education and remedial, corrective measures.

There are some fundamental differences between the proposed firm inspections by the PCAOB and the current programs. The PCAOB’s system will not be conducted by peers – it is not a firm-on-firm review. Moreover, the PCAOB firm inspection program will be punitive. Results could be the basis for disciplinary action by the PCAOB and SEC, or the impetus for formal investigations; furthermore, substantial fines could be assessed.

Although not a trend, other professions are also strengthening their peer review programs. California Senate Bill 16 has recently taken effect, which brings about a tenfold increase in the fine for failure to comply with medical board peer review reporting requirements. Maximum fines had been \$5,000 and now can reach up to \$50,000. These fines would be imposed personally and

¹ Any public accounting firm that wishes to prepare or issue any audit report with respect to any issuer must register. In addition, any public accounting firm that “plays a substantial role in the preparation or furnishing of an audit report” with respect to any issuer must register.

individually on the physician and it is dubious as to whether there is insurance coverage on such fines.

Unlike the review systems currently in place by the AICPA and SEC, for the PCAOB's there will be no deferrals for matters subject to litigation. The PCAOB's proposed registration requirements do not exempt foreign public accounting firms. How foreign firms are to be inspected is under discussion.

For firms with more than 100 issuers² as clients, the inspections will occur annually. For all other registered firms, inspections will occur once every three years. The PCAOB may adjust the inspection schedules if it finds that different schedules are appropriate. Additionally, it may conduct special inspections at the request of the SEC or upon its own motion.

Section 104 provides a general description of the procedures and conduct of the inspections. The Act states that during inspections the PCAOB will identify any activity, practice or commission in violation of the Act; report on such activities; and begin formal investigations or take appropriate disciplinary action. In its conduct of inspections the PCAOB will inspect and review selected audit and review engagements; evaluate the sufficiency of the quality control system; and perform such other testing of the audit, supervisory and quality control procedures as necessary.

Section 104 also indicates that firms may be required to maintain records for seven years. In addition, it allows for the review and response to draft inspection reports. Final reports, along with letters or comments relative to the inspection and firm responses, will be shared with the SEC and state regulatory authorities. Moreover, reports in appropriate detail will be shared with the public. Firms that disagree with the assessments of inspectors may appeal to the SEC.

The PCAOB has reported it will begin firm inspections in 2003 on some or all of the four largest firms. It is believed that PCAOB inspections will cover firms' SEC practices only. Therefore, a program will be needed to provide coverage of the areas that the PCAOB will not inspect, to ensure firms are able to meet their ongoing state licensing requirements and any association membership requirements. The AICPA's SEC Practice Section will continue its current Peer Review Program to ensure that member firms are able to satisfy

² The term "issuer" means any public company that is required to file reports with the SEC or that has filed a registration statement for a public offering of securities.

their licensing and membership requirements and plans to revise its program in the future in order to provide registered firms with the needed coverage.

Currently 39 boards of accountancy mandate peer or quality review and four boards are considering implementation of a peer review program. These vary as to the depth of information shared with state boards as well as the boards' mechanism for oversight. Interestingly, the New York State Board's proposed bill, while covering all firms registered with the state that perform attest or compilation services, says that firms participating in the PCAOB's inspection program will be deemed to have met portions of New York's peer review requirement, thereby eliminating duplication of oversight for auditors of publicly traded companies. The New York Board contends that while there may be a limited pool of peer review firms for publicly traded companies, which is one of the reasons the peer review process has been criticized, there is a substantially larger pool of prospective peer review firms for smaller companies.

DISCUSSION QUESTIONS

1. For state boards that currently mandate quality review:
 - a. Could boards eliminate their own quality review programs?
 - b. Should boards consider revising their programs to complement the PCAOB firm inspections in order to avoid duplication of oversight?
 - c. Should current quality review programs be considered punitive or educational? Can they be converted?
2. Will boards without quality review requirements need to implement such programs in order to provide better protection of the public?
3. Should reviews cover more than attest services?
4. For multi-state firms, how can boards be assured that the same quality control procedures are in place in the offices in their jurisdictions?
5. Are more transparent programs necessary?
6. How can quality review programs be retooled to make more information available to state boards?
7. Should a regulatory body be overseeing peer reviews? Should NASBA take a role in peer review?

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http://www.aicpa.org/download/statelegis/peer_review.pdf ; Internet

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Relationships with Other Organizations

(Federal, International and Professional)

Developments in the federal and international arenas have created questions about how the state boards can achieve transparent regulation while fulfilling their responsibilities under state law to protect the public and uphold licensees' rights as citizens.

Sharing Information

Sarbanes-Oxley Section 104 on Inspections of Registered Public Accounting Firms says (5)(c) all documents received in connection with the Public Company Accounting Oversight Board's firm inspections may be made available to any appropriate state regulatory authority at the discretion of the PCAOB when it determines it to be necessary to accomplish the purposes of the Act or to protect investors.

A task force of the NASBA Legal Counsel Committee requested that the state boards be afforded access to the PCAOB's investigators just as they can obtain information from the attorneys in the SEC's Enforcement Division.

In setting standards, the PCAOB has been given the authority to convene "expert advisory groups as may be appropriate," by Sarbanes-Oxley Section 103(a)(4). This includes standards for auditing, quality control, ethics, independence and other standards required by the Act. State board representatives could be included among those advisors on matters involving public protection. As with the SEC, the PCAOB's rules will be posted for public comment prior to being finalized.

DISCUSSION QUESTIONS

- How will the boards obtain the PCAOB's information?
- Will the state boards be able to use findings from the PCAOB's firm inspection process?

- Can the boards act without formal complaints being filed?
- Is any legislation required to facilitate the use of PCAOB findings at the state level?

International Recognition

Sarbanes-Oxley Section 106 on Foreign Public Accounting Firms extends the coverage of the Act beyond firms with headquarters in the US: “Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to the Act and the rules of the Board and the Commission under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State....”

The PCAOB has announced that over the next few months it will consider the appropriate scope of its oversight authority with respect to accounting firms located outside the United States (see March 7, PCAOB Release No. 2003-1 page 14). While the NASBA/AICPA International Qualifications Appraisal Board (IQAB) has been working on the development of mutual recognition agreements with foreign professional groups that have requirements which are substantially equivalent to the CPA’s, the PCAOB release makes no mention of how foreign auditors’ credentials will be evaluated.

However, foreign accountants already are subject to US requirements. As pointed out in Release No. 2003-1 page 10: (a) financial statements filed as reports with the SEC must be audited in accordance with US GAAS; (b) all financial statements filed with the Commission must also be audited by an auditor satisfying US independence requirements; (c) foreign firms that participate in audits of issuers are subject to SEC enforcement action; (d) members of the AICPA SEC Practice Section are required to provide the name and country of their foreign associated firms and seek their adoption of policies and procedures, including that an expert in US accounting, auditing and independence requirements review a sample of their audit engagements; and (e) foreign firms not affiliated with those in the SECPS are required by the SEC to engage a consulting accounting firm to review the firm’s policies and report to the SEC’s staff that those policies are in accordance with US GAAS.

Foreign regulators have made clear to the PCAOB, both at a March 31 roundtable meeting and in written comments, that they oppose the detailed

registration proposed by the PCAOB as well as the PCAOB's proposed oversight inspections of foreign auditors.
http://www.icaew.co.uk/index.cfm?AUB=TB2I_37743,MNXI_37743&tb5=1

International views will count. Section 701 of the Act calls for the General Accounting Office to conduct a study of factors that led to the consolidation of public accounting firms, the problems resulting from this limited competition and “whether and to what extent Federal or State regulations impede competition among public accounting firms.” The Act instructs the GAO to consult with the SEC’s counterparts in the Group of Seven Industrialized Nations. The study is due out by July 30, 2003.

DISCUSSION QUESTIONS

- Are U.S. licensing requirements being bypassed by the Commission?
- Is state licensing conducive to compliance by international auditors?
- Is the public being adequately protected by existing and proposed measures?
- How does state licensing affect global competition?

Adopting Standards

Sarbanes-Oxley Section 101 (c)(3) states that one of the duties of the PCAOB is to “establish or adopt, or both, by rule auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for auditors....” In Section 103 (a)(1) it is explained that this could be accomplished through adoption of standards proposed by one or more professional groups of accountants or advisory groups convened by the PCAOB.

In the International Federation of Accountants’ January 10, 2003 letter to the SEC, commenting on the Commission’s proposed rules implementing Sarbanes-Oxley, IFAC states: The Ethics Committee strongly believes that a high quality principles based approach to independence will best serve the public interest by eliciting thoughtful auditor assessment of the particular circumstances of each engagement.” This was in keeping with IFAC’s December 2001 revision to its Code of Ethics (Section 8) addressing

independence requirements for assurance engagements <http://www.ifac.org>. The January 10 letter went on to say, “The Ethics Committee is of the opinion that there is overwhelming international support for the principles based approach and that this approach assists with convergence of standards on a worldwide level.”

Recognizing that Sarbanes-Oxley would bring about changes in the independence standards being used by the SEC, the Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants <http://www.cica.ca> in 2002 released principles-based independence standards for auditors that combine the standards issued by the International Federation of Accountants and the SEC’s requirements for public companies.

The Financial Accounting Standards Board <http://www.fasb.org> issued a proposal for public comment on the whole subject of principles-based standards in October 2002, then held a public roundtable in December 2002 and is in the process of deciding what actions, if any, it should take. FASB Chairman Robert H. Herz testified before a Congressional committee on March 4, 2003 that in October 2002 the FASB began a project with the IASB to accelerate the convergence of standards through eliminating or narrowing the differences between US and IFAC standards. He estimated the project would go well beyond 2005, when the European Union adopts International Standards on Auditing en masse.

According to the International Auditing and Assurance Standards Board’s 2003-2004 Action Plan: “There is an increased support for the development of a worldwide public accounting profession responsive to the demands for a global marketplace and for the convergence of national and international standards, with national bodies continuing to set standards for local regulatory purposes and uniquely local situations.” It also states: “The World Bank and other regional development banks have expressed support for an initiative to establish one set of auditing and assurance standards for both private and public sector entities.” See <http://www.iaasb.org>.

The International Accounting Standards Committee has proposed its own testing and certification program, which is in its earliest developmental stage now. See <http://www.iasb.org.uk>. Would those certified by the IASC qualify to register with the PCAOB?

The AICPA is revising its code and standards. Proposed statements on auditing standards (comments due by June 15) and revisions to Rule 101-

Independence (comments due by May 19) can be found on the AICPA's Web site <http://www.aicpa.org>. However, in a March 18, 2003 letter to the AICPA, SEC Acting Chief Accountant Jackson Day underscored that it is the PCAOB, not the AICPA, that the Sarbanes-Oxley Act has given the authority to set auditing standards to be used by firms registered with the PCAOB (<http://www.sec.gov/info/accountants/staffletters/aicpa031803.htm>).

DISCUSSION QUESTIONS

- What codes will the states adopt and how will that be done, by reference as of a specific date?
- Does state legislation that includes specific prohibited services conform with principles-based standards?

Cooperative Efforts

In response to the Sarbanes-Oxley Act, the AICPA's Special Committee on State Regulation issued a report entitled "An Overview of State Issues Related to the Sarbanes-Oxley Act: A Reasoned Approach to Reform," which can be found on the Institute's Web site. On page 7 of Section II the report states: "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 test for inclusion in a future edition of the Uniform Accountancy Act." The current edition of the Uniform Accountancy Act can be found on the NASBA Web site <http://www.nasba.org>.

According to the US Public Interest Research Group, "The State Boards of Accountancy have become captive regulators, dominated by the industry they are supposed to regulate." (See <http://enronwatchdog.org/reports/watchingthewatchdogs.html>). The delicate balance between obtaining professional expertise and maintaining objectivity is difficult to achieve. As Andrew S. Grove, chairman of Intel Corporation, told the Conference Board: "Under no circumstances should we compromise the integrity of accounting decisions. If we as a group of business people decide we can mandate what the accounting should be without exploring the accounting issues, then our assumption and our message to the public is that accounting can be whatever a few elite people want it to be. How does that

restore public confidence?" (Findings and Recommendations of the Commission on Public Trust and Private Enterprise, 2003).

DISCUSSION QUESTIONS

- What areas in the Uniform Accountancy Act need to be revised to meet the concerns addressed in the Sarbanes-Oxley Act?
- Will the public/legislators/consumer groups be suspicious of recommendations made by state boards in conjunction with the professional association?

Corporate Governance³

Title 3 of the Sarbanes-Oxley Act of 2002 consists of eight sections. The following analysis is provided so that accountancy boards can consider whether state action consistent with these sections should be considered.

301 Audit Committees

Section 301 establishes that:

- Audit committees are required for listing. The SEC has adopted rules requiring this by December 2003 (see SEC Release 33-8220⁴).
- Audit committees are responsible for appointment, compensation and oversight of registered accounting firms (including resolution of disagreements between management and the auditor regarding financial reporting). Each PCAOB registered audit firm reports directly to the audit committee. The SEC has acted in this area by requiring additional disclosures by registrants (see SEC 33-8177).
- Independence of members. The SEC has acted to define independence (see SEC Release 33-8177). A member of the audit committee may not accept any consulting, advisory or other compensatory fee from the issuer.
- Complaint procedures.
- Audit committee given the authority to engage advisors.
- Audit committee determines appropriate funding for payment of auditors and other advisers.

302 Corporate Responsibility for Financial Reports

Section 302 establishes the responsibility of principal executive officers and principal financial officers for financial reports and requires certification by those officers. The SEC acted prior to Sarbanes-Oxley (see SEC Release 33-8124). The SEC has issued proposed rules to conform to minor changes required by Sarbanes-Oxley (see SEC Release 33-8212).

³ This analysis was prepared for the National Association of State Boards of Accountancy by Ray G. Stephens, Professor and Director, School of Accountancy, Ohio University and Member, Accountancy Board of Ohio, April, 2003.

⁴ All SEC documents can be accessed through the SEC website. Releases are found under final rules. Proposed releases are found under proposed rules. Reports are found under special reports.

303 Improper Influence on Auditors

Section 303 requires the SEC to issue rules about improper influence on auditors. The SEC has issued proposed rules in this area (see SEC Release 34-46685). The issue concerns actions taken by officers of public companies and others acting under their direction. There is a corollary question about the actions of auditors when improper influence appears to be exerted, but this is an issue for auditing standards when outside the realm of SEC registrants.

304 Forfeiture of Certain Profits and Bonuses

Section 304 provides for forfeiture of profits and bonuses by the CEO and CFO when an issuer has a restatement under certain circumstances.

305 Officer and Director Bars

Section 305 provides for officer and directors bars to practicing before the commission.

306 Insider trades during pension fund blackout periods

Section 306 prohibits trading by insiders during pension blackout periods. The SEC has acted in this area by providing for disclosure of certain blackout periods on a timely basis (see SEC Release 33-8177 which establishes new Rule BTR) and the reporting of trading by insiders on a two-day basis (prior to Sarbanes-Oxley, see SEC Release 34-46421), The SEC has proposed electronic filing of reports of trading by insiders and website posting (see SEC Release 33-8170).

307 Rules of Professional Responsibility for Attorneys

Section 307 requires the SEC to establish rules for professional responsibility of attorneys. The rules for accountants were already established in Rule 102(e) last amended in 1999. The SEC has acted by establishing rules for the professional responsibility for attorneys (see SEC Release 33-8185 establishes SEC Rule 205).

308 Fair Funds for Investors

Section 308 established that civil penalties could be added to disgorgements, that the SEC could accept donations and that the SEC had to prepare a study of enforcement actions regarding civil penalties and disgorgement. The SEC report was issued on January 24, 2003 (“Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002”).

Other Views

Appended is a list of articles summarizing various issues involved related to Title 3. Senator Charles E. Schumer (NY-D) has proposed adding internal auditor requirements to the audit committee's charge. Bills introduced in Ohio would add certain state requirements for selling securities by officers and principle shareholder loans.

The SEC's audit committee rules do not affect companies whose securities are traded on the pink sheets or the OTC Bulletin Board unless they are listed on an exchange or on the NASDAQ.

Since the accountancy boards have no authority over corporations or attorneys, it appears the state boards can take no actions directly comparable to corporate governance measures set out in the Sarbanes-Oxley Act.

QUESTIONS

1. Will the new standards focus the directors' deliberations on meeting checklists rather than judging management's performance and offering advice?
2. Sarbanes-Oxley calls for a one-year cooling off period before auditors accept employment with a client. Could former auditors serve on the audit committee?
3. Should state laws include corporate governance provisions similar to Sarbanes-Oxley?

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The Cascade Effect

The “cascade effect” is a term that has been applied by those who believe that the federal reforms brought by SOX and the SEC’s rules implementing Section II of the Act are not necessary at the state level. It is intended to evoke images of uncontrolled rushing water on its way to a very steep drop like Niagara Falls. It is the metaphor of the next phase of the independence debate as it flows from the halls of Congress to various state capitols.

Support for their opposition to state action was strengthened by a statement made by Senator Paul Sarbanes, the bill’s co-sponsor:

“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.”

Opponents find further support for their position in Section 209 of SOX that allows state regulators to make “an independent determination of the proper standards applicable” in supervising “non-registered” (with the PCAOB) accounting firms.

From this perspective the opponents reason that the “public” involved in the engagement arrangements between non-public SEC registered companies is very limited and that the “public” involved is more aware of the business and financial affairs of those private companies with which they are involved. Because of this, the opponents contend that the “public” in these situations do not require the same measures for protection and will be provided the information and financial transparency they need by the close relationship between auditors and their non-registered clients. The opponents believe the professional ethics requirements of the profession already sufficiently address most of the SOX prohibited non-audit services.

Then there is the concept of “public interest entities,” which has been introduced by the International Federation of Accountants to cover private entities that have a public-interest component. Trying to determine which companies belong in this category is a difficult problem. As the AICPA says in

its “Reasoned Approach”: “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.”

Despite the statement of Senator Sarbanes and scope limitation of Section 209, or perhaps because of both, some states have moved to adopt similar prohibitions on non-audit services to all accountants licensed by those states’ boards of accountancy. Some efforts have been successful and new state accountancy laws have resulted. Other efforts have failed to enact new legislation, regulations or rules.

California, New York, Texas, Maryland, New Jersey and Washington have considered SOX-type changes to their accountancy laws. Other states are expected to consider similar changes as well. It is to further informed debate by concerned individuals who are sincerely interested in public protection and fair regulation that this paper has been developed.

DISCUSSION QUESTIONS

1. Is the public interest of an investor inherently different from any other user of audited or attested to financial information?
2. Should some persons have less protection from possible wrongdoing by licensed accountants?
3. Should independence be objectively or subjectively determined?

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Acronyms

AICPA – American Institute of Certified Public Accountants

ASB – AICPA’s Accounting Standards Board

CA – Chartered Accountant

CICA – Canadian Institute of Chartered Accountants

CPE – Continuing professional education

FASB – Financial Accounting Standards Board

IAS – International Accounting Standards

IASC – International Accounting Standards Committee

ICAEW – Institute of Chartered Accountants in England and Wales

IFAC – International Federation of Accountants

IQAB – NASBA/AICPA International Qualifications Appraisal Board

NASBA – National Association of State Boards of Accountancy

PCAOB – Public Company Accounting Oversight Board

PIRG – Public Interest Research Group

SEC – US Securities and Exchange Commission

SECPS – AICPA SEC Practice Section

UAA – Uniform Accountancy Act

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