

To All Interested Parties:

In the wake of the Enron/Arthur Andersen and other well publicized audit failures, Congress initiated reactionary legislature that places restrictions upon the accounting industry. While ensuring that what happened with Enron would not be repeated, this new legislature, known as the Sarbanes-Oxley Act, caused businesses and owners to review their relationship with their auditors. The new law stipulates that certain "consulting services" can no longer be performed by the same accounting firm that performs the company's audits.

As with larger firms, Zdonek & Wolowicz Accountancy Corporation is peer reviewed at the SEC level. We do not, however, have outside affiliations that would create conflicts of interest. In addition to providing core accounting services, we also specialize in a variety of business services which include:

- Internal Control and Audit issues
- 401K Plan Audits
- Pension Plan Audits
- Mergers & Acquisitions including providing Due Diligence Aid
- Appraisal and Valuation Services
- Accounting and Bookkeeping System Design & Implementation
- Contract Controllership services
- Inventory and Control Systems Analysis

A summation of the Sarbanes-Oxley Act is attached on the following pages. Many of these same concepts have recently been enacted by the State of California. If your company is currently reviewing their accounting procedures, and are looking for an accounting firm to assist you with non-audit services, please contact my office. I would be happy to clarify any questions you might have about our services.

Sincerely,

Kathy Pape  
Director of Marketing

## **Sarbanes-Oxley and the Cascade Effect**

### **Pennsylvania CPA Journal, Fall 2002**

By Peter N. Calcara

On July 30, 2002, President Bush signed into law the most far-reaching and significant changes to the accounting profession in more than half a century. The Sarbanes-Oxley Act of 2002 further regulates the accounting profession and public companies. Unparalleled bipartisan support for the Sarbanes-Oxley Act—only three negative votes in the House and none in the Senate—paved the way for a speedy passage rarely seen in our nation's capital. The bill was signed nine months after the Enron debacle first made news and only weeks after the WorldCom collapse.

The Act fundamentally changes how audit committees, corporate management, and auditors of publicly traded companies carry out their respective responsibilities and interact with each other.

This is a time of unprecedented change for the CPA profession. Sarbanes-Oxley is the most significant legislation to affect the accounting profession since passage of the Securities Exchange Act in 1934, and additional changes may still be coming at the state level—which is often referred to as the “cascade effect.”

The Sarbanes-Oxley Act is specific in certain areas, but it provides only a framework in others. This article takes a look at some of the important changes made by the Act, and the impending cascade effect it may have on Pennsylvania CPAs.

**Scope of Services.** The Act specifically outlines the nonauditing services that can't be provided to an accounting firm's audit clients. It is now illegal for a registered accounting firm to provide the following nonaudit services to audit clients:

bookkeeping or other services related to the accounting records of 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 advisor, or investment banking services

legal services and expert services unrelated to the audit

any other service that the board determines is not permitted under current regulations.

All other nonaudit services, including “tax services,” are permissible, but only if the activity is previously approved by the company’s audit committee and is disclosed to investors in periodic reports. The Act gives the board the authority to add additional services to the list of banned nonaudit services at a later date.

The preapproval requirement is waived for nonaudit services to a public company if the aggregate amount of nonaudit services is less than 5 percent of the total amount paid by the company to its auditor; the services were not recognized by the public company at the time of the engagement to be nonaudit services; and the services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

**Auditor Independence.** The Act provides that the lead auditor or coordinating partner and the reviewing partner must rotate off the audit every five years. The CEO, controller, CFO, chief accounting officer—or person in an equivalent position—cannot have been employed by the audit firm during a one-year period preceding the audit.

**Public Company Accounting Oversight Board.** The Sarbanes-Oxley Act establishes a five-member Public Company Accounting Oversight Board, the members of which will be financially literate, will serve full-time, will serve five-year terms—with no more than two terms—and are appointed by the SEC in consultation with the Federal Reserve and the Treasury Department. The initial appointments to the board must be made before Oct. 30 of this year.

Two of the five members must be CPAs, but if one of the CPA members is chair, he or she must not have practiced for the previous five years. The board must be operating to the SEC’s satisfaction within 270 days from the day Sarbanes-Oxley became law. The board will be funded primarily by assessments on public companies—which also will provide funding of the FASB.

Accounting firms will pay registration and annual fees to cover the cost of processing applications and annual reports. The Act states that the board is not a government agency, but it does many things that government agencies do.

The Act states that accounting firms that audit public companies must register with the board within 180 days after the SEC makes the determination that the board is ready to carry out its responsibilities.

**Authority of the Board.** The board was given numerous responsibilities. Some of its authority and duties include:

registering public accounting firms that prepare audit reports for publicly traded companies.

establishing or adopting standards rules for auditing, quality control, ethics, and independence relating to the preparation of audit reports for public companies.

conducting inspections of registered public accounting firms. Note that the Act provides for annual inspections of public accounting firms that “regularly” provide audit reports for

more than 100 public companies, and inspections of public accounting firms that provide audit reports for 100 or fewer public companies not less than once every three years.

conducting investigations and disciplinary proceedings, and imposing appropriate sanctions when justified upon registered public accounting firms and persons associated with the firm.

The board can adopt appropriate standards developed by professional groups, such as the AICPA's Auditing Standards Board, that are recognized by the board for this purpose, or by advisory committees convened by the board.

The Act gives the board broad authority to perform other duties that it or the SEC determines are necessary to protect investors and further the public interest. The board's authority and rules do not extend to privately held companies, and the SEC must approve all its proposed rules.

The Act further stipulates that accounting firms must report to the audit committee, on a "timely" basis, all of the following:

"critical" accounting policies and practices to be employed in connection with the financial statements

"alternative treatments of financial information" under GAAP that have been discussed with management, the ramifications of alternative "treatments and disclosures," and the treatment "preferred" by the auditor

other "material written communications" between the auditor and management, specifically including any management letter and any schedule of unadjusted differences.

**Audit Committees.** The Act requires the SEC to direct the exchanges and national securities associations to make sure the audit committee of a listed company is composed of independent directors and is responsible for the appointment, compensation, and oversight of the company's auditors. Auditors must report directly to the audit committee. This directive must go into effect no later than 270 days after passage of the Act.

Companies must grant audit committees the authority to employ independent counsel and other advisors. Audit committee members must not be affiliated with the company or a subsidiary in any way other than as a director, and members cannot accept consulting, advisory, or other compensatory fees from the company other than fees for service on the board of directors and its committees.

**Attestation Report on Internal Controls.** The Act directs auditors to report on management's assessment of internal controls under attestation standards to be established by the board.

The auditor is now required to report any "material noncompliance" that the auditor finds as a result of that testing, although the statute does not explain to what "material noncompliance" relates.

Corporate and Criminal Fraud Accountability. The Act makes it a felony to “knowingly” destroy or create documents to impede, obstruct, or influence existing or contemplated federal investigation. Auditors are required to maintain all audit or review work papers for five years. The statute of limitations on securities fraud claims was extended to the earlier of five years from the fraud or two years after the fraud was discovered. Previously it had been three years from the fraud and one year from the discovery.

Employees of public companies and accounting firms are extended “whistle-blower” protection, which would prohibit employers from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle-blowers are also granted a remedy of special damages and attorney’s fees.

The Act makes it a crime to alter, destroy, mutilate, or conceal any document with the intent to impair the object’s integrity or availability for use in an official proceeding, or to otherwise obstruct, influence, or impede any official proceeding. Penalties call for up to 20 years in prison and a fine.

#### The Cascade Effect

On Aug. 1, less than a week after Congress approved Sarbanes-Oxley and only two days after President Bush signed the Act into law, Republican leaders in the Pennsylvania House of Representatives unveiled their Pension and Investor Protection package. (As this issue went to press, few details of the proposal were available.)

With the Philadelphia Stock Exchange as the backdrop, House Majority Leader John M. Perzel (R-Philadelphia), flanked by members of his Republican caucus, opined, “I am happy that the president and Congress have approved a corporate responsibility plan at the federal level, but our concern is Pennsylvania— Pennsylvania pension funds, Pennsylvania investors, and Pennsylvania companies.”

Perzel explained that the Republicans’ Pension and Investor Protection Package is intended to help small investors and contributors to pensions regain confidence in their investments.

In addition to Perzel’s proposal, several bills have already been introduced in the state legislature that could have a tremendous impact on all CPAs, not just those whose clients are public companies. Senate Bill 1348 and House Bill 2578 propose amending the CPA Law to prohibit a CPA from directly or indirectly serving as an accountant and investment advisor to a client or potential client. The bills also prohibit a CPA from directly or indirectly providing management advisory and consultant services for any client or potential client.

Senate Bill 1349 and House Bill 2581 would amend the CPA Law to require CPAs to report “wrongdoing” discovered during employment to the authorities without fear of reprisal or retaliation from the employer or client. Specifically, an employer or client cannot terminate or discriminate against an accountant for disclosing illegal activity or for cooperating with an investigation, hearing, or civil action arising from the disclosure.

House Bill 2657 would amend the CPA Law to require the State Board of Accountancy to immediately impose a one-year suspension of a CPA's license upon certification from a court of competent jurisdiction that the accountant has been sentenced for falsification of a report to shareholders or similar offense. After the suspension, the CPA could petition the State Board of Accountancy for reinstatement.

#### State Regulatory Authorities

Section 209 of the Sarbanes-Oxley Act opens the door to possible state action. The Act directs appropriate state regulatory authorities to "make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms." Some states will use this section as an impetus to push for additional—perhaps even tougher and broader—reforms than what is detailed in Sarbanes-Oxley.

You have to go back to the early 1930s to find a similar era of significant change in the accounting profession. The Sarbanes-Oxley Act of 2002 will bring fundamental changes in how auditors, audit committees, and management carry out their respective responsibilities and interact with each other. In the coming weeks and months, as the major provisions of the new law start taking shape, the Act will be subject to further clarification and rules making on a number of important provisions.

The PICPA is committed to keeping members apprised of all Sarbanes-Oxley developments and any resulting cascade effect in Pennsylvania's legislature through regular postings on the PICPA Web site and the weekly electronic newsletter, Legislative Update. For more details, subscription information, and past issues, visit [www.picpa.org](http://www.picpa.org).

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Summary of the Sarbanes-Oxley Act of 2002 (PDF File)

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