



## SARBANES-OXLEY ACT OF 2002

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### PCAOB'S REGISTRATION SYSTEM FOR PUBLIC ACCOUNTING FIRMS

In Securities and Exchange Commission ("SEC") Release No. 34-47990, which is available at <http://www.sec.gov/rules/pcaob/34-47990.htm>, the SEC published the proposed rules of the Public Company Accounting Oversight Board ("PCAOB") concerning the registration system for public accounting firms implementing Section 102 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). On July 16, 2003, the SEC issued an order approving PCAOB's public accounting firm registration rules, Release No. 34-48180, which is available at <http://www.sec.gov/rules/pcaob/34-48180.htm>. The SEC found that the proposed registration system is "consistent with the requirements of [Sarbanes-Oxley] and the securities laws and is necessary and appropriate in the public interest and for the protection of investors." However, the SEC did acknowledge the concerns of the international community. The SEC encouraged PCAOB to "continue its dialogue with oversight bodies outside the United States in order to try to find ways to reduce administrative burdens and coordinate in areas of common programmatic interest" and that it "move expeditiously to determine the nature and scope of its oversight over foreign public accounting firms." The SEC addressed comment letters discussing the need for clarification of certain definitions, rules and registration form line items stating that many of these questions can be addressed through formal or informal interpretations and clarifications and through a "Frequently Asked Questions" publication, which PCAOB intends to publish. The SEC stated that, as PCAOB gains more experience with the registration form, it should consider amendments to the form that will make registration more efficient. Finally, the SEC expressed appreciation for the efforts of the National Association of the State Boards of Accountancy and believes that both PCAOB and state regulatory bodies will "benefit from continued close cooperation."

PCAOB's registration system consists of eight rules, Rule 1001 (definitions), Rules 2100 through 2106, Rule 2300 and a Web-based registration form (Form 1) that must be filed electronically. The information to be disclosed under PCAOB's rules either is required by Sarbanes-Oxley Section 102(b) or, in PCAOB's judgment, is reasonably related to the determination that will be made by it in deciding whether to approve or disapprove an application. PCAOB will require additional disclosures in the annual reports and the periodic updating of the registration application, which rules will be published subsequently. The substance of the public accounting firm registration rules generally tracks the language, and is guided by the policies, articulated in Sarbanes-Oxley and in the following auditor independence rules: (1) *Revision of the Commission's Auditor Independence Requirements*, Release No. 33-7919, November 21, 2000 (the "2000 Independence Release"); and (2) *Strengthening the Commission's Requirements Regarding Auditor Independence*, Release No. 33-8183, January 28, 2003, as amended by Release No. 33-8183A, March 26, 2003 (the "2003 Independence Release").

As stated in PCAOB's Release No. 2003-007, which is available at <http://www.pcaobus.org/rules/Release2003-007.pdf>, all public accounting firms<sup>1</sup> that wish to prepare or issue audit reports on U.S. public companies or to play a substantial role in the preparation or issuance of such reports must register with PCAOB. The rules apply to both U.S. public accounting firms, which must register by October 22, 2003, and non-U.S. public accounting firms, which must register by April 19, 2004. In order for a public accounting firm to become a registered public accounting firm by the required date in view of PCAOB's 45-day application review period, U.S. firms will have to file their registration applications by no later than early September 2003 and non-US. firms will have to file their registration applications by early March 2004, at the latest. In addition, U.S. and non-U.S. firms should keep in mind that a request by PCAOB for further information will restart the 45-day review period. Therefore, PCAOB "encourages firms to file their applications as soon as possible."

What follows is a discussion of certain aspects of the public accounting firm registration rules of particular relevance to large U.S. and non-U.S. public accounting firms.

## WHO MUST REGISTER

Rule 2100 provides that any public accounting firm, whether U.S. or non-U.S., that prepares or issues audit reports on U.S. public companies or plays a substantial role in the preparation or issuance of such reports must register with PCAOB. The phrase "play a substantial role in the preparation or issuance of an audit report means (1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer; or (2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer."

The first prong of this definition is based on the language in Sarbanes-Oxley Section 106(b)(1), while the second prong is based on a similar standard used in the 2003 Independence Release related to partner rotation. For both prongs, as opposed to a qualitative test, PCAOB has articulated a quantitative test, which includes a 20% threshold. The definition (a) does not include non-audit services provided to a non-audit client, (b) is limited to performing "the majority of

audit procedures . . . necessary for the principal accountant to issue an audit report on the issuer" and (c) clarifies that the 20% determination should be made at the beginning of the issuer's fiscal year using the prior year's information and should be made only once during the issuer's fiscal year.

Individual accountants<sup>2</sup> associated with public accounting firms are not required to register. However, an individual accountant who prepares or issues, in his or her own name, an audit report on an issuer would be viewed as a sole proprietor and would be required to register. Finally, a note in the Release clarifies that "the issuance of a consent to include an audit report for a prior period by a public accounting firm, that does not currently have and does not expect to have an engagement with any issuer to prepare or issue, or to play a substantial role in the preparation or furnishing of an audit report with respect to any issuer, will not by itself require a public accounting firm to register."

## NON-U.S. PUBLIC ACCOUNTING FIRMS

Non-U.S. public accounting firms are not exempt from registration. Any non-U.S. public accounting firm that wishes to prepare or issue audit reports on U.S. public companies or to play a substantial role in the preparation or issuance of such reports will need to register with PCAOB. Consistent with Sarbanes-Oxley, however, registration with PCAOB does not by itself subject a non-U.S. public accounting firm to the jurisdiction of the U.S. courts, other than with respect to controversies between PCAOB and such firm. In response to comments made by non-U.S. public accounting firms, there are certain differences in the rules with respect to non-U.S. laws and as applied to non-U.S. public accounting firms.

With respect to conflicts with non-U.S. laws, an applicant (U.S. or non-U.S.) may withhold information from its registration application, if the submission of such information would cause the applicant to violate non-U.S. laws. Such applicant must file an Exhibit 99.2 that provides (i) a copy of the relevant portion of the conflicting non-U.S. law, (ii) a legal opinion that submitting the information would cause the applicant to violate the conflicting non-U.S. law, and (iii) an explanation of the applicant's efforts to obtain a consent or waiver to eliminate the conflict, if the withheld information could be provided to PCAOB with a consent or waiver and a representation that the applicant was unable to obtain such consent or waiver to eliminate the conflict (the "Evidence of Conflict With Non-U.S. Law Exhibit").

<sup>1</sup> "Public accounting firm" has the same meaning as used in Sarbanes-Oxley Section 2(a)(11)(A), except that the definition only includes legal entities and does not include natural persons. PCAOB did not exercise the authority granted to it pursuant to Sarbanes-Oxley Section 2(a)(11)(B) to expand this definition and include "any associated person of any entity" in the definition.

<sup>2</sup> The term "accountant" is not defined in Sarbanes-Oxley but its usage refers to a natural person, which differs from the definition of accountant in Regulation S-X. PCAOB's definition of accountant covers three types of natural persons that includes "all natural persons who have the requisite licensing, certification, training and/or experience, whether obtained in the U.S. or a non-U.S. jurisdiction."

In addition, while the rules require a U.S. public accounting firm to disclose information about itself, any "associated entity" and any "associated person," a non-U.S. public accounting firm only needs to disclose information about itself, any "associated entity" and any proprietor, partner, principal, shareholder, officer or manager of the applicant who provided at least 10 hours of audit services for any "issuer" during the last calendar year (collectively, the "Foreign Accounting Principals"). The following information must be disclosed or obtained with respect to the Foreign Accounting Principals: (i) a list of the full roster of Foreign Accounting Principals (ii) any involvement by the foreign public accounting firm and its Foreign Accounting Principals in civil, criminal, administrative or disciplinary proceedings, and (iii) consents from each of the Foreign Accounting Principals.

### ASSOCIATED ENTITIES

Item 1.6 of Form 1 requires both U.S. and non-U.S. applicants to list all "associated entities." Under the broad definition of "associated entities" under Rule 1001(a)(iv)(2), depending on the relevant facts and circumstances, non-U.S. public accounting firms associated with U.S. public accounting firms could fall within the definition of "associated entity." Whether or not such non-U.S. public accounting firms were registered directly with PCAOB, the U.S. public accounting firm would be required to list the names and physical addresses for such firms as "associated entities" under Item 1.6 of Form 1, which list does not include any person listed in Form 1, Item 7.1 as an "associated person."

"Associated entity" is defined as (a) any entity that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or under common control with, such public accounting or (b) any "associated entity" as used in Rule 2-01(f)(2) of Regulation S-X that would be considered part of that firm for purposes of the SEC's auditor independence rules. The phrase "and associated entities, including those located outside the United States," in the Regulation S-X definition of "accounting firm" reflects the SEC staff's current practice of addressing attribution questions in light of all relevant facts and circumstances. See Rule 2-01(f)(2) of Regulation S-X, 17 CFR 210.2-01(f)(2); see also the 2000 Independence Release. PCAOB chose a broad definition of the term "associated entities" to capture certain entities that are related to the applicant, but that are not necessarily in a controlling, controlled or common control relationship with the applicant. The 2000 Independence Release states that the term "associated" was used instead of "affiliated" in the

final rule to make clear that, consistent with the status quo, the entities treated as if they were the accounting firm will not be determined by reference to the definition of "affiliate" in Rule 1-02 of Regulation S-X.

In the past, many public accounting firms may have adopted a broad reading of the term "associated entity" in the context of the independence rules. However, going forward such firms may need to reconsider the application of the term "associated entity" in the context of the registration rules because the regulators may take the approach that identifying a firm as an associated entity on an applicant's registration form is deemed to be a concession by the applicant on this issue for independence purposes.

### ASSOCIATED PERSONS

If U.S. or non-U.S. persons are deemed to be "associated persons" of a U.S. applicant, such applicant would be required to: (a) list in Form I, Part VII such associated persons and such persons' auditing or accounting licenses or certifications; (b) provide information in Form I, Part V about any applicable legal proceedings involving such associated persons; and (c) pursuant to Form 1, Part VIII, obtain consents from such associated persons. An applicant does not have the foregoing disclosure and compliance obligations, however, for any "person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm."

PCAOB Rule 101(p)(i) defines "person associated with a public accounting firm" (and related terms) to mean "any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor that, in connection with the preparation or issuance of any audit report (1) shares in the profits of, or receives compensation in any other form from, that firm; or (2) participates as agent on behalf of such accounting firm in any activity of that firm." The definition of the term does not require an employment or independent contractor relationship in order to fall within the rule and does not include persons engaged in only clerical or ministerial tasks.

PCAOB staff recognizes that the term "independent contractor" could include other U.S. or non-U.S. persons (other than natural persons) that are public accounting firms, whether or not they are registered. Thus, as the date for registration nears, PCAOB intends to issue additional guidance regarding the definition of "associated persons."

## DISCLOSURE OF CERTAIN PROCEEDINGS

Part V of Form 1 requires that an applicant disclose basic information, such as the parties involved, the allegations and the outcome, about any criminal, civil, administrative or disciplinary proceedings against the applicant or its associated persons. Even though such proceedings may no longer be pending or do not relate to an audit report, this part requires disclosure about certain additional proceedings that may reflect on the applicant's fitness for registration. The look-back period for this rule is five years. A foreign public accounting firm must disclose such proceedings for the applicant and its Foreign Accounting Principals. An applicant may, but is not required to, file an explanatory exhibit regarding any listed proceeding and why such proceeding should not be a basis for the denial of its application for registration.

## CONSENTS

Part VIII of Form 1 requires an applicant to provide, as an exhibit, consents related to the applicant's and its associated persons' cooperation and compliance with any request for testimony or the production of documents made by PCAOB. A foreign public accounting firm need only obtain consents from its Foreign Accounting Principals. The consents must be manually signed and such manually signed consents must be retained for 7 years (PCAOB Rule 2104). The language in the instructions for Part VIII must be used verbatim in the consent. In addressing commenters' concerns about the administrative burden, PCAOB clarified that the consent must be secured not later than 45 days after submitting the registration application. However, PCAOB "leaves it to the individual applicants to determine other details as to how such consents will be obtained and maintained internally."

## DISCLOSURE OF CLIENT FEES

Part II of Form 1 requires disclosure about the applicant's issuer audit clients, including disclosure about the total amount of fees billed for "audit services," "other accounting services" and "non-audit services." Disclosure must be provided for issuers for which the applicant (a) prepared audit reports during the preceding calendar year (Item 2.1), (b) prepared audit reports during the current calendar year (Item 2.2), and (c) expects to prepare audit reports during the current calendar year (Item 2.3). The note to Item 2.3 states

that an "applicant may presume that it is expected to prepare or issue an audit report for an issuer (i) if it has been engaged to do so or (ii) if it issued an audit report during the preceding calendar year for an issuer, absent an indication from the issuer that it no longer intends to engage the applicant."

The only fees that must be disclosed are those of the principal accountant, which is the public accounting firm that issued the audit report, and the rule does not require any fee disclosure with respect to any "associated entities." In addition, Item 2.4 requires disclosure information about issuers for which an applicant played, or expects to play, a substantial role in their audit. As the note to Item 2.4 explains, applicants that disclosed the names of issuers in Items 2.1 through 2.3 need not respond to Item 2.4.

The definitions of "audit services," "non-audit services" and "other accounting services" are harmonized with the 2003 Independence Release, effective after December 15, 2003. If the fees have not been previously disclosed or are not otherwise known to the applicant, estimated amounts may be used. Currently, applicants are not required to disclose fees for "tax services." However, once the 2003 Independence Release's disclosure rules are effective, PCAOB may require disclosure of "tax services" as part of a registered public accounting firm's annual reports.

PCAOB had originally proposed as Part III to Form 1 that all fees for audit services, other accounting services, tax services and all other products and services for all issuer clients be disclosed. Although such information need not be disclosed at this time, PCAOB does intend to require applicants to disclose this information in their annual reports to PCAOB pursuant to Sarbanes-Oxley Section 102(d). Thus, PCAOB stated in its release that it encourages public accounting firms planning to register to begin collecting fee information in these four categories for all their issuer clients in order to be in a position to report revenue in this format on an ongoing basis in the future. As the date for registration nears, PCAOB will consider issuing additional guidance on the fee disclosures required by Form 1, Part II.

## INFORMATION PUBLICLY AVAILABLE

Consistent with Sarbanes-Oxley Section 102(e), registration applications will be publicly available as soon as practicable after PCAOB approves or disapproves the application.

Information disclosed on the Form 1 will not be publicly disclosed if PCAOB grants a confidential treatment request from an applicant and such applicant files an Exhibit 99.1 that provides an explanation as to why the information is confidential. Information may also be omitted from the Form 1 if providing such information would violate the laws of a non-U.S. jurisdiction and such applicant files the Evidence of Conflict with Non-U.S. Law Exhibit.

Pending PCAOB's determination, the information in question will not be made publicly available. If PCAOB denies the request, the applicant will be notified of PCAOB's decision and of the date on which the information in question will be made public. If PCAOB grants the request for confidential treatment, the information in question will not be made public - although such information may be provided to the SEC or pursuant to a subpoena. PCAOB will provide notice to an applicant upon receiving a third-party subpoena. Finally, confidential treatment will not prevent PCAOB from making use of such information in connection with executing its responsibilities under Sarbanes-Oxley.

## RECOMMENDATIONS

In view of the matters discussed in the SEC Release 34-47990 and the PCAOB Release No. 2003-007, large public

accounting firms should consider the following recommendations:

- iron out the details as to how consents will be obtained and maintained internally and begin obtaining the consents as soon as possible.
- begin collecting fee information regarding "audit services," "other accounting services," "non-audit services" and "tax services" for all their clients in order to be in a position to report revenue in this format on an ongoing basis in the future.
- determine which associated non-U.S. public firms will be directly subject to the registration rules or may fall within the definition of "associated entity."
- begin collecting information regarding any criminal, civil, administrative or disciplinary proceedings involving the applicant or any of its associated persons that may have occurred in the past five years, if any.
- begin drafting a narrative of procedures used to monitor independence and a simultaneous review of any pertinent independence documents that might be cross-referenced in such narrative.

For more information on the PCAOB's registration system for public accounting firms, please call your regular Sidley Austin Brown & Wood LLP contact or any of the attorneys listed below. You should also visit our web site, <http://www.sidley.com/corporategovernance>, where we have posted our earlier client bulletins on SEC developments, including particularly rules under the Sarbanes-Oxley Act, and on corporate governance issues generally.

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