



TO: The Honorable the Members of the Board of Regents

FROM: Johanna Duncan-Poitier
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COMMITTEE: Professional Practice

TITLE OF ITEM: The Mandate for Accountancy Reform: A Call to Action

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Summary:

At no other time during its 107-year history, as the fourth oldest licensed profession in New York, has the public focused so much serious attention and concern on the independence of the certified public accountant (CPA) and public accountant (PA). The role that several prominent accounting firms have played in a series of unprecedented recent corporate failures underscores the urgent need for an examination of the regulatory structure and the implementation of needed reforms in public accountancy. These corporate failures have negatively impacted international capital markets, undermined the financial security of many Americans, and raised serious doubts on the part of consumers about the integrity of the accounting profession.

A 2001 U.S. Securities & Exchange Commission (SEC) study reported that corporations have been forced to revise their financial statements with increasing frequency: 116 in 1998, 142 in 1999, and 156 in 2000. The study further reports that these restatements resulted in total market losses of \$17.7 billion in 1998, \$24.2 billion in 1999, and \$31.2 billion in 2000. At Enron, financial statement adjustments reduced its net worth by \$1.2 billion and net income by \$586 million. As a result of these corporate restatements, bankruptcies, and accounting irregularities, thousands have been left unemployed and millions have incurred substantial reductions in the value of their savings, investments, and pension and profit sharing plans.

The solutions to these and other problems related to the regulation of public accountants are not simple because of the complexities of the current regulatory structure governing contemporary public accountancy practice and the limitations that result from an outdated scope of practice definition. State regulators, such as the Board of Regents, are responsible for the licensure and regulation of CPAs and PAs. Such regulatory authority includes the responsibility to discipline licensees for professional misconduct. CPAs and PAs must also adhere to a series of other regulatory and professional standards, rules and regulations, and practice principles depending on the type of professional service that they

perform for their clients. For example, licensees providing tax preparation services must meet standards established by the U.S. Internal Revenue Service. Similarly, licensees auditing clients that receive federal grants must conduct their audits in conformity with standards established by the U.S. General Accounting Office.

With the endorsement of the Board of Regents, the Department and the State Board for Public Accountancy have led a comprehensive effort focused on improving the integrity of the accounting profession, involving an ongoing series of initiatives over the last seven years. A wide range of stakeholders have joined us in the following initiatives:

- Providing testimony to the U.S. Securities & Exchange Commission when it was considering amendments to regulations to enhance auditor independence (September 2000)
- Former SEC Chief Accountant Lynn Turner provided the Regents and the Department with a first-hand account of the need for accountancy reform during his presentation at the Regents Conference on the Professions (October 2000)
- Issuing a survey to New York's licensed accountants to gather their perspectives on proposed accountancy reforms (May 2001)
- Hosting a high profile public forum with major stakeholders to address New York accountancy reforms (May 2002)
- Participating in multi-state conference calls to review state-based activities and share meaningful reform proposals (Spring 2002)
- Reviewing draft federal legislation to provide a state-based regulatory perspective (February - June 2002)
- Meeting with the ranking member of the U.S. House of Representatives Financial Services Committee to share perspectives on accountancy reform measures (April 2002)

This ongoing interaction and dialogue with regulators, consumer representatives and members of the profession provided a platform of valuable information for the Board of Regents to develop a meaningful framework for legislative and regulatory reform.

The Regents have enacted important regulatory changes regarding ethics and work paper retention and documentation. In 2001, the Regents adopted regulations requiring all registered accountants to participate in continuing education focused on professional ethics. This reform initiative addressed the public's increased concern about the ability of licensed professionals to make independent assessments when performing attest engagements by recognizing the positive value that continuing education has on professional practice. In December 2002, the Regents approved regulations that establish uniform standards for the documentation and retention of the work papers in connection with attest and compilation engagements.

These regulations are the first of a number of regulatory reforms, consistent with new federal laws, designed to address the need for greater accountability in the profession. Additionally, a number of other important proposals, included in several bills, have been

introduced but not passed by the Legislature, including a clarification of the Regents authority over the practice of public accountants.

This report is intended to update the Regents on current challenges in the regulation of the practice of public accountancy, outline the significant progress made by the Regents, the Department and the State Board for Public Accountancy toward reform, and present additional recommendations for Regents consideration and guidance that would achieve more effective oversight of public accountancy. The proposed actions and discussion items are based on a two-pronged approach that includes both legislation and regulations:

- Strengthened regulations in those areas where additional accountability can be achieved through Regents oversight of the licensed accountant's independence while performing attest and compilation engagements; and
- Tightened oversight in the Education Law in areas that can only be addressed through legislative action, focused on providing the Regents with necessary legal authority to govern the contemporary practice of public accountancy.

Our ongoing commitment to this comprehensive set of recommendations, focused on stronger public protection involving services provided by licensed accountants, is consistent with the Regents history of leadership and professional integrity in the practice of all 43 licensed professions that serve the people of New York State.

THE MANDATE FOR ACCOUNTANCY REFORM: A CALL TO ACTION

The need for more effective oversight of public accountancy has never been greater. Reform proposals for greater professional responsibility and tighter controls over attest and compilation engagements have been made in a wide variety of quarters, from Congress and the SEC at the federal level to the Board of Regents, the Department, the State Board for Public Accountancy and the New York State Attorney General at the State level. Since the mid-1990s, the Regents and Department have worked with the Legislature and a variety of stakeholders to fashion legislative amendments to strengthen necessary oversight of the profession. The Regents have recently adopted regulations requiring licensed accountants to complete new continuing education in professional ethics and adhere to work paper retention and documentation requirements. Over the next few months, the Department will present additional proposed regulatory reforms for discussion by the Regents. As background for a detailed discussion of these initiatives, this report will first examine the mandate for reform and review the many achievements the Regents and Department have had to date.

The Public Accountancy Profession

The hallmarks of public accountancy are objectivity, integrity, ethics, and independence. The public engages an accountant because they trust the ability of that individual to provide necessary services consistent with high professional standards. Likewise, the public reasonably expects that if an accountant is negligent or incompetent, he/she will be held professionally accountable.

Any discussion of the factors that must be addressed to improve the accounting profession and enhance public protection must include:

- The evolving scope of practice for public accountancy
- Effective professional oversight
- Enhanced education, independence and ethics

Since the last amendment to the scope of practice statute in 1947, the breadth of services provided by accountants has expanded dramatically to include a number of non-traditional services, including financial advisory services and the design and implementation of computer systems, in addition to tax return preparation, which had already been part of the practice. A rational and consistent regulatory system requires the appropriate regulation of all professional services performed by licensed accountants. Those non-traditional services range from financial consulting services to the design and implementation of computer systems often for the very corporations that are audited by the CPA firm. For such regulation and oversight to be effective, it must apply regardless of where an accountant is employed or what professional services are rendered.

Accountants employed by public accounting firms provide many different types of professional services to a variety of clients. New York licensees must comply with New York's statutes and regulations as well as with rules of practice established by other federal or state government regulatory agencies and/or the profession's major membership organization. For example, accountants preparing income tax returns are subject to practice rules established by the U.S. Internal Revenue Service.

Similarly, accountants auditing government agencies or clients receiving federal aid must also comply with rules established by the U.S. General Accounting Office. In addition, accountants who choose to belong to trade associations such as the American Institute of Certified Public Accountants (AICPA), are also subject to the rules of conduct and ethical standards established by those organizations. While accountants may provide many types of service under various regulatory structures, it is the Regents who have the responsibility and the authority to license and discipline CPAs and PAs and/or their firms in New York. The public relies on the fact that only the Regents, as authorized by the Legislature, may revoke an individual's license for unprofessional or negligent practice.

Clarification of Regents Jurisdiction

The need to clarify New York's law defining the scope of practice of public accountancy is greater today than ever before. Progressive new laws adequate to protect the people of New York State are necessary to address the public's rising concern over unethical accounting practices and the impact that the latest corporate failures have had on consumer confidence and world financial markets. This year, the Department will again seek the introduction of legislation to clarify the Regents regulatory authority over all licensees for all professional services provided to the public and to strengthen the Regents oversight over accounting practices in general.

In November 1999, under the administration of Arthur Levitt, the Chief Accountant and the General Counsel of the SEC sent the Department a letter discussing the expansion of the sale of non-traditional services by accounting firms. The letter emphasized the need to clarify New York's Education Law to improve the Regents regulatory oversight of the accounting profession. This letter states:

"Your ability to protect the public might be impaired significantly if you are deemed to be precluded by law from looking past the accounting and auditing division and into the larger, more profitable operations of an accounting firm or a corporate parent of an accounting firm. If the blinds are shut when you attempt to look into the marketing and performance of consulting, tax and other activities, you will neither have the information you need nor the power to assure the protection of the public interest in receiving competent and creditable accounting services provided by independent and skeptical accounting professionals."

The Need for Greater Professional Oversight in New York - Registration of All CPAs and CPA Firms

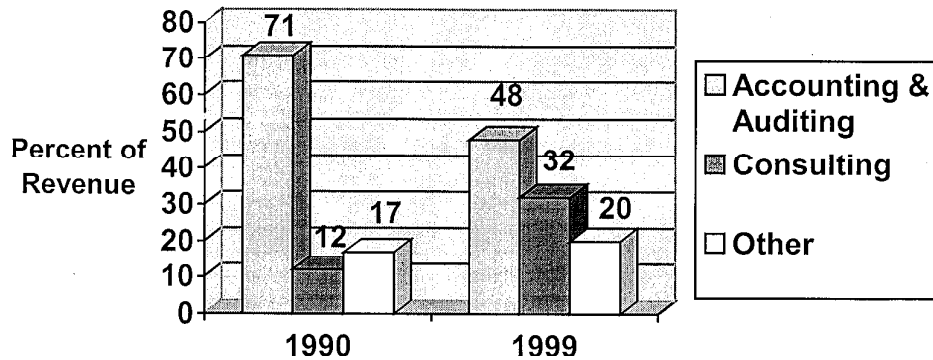
Because the relevant Education Law provisions were enacted over 50 years ago, only licensees who are employed by public accounting firms are required to be registered with the Department. Today, a significant percentage of licensed accountants are employed in private industry providing peripheral or non-traditional services such as tax preparation and financial planning to the public. In addition, there is no provision in the Education Law that requires sole proprietorships to register with the Department or for professional services limited liability companies (LLCs) to maintain a current registration with the Department after initial registration. The Department supports legislation that would require all licensees, with limited exceptions, to maintain a current registration with the Department. The legislation should also require current registration for all firms providing services to the public in New York.

Evidence of the need to expand the Regents jurisdiction is reflected in a recent review of referrals for disciplinary action by the SEC. Approximately 45 percent of all referrals between 1991 and 2001 were related to incidents of misconduct by New York licensees that fell outside the Regents regulatory authority, primarily because the licensee was an owner or key member of management rather than an employee of a public accounting firm.

Growth of Consulting and Non-audit Services

Since 1995, the Department, on behalf of the Board of Regents, has proposed amendments to the accountancy provisions of the Education Law that would strengthen public protection by clarifying the profession's scope of practice to ensure that licensees are professionally responsible for all of the services that they provide beyond core attest and compilation services. The amount and degree to which accounting firms have expanded the types of non-traditional services offered to the public in recent years is staggering. Non-traditional services include tax return preparation; financial advisory services; and, computer system design and implementation services. As indicated in Table 1, according to a recent SEC report, from 1990-1999, the ratio of accounting and auditing revenues generated by the Big Five accounting firms from SEC clients dropped from 71 percent to 48 percent. In contrast, during the same time period, consulting revenue grew from 12 percent to 32 percent.

Growth of Consulting Services - Table 1
(Big 5 Accounting Firms)

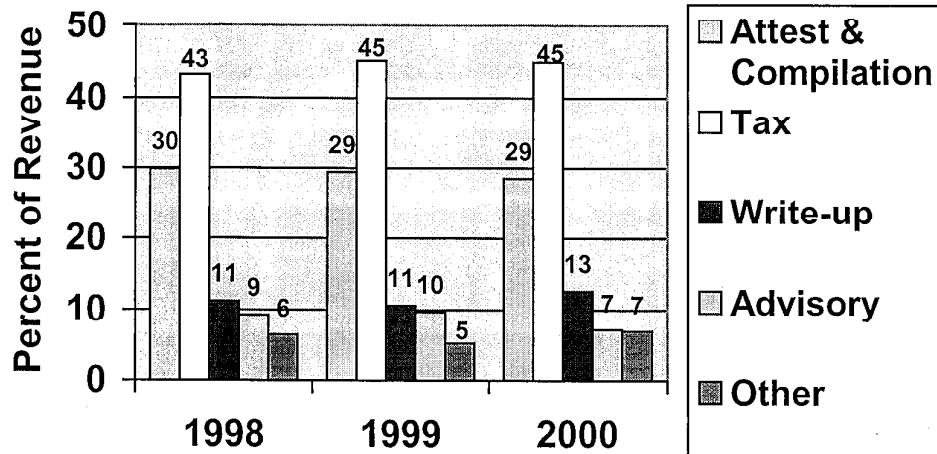


In a 2001 speech, SEC Commissioner Laura Unger described a dramatic example of how the expansion of non-traditional services and the revolving door scenario could impact an accounting firm's professional judgment when she outlined the relationship between Waste Management, Inc. and their auditor, Arthur Andersen. Although the Commission did not ultimately charge Andersen with a violation of the auditor independence rules, the Commission's order did summarize some of the factors that may have played into Andersen's failure to make objective decisions, including:

- Andersen regarded Waste Management, Inc. as a "crown jewel" client;
- Until 1997, every CFO and CAO of Waste Management, Inc. had previously worked for Andersen; and
- Between 1991-97, Andersen billed Waste Management, Inc. approximately \$7.5 million in audit fees and \$11.8 million in non-audit fees.

The growth of non-traditional or peripheral services is not limited to the national accounting firms. A recent national survey of local accounting firms reported a similar trend toward non-traditional services. As indicated in Table 2, such firms derived only 29 percent of total net fees from the traditional attest and compilation services that fall within the Regents regulatory authority under the current provisions of New York law.

Sources of Revenue - Table 2
(Local Accounting Firms)



These findings are further supported by a 1999 survey performed by the National Association of State Boards of Public Accountancy that reported that 66 percent of Americans believe that the principal reason to hire an accountant is to prepare taxes or provide tax advice. However, in New York, the Regents do not have regulatory authority over tax return preparation and advisory services in stark contrast to the public's perception.

The profitability of non-traditional consulting and advisory services provided by public accounting firms did not go unnoticed by business corporations. In 1997, the Department was approached by American Express Tax and Business Services, regarding the proposed purchase of the non-attest business segment of a New York State registered public accounting firm. As a result of this inquiry, the Department and the State Board for Public Accountancy initiated a comprehensive analysis of the definition of the scope of practice of public accountancy that included input from an outside consultant and the New York State Office of the Attorney General. The Department subsequently issued a memorandum to the field discussing the Department's and the State Board's interpretations and conclusions, the details of the transaction and assurances provided by the parties to ensure compliance with the laws of New York. Since that time, additional consolidations have occurred in New York.

STATE EDUCATION DEPARTMENT ACTIONS

During July 2000, the Department provided testimony before the O'Malley Panel on Audit Effectiveness. The panel was appointed in October 1998 at the request of SEC Chairman Arthur Levitt and charged with the responsibility of reviewing and evaluating how independent audits of financial statements of public companies were performed and assessing whether new trends in audit practices served the public interest.

The Department's testimony focused on:

- Enhancements to the profession's regulatory structure and the important role of state regulatory bodies;
- The impact of the growth non-audit services on the independence of public accounting firms; and
- The need for joint federal and state regulatory cooperation to ensure the "seamless" oversight of public accountancy.

As a result of the proliferation of non-traditional services within public accounting firms and the impact these services may have on an auditor's independence, the SEC proposed amendments to its regulations aimed at enhancing auditor independence during the summer of 2000. In September 2000, the Department and the State Board were asked to provide testimony on auditor independence and regulatory enhancements at a SEC public hearing.

Combating Proposals to Lower New York's Licensure and Practice Standards

At a time when the SEC, under Chairman Arthur Levitt, sought to tighten government oversight over accounting practice, the profession's State membership organization and various business organizations proposed substantive amendments to the Education Law that would lower New York's licensing requirements and liberalize New York's practice standards, including a provision permitting the ownership of public accounting firms by non-licensees.

During November 1999, the Department and the State Board provided testimony at a New York State Assembly public hearing on accountancy reform legislation resisting proposals to weaken New York's licensure and practice standards. Instead, we called for legislation that would amend the scope of practice definition in the Education Law to strengthen Regents oversight of professional practice. This testimony was in stark contrast to the testimony of various lobbyists at that meeting who called for the adoption of legislative proposals that would lower New York's licensure and practice standards. Department and State Board representatives continued advocacy efforts by participating in a New York State Senate roundtable discussion focused on accountancy reforms during March 2000.

Department Survey of Licensed Accountants

Given the divergence of opinions concerning the SEC's independence proposals and the trend toward more liberal licensure and practice standards, the Department recognized the need to solicit input from New York's licensed accountants. In 2001, we surveyed more than 34,000 licensed accountants and received more than 12,000 responses from a broad cross section of licensees registered in New York. This survey provided an accurate and independent assessment of the views of individual licensees regarding many of the accountancy proposals. The results of the survey indicate that an overwhelming majority of licensees want to uphold New York State's high practice standards and ensure the continuation of a regulatory structure that prevents inherent conflicts of interest.

- More than 90 percent of the respondents believed that New York's experience requirement for licensure should remain intact.
- More than 72 percent of the responding accountants disagreed with the proposition that practitioners working in private industry should be allowed to perform compilation services for the public on behalf of their corporate employers.
- More than 80 percent of the respondents indicated that the Education Law should not be amended to allow non-licensed individuals to become up to 49 percent owners of public accounting firms.
- Over 75 percent of the respondents said they believed that New York should not embrace the concept of substantial equivalency to make it easier for out-of-state accountants to practice in New York if it means lowering some of New York's licensing standards.

Department and State Board Public Forum on Accountancy Reforms

To inform future discussions with the Regents and the Legislature, on May 16, 2002, the Department and members of the State Board for Public Accountancy held a public forum in New York City. The purpose of the forum was to discuss proposed accountancy reform measures and to solicit comments and suggestions from various constituencies regarding the regulation of licensed accountants.

The Department asked participants to comment on the following questions:

1. Should licensed accountants be required to inform clients that they are not subject to Board of Regents jurisdiction for professional services that are not included in the scope of practice, such as tax and consulting services ("disclaimer notice")?

2. Should licensed accountants be subject to specific guidelines for the retention of records and paperwork related to an audit engagement?
3. Should licensed accountants be prohibited from simultaneously providing certain non-audit services to their audit clients during the course of their audit?
4. Should audit firms be required to rotate their audit clients every seven years to enhance independence?
5. Should a mandatory "cooling off" period for senior audit team personnel contemplating employment with audit clients be required for audit firms?

The following distinguished speakers provided testimony:

- ◆ Douglas Carmichael (CPA), Director of the Center for Integrity in Financial Reporting and the Wollman Distinguished Professor of Accountancy at the CUNY Bernard M. Baruch College;
- ◆ Elizabeth Fender (CPA), Director of Corporate Governance, TIAA CREF;
- ◆ Russ Haven, Esq., Legislative Counsel, New York Public Interest Research Group;
- ◆ Gail Hillebrand, Esq., Senior Attorney, Consumers Union;
- ◆ Jeffrey Hoops (CPA), Partner, Ernst and Young, President-elect, New York State Society of Certified Public Accountants;
- ◆ Gary Illiano (CPA), Partner, Grant Thornton, LLP;
- ◆ Wayne Kolins (CPA), Partner, BDO Seidman;
- ◆ Nancy Newman-Limata (CPA), Partner, PricewaterhouseCoopers, President, New York State Society of Certified Public Accountants;
- ◆ Bevis Longstreth, Esq., Counsel to Debevoise & Plimpton and former Commissioner of the US Securities and Exchange Commission;
- ◆ Vincent Love (CPA), Partner, Kramer and Love, former Ethics Committee Chair, New York State Society of Certified Public Accountants;
- ◆ Louis Lowenstein, Esq., Member, O'Malley Panel on Audit Effectiveness;
- ◆ Eli Mason (CPA), Partner, Mason & Company, LLP;
- ◆ Edmund Mierzwinski, Consumer Program Director, US Public Interest Group;
- ◆ Damon Silvers, Esq., Associate General Counsel for the AFL-CIO;
- ◆ Lynn Turner (CPA), Director of the Center for Quality Financial Reporting at Colorado State University and former Chief Accountant of the US Securities and Exchange Commission; and
- ◆ Celia Wexler, Esq., Senior Policy Analyst and Program Director for Common Cause.

Several consumer groups, educators, and former regulators urged the Regents, the Department and the State Board to continue to take a leadership role; suggesting that other

states and the SEC will follow New York's lead by enacting necessary reforms. Participants also expressed support for current Department and State Board activities focused on mandatory work paper retention and documentation rules and providing disclosure to clients whenever professional services fall outside the Regents oversight authority. The recommendations from the session were instructive and have significantly contributed to our ongoing discussions with the Legislature about accountancy reform measures.

Sharing Information with Key Stakeholders

The Department survey and the Department and State Board public forum provided valuable input that was subsequently shared with other key stakeholders. In the months following the Enron scandal, the Department coordinated a series of meetings and conference calls with other regulators to share this information, which later served as the basis for subsequent state accountancy reforms. As a result of these discussions, the Department was invited to provide input on key aspects of federal accountancy reform legislation. During April 2002, Department and State Board representatives met with the ranking member of the House of Representatives Financial Services Committee to share concerns about needed accountancy reform legislation.

Department and State Board representatives also appeared before the New York State Senate Higher Education Committee and provided testimony on specific accountancy reforms focused on auditors of publicly traded companies during February 2002. This testimony included a series of proposed reforms, some of which were identical to provisions that were later incorporated into the federal Sarbanes-Oxley Act of 2002. The Department also provided written testimony to a joint New York State Senate & Assembly public hearing on corporate responsibility and accounting practices during September 2002.

In December 2002, the Department and State Board for Public Accountancy participated in a U.S. General Accounting Office forum discussing corporate governance and accounting oversight reforms. Participants highlighted the importance of state licensure and regulation and reiterated the call for a seamless mechanism of professional oversight.

While the Department has been working with the Legislature to seek necessary legislative revisions relating to the regulation of the public accountancy profession, it has succeeded in helping to block legislative proposals that would undermine the public interest. Additionally, we have carefully identified initiatives that could be enacted by regulation and the Regents have already adopted two significant regulatory reforms:

- *Professional Ethics*

Recognizing the evolving practice climate, the Regents recently adopted an amendment to the Commissioner's Regulations that requires all registered accountants to participate in four hours of continuing education focused on ethics

during each three-year registration period beginning September 1, 2001. Sustained focus on professional ethics through continuing education supports the objectivity, integrity and independence of the accounting profession, and is highly relevant to preventing the ethical lapses that contributed to several highly publicized corporate failures.

- *Work Paper and Record Retention*

One of the most disconcerting actions reported to have occurred in the Enron-Andersen scandal was the intentional destruction of documents that could serve as critical evidence in subsequent criminal prosecutions and/or professional disciplinary actions. Effective January 3, 2003, an amendment to the Rules of the Board of Regents established uniform standards for work paper documentation and retention for attest and compilation engagements in the practice of public accountancy. The amendment ensures that work papers that support attest and compilation engagements are maintained for a minimum of seven years and that such work papers contain adequate documentation.

Regulations related to the National Regulatory Model - Sarbanes-Oxley Act Of 2002

The regulatory structure for auditors of publicly traded companies is very complex. Prior to July 2002, accountants and the firms that employed them were subject not only to state regulatory oversight, but also to the oversight of the SEC and other private sector regulatory bodies. SEC regulation S-X requires all accountants practicing before the SEC to be currently registered and in good standing with their state licensing board(s).

A majority of the SEC's disciplinary actions are administrative proceedings brought against publicly traded companies, their owners and management, licensees or their public accounting firms. The majority of these administrative proceedings are resolved through an offer of settlement where the respondent makes no admission of guilt or innocence. Once an offer of settlement is accepted, the SEC notifies the licensing authority, which then must decide if investigation and prosecution is warranted. The process, from SEC investigation to prosecution by a licensing jurisdiction, can take several years to complete.

As a result of numerous corporate bankruptcies, financial statement re-statements, and accounting irregularities, the most far-reaching corporate responsibility and accountancy reform legislation since 1934, entitled the Sarbanes-Oxley Act of 2002 was enacted in July 2002.

Key Provisions of Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act includes a series of provisions that apply to auditors of publicly traded companies. Specifically, the Act:

- Establishes a five-member Public Company Accounting Oversight Board (PCAOB) that is subject to SEC oversight;

- Requires public accounting firms to register with the PCAOB to participate in the preparation or issuance of any audit report with respect to a public company;
- Requires registered accounting firms to prepare and maintain audit work papers and other information related to an audit for at least seven years in sufficient detail to support the conclusions reached in the audit report;
- Mandates inspection of registered public accounting firms annually if the registered public accounting firm regularly provides audit reports for more than 100 issuers (at least once every three years for registered firms that audit fewer than 100 issuers);
- Prohibits most "consulting" services outside the scope of practice of auditors;
- Prohibits a registered accounting firm from auditing any SEC registered client whose chief executive, CFO, controller or equivalent officer was employed by the registered accounting firm and who participated in any capacity on the audit team of the registered accounting firm within one year of the initiation of the audit; and
- Requires audit partners who either have performed audit services or been responsible for reviewing the audit of a particular client to be rotated every five consecutive years.

The Department is currently working on an amendment to conform New York's regulations to the Sarbanes-Oxley Act. This amendment is consistent with the regulatory model that we have employed in recent years and fosters our important mission to protect the people of New York State. This amendment will clarify that with or without federal disciplinary action for violations of the provisions of the Sarbanes-Oxley Act, the State Board of Regents reserves the right to independently prosecute similar professional misconduct in New York. Such action is critical to the continuing viability of the Regents regulatory authority.

PROPOSED REFORMS IN NYS STATUTES

The Department has prepared a comprehensive legislative proposal that identifies a series of proactive reforms that will enhance public protection by clarifying the Regents oversight over the professional services of all licensees. If enacted, this legislation would enact the following reforms:

Clarify the Accountancy Scope of Practice

As the Education Law is currently written, the Regents do not have jurisdiction over licensed accountants when they provide services such as tax return preparation, financial advisory services and the design and implementation of computer systems which are not included in the scope of practice of the profession. The Department's proposed bill would expand the profession's scope of practice to include the full range of services that

accountants currently provide to consumers, even if they are not related to an attest or compilation engagement. This proposal would modernize New York's Law and bring it into conformity with the more progressive practice definitions of most other states.

Individual and Firm Registrations

The Department's proposed bill reflects the evolution of the practice of public accountancy. CPAs and PAs often provide a number of necessary services, including tax return preparation and financial planning services as employees of business corporations or other unlicensed entities. The ability of licensees to provide those services is unclear under current law. The proposed bill clarifies recent court decisions allowing these additional services to be provided in a business corporation, but also sets out necessary public safeguards. The Department's bill would hold all licensees to the same standards of practice whether employed by public accounting firms or business corporations.

The Department's bill would further enhance the regulation of the profession by requiring all firms to maintain current registration with the Department. Currently, professional service limited liability companies (LLCs) register with the Department when initially established and sole proprietorships have no registration requirement. By requiring all firm types to maintain current registration with the Department, all firms would be held to the same standard of oversight.

Continuing Education

The Education Law provides an exemption from mandatory continuing education if a licensee is not employed in a public accounting firm. Demographic shifts in employment have resulted in a large segment of licensees being employed in private industry, government and academia. The Department's proposed legislation provides that all CPAs and PAs, with limited exceptions, would be required to participate in mandatory continuing education as part of the continuum of learning throughout a professional's career. Recognizing the need for adequate course content, the bill would expand the breadth of recognized areas of study for a concentrated learning program. The bill would also change the reporting requirement from an artificial September to August fiscal year to an easily understandable calendar year.

Firm Inspections and Peer Review

The original peer review program was developed by the AICPA as an educational tool for its members to enhance their knowledge of administrative policies and procedures when conducting financial statement services. There were at least two criticisms of the peer review system when it was applied to auditors of publicly traded companies: It was inherently compromised because of the limited pool of peer review firms and peer review was only required on a triennial basis. These shortcomings do not translate to peer reviews conducted of auditors of closely held businesses because of the substantially larger pool of prospective peer review firms.

Recognizing the potential public benefit of a mandatory peer review program, the Department's proposed bill would require all registered public accounting firms that perform attest or compilation services to participate in a mandatory peer review process. The Department's proposed reform legislation seeks to enhance AICPA's peer review model by requiring licensees conducting peer reviews consider compliance with New York's laws, rules and regulations as part of the peer review program. Failure to participate in mandatory peer review could result in the revocation of a firm's registration.

The proposed bill would also enable the Department to conduct inspections of firms if substandard professional services were identified as part of the peer review process. The Department proposal also clarifies that firms participating in the federal 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.

Public Accountancy Task Force

The practice of public accountancy is performed in firms ranging from sole proprietorships to multi-national firms earning several billions dollars per year. The current provisions of the Education Law limit fines for professional misconduct to a maximum of \$10,000 per specification. Recognizing the inherent differences in the size and structure of registered public accounting firms compared to other licensed professions, the Department's bill proposes to increase maximum penalties for professional misconduct in the practice of public accountancy. In addition, to enhance the Regents oversight of the public accountancy profession, the proposed bill would establish a Public Accountancy Task Force that would consist of CPA investigators, prosecutors and support staff focused on complaints filed with the Department in the practice of public accountancy. The proposed bill would also authorize the Commissioner to hire staff and create a funding mechanism to utilize registration fees, fines and penalties to pay for the cost of the task force.

Future Legislative Proposals for Regents Discussion

Temporary Practice Permits

The Department has been actively engaged in discussions with interested stakeholders about two other legislative proposals for consideration by the Regents. One initiative, temporary practice permits, would allow a certified public accountant, licensed and in good standing in another jurisdiction, to work under the supervision of a New York licensed CPA on a temporary basis. This initiative recognizes and incorporates the Regents policy discussions on horizon issues impacting the practice and regulation of public accountancy. With the evolution of scopes of practice in public accountancy, there has been a movement toward consolidation and specialization among public accounting firms. As a result, there is an increased need for public accounting firms that practice across state lines to utilize the expertise of accountants licensed in other jurisdictions on a temporary basis. One proposal under consideration would provide that a CPA, licensed and in good standing in their home

jurisdiction, could provide professional services under the supervision of a New York licensed CPA for up to 15 days on an engagement basis.

Specifically, we are asking the Regents for input and guidance on whether an out-of-state licensed CPA should be granted temporary practice rights in New York?

Reportable Events

A second legislative reform initiative that will be considered and discussed in the coming months involves mandatory reporting of certain reportable events by a licensee. This proposal would enhance public protection by requiring licensees to report to the Department whenever he/she issues a restatement of a previously issued financial statement related to public companies incorporated, located in, or doing business in New York; New York government entities; charities; and any other entities that are required by law to make their financial statements public. The restatements could be the result of errors or any other purpose that does not involve a restatement required solely by newly issued or revised accounting standards. This reform proposal would also require licensees to report investigations by the Public Company Accounting Oversight Board, as well as, settlements and arbitration awards to actions brought by persons located, residing or doing business in New York.

We are asking the Regents to consider and comment on this reform initiative.

PROPOSED REFORMS IN REGENTS REGULATIONS

Conformity with Federal Statute

The Department has studied various regulatory models and participated in numerous meetings with state and federal regulators focused on enhanced oversight of the public accounting profession. The Department has also sought and received extensive commentary from interested parties and stakeholders on the current regulation of professional accountants. Based upon this input, the Department is initially proposing amendments that will conform the Regents Rules to recently enacted federal legislation.

These amendments will provide the Regents with the option of investigating and prosecuting professional misconduct violations of the federal statute regardless of federal action. Consistent with the provisions of the federal Sarbanes-Oxley Act of 2002, these amendments will establish independence standards for accountants conducting an audit of a client that issues securities registered with the SEC. Specifically, these amendments will:

- Prohibit the performance of certain non-audit services contemporaneously with an audit engagement;
- Require the rotation of the audit partner and concurring audit partner every five years; and,

- Prohibit a licensee from accepting certain management positions with an audit client within one year of an audit engagement.

Together, the amendments will serve to protect the public interest and enhance the integrity of the public accountancy profession by ensuring the independence of licensees when conducting audits of publicly traded companies registered with the SEC.

Commissions

The evolution of professional services provided to the public by CPAs and PAs has also increased the means by which licensees are compensated for their services. This is especially true when a CPA or PA provides advice on insurance or financial products and receives a commission for the sale of the product. New York's current regulations lack clarity with respect to the receipt of commissions by CPAs and PAs.

Permitting the acceptance of commissions and referral fees raises significant public policy concerns. The public relies upon the integrity and objectivity of the profession when it chooses to use the services of a CPA or PA. Will the licensed professional provide objective professional guidance if required to choose between two similar financial products differing only in the amount of commissions paid to the licensee? Commissions and referral fees should not be permitted in any situation that could affect the independence of the CPA or PA.

Recognizing the public benefit of clarifying the rules in this area, the Department is developing a proposed regulatory amendment that would prohibit a licensee from accepting a commission when serving a client for whom the licensee performs:

- an audit or review of a financial statement,
- a compilation of a financial statement when the licensee knows or has reason to know that a third party will use the financial statement and the licensee's compilation report does not disclose a lack of independence,
- an examination of prospective financial information, or
- any other service requiring independence.

Public Notification

The public engages a licensed accountant because they trust the ability of that individual to provide professional services consistent with high professional standards. Likewise, the public reasonably expects that if a licensed accountant is negligent or incompetent, he/she will be held professionally accountable. We are encouraged that legislative reforms may occur this year in the wake of recent legislative public hearings and round table discussions and the introduction of various accountancy reform proposals.

However, if legislation expanding the scope of practice is not enacted, the Department and the State Board have discussed a potential amendment to the Rules of the Board of Regents that would require licensees to provide written notification to their clients whenever he/she performs professional services that are outside the Regents oversight. Such disclosure is critical to ensuring public protection.

Future Regulatory Reforms

Disclosure of Professional Fees

At the federal level, the SEC requires all publicly traded companies to disclose in their annual proxy statements a breakdown of professional fees paid to their outside public accounting firm. Similar rules do not exist for auditors and accountants of closely held business entities where bankers, insurers and other third parties place reliance on the business entity's financial statements.

The proposed rule would allow licensees to issue standard unmodified financial statement reports if the notes to the financial statements disclose the percentage breakdown of professional fees for accounting and auditing, tax compliance services, including tax preparation services, and other consulting services. This requirement would provide third party users of financial statements with an understanding of the breadth of professional services provided by the public accounting firm.

In the coming months, we will be asking the Regents for their input and guidance regarding this proposed accounting reform.

NEXT STEPS

The Department and the State Board for Public Accountancy have been actively engaged in upholding New York's high licensure and practice standards while developing a legislative and regulatory approach that enhances public protection and reflects contemporary practice. The Department and the State Board will continue to maintain their presence by providing testimony and other input as requested and by working with federal regulators directly and through the National Association of State Boards of Accountancy.

The Regents and the Department will continue to exercise their regulatory responsibility and meet their commitment to enforce New York's laws to the fullest extent possible. In addition to ongoing work with the Legislature, the Department is also working with the Office of the Attorney General to coordinate enhanced corporate oversight and accountancy reform efforts.

In the coming months, the Department will propose the additional regulatory reforms referenced above for consideration by the Regents while working with legislators and their staff members to introduce the departmental bill to the Legislature.

We believe that the comprehensive reform plan outlined in this report, incorporating both legislative and regulatory amendments, will restore the public's confidence in the integrity of public accountancy in New York while also reflecting contemporary practice of the profession. We will keep the Regents informed of these efforts and ask for the Regents review and endorsement.