

Client Alert

A report
for clients
and friends
of the firm April 2003

The Public Company Accounting Oversight Board ("PCAOB") has proposed rules for the assessment of public companies for the annual "accounting support fees" required by the Sarbanes-Oxley Act ("SOX").

Sec. 109 of SOX requires that "issuers" be assessed annual formula based "accounting support fees" for the support of the PCAOB, the private entity that, together with the Securities and Exchange Commission ("SEC"), is designated under SOX to regulate the accounting profession, and for the support of the accounting standard setter designated by the SEC, as required by Sec. 108 of SOX.

The PCAOB is authorized to adopt rules, subject to SEC approval for the assessment and collection of the accounting support fees required to fund its annual budget. The accounting standard setter designated by the SEC, expected to be the Financial Accounting Standards Board ("FASB"), may designate agents, including the PCAOB to collect the accounting support fees required to fund its annual budget. (For convenience, the designated accounting standard setter will be referred to as the FASB in this client alert.) Combined PCAOB/FASB invoices would be an efficient means of collecting these two fees.

The purposes of these accounting support fees are to enhance the independence of the PCAOB and the FASB by eliminating their dependence for funding on the voluntary support of the accounting profession and others and isolating their funding from the political pressures of the Congressional appropriation process.

The comment period for the PCAOB's proposals closed on April 4, 2003, but the final rules are subject to SEC approval. Thus, the final rules are not expected to be effective until later this year and the first fees for 2003 are expected to be assessed during the first 30 days of 2004.

The exact amount of the assessments for a particular issuer will not be known until the fees are assessed, since they depend on the budgets of the PCAOB, which must be approved by the SEC, and the FASB. (SOX does not require that the SEC to approve the FASB's budget. However, since the SEC, under Sec. 108 of SOX, must designate the accounting standard setter and has general rulemaking authority, it is doubtful, as a practical matter, that the FASB would adopt a budget that was objected to by the SEC.)

The aggregate amounts of the assessments cannot exceed the budgets of the PCAOB and the FASB. In the case of the PCAOB, its assessment must be reduced by the amount of registration and annual fees it collects from registered public accounting firms. It is not clear whether the aggregate assessments of both the PCAOB and the FASB would be reduced by any publication or other income that they receive. Some estimates are that the PCAOB will receive approximately 70% of the aggregate accounting support fees and that the FASB will receive the other 30%.

Companies Subject to Assessment

Under Sec. 109 of SOX, accounting support fees may be assessed only on "issuers", companies subject to the reporting provisions of the Securities Exchange Act of 1934 (the "Exchange Act")

Under the Board's proposals fees only would be assessed against the following categories of companies ("Covered Companies"):

- Companies with average monthly U.S. market capitalization during their preceding fiscal years based on classes of their common stocks greater than \$25 million ("Market Cap Companies"); and
- Certain registered investment companies.

Companies in bankruptcy proceedings that are not filing reports including audited financial statements with the SEC and employee stock purchase, savings and similar plans and companies with \$25 million or less of market capitalization would not be assessed.

Market Cap Companies would pay 90% of the aggregate fees assessed by the PCAOB and the investment companies would pay the remaining 10%. Although the FASB will be required to use the same market cap formula as the PCAOB, it is not clear whether the FASB will use the same categories of Covered Companies or the 90%/10% allocation proposed by the FASB.

Assessment Procedures

The PCAOB expects to compute the accounting support fees during the first 30 days of each calendar year, although this may slip somewhat, particularly with respect to the first assessment. The PCAOB's proposals do not explicitly address how this will affect companies with fiscal years ending other than on December 31. A company that is not a Covered Company at the time the Board determines the fees will not be assessed.

The assessment formula. Sec. 109 of SOX provides the market capitalization formula used in the PCAOB's proposals. The FASB must use the same formula. The formula is:

- The numerator is the average monthly equity market capitalization of the issuer for the 12-month period immediately preceding the beginning of the fiscal year to which the PCAOB's budget relates (It is not clear whether the PCAOB will budget on a calendar year basis or use the Federal Government's fiscal year beginning on October 1.);
- The denominator is the average monthly equity market capitalization of all Covered Companies for that 12-month period.

Notices. The PCAOB proposes to give Covered Companies notices of their assessments either electronically or by first class mail to the latest address appearing on the SEC's EDGAR system. Payment would be due within 30 calendar days of the issuance of the notice. If payment is not received by the thirtieth day, interest would accrue at the rate of 6% per annum. If payment is not received by the sixtieth day, the PCAOB may send a second notice. If payment is not received by the ninetieth day, the PCAOB would notify the SEC of the non-payment.

No advance public notice or opportunity for comment is required of the aggregate amount of the annual assessment to support either the PCAOB or the FASB before those amounts are determined finally by those entities.

Foreign private issuers. The market capitalization of foreign private issuers would be determined based only on the trading in the United States of the shares of the classes of their common stock traded in the United States.

Small business issuers. The PCAOB's proposals will apply to small business issuers, as defined in SEC rules. However, the \$25 million market capitalization cut off should relieve many small business issuers from being assessed.

Method of payment. Although the PCAOB's proposed rules do not so specify, presumably, the payments are to be made to the PCAOB and not the U.S. Treasury. Also, the proposed rules do not specify the method of payment, e.g., wire transfer, certified check or personal check. Nor do the proposed rules provide instructions for wire transfers, if an issuer should want to use that method of payment. Presumably, these instructions will be included in the PCAOB's notice of assessment.

Procedures for disputing assessments. The proposed rules provide no procedures for disputing an assessment. The PCAOB's proposing release states that, if a Covered Company disagrees with an assessment, it should inform the Secretary of the PCAOB in writing.

Remedies for Non-Payment

The PCAOB has proposed harsh remedies for non-payment of its fees.

PCAOB assessments. The PCAOB proposes to require a Covered Company's outside auditors to confirm payment of the fees assessed by the PCAOB and to preclude the auditors from issuing unqualified reports on Covered Companies' financial statements and the auditors' consents to the inclusion of their reports on those financial statements in Securities Act of 1933 registration statements. Although not specified in the proposed rule, non-payment presumably does not occur until 31 calendar days after issuance of the assessment notice by the PCAOB, rather than 31 calendar days after the receipt of the notice by a Covered Company. The PCAOB's authority to require an auditor to withhold an unqualified report in these circumstances is questionable, since it is not expressly provided by SOX.

The PCAOB also proposes to notify the SEC if payment of the required fee is not made within 90 days of issuance of the notice. Failure to pay a required fee is a violation of the Exchange act. However, a company cannot be prosecuted in a criminal proceeding for such a violation.

It is not clear how this will apply to Covered Companies with fiscal years ending other than on December 31, since the audit reports for their preceding fiscal years may have been issued before the Board determines the assessment for those companies for that fiscal year.

Due to the harshness of the PCAOB's remedies for non-payment of assessed fees and the proposed requirement for the outside auditor to confirm payment of the fee, Covered Companies should develop procedures for determining whether they are Covered Companies (since their status may vary from year to year), receipt of assessment notices, payment of assessments and protests of assessments.

FASB assessments. Neither the FASB nor the SEC have announced procedures for assessing the accounting support fee for the FASB. Further, SOX does not require that the SEC approve the FASB's annual budget.

The PCAOB has proposed that, if it is designated as the agent for collecting the fees assessed to support the FASB, which is under consideration by the two entities, it will apply the same notice and collection procedures that it proposes to apply with respect to its own assessments. In cases where it acts as the collection agent for the FASB, the PCAOB also proposes to prohibit a registered public accounting firm rendering an unqualified opinion on the financial statements of a Covered Company, if it fails to pay an assessment of fees to support the FASB. However, SOX does not expressly grant the PCAOB, or any other agent acting for the FASB, the authority to impose such a penalty.

Conclusion

Although it is too early to predict the amount of an assessment for a particular company, the PCAOB has estimated that for every \$10 million of its budget the largest Market Cap Company would pay a fee of \$260,000; the 1,500th largest Market Cap Company would pay \$500; and the 3,000th largest Market Cap Company would pay \$100. This does not include the fees assessed to support the FASB. The annual budget of the PACABO has been estimated to be in excess of \$50 million and that of the FASB to be about \$25 million. Thus, some of the larger Market Cap Companies may pay more than \$1.0 million in accounting support fees in addition to the audit fees paid to their outside auditors, which are expected to increase significantly in 2003, particularly since new audit and attest procedures will be required with respect to internal controls over financial reporting.

Due to the severe consequences of non-payment of PCAOB assessments, Covered Companies should develop controls and procedures to assure payment of the required fees within the time frame required by the PCAOB.

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