



AICPA Rules Impact Business Valuation

Since Congress enacted the Sarbanes-Oxley Act in 2002, CPAs have been working under a new set of rules for audit clients. In order to avoid conflicts of interest and maintain independence, firms providing audit services are precluded from providing certain other services to their publicly held audit clients, including appraisal or valuation services.

In order to be considered “independent,” accounting firms must not audit their own work, function as a part of management or as employees of the audit client, act as an advocate for the audit client, or promote the client’s company stock or other financial interests.

In addition, if the accounting firm chooses to perform other services for audit clients, the firm and its client must agree to strict rules:

- The CPA cannot perform management functions or make management decisions for the client.
- The client must agree to perform “significant” functions in connection with the engagement, including appointing a competent employee to oversee the CPA’s services and accept responsibility for the results.
- The CPA must document in writing the scope of the engagement and the client’s and CPA’s respective responsibilities.

Given all of these restrictions, is it ever possible for accounting firms to perform non-audit services such as business valuations for their audit clients? The answer is, “It depends.”

Difficult, But Not Impossible

The American Institute of Certified Public Accountants (AICPA) has been working since 2003 to establish its own set of professional standards relative to the Sarbanes-Oxley independence issue, known as Interpretation 101-3. Early in 2005, the AICPA’s Professional Ethics Executive Committee formally clarified its position with a proposed set of independence requirements by which CPAs would operate. The revisions don’t relax the rules or change their meaning. They simply clarify them for CPAs and their clients.

What’s the issue? Generally accepted accounting principles (GAAP) require professional valuation to properly reflect the value of certain assets in a company’s financial statements, including such items as employee stock options, derivatives, goodwill and other intangible assets. In terms of independence, the issue is straightforward: If an accounting firm provides audit services for a client, and valuation issues affecting financial statements arise, can firm employees provide valuation services?

For publicly held clients, an accounting firm providing audit services for a client generally cannot provide valuation services as well. Sarbanes-Oxley independence standards prohibit auditors from auditing their own valuation work. The SEC rules are very strict and very clear on this.

For non-public companies, the answer is slightly more open to interpretation. Proposed AICPA standards specifically mention valuation services, suggesting that full-service accounting firms carefully consider the valuation work they perform for audit clients. For non-public companies, the litmus test focuses on whether the valuation work has a material effect on the client’s financial statements.

Do's and Don'ts

Assuming a valuation does have a material effect on the financial statements, the auditing CPA firm cannot determine the value of:

- The purchase price in a business combination.
- The shares of an employee stock option plan.
- The shares in a corporate stock redemption.
- A non-compete covenant.

However, even if the valuation has a material effect on financial statements, the auditing CPA firm can:

- Perform the "Step 1" test for goodwill impairment calculations.
- Value the client's shares in a sale between two individuals.
- Perform a tax-only valuation for the client or the client's employees.

Auditor independence is certainly not a new issue, but recent events have created a need for highly specific interpretations of the rules. The AICPA will soon be issuing an Exposure Draft of its new business valuation standards. Once that draft is approved, the new standards are expected to be effective December 31, 2005.

If you have any questions about the valuation services our firm can provide, please give us a call. We will be happy to discuss the new standards with you. And if we are not able to help with your valuation needs, we are happy to recommend another firm that can.