

ROBERT G. HUTCHINS - LEGAL BULLETINS

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The Sarbanes-Oxley Act became effective on July 30, 2002. Over the ensuing three years, it has become apparent that the Act has substantially increased the cost, complexity and risk of doing business for all but the smallest of enterprises, even though it applies expressly only to public companies. Here are some reasons why:

- Section 404 of the Act requires that public companies formally assess, certify and obtain auditor attestations of the effectiveness of the companies' internal *controls* over financial reporting, notwithstanding the fact that the resulting financial statements will also be audited. On June 17, 2004, the SEC approved Auditing Standard No 2 of the Public Company Accounting Oversight Board ("PCAOB"), the entity empowered to oversee the Act's auditing and accounting requirements. Under this Standard, an auditor must issue opinions respecting two distinct internal control questions; whether management's assessment of the effectiveness of the controls is fairly stated and whether the controls themselves are, in fact, effective. Because they are exposed to liability both for misleading attestation reports and for misleading financial reports, auditors have been aggressive in probing for weaknesses in client control regimes. For their part, executives fear that a suspicious auditor may issue a negative attestation report unfairly solely on the basis of a readily curable defect or mistake. Section 404 thus contributes to a developing rift between outside accountants and management.¹
- As has been widely reported in the business press, management assessments under Section 404 have not been uniform in terms either of their underlying procedures or their format. Accordingly, regardless of their conclusions, these assessments have not been helpful to regulators or investors seeking meaningful comparisons between peer group companies. One result of this disarray has been a high incidence of exhaustively detailed financial control audits by outside accountants that overlap, and in many respects duplicate, their parallel audits of financial statements. The aggregate increase in audit costs has been staggering.²

¹ Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder provide, in effect, that it is unlawful and actionable for "any person" ... "in connection with the purchase or sale of any (registered) security" to mislead investors by means of an untrue or omitted material fact. An equivalent provision is found in Section 17 of the Securities Act. Section 102 of Sarbanes-Oxley makes it unlawful for any person to "participate" in the preparation of an audit report unless it is a "public accounting firm" registered with the PCAOB. Under Section 105, that agency can sanction any such firm, and revoke its registration, for any "act, practice or omission" that violates any provision of the Act, any another securities law, a rule of the Board or a rule of the SEC relating to audits.

² The SEC is required to publish a cost/benefit analysis when adopting new rules. On June 5, 2003, in Release 33-8238 - 34-47986 IC - 26068, the SEC adopted rules implementing Section 404. The Release contained the SEC's estimate that the average cost of preparing attestation reports would be \$91,000 per company. The magnitude of that error would be amusing if the actual costs were not so devastating. In a survey of reporting companies conducted by Foley and Lardner, LLC, for example, participating companies with less than \$1 billion of revenue reported that average annual audit costs increased 96% during the first two years of the Section 404 phase-in period, from \$532,000 to \$1 million. These companies attributed the increase, almost entirely, to Section 404. See www.foley.com/features, *Third Annual Corporate Governance Cost Study*, June 16, 2005.

- Fallout from Section 404 has reached the private sector. Certifying public companies are routinely demanding, as a condition of entering a material, normal course business relationship, or consummating a material transaction, the right to review and approve the financial records and internal controls of their privately held suppliers or acquisition targets.
- Section 201 of the Act makes it unlawful for accountants to perform enumerated consulting and other non-audit services for publicly held clients while auditing the financial reports of those clients. Accounting firms have responded to the resulting shortfall in revenue by increasing rates for public company audits substantially, reversing the prior structure in which such rates remained low to attract consulting engagements. That trend has triggered proportionate increases in the rates for private financial audits.
- Sections 202 and 204 of the Act attempt to sever any remaining relationship between auditors and management that could compromise auditor independence by requiring that “all auditing services” be approved in advance by, and that auditors report exclusively to, an audit committee comprised of directors who are independent of management. The committee is to be “directly” responsible for the appointment, compensation and oversight of auditors. This requirement has deepened the wedge between auditors and executives.³
- Section 302 of the Act directs the SEC to require by rule that the “principal executive officer(s)” of public companies, as well as the “principal financial officer(s),” certify the accuracy of financial statements personally, whether or not they are financial experts. A common response has been for senior management to impose upon mid-level executives a contractual duty to certify the accuracy of the internal reporting for their departments. Large private and non-profit organizations, many of which are under pressure from investors, lenders or watchdog groups to enhance their financial reporting, can be expected to adopt similar measures. Middle management executives confronted by this development are thus exposed to personal liability that may not be covered by conventional directors and officers insurance.⁴
- In accordance with Section 307 of the Act, the SEC adopted rules imposing “whistle blowing” obligations on attorneys for public companies who “appear and practice” before it. The rules (205.1 through 205.7) require that attorneys report suspected securities law violations “up the corporate ladder” to the highest governing level, including the audit committee, another committee of independent directors or, if necessary, the full board. Since violations are orchestrated by individuals, but the relevant “client” is the corporation as an entity, the rules can be seen as merely codifying a course of action attorneys should be taking in any event. Nevertheless, the rules have had a chilling effect on vital communications between attorneys and corporate officers. The officers are not protected personally by the corporation’s attorney-client privilege. Accordingly, they increasingly believe that confiding in corporate counsel may expose them to job loss, civil liability or even criminal sanctions for acts that may be inadvertent, trivial

³ The avowed purpose of the Act’s auditor independence provisions (Sections 201 through 209) is to prevent accounting firms from auditing their own work by separating the audit function from other services and divorcing the auditors from dependence for their engagements on senior executives. For an extended discussion of Sarbanes-Oxley containing my contention that these provisions will be ineffective see www.hutchins-law.com/publications, *Evolving Trends in Financial Disclosure - Part III - Congress Intervenes - The Sarbanes-Oxley Act of 2002*.

⁴ The SEC adopted Section 302’s implementing rules as of August 29, 2002. The adopting Release is 33-8124 - 34-46427 - IC 25722.

or perfectly lawful. Moreover, the rules cover attorneys “transacting any business” with the SEC, including attorneys who provide advice respecting any document that “will be filed with or submitted to” the SEC. The rules thus cover attorneys advising public companies engaged in private offerings under Regulation D, which requires the filing with the SEC of a summary report on Form D. (In a truly ominous development, the SEC initially considered, though it so far has rejected, a companion rule requiring that, if a corporate client fails to correct a violation duly reported “up the ladder,” the attorney must withdraw from the representation in writing with a copy to the SEC, a so-called “noisy withdrawal.”)⁵

- Section 401 of the Act and the SEC’s implementing Regulation G require that public companies provide detailed disclosure (and reconciliation to generally accepted accounting principles, or “GAAP”) of “Non-GAAP” financial measures, including those that produce “pro forma” earnings or are influenced by “off balance sheet” arrangements. (“Non-GAAP” financial measures are those that exclude amounts that would be included in the “most directly comparable” GAAP measure.) Sophisticated investors now expect private issuers to provide the same disclosures.

- In accordance with Section 407 of the Act, the SEC adopted rules requiring that a public company disclose whether, and if not why not, it has at least one audit committee member who is, in the words of the statute, a “financial expert.” The final rules substitute the term “audit committee financial expert” to emphasize the fact that a major qualifying element will be an understanding of the committee’s comprehensive oversight role. (It is worth noting that such an understanding requires a grasp of legal as well as purely accounting issues.) The remaining qualifications include experience as a public accountant, auditor, or principal financial officer, an understanding of GAAP (including its application to accounting estimates, accruals, reserves and internal controls) and experience in the preparation or auditing of financial statements. It remains to be seen how effective small public companies will be in recruiting “audit committee financial experts” given the qualifications and legal risks associated with serving in that capacity.⁶

- Titles III (Sections 301-308) and IV (Sections 401-409) of the Act impose requirements for corporate responsibility and enhanced financial disclosure that have been amplified by the securities exchanges to ensure that listed companies will be dominated by non-management directors. Thus a majority of the directors of companies listed on the NYSE or NASDAQ must now be “independent” of management. At the same time, these directors remain obligated to oversee the business and affairs of their companies effectively, which necessitates a close working relationship with senior executives.⁷

⁵ At the October seminar several speakers reported it is now commonplace for the Justice Department to demand that corporate counsel cooperate with government investigations and pressure clients to waive the attorney-client privilege, even though that may cripple the preparation of a defense. The government’s leverage derives from obstruction of justice statutes and from sentencing guidelines that purport to reward “cooperation.”

⁶ The Section 407 rules direct the national securities exchanges to deny listing to any company not in compliance with them. They became effective January 23, 2003 and were amended March 31, 2003 to make it clear that the relevant disclosures need be made only in annual reports. See Release 33-8177 - 34-47235 and Release 33-33-8177A and 34-47235A.

⁷ The new listing requirements were approved by the SEC as of November 4, 2003. See Release 34-48745.

Taken as a whole, Sarbanes-Oxley has created pervasive expectations about corporate conduct that, in my judgment, ignore some important questions. For example, why should financial expertise be an indispensable requisite for chief executive officers? Can directors discharge their duties effectively if they are systematically divorced from management? Can directors truly be “independent” of *any* constituency that could deprive them of objectivity? Whose financial interests, exactly, are directors obliged to protect? The legal answer is “shareholders,” but that term does not describe a homogenous group. “Shareholders” include executives, pension plans, hedge funds and other institutions that wield disproportionate voting power and use it to pursue financial objectives that may be entirely inconsistent with those of individual investors. Is there any reason to assume that a director put in office by, say, a hedge fund will represent the interests of all shareholders more effectively than one put in office by management? Do the benefits of Sarbanes-Oxley really exceed its costs?

Regardless of the ultimate answers to such questions, the SEC has the bit in its teeth. On May 16, 2005, without seeming to recognize the incongruity of its position, it issued a “Statement on Implementation of Internal Control Reporting Requirements” containing this pronouncement:

“Although it is not surprising that first-year implementation of Section 404 was *challenging*, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even *overly cautious*, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance.” (*Emphasis supplied.*)

What else did these regulators expect? Violations of the Sarbanes-Oxley Act are subject to criminal as well as civil sanctions. It is hardly surprising that implementation of the auditing standards, which involve extraordinarily complex financial judgments, has been “challenging” and “overly cautious.” Unfortunately, given the attitude of the SEC, and the preoccupation of Congress with other issues, it does not appear that the standards will either be clarified meaningfully or relaxed any time soon.⁸

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⁸ The SEC’s pronouncement should be compared with the Foley and Lardner study referenced in Note 3. The notion that 404 complaints could relate to the *application* of the rules without relating to the rules themselves is, of course, absurd. The Statement was accompanied by a companion Statement from the SEC staff substantially to the same effect. Both Statements are available on the SEC website. See <http://sec.gov/news/press/2005-74.htm> and <http://sec.gov/info/accountants/stafficreporting.htm>.