

## **ROBERT G. HUTCHINS – LEGAL ESSAYS**

### ***Public Companies – Evolving Trends in Financial Disclosure***

#### **Part III – Congress Intervenes - The Sarbanes-Oxley Act of 2002**

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##### **Preliminary Note**

Parts I and II of this series of Essays analyzed amended accounting and financial disclosure rules proposed by the SEC in response to the corporate scandals that began with the Enron debacle.<sup>1</sup>

On July 30, 2002, while its amendments were still under consideration, the SEC was overtaken by events. The Sarbanes-Oxley Act of 2002 became effective and imposed sweeping new disclosure and conduct requirements, some of them hastily contrived, upon public companies, their directors, officers, auditors and other advisers, and upon securities market professionals such as broker-dealers.

The Act removes from state agencies and the accounting profession the power to regulate public company auditors and vests that power in a “Public Company Accounting Oversight Board,” subject to the ultimate supervision of the SEC. It creates new standards for “Auditor Independence,” “Corporate Responsibility” and “Enhanced Financial Disclosures,” including disclosures respecting “off-balance sheet” financing and “pro-forma” earnings. It accelerates the filing deadlines for annual, quarterly and current reports by public companies and for reports of transactions in their securities by “insiders” (directors, officers and greater than 10% shareholders). The Act also defines and sanctions “Analyst Conflicts of Interest,” while imposing specific conduct rules on broker-dealers and on attorneys who practice before the SEC. Finally, the Act expands the definitions and substantially increases the penalties for “Corporate Fraud” and “White Collar Crime.” The SEC is directed to conduct studies and prepare rules to implement the statutory requirements. Funding for all of this will be provided by public companies and by “registered public accounting firms” through special assessments added to their registration and filing fees.

Sarbanes-Oxley is a massive piece of legislation divided into 11 Titles and 69 Sections. This Essay examines the immediate effect of the Act upon audits and auditors. It is written from the perspective of the corporate directors, officers and

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<sup>1</sup> See this website, *Publications/Public Companies - Evolving Trends in Financial Disclosure – Parts I and II – “Pro-Forma” Financial Information in Earnings Releases and Identification and Disclosure of “Critical” Accounting Policies.*

outside accountants who participate in the audit process. Given the length of this Essay, the following table may be helpful:

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### **The Traditional Audit**

For financial disclosure purposes, the word “audit” has traditionally meant an examination and verification of the books of account and related business records of a company undertaken by an independent accountant for the purpose of expressing an opinion on the company’s financial statements. This process culminates in an “auditor’s report” that contains the auditor’s opinion whether the statements, considered as a whole, present the financial position and results of operations of the company “fairly,” in all material respects, in accordance with generally accepted

accounting principles or “GAAP.” The audit is conducted in accordance with generally accepted auditing standards or “GAAS.” GAAP and GAAS are published by private sector standard-setting bodies established, and recognized as authoritative, by the accounting profession. Today, the primary standard-setting body is the Financial Accounting Standards Board.<sup>2</sup>

A traditional auditor’s report contains a series of statements respecting the scope, methodology and significance of the audit examination. The auditor begins by asserting that it is “independent” and that the audit was in fact performed in accordance with GAAS. The auditor disclaims responsibility for the financial statements, as such, declaring instead that the statements are the responsibility of “management.” The auditor does acknowledge that, under GAAS, the audit must be planned and performed to obtain “reasonable assurance” that the financial statements are free of “material misstatement.” The auditor confirms that the audit included an examination of the evidence supporting the financial statements, an assessment of the accounting principles and estimates used by management and an evaluation of management’s overall financial statement presentation. The auditor then asserts its “belief” that the audit provides a reasonable basis for the opinion given.

The opinion itself can be categorized three ways. An “unqualified” opinion confirms that the company’s financial statements are fair and conform to GAAP. A “qualified” opinion subjects fairness or conformity to exceptions, such as the use of identified non-GAAP accounting principles, or to conditions that may be in doubt, such as the continuation of a financially distressed company as a “going concern.” An “adverse” opinion disclaims any assurance respecting the statements because they do not conform to GAAP and may be materially misleading.<sup>3</sup>

Current SEC forms for registration statements and periodic reports require that, with limited exceptions for interim periods, a company’s financial statements must be audited. SEC Regulation S-X, which sets forth the form and content of these statements, defines the term “audit” as an examination undertaken in accordance with GAAS “...as may be modified or supplemented by the (SEC).” The Regulation defines the term “accountant’s report” as “a document in which an accountant sets forth his opinion regarding the financial statements taken as a whole, or an assertion to the effect that an overall opinion cannot be expressed.” In the latter case, the accountant must explain why an opinion was omitted.

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<sup>2</sup> See, e.g., Statements on Auditing Standards (“SAS”) 1 and 69.

<sup>3</sup> SAS 58.

## **Enter Sarbanes-Oxley**

Sarbanes Oxley expands the scope of the traditional audit as it affects public companies, and it increases substantially the responsibilities of auditors. For example, the Act requires expressly that auditors examine and report not only on financial statements, but also upon all “related” reports or documents. Section 103 authorizes the Oversight Board to adopt rules under which an auditor must express its “findings” on tests of the quality of a company’s “internal control structure and procedures.” The Auditor must include its “evaluation” of whether the procedures ensure accurate financial recording of transactions that are being made “only in accordance with authorizations of management and directors.” The auditor must describe “at a minimum” “material weaknesses” and any “material noncompliance.”

The Act also strains the relationship between auditors and management and between “inside” and “outside” directors. It requires that the auditors be engaged exclusively by, and report directly to, an audit committee composed entirely of directors who are “independent” of management. Yet the Act necessarily leaves the auditors dependent upon management and inside directors for information and assistance. This may increase boardroom tension at a time when the complexities of corporate life place unprecedented importance upon teamwork and a sense of unity. Furthermore, all significant management decisions have financial consequences. The power to control the process by which those consequences are evaluated, measured and reported publicly is perilously close to the power to govern. It is doubtful that a public corporation can be governed effectively by independent directors.<sup>4</sup>

## **Applicable Definitions**

To accomplish its purposes, the Act builds upon key definitions that change the meaning of some terms, introduce new ones and create more than a little confusion in the process. I will use some of these definitions to provide a framework for the discussion:

### **“Audit”**

Section 2(a)(2) defines an “Audit” as an examination of financial statements undertaken in accordance with rules to be adopted by the Oversight Board or the SEC. Until then audits will continue to be conducted in accordance with GAAS. The

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<sup>4</sup> Both the NYSE and the NASDAQ have proposed new listing standards under which a majority of *all* directors must be independent. The SEC is expected to approve them. A public company will then be subject to the ultimate control of shareholders that are not aligned with management. Some of these shareholders, such as employees or would be acquirers, will have a direct stake in the financial success of the corporation. Others, however, may have environmental or social agendas extending far beyond the mere maximization of profit. I will leave to others the question whether this is desirable.

Board rules need not be based upon GAAP or GAAS. Under Section 103, the rules will include detailed standards for the audit process and for the independence of auditors. The Oversight Board may incorporate standards proposed by accounting and other professional groups, but it is not required to follow them. The Act thus is consistent with Regulation S-X with the qualification that the Oversight Board rules, in addition to those of the SEC, may “modify” or “supplement” GAAS.

### **“Audit Committee”**

Prior to Sarbanes-Oxley, nothing in the securities laws required that a public company have a formally designated “audit committee” of its directors to supervise its financial reporting. The SEC and the stock exchanges imposed structural, competency and disclosure requirements upon such committees when they in fact existed. If they did not, the requirements were imposed by default upon the directors that performed “equivalent” functions or upon the entire board. Examples of these requirements included obligations to supervise the internal preparation, verification and final publication of audited financial statements.<sup>5</sup>

Section 2(a)(3) of Sarbanes-Oxley defines an “Audit Committee” as either a formally appointed accounting and financial reporting oversight committee or the entire board of directors, thus dispensing with the ambiguous intermediate concept of directors who perform “similar” functions. The stock exchanges, not wishing to be outdone by congress, have now included audit committee requirements paralleling those of the Act in their listing standards. As will be seen below, statutory audit committee members must satisfy specific independence and financial literacy requirements and accept expanded oversight duties. Since it is doubtful that any company would subject all of its directors to them, I expect that all public companies will now have formal audit committees. I also expect that it will be significantly more difficult than previously for companies to induce qualified persons to serve as members. It will also be significantly more costly, since premiums for directors’ and officers’ liability insurance, already rising in the face of widespread corporate scandals, will increase further for periods after July 30, 2002.

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<sup>5</sup> See, e.g., Item 306 of SEC Regulation S-K requiring that an audit committee make the following specific disclosures in a company proxy or information statement (but not elsewhere). First, the committee must disclose whether it has received from and discussed with the company’s auditors written assurances respecting auditors’ independence and management’s compliance with qualitative reporting guidelines found in the prevailing accounting literature. Second, the committee must disclose whether, on the basis of these assurances and its own discussions with the auditors and with management, it has recommended to the full board that the audited financial statements be included in the company’s annual report on Form 10-K. Similar requirements are imposed on audit committees for small business issuers reporting on Form 10-KSB by Item 306 of Regulation S-B. In each case, the requirements are imposed ultimately upon the entire board if no audit committee has been formally appointed.

## **“Audit Report”**

Section 2(a)(4) of the Act continues the departure from past audit practice by introducing the term “Audit Report” and defining it broadly as a “document or other record” of an “audit” performed to enable a company to comply with the securities laws. Audit Reports must be disclosed publicly. In them, a “public accounting firm” will either set forth its “opinion” on a “financial statement, report, or other document” or assert that “no such opinion can be expressed.” The definition, whether by design or inadvertence, abandons or ignores the Regulation S-X definition of an “Accountant’s Report” as a document containing an opinion on financial statements or an assertion that an “overall” opinion “cannot be expressed.” Further, it is not clear under the Act whether an auditor could resign an engagement without expressing any conclusion at all, as is the case under GAAS.

Section 2(a)(4) is thus confusing and it may have troubling consequences. First, the Section is inconsistent with GAAS, and with Section 2(a)(2) of the Act, both of which limit “audits” to examinations of “financial statements” and do not require that the auditor also address in some way the significance of all related “reports or other documents.” Under GAAP, reports or documents that are significant for financial statement purposes, but not adequately taken into account in the line items, are summarized in footnotes or in schedules containing supplementary information. The Act seems to require expanded disclosure without defining it.

Second, Section 2(a)(4) may require that, to complete an “Audit Report,” an accounting firm that disclaimed an opinion would have an affirmative duty to assert, in effect, that *no other accounting firm could have expressed one*. In this respect, Section 2(a)(4) would be a major departure from GAAS under which, if the auditor disclaims an opinion, no formal statement of any kind is issued. Put differently, if the financial information furnished by a company is defective or incomplete, or the parties cannot agree upon the scope of the audit, GAAS requires simply that the engagement be terminated, not that there be a negative assertion that the facts preclude an opinion by any other auditor.

Perhaps congress intends merely to facilitate the flow of material information to investors by preventing the termination of an audit engagement without explanation. The initial difficulty, however, is that the possible reasons for termination include matters that another auditor might view differently, such as disagreements over the effectiveness of internal controls, the appropriateness of accounting policies or the bases for estimates used in applying accounting principles. It is one thing for an auditor to disclaim an opinion for itself, quite another for it to disclaim an opinion for the entire accounting profession.

Moreover, the SEC’s Current Report on Form 8-K already covers this situation. The Form requires that a company disclose all material facts when a disagreement causes its auditor to resign or be dismissed. Among other things, the company must furnish

a copy of its Report to its former auditor with a request that the auditor state whether it agrees or disagrees with the company's version of events. The auditor's response is contained in its own letter, addressed to the SEC with a copy to the company. The company must file the copy as a supplementary exhibit to its Report. Sarbanes-Oxley distorts this process by requiring that, in all cases, the auditor assert from the moment the engagement is terminated that no opinion could have been expressed by anyone. That, of course, is itself an opinion for which auditors can be held accountable. I hope the confusion here is clarified through rule making<sup>6</sup>

Section 2(a)(4) adds a new and uncertain element to the responsibilities of auditors. In any number of complex situations, it will put auditors in the unenviable position of either resigning an audit engagement already under way, an act with its own adverse repercussions, or issuing a comprehensive denunciation in which neither they nor anyone else could have much confidence.

#### **“Non-Audit Services”**

Section 2(a)(8) defines this term as including any professional services provided to “*an issuer*” (the company) by a registered public accounting firm “other than those provided ...in connection with an audit or a review of the financial statements of *an* (sic) issuer.” The definition is flawed because of the careless second reference to “an issuer” when the obvious intended reference was to “the same issuer.” That detail aside, the definition is of major importance because, under Section 201(a) of the Act, it is unlawful for a registered public accounting firm (or any of its associated persons) provide both Audit and enumerated non-audit services to the same client at the same time. The prohibited non-audit services include bookkeeping or other financial record services, appraisals, valuations and fairness opinions, internal audits, management or human resource services, broker-dealer, investment advisory or investment banking services, legal services and “any other service that the (Oversight) Board determines, by regulation, is impermissible.”

The avowed purposes of this are to prevent an accounting firm from auditing its own work, which it presumably would be loath to criticize, and to reduce the threat to auditor independence presented by the large fees attributable to the prohibited services. Here again, I have reservations:

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<sup>6</sup> Imagine the lawsuits flowing from the following sequence of events: first, an accounting firm, unaware of the firestorm to follow, issues an Audit Report that disclaims an opinion and asserts that no opinion could have been expressed. Second, the stock price of the audited company crashes on the news. Third, a new accounting firm issues an unqualified opinion respecting the company's financial statements and other records. In addition to the company's shareholders, the potential plaintiffs could include the company itself, its audit committee members, its other directors, executives and employees (all of whom could also be defendants), the Oversight Board, the SEC and various state enforcement agencies.

First, many prohibited services, such as appraisal, valuation, investment advisory and broker-dealer services, are transaction based. They are not performed continuously and can often be performed during the year under audit without coinciding with, or overlapping, the audit period. Nothing in Sarbanes-Oxley precludes an agreement or understanding that the accountants will terminate prohibited services the day before an audit begins and will resume them the day after the Audit Report is issued. Even services historically treated as continuous may prove to be divisible into discrete projects. Facilities and systems management, legal services and other expert services can fit this category. In short, auditors may be reporting on their own work after all.

Second, a well-planned audit conducted by a firm that is thoroughly familiar with the financial records of its client can be completed within a much shorter time frame, and at a substantially lower cost, than the same audit by a new firm. As a result, most companies are reluctant to change auditors absent some compelling reason. Under the circumstances, the prospect of pre-arranged, renewable engagements for both audit and non-audit services is hard to discount.

Third, tax services, which are not audit-related, are currently permitted and they presumably will remain so unless the Oversight Board prohibits them by rule. The performance of tax services involves planning and advice about all business matters that have material tax consequences, to wit, all material business matters. Under the guise of performing tax services, accounting firms can perform many of the services previously categorized by different labels. I expect to see a significant expansion of “tax services” in the near term.

Fourth, the immediate effect of prohibiting specified “non-audit” services by auditors acting as such will be a dramatic increase in audit fees for all companies, public and private. Accordingly, the previous threat to auditor independence and objectivity inherent in the prospect of substantial non-audit revenue may simply be replaced by a new threat, the prospect of substantial audit revenue.<sup>7</sup>

If congress, the SEC and the Oversight board remain convinced that the lure of non-audit services threatens the integrity of an audit, the regulatory cure may be relatively simple. Accounting firms would be prohibited from performing any non-audit services for a company during any fiscal year of that company for which they act as auditors. Sarbanes-Oxley, which prohibits non-audit services only while an audit is actually being performed, may result merely in a rescheduling of the year’s work by accountants who, over the long term, will still be auditing themselves.

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<sup>7</sup> Several members of congress advocated a government compensation system quite seriously while Sarbanes-Oxley was being debated. Inherent conflicts aside, I would regard such a system as a disastrous government intrusion into the affairs of both accounting firms and public corporations.

### **“Person Associated with a Public Accounting Firm”**

Under Section 2(a)(9) a “person associated with the public accounting firm” includes any proprietor, partner, shareholder or professional employee of the firm and any independent contractor engaged by the firm that is compensated by or “participates” in any activity of the firm in connection with an audit. The Oversight Board is given authority to exempt employees engaged in purely ministerial tasks. By its terms, this definition would include attorneys, engineers or other third parties that advise the firm during the course of an audit. All of these persons are subject, together with the firm itself, to civil liability and Oversight Board sanctions for their actions in violation of the Act or of the general securities laws. The definition makes it clear that specific individuals can be compelled to give evidence and can be held accountable individually for their involvement in auditor misconduct, although that was also the case under prior law. I hope that, by focusing attention on individual accountability, this Section reduces the risk of blanket indictments of entire firms, such as Arthur Anderson, because of the activities of a few “associated persons.”

### **“Professional Standards”**

The definition of this term in Section 2(a)(10) reflects congressional dissatisfaction with the lack of independence and perceived resistance to change associated with standard setting bodies sponsored by the accounting profession, such as the Financial Accounting Standards Board. The definition permits the SEC to recognize accounting and auditing standards established by a private “standard setting body,” but only one that meets specific requirements. Its trustees, directors or other managers must not have been associated for at least two years with a registered public accounting firm. It must be funded by the set-aside of fees paid by issuers under Section 109 of the Act, presumably to avoid conflicts inherent in private contributions. It must establish formal procedures to implement changes in accounting principles rapidly and keep them current. The SEC must determine that the entity has the capacity to help promulgate and update financial disclosure rules in response to evolving technologies and increasingly global markets.

### **“Public” and “Registered Public” Accounting Firms**

Under Sections 2(a)(11) and (12), a “public” accounting firm means one engaged in the practice of public accounting (presumably as traditionally defined) *or* in “preparing” or “issuing” audit reports. The term can also include a person “associated” with such a firm under rules to be developed by the Oversight Board. A “registered” public accounting firm is one that, upon application, has been authorized by the Oversight Board to conduct audits and issue audit reports for a public company. The inclusion of associated persons in the first definition makes it at least semantically possible that principals or employees of a registered firm could be required to register separately even though they do not practice independently of the firm, another example of poor draftsmanship.

## **The Public Company Accounting Oversight Board**

The Oversight Board is established by Section 101 of the Act as a “body corporate” operating as a nonprofit corporation that will have “succession” until it is dissolved by Congress. Its purpose is “to oversee the audit of public companies that are subject to the securities laws, and related matters, to protect the interests of investors and further the public interest etc.” As will be seen, the oversight of “related matters” involves nothing less than a subjugation of the accounting profession to the dictates of a quasi government entity.

### **Status, Duties and Powers**

The Act provides that the Oversight Board is not a government agency, but a nonprofit corporation. The rights and duties of this corporation are to be derived from the Act and, where the Act does not cover the point, from the District of Columbia Nonprofit Corporation Act. Accordingly, no member, employee or agent of the Oversight Board will be treated legally as an officer, employee or agent of the Federal Government.

The Oversight Board is subject, under Section 107 of the Act, to the ultimate control of the SEC, which must approve and can modify or abrogate the actions of the Board, sanction or replace its members, or abolish its authority when necessary to serve the public interest. In the absence of SEC intervention, however, the duties and implementing powers of the Oversight Board are formidable. Specifically, the Oversight Board is authorized and directed to:

- (a) Register public accounting firms that prepare audit reports for companies with registered securities;
- (b) Set standards for auditing, quality control, ethics and independence in the preparation of audit reports;
- (c) Investigate, initiate disciplinary proceedings against and impose sanctions upon registered public accounting firms and their associated persons;
- (d) Perform whatever other duties and functions it (or the SEC) believes are “necessary or appropriate” to improve the quality of audit services offered by registered public accounting firms or otherwise carry out the purposes of the Act;
- (e) Enforce compliance with the Act, its own rules, and the securities laws relating to the preparation and issuance of audit reports; and
- (f) Set its own budget, and manage its operations and staff.

## **Members and Qualifications**

The Oversight Board is to have 5 members appointed by the SEC “from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public and an understanding of ... the financial disclosures required (by) ...the securities laws.” No more than 2 members may be certified public accountants and a CPA who serves as chair may not have practiced for at least 5 years prior to becoming a member, a further insult to the integrity of the accounting profession. Initial members must be appointed by the SEC by October 30, 2002, after consultation with the Federal Reserve Chairman and the Treasury Secretary, and will serve staggered terms. Thereafter, members, appointed by the same process, will serve 5-year terms subject to a 2-term limit that applies whether or not the terms served are consecutive. Members must devote full-time to the Oversight Board and may not accept other employment. With minor exceptions for normal course retirement payments, no member may share in the profits of or be compensated by a public accounting firm (whether or not registered) “or any other person.”

To carry out its mandate the Oversight Board is given the usual broad corporate powers including the power to lease, purchase, accept gifts of and own its properties, bring or defend lawsuits, hire and terminate employees and otherwise conduct its affairs. It is also given the power to operate in any state without regard to corporate qualification laws and to allocate, assess and collect accounting support fees and other charges that are to be paid by public companies that file registration statements or have outstanding a class of registered securities. These companies are invited to take comfort in the fact that the fees are to be “reasonable.”

## **SEC Control**

Section 107 vests ultimate control of the Oversight Board in the SEC. That agency is directed to approve rules adopted by the Board, but only if it finds that the rules are consistent with the purposes of the Act and the general securities laws and are appropriate in the public interest or for the protection of investors. The SEC is empowered, upon the same findings, to amend or rescind the rules of the Board. The SEC can also review, amend or rescind disciplinary action or sanctions taken or imposed by the Board, censure the Board itself or relieve it of its responsibilities and censure or remove from office any member of the Board. Thus, in the final analysis, the Oversight Board is a convenient but expendable administrative arm of the SEC, not an autonomous entity. Put differently, Sarbanes-Oxley increases substantially the regulatory power and influence of the SEC over public corporations.

## **“Registration” of Public Accounting Firms**

Under Section 101(d) of the Act, the SEC is given until April 30, 2003 to determine that the Oversight Board is properly organized and equipped to carry out its duties.

The Act does not specify what would happen if the determination is negative, but given the SEC's ultimate power to modify Board action, or even terminate its existence, I assume the SEC would have ample authority to take intermediate measures to ensure the Board was properly constituted.

Section 102 provides that, beginning no later than October 31, 2003, it shall be unlawful for any person to participate in the preparation of an audit report unless that person is a public accounting firm registered with the Oversight Board. The application to become registered shall be submitted on a form prescribed by the Board that shall disclose, as a minimum, the following information:

- (a) The names of all public companies for which the applicant prepared audit reports during the past year, and all such companies for which the applicant expects to prepare audit reports during the current year;<sup>8</sup>
- (b) The annual fees received by the applicant from each named company for services, including non-audit services;
- (c) Such other current financial information, derived from the applicants most recent fiscal year, that is reasonably requested by the Oversight Board;
- (d) A description of the applicant's quality control procedures as they relate to its accounting and auditing practices;
- (e) A "list" containing the state license number(s) of the applicant and the names and state certification or license numbers of all accountants associated with the applicant who participate (or would participate) in the preparation of audit reports;
- (f) "Information" relating to civil, criminal or administrative actions or disciplinary proceedings pending against the applicant (or any of its "associated persons") "in connection with" an audit report;

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<sup>8</sup> I assume an accounting firm that had begun an audit under GAAS, but had not completed it for some reason, would ask for clarification as to whether the former client should be named. The reason is that, by definition, the accounting firm would not have issued either an opinion letter or an assertion that no opinion could be given. Thus the firm would not have prepared or participated in the preparation of an audit report as that term is defined in Section 2(a)(4). If the purpose of this disclosure is to inform the Board about relationships between auditors and their clients or former clients, however, the name of the company would be relevant information. This is another example of the careless draftsmanship that pervades Sarbanes-Oxley.

- (g) Copies of any disclosure to the SEC respecting accounting disagreements between the applicant and a client “in connection” with an audit report;
- (h) Such other information as the Oversight Board may require;
- (i) A “consent” or undertaking by the applicant to act as a watchdog for the Oversight Board by cooperating with the Board respecting any request for testimony or document production made by the Board in the course of its duties, plus an agreement to secure a “similar” undertaking from all of its “associated persons;” and
- (j) An affirmative statement that the applicant realizes that performance of its “consent” (i.e. its watchdog function) “shall be a condition to the continuing effectiveness of the registration of the (applicant).”

The Act follows with a requirement that the Oversight Board approve or deny an application within 45 days, then deprives the requirement of meaning by adding that the Board can delay its ruling if it requests additional information. The denial of an application is treated as a disciplinary action subject to review by the SEC.

Once registered, public accounting firms must update the information contained in their applications by filing reports with the Oversight Board. The reports will be due at least annually and more frequently if required by the Board. The reports will be deemed public records subject only to privacy laws and to copyright, patent and other laws for the protection of intellectual property rights. To guard against the possibility that such laws may be inadequate in a given case, the Board must “protect from public disclosure” information reasonably identified by a registrant as “proprietary. The cost of reviewing applications and reports is to be covered by registration and annual renewal fees collected from accounting firms whose applications are accepted.

The immediate consequence of registration for public accounting firms is the right to audit public companies, albeit at some considerable sacrifice as will be seen. The immediate consequence for public companies is that their audit costs will increase significantly and the choices they have between auditors will narrow considerably. Over the long term I think a new tier of regional accounting firms will “step up” to perform many of the audits previously reserved only for the major, international firms.

### **Standards and Conduct Rules for Public Company Auditors**

Section 103(a) grants to the Oversight Board authority to adopt rules imposing auditing, quality control and ethics standards upon registered public accounting firms. The rules may, but need not, take account of proposals by advisory groups

from the accounting profession. As a *minimum*, the rules are to include requirements that registered public accounting firms:

- (a) Maintain for 7 years work papers and “other information” related to each audit report “in sufficient detail to support the conclusions reached in such report;”
- (b) Provide for a concurring review of the content and issuance of an audit report by someone other than the person in charge of the audit who is either a “qualified person” or an “independent reviewer” as “prescribed” by the Oversight Board;
- (c) Include in each audit report a description of its review of the internal accounting procedures of the company for which the audit was performed, a summary of its overall findings, an evaluation of whether the controls ensure that the company retains adequate records and that receipts and expenditures are made “only in accordance with authorizations of “management and directors” and a statement of material weaknesses in the controls<sup>9</sup>;
- (d) “Monitor” its compliance with ethical and independence standards and follow Oversight Board guidelines respecting internal consultation, hiring and advancement, the terms of its engagements (whether or not they are auditing engagements apparently), its “internal inspection” procedures; and
- (e) Comply with such other rules as the Board sees fit to adopt respecting ethics and quality control issues.

The Oversight Board is directed to consult with professional advisory groups from within the accounting profession, but it may disregard entirely any recommendations from those groups. To ensure that auditors do not procrastinate in getting their houses in order, the Oversight Board may adopt interim ethics and quality control rules without waiting for the SEC to make its initial determination whether the Board is properly constituted, staffed and equipped. While I recognize the need for prompt action to restore confidence in our capital markets, I hope the Board carries out its mandate with more restraint than the Congress exhibited when conferring it.

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<sup>9</sup> Under Section 404, the SEC is to prescribe rules for the inclusion in annual reports of an acknowledgment by management that it is responsible for maintaining adequate internal controls and an assessment by management as to whether the controls were effective for the relevant year. The auditors are to report on management’s assessment.

### **Inspections of Registered Public Accounting Firms**

Section 104 directs the Oversight Board to adopt a “program” of “continuing” compliance inspections to be conducted annually for registered public accounting firms that regularly perform audits for more than 100 companies each year and at least one every three years for all other registered firms.

### **Investigations - Disciplinary Proceedings against Firms and Associated Persons**

Under Section 105, the Oversight Board is provided with comprehensive authority to investigate any “act, practice or omission...” by a public accounting firm or any of its associated persons that “may” violate the Act, other securities law relating to audits, the rules of the SEC or those of the Board. To facilitate these investigations, the Board may compel testimony and the production of documents from the target accounting firm, its associated persons, its clients and any other person believed to be in possession of relevant information. It may examine underlying books and records to verify the accuracy of the evidenced so produced. If a registered public accounting firm or associated person “refuses” to cooperate with an investigation the Board is expressly authorized to impose sanctions including a suspension or revocation of the firm’s registration. It is unclear what sanctions would be imposed on a firm client or other third party that refused to cooperate.

The Oversight Board is directed to adopt rules for the “fair” conduct of its investigation and to notify the SEC of each pending investigation. The Board must coordinate its investigation with the SEC’s Division of Enforcement and may also refer an investigation, and disclose the evidence produced thereby, to other federal and state authorities. All authorities, however, are required to treat such evidence as confidential, privileged, exempt from disclosure under the Freedom of Information Act and not subject to civil discovery or other legal process unless the parties consent or the evidence is “presented in connection with a public proceeding.” Presumably, the term “public proceeding,” which is not defined in the Act, will be limited in practice to civil enforcement or criminal proceedings that are already public under settled law.

Although the Oversight Board is not to be considered a government agency, its employees are immune from civil liability for their investigative actions “to the same extent as an employee of the Federal Government in similar circumstances.” Without belaboring the point, that provision will do nothing to encourage reticence on the part of crusading Board employees convinced.

### **Sanctions**

The sanctions for acts or omissions viewed by the Oversight Board as unintentional range from censure or required additional professional education to civil penalties of up to \$100,000 for a natural person and \$2,000,000 for organizations. Intentional,

knowing, reckless or repeated negligent violations can result in fines up to \$750,000 for a natural person and \$15,000,000 for an organization and can also trigger the suspension or revocation of the registration of a public accounting firm. The last sanction would be devastating to a firm that, as will be seen below, had already terminated its “non-audit” consulting and systems support services for audit clients.

### **“Recognized” Accounting Standards under Sarbanes-Oxley**

Section 19(a) of the Securities Act of 1933 authorizes the SEC to adopt rules to give effect to the securities laws including rules and forms setting forth, by line item, the financial information to be furnished in registration statements and periodic reports. These rules and forms have always required that financial statements be prepared in accordance with GAAP. Until Sarbanes-Oxley, GAAP meant accounting principles promulgated, usually after extensive debate and comment, by standard setting bodies established by the accounting profession such as the Financial Accounting Standards Board. The post-Enron Congress, however, was exasperated by the apparent failure of these bodies to modernize standards to keep pace with rapid changes in business conditions and practices brought about by revolutionary improvements in computing and communications technology. Congress unburdened itself by adopting Section 108 of Sarbanes-Oxley. That Section provides that the SEC “may” (but need not) recognize as “generally accepted” other accounting principles established by “a” (not any) standard setting body meeting specific requirements. The body must be organized as a private entity governed by a board of trustees or similar officials who serve the public interest and have not been “associated persons” of any “registered public accounting firm” for two years. Since there has never before been a “registered public accounting firm” the two-year requirement will be measured from the date final rules for such firms are adopted.

### **Study and Report on “Principles-Based” Accounting**

The United States currently has a “rules-based” accounting system as opposed to the “principles-based” system followed by other developed nations. A principles-based system provides substantial latitude for reporting entities. For example, it might require simply that the tangible assets owned by the entity be depreciated over time to reflect wear and tear and any resulting diminution in value. The details would be left to the entity itself subject only to a general requirement that the depreciation method actually used be realistic. The rules-based system followed in the US, by contrast, imposes elaborate requirements for categorizing tangible assets and strict controls over the time periods over which the assets may be written off. Section 108(d) of the Act obligates the SEC to study the feasibility of and methods by which a principles-based system could be implemented in the US. The SEC must report its conclusions to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services by July 30, 2003.

## **Auditor Independence**

Title II of the Act (Sections 201 –209) attempts to enhance auditor independence by prohibiting the performance of specified “non-audit” services “contemporaneously” with an audit as already stated. It requires that, subject to de minimus exceptions that must be disclosed to investors, all audit and non-audit services must be pre-approved by the “independent” audit committee defined by Section 2(a)(3). Title II also prohibits a registered public accounting firm from performing an audit for any company whose chief executive, financial or accounting officer, controller, or person performing equivalent functions participated in the audit of the company during the previous year *as an “employee” of the would be auditor*. The relevant section, however, does not refer expressly to non-employees who may have been a “person associated with” the auditor; an astonishing lapse given the all-encompassing definition of associated persons contained in Section 2(a)(9).

A particularly hapless effort at ensuring independence is a requirement making it unlawful to provide audit services for a company if the “lead (or coordinating) audit partner” has performed such services for the company in each of its 5 previous fiscal years. Accounting firms can circumvent this requirement simply by rotating lead audit partners. (The SEC, however, is directed to study the possibility of substituting a requirement that the entire audit firm be rotated.)

Considerably more promising is a requirement that auditors report directly to the audit committee on a timely basis. The report must cover all “critical” accounting policies, all alternative policies or principles discussed with management and their ramifications, the alternatives preferred by the auditor, and all material written communications between the auditor and management personnel. Examples of the latter would include letters criticizing internal controls or schedules of unadjusted differences in the treatment of journal entries.

Title II contains conforming amendments to existing securities laws, requires the SEC to implement the independence standards by specific rules within 6 months and closes with a curious and entirely unnecessary admonition to state regulatory authorities. State authorities should make their own determination of the “proper standards” applicable to accounting firms under their jurisdiction that are not “registered public accounting firms” bound by the standards of the Oversight Board.

I share the prevailing view that the breadth and detail of the information included in public company financial statements (their so-called “transparency”) will increase because of the Act. It is not clear, however, whether the increase will be traceable to the Act’s specific measures or only to the general feeling of intimidation that swept corporate boardrooms when the Act became effective.<sup>10</sup>

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<sup>10</sup> In the former case, the ripple effect might affect private companies as well as public ones. For example, if newly empowered audit committees appear to enhance the financial

It seems clear, however, that Sarbanes-Oxley has effectively placed the public capital markets beyond the reach of most business enterprises. There have always been companies that succumbed to the lure of “going public” only to find that, even though their securities were traded on the NASDAQ National Market, they simply were too small to attract the investing public on a sustained basis. When the price of their stock did not skyrocket after their initial public offering, they remained saddled with all of the expense and burden of complying with registration, periodic reporting, insider trading, proxy solicitation and financial disclosure requirements. Yet they enjoyed none of the benefits associated with being public. There was no market in their securities because the investment bankers that took them public lost interest in them and they could not attract new market makers. They could neither raise additional capital nor use their securities as currency to make acquisitions or attract executives. Throughout all of this, their public reports exposed their financial condition and internal affairs to competitors, shareholder activists, unions and hostile acquirers.

Under Sarbanes-Oxley, the demands and risks of being public have increased exponentially. It will be extraordinarily difficult for a small company with limited resources to cope with them or to recruit quality managers and directors to carry it forward. Most middle market companies will be forced to turn for risk capital to exempt offerings under SEC Regulations A and D and their state counterparts. There may, however, be some opportunities here for companies able to make adroit use of those Regulations, a subject in which I am particularly interested.<sup>11</sup>

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disclosure in registered offerings, private investors, as a condition to purchasing securities in an exempt offering, might require that a financially literate consultant selected by them be engaged at the expense of the issuer to supervise the preparation of the issuer’s financial statements.

<sup>11</sup> See the series of Essays on Private Placements, this website, *Publications/Essays/Corporate Finance/Private Placements*.