# THE SARBANES-OXLEY ACT AND ACCOUNTANT LIABILITY

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## ABSTRACT

*President Bush signed the Sarbanes-Oxley Act (SOA) into law on July 30, 2002. At that time he said that it brought about "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt". The SOA was passed in response to corporate scandals involving Enron, WorldCom and others. It was intended to restore public confidence in our capital markets. Much of the SOA is directed at corporate and securities industry behavior. But the SOA also raises the regulatory bar far higher for the accounting profession, especially for accounts who audit public companies. The SOA created a new regulatory agency to oversee accountants' work: the Public Company Accounting Oversight Board (PCAOB). The SOA also imposed high ethical standards, including prohibiting conflicts of interest and even potential conflicts of interest. Civil and criminal penalties for violations were increased. The net effect was to substantially increase the legal liability of accountants.*

*Business schools are trying to include SOA materials into their curricula. However, as the AACSB publication BizEd pointed out in August 2005, there is a lack of material that is appropriate for classes in accounting and business law. This paper will help to fill that need. It examines and assesses those parts of the SOA that impact accountant liability, particularly the new regulatory agency and also accountant independence. The SOA is then assessed and its future considered.*

## INTRODUCTION

As most readers know, the Sarbanes-Oxley Act (SOA) is the most far-reaching and significant new federal regulatory statute affecting accountants and corporate governance since the Securities Acts of 1933 and 1934. Corporate scandals involving Enron, WorldCom and others had shaken public confidence in American capital markets. Public outrage plus the obvious need for reform led to the passage of the SOA which was signed into law on July30, 2002.

The SOA significantly affected the legal liability of accountants. A new federal regulatory agency, the Public Company Accounting Oversight Board was created to oversee auditors' work, with authority to conduct inspections and punish violations. Conflicts of interest were prohibited, and a high wall was erected separating the audit function from consulting and other non-audit functions. Auditing standards were no longer controlled by the accounting profession. Auditors' civil and criminal liability were increased, and additional record-keeping burdens imposed. Audits of public companies became riskier for accountants but also more profitable, reflecting the greater amount of work and risk involved.

The topic of accountant liability is an important one in accounting and business law classes, especially at the Junior, Senior and Graduate level. The SOA significantly impacted this liability. However, business schools have had difficulty incorporating SOA material into their curricula. As the AACSB publication BizEd recently pointed out, every school it surveyed "incorporated at least some SOX material in its courses" but there was a "lack of dedicated material on Sarbanes-Oxley" that was appropriate. Most of what has been written on SOA deals with corporate compliance and is directed at lawyers and practicing accountants. Very little has been written that directly addresses SOA's impact on accountant liability that is also appropriate for business and accounting students. The contribution of this paper is to help fill that void.

## THE SARBANES-OXLEY ACT AND ACCOUNTANT LIABILITY

The SOA is a large and complex statute that contains eleven titles. Title I creates a new regulatory agency to oversee auditors' work, the Public Company Accounting Oversight Board (PCAOB). Title II deals with auditor independence and auditor conflicts of interest. These two titles contain the provisions of greatest interest to accountants. Title III deals with corporate responsibility. Title IV provides for enhanced financial disclosures. Section 404 of this title requires a management assessment of internal controls. This Section has added substantial cost to audits and is the subject of much criticism and complaint; it will be discussed below. Title V deals with financial analyst conflict of interest. Title VI deals with the authority of the Board. TitleVII requires various studies and reports by the GAO and SEC relating to consolidation of public accounting firms and violations of securities laws. Title VIII increases penalties for corporate and criminal fraud. Section 804 makes a significant change in the law by extending the Statute of Limitations to two years after discovery or five years after the date of violation. Previously it had been one year and three years. This Section has been extensively litigated and will be discussed in the section on litigation. Title IX increases penalties for white-collar crime. Title X requires the signing of corporate tax returns by chief executive officers. Title XI increases potential prison terms under the Federal Sentencing Guidelines and deals with corporate fraud and accountability. It also contains a provision prohibiting retaliation against informants. In all there are 1,107 separate Sections in this statute. Those that impact the legal liability of accountants will now be discussed.

### The Public Company Accounting Oversight Board (PCAOB)

Title I of SOA created the PCAOB, and defines its authority. This represents the first time the accounting profession experienced direct external oversight by a government-sponsored organization. The Board consists of five members, appointed by the SEC for five year terms. Two must be or have been certified public accountants, and three can not be or have been CPAs. It is a private nonprofit organization but was established by Congress and has strong ties to the SEC. Section 109 describes the funding of the PCAOB and is of interest. Recall that in the section above titled "Origins and Attitudes" the precursor to the PCAOB, the Public Oversight Board (POB) had proven ineffectual in part because it lacked a reliable, independent funding source. Section 109(d) states that PCAOB funding will come from public companies, in proportion to their market capitalization. This is a funding source independent of accounting firms or their professional association.

Sections 104 and 105 may have the greatest impact on accountants' liability of all sections of the SOA. These sections deal with inspections, investigations and disciplinary action that can be taken by the PCAOB against accounting firms and accountants. The PCAOB may in effect audit the auditors. Sections 104 and 105 give the PCAOB strong oversight power, in contrast to the flaccid or non-existent oversight power of the predecessor POB.

Section 104(b) requires the PCAOB to conduct inspections of accounting firms that perform audits on public companies. Larger firms are to be inspected more often: firms that perform audits for more than 100 public companies are to be inspected once each year. Accounting firms that perform 100 or fewer public company audits are to be inspected "not less frequently than once every 3 years". This scaling of inspection frequency to audit firm size and activity is interesting. It is certainly a rational response to treat a Big Four accounting firm differently from a small accounting firm that might perform only a handful of public company audits each year. However SOA does not provide a similar scaled response to the public companies themselves. The standards are the same for public companies large and small. Small companies have complained loudly that their cost of compliance with SOA is proportionally much greater than that of large companies.

If a regular PCAOB inspection reveals violations, an investigation may follow. Section 105(b) authorizes the PCAOB to perform investigations that include subpoenaing of witnesses and documents. The PCAOB may require the testimony "of the firm or any person associated with a registered public accounting firm". In order to perform audits of public companies, accounting firms must register with the PCAOB, per Section 102. If a person or firm fails to cooperate with the investigation, registration may be suspended or revoked. The teeth of this section are found in Section 105(c)(4). In addition to suspension or revocation of registration, the PCAOB may impose a "civil money penalty" of "not more than $750,000 for a natural person or $15,000,000 for any other person" for violations that consist of "intentional or knowing conduct, including reckless conduct" or "repeated instances of negligent conduct". Note the conjunctive, "or". Even a negligent, unintentional violation, if repeated, can bring on these severe penalties. If the violation is not intentional or knowing, the penalties are less severe but still substantial: up to $100,000 for natural person or $2,000,000 for others. Natural persons are, of course, accountants and other employees of an accounting firm. The "other persons" are the firms themselves. PCAOB's inspections began in May 2004 and it is currently inspecting the eight largest U.S. public accounting firms and also a number of smaller firms.

Section 103 gives PCAOB the independent standard-setting authority that Lynn Turner (see above in the "Origins and Attitudes" section) and others complained was lacking previously. Section 103(a)(1) provides authority to create "attestation standards, such quality control standards , and such ethics standards to be used by registered public accounting firms…". They must preserve audit papers and "other information related to any audit report, in sufficient detail to support the conclusions reached in such reports" for at least 7 years. Storing these records for 7 years brings accountants into compliance with the requirements of Section 103; a failure to store them for at least 5 years can result in criminal liability that carries a maximum of 10 years in prison, per Section 802, discussed below.

Another Section in Title I that may be of interest to academics is Section 109(c)(2). That Section states that "all funds collected by the Board as a result of the assessment of monetary penalties shall be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs…" Academic Accounting departments may wish to contact the PCAOB regarding that provision.

The Board has been creative in seeking complaints. It recently created a new online form (www.pcaobus.org/tips), an email address (tips@paaobus.org) and a toll-free phone number (800.741.3158). It is interested in receiving tips on potential violations of the SOA, especially if they are relevant to one of PCAOB's inspections. Information can be provided anonymously.

**Auditor Independence**

Title II addresses auditor independence. Lack of auditor independence from the companies they are auditing is generally credited with contributing to audit failures and accountant-related corporate scandal. Many accounting firms collected substantial professional fees for non-audit related services performed for their audit clients. In some cases the non-audit fees exceeded the audit fees. For example, Arthur Anderson collected $21 million annually for audit services and $29 million annually for consulting services. An auditor in that position would not be inclined to push too hard on the audit side for fear of losing the even more lucrative consulting side. Such an auditor faces a clear conflict of interest. In order to eliminate that conflict, SOA puts up a high wall separating audit work and other accounting work.

Section 201 provides a laundry-list of nine specific services that an auditor may not perform for a public company audit client. These include bookkeeping, financial information system work, appraisal or valuation, actuarial services, internal audit outsourcing, management or human resource

services, investment banking, legal work related to the audit and "any other service that the Board determines, by regulation, is impermissible."

Section 203 requires audit partner rotation. The "lead (or coordinating) audit partner (having primary responsibility for the audit)" may not work for more than 5 years on a audits for the same public company. In this way SOA hopes to curtail the natural congenial relationships that may develop over many years between corporate managers and auditors. These relationships pose a potential conflict of interest. Also, the knowledge that a new audit partner will be reviewing his/her work may tend to make the audit partner behave more correctly. However, at least one commentator feels that audit partner rotation does not go far enough.

Title II contains a section that has not drawn much attention, but is potentially very significant. Section 207 calls for the Comptroller General of the U.S. to conduct a study of the "potential effects of requiring the mandatory rotation of registered public accounting firms." This goes far beyond merely rotating auditing partners within the same firm. Perhaps Congress is waiting to see how effective SOA will be, and whether even more stringent regulation will be required.

**Other Sections That Impact Accountant Liability**

While Titles I and II deal directly with audit practice and accountant liability, other sections of the SOA also relate to accountant liability. These include Section 802, which increased criminal penalty for "destruction, alteration, or falsification of records in Federal investigations" to a maximum of 20 years in prison. Accountants are required by this section to "maintain all audit or review workpapers for a period of 5 years", and an accountant who "knowingly and willfully" violates this requirement faces a maximum sentence of 10 years in prison. Section 806 increases the maximum sentence for securities fraud to 25 years in prison. Section 804 increases the Statute of Limitations cut-off for bringing private actions under the Securities Act of 1934 to 2 years from date of discovery and 5 years from date of violation. Previously it had been 1 year and 3 years. Section 805 requires the U.S. Sentencing Commission to review its sentencing guidelines with a view to increasing sentences for violations of the SOA. The very last section of the SOA, Section 1107, makes it a crime to retaliate against whistleblowers. The maximum sentence is 10 years in prison. Retaliation includes "any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense". This last section may be of assistance to an accountant such as an internal auditor who discovers a violation and reports it.

## CONCLUSION

We have seen that the SOA substantially changed the liability environment in which auditors of public companies must operate. Before the SOA liability would typically come about only after a corporate collapse. But while auditors knew that the resulting liability would be great, they also knew that for any given audit it was very unlikely to occur. Now, as William McDonough, Chair of the PCAOB has said "under the new system, auditors understand that their work is much more likely to be reviewed within months or even weeks by the PCAOB's well-experienced, full-time inspectors." It is now far more likely that violations will be caught.

Auditors are now much more sensitive to conflicts of interest. The SOA lists specific conflicts to avoid, such as consulting work and other non-audit work. It also gives the PCAOB authority to outlaw additional conflicts. This has changed the fundamental economic structure of the public accounting profession. Audits can no longer be "loss leaders" supporting other more profitable work. Congenial personal relationships between auditors and corporate officers are now

discouraged and the term of "lead accountants" auditing a public company is now limited to 5 years. Audits have become more adversarial, and more expensive.

Accountants now face greater risk when performing audits of public companies. A PCAOB inspection could result in suspension or termination of the accountant's and/or the firm's registration status. Without registration, the accountant or firm is prohibited from performing audits of public companies. In a worst case scenario, prison terms of 10 years could result from willfully failing to maintain all audit workpapers for five years. An accountant could spend 20 years in a federal prison for willfully destroying or altering documents.

No longer will auditing standards be formulated by an industry-friendly body like the Auditing Standards Board of the AICPA. They will now be formulated by the tough-minded PCAOB. The more stringent standards and practices mandated by the SOA might become accepted as best practices and be imposed even in ordinary negligence lawsuits.

All these changes might seem disheartening to accountants and especially those auditing public companies. And yet there is a very bright and hopeful side to the changes that the SOA has brought about. Progressive firms like Deloitte & Touche view the SOA as "a bridge to excellence". Their booklet by that title states "corporate leaders who embrace the spirit of the law – strong ethics, good governance, reliable reporting – will get a re-energized company, reassured investors, and maybe even reduced costs". Business Week Online recently reported a decline in "vehement railing against Sarbanes-Oxley" as corporations begin to see benefits of improved business controls and processes.

It is clear that the SOA is here to stay. It addresses the critical need to restore investor confidence following unprecedented business scandals. While it has increased the cost of compliance for corporations and added to auditors' legal liability, it has also brought about more reliable financial reporting, improved internal control processes and eliminated many conflicts of interest. It has also led to a greater emphasis on ethical behavior. Moreover, the SOA represents the best kind of regulation: that which seeks to prevent harm, not just to provide a remedy for those injured by that harm.

The benefits of the SOA appear to outweigh its costs. Moreover it is unlikely that Congress will significantly weaken it. It would be politically inopportune to appear to side with the corporate abusers. However, it is well recognized that the SOA was drafted in haste, and fine-tuning will no doubt occur. One measure that is almost certain to be adopted is a reduction of the regulatory burden and cost on small corporations. Congressman Oxley has recently said that if he could do it all again, he would provide "a bit more flexibility for small and medium-size companies".