The Sarbanes-Oxley Act and the Changing Responsibilities of Auditors

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On July 30, 2002 the Sarbanes-Oxley Act was signed into law. This law provides for sweeping reforms to corporate governance, accounting auditor oversight, and executive responsibility. Provisions of the law are designed to: 1) require greater corporate responsibility and accountability among senior management of public companies; 2) enhance disclosures by public companies; 3) improve auditor independence; and, 4) enhance the oversight of the auditing profession.

Introduction

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act"). Among its many provisions, the Act requires certain disclosures and reports by auditors and sets conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements. When he signed the Act, President Bush stated, "This law says to corporate accountants: the high standards of your profession will be enforced without exception; the auditors will be audited; the accountants will be held to account."

The Act, which is the most significant change to securities law since the Securities Exchange Act of 1934 (Exchange Act), fundamentally changes the way public companies do business and how the accounting profession performs statutorily required audits. The Act is intended to restore confidence in financial markets and give investors more confidence that public company financial statements are accurate.

Besides establishing a number of provisions that directly increase the responsibilities of senior executives and directors at publicly held companies, the Act contains numerous provisions that affect the accounting profession directly. Those provisions include: establishing a comprehensive framework for reforming the oversight of public company auditing; strengthening the independence of auditors; requiring greater corporate responsibility and accountability among senior management of public companies; and improving the quality and transparency in financial reporting by public companies. This article addresses the audit-related provisions of the Act and the Securities and Exchange Commission (SEC) proposals to implement those provisions.

Public Company Accounting Oversight Board

One of the most fundamental changes affecting the public accounting profession is the creation of an independent Public Company Accounting Oversight Board (the Oversight Board) — a nonprofit corporation that is subject to SEC oversight. Until now, the accounting profession has relied on self-policing of the audit process, auditing and accounting standards setting, and, for the most part, disciplinary measures. Duties of the Oversight Board will include:

- Registering public accounting firms (foreign and domestic) that prepare audit reports for issuers;
- Establishing auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;
- Conducting inspections of registered public accounting firms; and
- Conducting investigations and disciplinary proceedings concerning, and imposing appropriate sanctions where justified

upon, registered public accounting firms and associated persons of such firms.

The SEC control over the Oversight Board is similar to the powers it now has over such self-regulatory organizations as the National Association of Securities Dealers (NASD). As a check on its power, all of the Oversight Board's decisions are subject to SEC review. Unlike the prior Public Oversight Board (POB), which depended on fees from the auditors that it was meant to regulate, mandatory fees paid by all public companies will fund the new Oversight Board. All accounting firms that conduct audits of public firms must register with the Oversight Board.

The Oversight Board is required to review annually each accounting firm that conducts more than 100 audits a year; accounting firms conducting fewer than 100 audits yearly are to be reviewed every three years. The Oversight Board can investigate potential violations of rules and impose sanctions. Its power even extends to foreign public accounting firms that audit financial statements of companies under U.S. securities laws.

The Oversight Board will be made up of five members appointed by the SEC with no more than two who may be licensed certified public accountants. On October 25th, the five commissioners of the SEC selected Judge William Webster, the former head of the Federal Bureau of Investigation and Director of the Central Intelligence Agency, to chair the Oversight Board for a five-year term expiring in 2007. Shortly thereafter, the Oversight Board Chairman, the SEC Chairman and the SEC's Chief Accountant resigned as a result of an apparent conflict of interest of Judge Webster that was not disclosed by the SEC's Chairman and Chief Accountant.

Also appointed to the Board were four other attorneys:

- Daniel Goelzer, a certified public accountant who served on the Touche Ross audit staff early in his career and lawyer and former general counsel of the SEC for a four-year term expiring in 2006.
- Kayla J. Gillan, Vice President of Independent Fiduciary Services and former chief legal adviser to the California Public Employees Retirement System (CalPERS) for a three-year term expiring in 2005.
- Willis Gradison Jr., a former Republican nine-term congressman from Ohio and Cincinnati mayor now with the law firm of Patton Boggs for a two-year term expiring in 2004.
- Charles Niemeier, a certified public accountant and attorney who currently is the SEC's chief accountant in the division of enforcement for a one-year term expiring in 2003.
- The newly established Oversight Board, which will have little to no accounting or auditing experience, will set auditing standards and replace the role of the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). It will also replace the role of the AICPA in setting standards for Ethics and Quality Reviews.

At its first meeting on November 13, 2002, the Oversight Board did not endorse the audit standards issued by the AICPA. At that meeting, which was chaired by Judge Webster (even though he has already resigned from his position as Chairman on a permanent basis), the board considered adopting the existing standards on an interim basis. However, some Oversight Board members believed this would send a message that they supported the status quo instead of reform. The five attorneys on the Oversight Board concluded that they needed legal advice on whether the AICPA's standards remain in effect. The Oversight Board will not be asked to set accounting standards. The role of the Financial Accounting Standards Board (FASB) remains unchanged by the Act, and the FASB will continue to set accounting standards. However, the FASB will receive public funding to enable it to better fulfill its standard-setting role. Thus, the Act provides for a new FASB, giving it for the first time, full financial independence from the accounting industry.

Auditor Independence

For many years the question whether public accounting firms should be allowed to provide certain non-audit services to their audit clients prompted significant controversy. Many members of Congress viewed the provision of permitting consulting services by a company's independent auditor as constituting a "conflict of interest" and urged a ban on such services.

The Act will limit the scope of consulting and other non-audit services that accounting firms can offer their public company audit clients. The Act, which only applies to public companies that are required to report to the SEC, indicates that state regulatory authorities should make independent determinations of the proper standards and should not conclude that the Act's standards apply to small- and medium-sized accounting firms that do not audit public companies.

The Act permits the Oversight Board the authority to grant case-by-case exceptions and doesn't limit accounting firms from providing non-audit services to public companies that they don't audit or to any private companies. Accounting firms will be prohibited from providing to their public company audit clients a number of ancillary services. The prohibited services include:

- Bookkeeping or other services related to accounting records or financial statements of the audit client;
- Financial information systems design and implementation, appraisal or valuation services; fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker-dealer or investment advisor services; or investment banking services;
- Legal services and expert services unrelated to the audit; and any other service that the new Public Company Accounting Oversight Board determines, by regulation, is impermissible.

Many non-audit services have been performed well before the beginning of the requirements for public company audits in 1933 and are closely related to the audit itself (such as reporting on internal controls or performing statutory audits) or, as a practical matter, can only be performed by the auditor (such as advising on the appropriate accounting treatment of a transaction or assisting on SEC registration statements). Many accounting professionals believe that a total prohibition on non-audit services for audit clients would, over time, diminish accounting firms' overall technical expertise and undermine their audit effectiveness. Indeed, even the current prohibitions are likely to diminish the expertise available to accounting firms and undermine audit effectiveness. The SEC noted that certain exceptions to the prohibited non-audit services may be permitted and that a complete ban on particular services was considered unnecessary or inappropriate. For instance, instead of prohibiting all bookkeeping services, the SEC's final rule allows such services in emergency or other unusual situations, provided the accountant does not act as a manager or make any managerial decisions. In fact, after the terrorist attack of September 11th, the SEC waived its prior restrictions on this service to allow those firms most affected by the tragedy to obtain such assistance from their public accountants.

Also, the SEC provided an exception for appraisal or valuation services where the accounting firm merely reviews and reports on work done by the audit client or by a third-party specialist employed by the audit client, because, the SEC explained, in such a situation the third party or the audit client is the source of the financial information.

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Pre-Approval Requirements

The Act provides that a registered public accounting firm may engage in any non-audit service that is not described in the list of specifically prohibited services for an audit client only if the activity is approved in advance by the audit committee of the issuer. Requiring audit committee pre-approval of non-prohibited services reflects the Congressional consensus on how permitted non-audit services should be scrutinized. Audit committees must understand the nature of the non-audit services being provided and consider whether they raise independence concerns. The Act did not include tax services in the list of prohibited services. In its release adopting its independence rule, the SEC noted that tax services generally do not create the same independence risks as other non-audit services.

On November 19, 2002, the SEC proposed to amend its rules to require certain disclosures and reports by auditors and to set conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements. The SEC proposed rules to:

- Revise its regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence (based on the nine prohibited services listed in the Act);
- Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements; and
- Require disclosures to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements. The disclosures, to be made in issuers' annual reports, would include fees paid by issuers for audits, tax preparation and all other fees. The proposal would require disclosure of fees for the year covered by the filing and for the previous year.

Rotation of Partners on Audits

Under the Act, registered public accounting firms will be required to rotate their lead partner (the partner in charge of the audit engagement) and their review partner (the partner brought in to review the work of the lead partner and audit team) on audits so that neither role is performed by the same accountant for the same company for more than five consecutive years.

On November 19, 2002, the SEC proposed rules that would prohibit partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years and from returning to audit services with the same issuer within five years. This would preclude the engagement partner from rotating onto the position of review partner and will likely require the relocation of audit partners with a resultant increased cost for companies outside major metropolitan areas.

The SEC also proposed rules to:

- Prohibit an accounting firm from auditing an audit client's financial statements if certain members of management of that client had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures; and
- Require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer.

In addition, under the proposed rules, an accountant would not be independent from an

audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review and attest services.

Record Retention

The Act toughens penalties for shredding specific types of records and requires that such audit documents must be preserved for five years. It provides tough criminal penalties for their destruction. On November 19, 2002, the SEC proposed rules that would implement §802 of the Act by specifying the information that must be retained by auditors for a five-year period subsequent to the completion of an audit or review of a registrant's financial statements. In particular, the proposed rules would specify that auditors should retain workpapers and other documents that form the basis of the audit or review and memoranda, correspondence, communications, other documents, and records (including electronic records), which are created, sent or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit or review. The Act requires that final rules be in place by January 26, 2003.

Disclosures about Internal Control

The SEC is required by §404 of the Act to adopt rules requiring a company's management to present an internal control report in the company's annual report containing: (a) a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (b) an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. §404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment.

The proposed amendments do not specify the exact content of the proposed management report. The SEC stated that management should tailor the report to the company's circumstances and not provide boilerplate responses that are of little value. Under §404(b) of the Act, the company's auditor must attest to, and report on, management's assertions in the internal control report. The company must state this fact and file the auditor's attestation in its annual report. In addition, recently adopted rules require companies to conduct a quarterly evaluation of their disclosure procedures and controls. The proposed rules would also require companies to conduct quarterly evaluations of their internal controls and procedures for financial reporting. They would also make conforming revisions to recently adopted certifications by a company's principal executive and financial officers regarding the company's quarterly and annual reports, and related rules.

One of the most fundamental changes affecting the public accounting profession is the creation of an independent Public Company Accounting Oversight Board.

Improperly Influencing Auditors

On October 24, 2002, the SEC proposed rule amendments to implement §303 of the Act. Specifically, the SEC proposed to redesignate Rule 13b2-2 of Regulation 13B-2 as Rule 13b2-2(a) and to add new Rule 13b2-2(b). As directed by §303(a) of the Act, the SEC's proposed rules would prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading.

The proposed rules, in combination with the existing rules under Regulation 13B-2, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. The rules prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings.

The proposed rules would supplement the rules currently in Regulation 13B-2. The current rules address the falsification of books, records and accounts and false or misleading statements, or omissions to make certain statements, to accountants. Specifically:

- Proposed Rule 13b2-2(b)(1), which substantially would mirror the language in §303(a) of the Act, specifically would prohibit officers and directors, and persons acting under their direction, from fraudulently influencing, coercing, manipulating or misleading the auditor of the issuer's financial statements for the purpose of rendering the issuer's financial statements misleading.
- Proposed Rule 13b2-2(b)(2) would provide examples of actions that improperly influence an auditor that could result in rendering the issuer's financial statements materially misleading.

The paragraph also would clarify that such actions should not occur at any time in connection with the professional engagement. The proposed rule would provide an additional means to address conduct intended to fraudulently influence, coerce, manipulate, or mislead an auditor during his or her examination or review of the issuer's

financial statements, including conduct that did not succeed in affecting the audit or review. Types of conduct that the SEC noted might constitute improper influence include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- Providing an auditor with inaccurate or misleading legal analysis;
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- Blackmailing; and
- Making physical threats.

Disclosure and Conflicts of Interest

The Act also would require auditors to discuss specific accounting issues with the company's audit committee. This not only increases the understanding of the company's board of directors, but also prevents directors from later claiming they weren't informed about the company's accounting practices.

The Act requires public companies to disclose all off-balance-sheet transactions and conflicts. Also, pro forma disclosures must be presented in a way that is not misleading and must be reconciled with a presentation based on generally accepted accounting principles. Because more companies are making pro forma disclosures, Congress noted that it was concerned that they were not accurately reflecting the financial conditions of the company.

As directed by §401(a) of the Act, the SEC proposed to require disclosure of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The new disclosure would be located in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) section in a company's disclosure documents.

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The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposals also would require a registrant (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

Conclusion

The question that remains unanswered concerns the impact Sarbanes-Oxley will have on the accounting profession and investors' perceptions. The answer to this question is tied inexorably to the faith that the investing public places in audited financial statements. Unless investors believe that financial statements represent the status of the organization and the results of its operations, then all the rule-making and penalties set forth by Sarbanes-Oxley will be useless.

The problem that has led historically to auditor conflict and corruption is the flow of money. Even after Sarbanes-Oxley, the audited firm continues to pay for the audit. This situation has always placed the auditor in a less-than-arm's-length position and presented a situation ripe for corruption.

As time passes, we will learn whether the Sarbanes-Oxley threats and penalties are sufficient to overcome the power of the money flow from the client company to the auditor, and how detrimental this money flow is to the integrity of the financial statements. Hence, it is only after a number of years have passed that we will be able to assess this legislation's benefit or harm.

Endnotes

1. The U.S. Securities and Exchange Commission, SEC Website, July 2002, available from http://www. SEC gov. INTERNET.