SARBANES-OXLEY ACT OF 2002: WHAT YOU NEED TO KNOW

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How will 2002 be remembered by Wall Street and the accounting profession? Will the names Enron, WorldCom, Adelphia, Global Crossing, and Arthur Andersen be forever linked with business scandals? Likely these names will be permanent black marks on Wall Street and the accounting profession. The stock market price of these companies and others who were even remotely linked to possible accounting shenanigans has dropped dramatically. This crisis in investor confidence spurred Congress to swiftly act to begin the process to restore public trust in the markets. During July 2002 Congress passed and President Bush signed an historic corporate governance/accounting bill that has implications for both Wall Street and the accounting profession.

As a student going into the accounting profession it is important that you know not only the major points of this bill but also how it may affect your future in accounting. Following is a presentation of the major points of the bill along with possible effects on the accounting industry.

Establishment of Accounting Oversight Board

Presently, three organizations primarily influence the accounting profession in various ways. First, the Financial Accounting Standards Board (FASB) issues various types of pronouncements. The most authoritative of these pronouncements are Statements of Financial Accounting Standards (SFAS). SFASs establish Generally Accepted Accounting Principles (GAAP) and indicate the methods and procedures required on specific accounting issues. The Securities and Exchange Commission (SEC) is a second organization impacting the profession. The SEC was created by Congress under the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC has

the legal authority to establish accounting principles and reporting practices for all companies issuing publicly traded securities. This legal authority is seldom used but occasionally the SEC exerts pressure on the FASB concerning specific methods and procedures that it prefers. Generally, the impact of the SEC is through its informal approval of SFASs before their issuance by the FASB. The third organization to influence the accounting profession is the American Institute of Certified Public Accountants (AICPA). The AICPA is the professional organization for all certified public accountants in the United States. The AICPA publishes guides to assist in the preparation and audit of financial statements that in specific instances may be considered as sources of GAAP. Additionally, the AICPA provides input to the FASB in identifying problem accounting areas that need to be addressed and clarified.

The Sarbanes-Oxley bill creates a fourth organization with the ability to influence the accounting profession. This new organization appointed and overseen by the SEC is entitled the "Public Company Accounting Oversight Board." This Board will oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies. It will operate as a nonprofit corporation and not be an agency or establishment of the United States Government.

The Board will be composed of five financially literate members appointed by the SEC for five-year full-time terms. Two members must be or have been CPAs while the remaining three members may not be and cannot have been CPAs. The chair of the Board

may be held by one of the CPA members, provided that he or she has not been engaged as a practicing CPA for five years.

Duties of Board

The following duties of the Board are detailed in the bill:

1. Register public accounting firms;
2. Establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;
3. Conduct inspections of firms;
4. Conduct investigations, disciplinary proceedings, impose sanctions;
5. Enforce compliance with Act, the rules of the Board, professional standards, and the securities laws relating to preparation and issuance of audit reports;
6. Has authority to amend, modify, repeal, and reject any standards suggested by the groups.

IMPLICATIONS:

While CPAs will be represented on the Board they will be in the minority by a 3-2 margin. Theoretically, any disputes about auditing standards, quality control, ethics, and independence will be decided by non-CPAs. The Board's broad-based powers also should concern accountants. These are appointed not publicly elected members who will have the power to establish, amend, modify, repeal, and reject any standards suggested by accounting groups.

Under the Board's duty to conduct inspection of accounting firms, the Board is empowered to investigate potential violations of standards, security laws, competency and conduct of accounting firms and their employees. Additionally, the Oversight Board

has the power to sanction accounting firms and accountants for non-cooperation, violations, or failure to properly supervise partners and accountants. These sanctions can be severe including prohibiting accounting firms from conducting audits of public companies, suspending or revocating the registration of an accounting firm, and imposing civil penalties.

Prohibition of Non-Audit Services Concurrently with Audit Services

The Act prohibits a registered public accounting firm from providing any non-audit service to a company while concurrently offering audit services. These services include but are not limited to: (1) bookkeeping or other services related to accounting records; (2) financial information system design and implementation; (3) appraisal or valuation services, fairness opinions; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment advisor, or investment banking services; (8) legal services and expert services unrelated to the audit.

The Act does provide for some exceptions from these prohibitions. One, the Board may, on a case-by-case basis, exempt from these prohibitions any persons, issuers, or public accounting firms. Two, a public accounting firm may provide these non-audit services along with audit services if it is pre-approved by the audit committee of the public company. The audit committee will disclose to investors in periodic reports its decision to approve the performance of non-audit services and audit services by the same accounting firm. This requirement to disclose to investors is likely to inhibit auditing committees from approving the performance of auditing and non-auditing services by the same accounting firm. Three, the pre-approval requirement is waived if the aggregate

amount of all such non-audit services provided to the client constitutes less than 5% of the total amount of revenues paid by the client to its auditor.

IMPLICATIONS:

For years public accounting firms have tried to justify their conflict-of-interest of auditing and consulting the same client. This bill attempts to restore investors' confidence in the accountants' objectivity of clients' books. While loopholes still remain, the bill appears to alleviate some of investor's concerns about the objectivity of CPAs. The effect on the accounting industry's business is unknown. On one hand, firms will lose non-audit service revenue from their audit clients. On the other hand, they could compete for non-audit business from other CPA firms who have to discontinue providing certain non-audit services for their audit clients. The effect would depend on the type of services a CPA firm normally provides for its clients. Often, large CPA firms provide a multitude of services so CPA firms could potentially be substantially hurt by this change.

Conflicts of Interest

The Act makes it unlawful for a registered public accounting firm to perform an audit for the issuer (audit client) if the issuer's CEO, Controller, CFO, Chief Accountant Officer or person in an equivalent position was employed by the company's audit firm during the one year period preceding the audit. Currently, many employees and partners of public accounting firms obtain employment with their clients immediately after leaving the employment of a public accounting firm. This rule will decrease the hiring of former auditors by their current clients.

Certification of "Appropriateness of Financial Statements

The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the report, and that those financial statements and disclosures fairly present, in all material respects, the operations and the financial condition of the issuer." A violation of this certification must be knowing and intentional to give rise to liability.

IMPLICATIONS:

At first glance the "certification to the accuracy" of financial statements seems like an onerous burden on the CEO and CFO. Increased liability would seem to accompany any certifying of financial results. Yet the new requirements' effects probably will be only incremental. Jonathan Weil of *The Wall Street Journal* says, "Under the old way of doing things, corporate executives were supposed to tell the truth to the public in their financial filings, and their companies' financial statements had to comply with generally accepted principles. The main difference now is that they will have to swear to that."[1] Another angle considers the similarity in the wording of the certification with the wording on the signing of an IRS federal income tax return. Certainly, people sign the return but that doesn't stop them from cheating on their taxes.

Some believe that CEOs and chief financial officers will undertake greater due diligence to ensure the veracity of their financial reports. That may largely take the form of instructing their underlings at the division levels to sign their own sworn statements about the operations they oversee. Others anticipate that the threat of criminal investigations will inspire fear in executive suites—and consequently, more reliable financial reports.[2]

Bonuses/Profits/Loans to Executives

The press has widely reported the abuses of executives (e.g. Enron, WorldCom) who took large bonuses and loans at the same time as their firms' falsified financial statements. The Act requires the CEO and CFO to reimburse issuers for any bonus, incentive-based compensation during the 12 months following issuance of a non-compliance document. Also, generally, it will be unlawful for issuers to extend credit (e.g. personal loans) to a director or executive officer.

IMPLICATIONS:

Rightly so, officers should not be enriched at the trough of fraudulent reporting. In addition, the issuers' resources which are owned by shareholders should not be consumed by officers in the form of low or no interest personal loans.

Falsifying Documents and "Whistleblower Protection"

The last part of the bill addresses corporate and criminal fraud along with stiffer penalties for white collar crimes. It is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation. To encourage reporting of fraudulent reporting, employees of issuers and accounting firms are extended "whistleblower protection" that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle blowers are also granted a remedy of special damages and attorney's fees.

IMPLICATIONS:

The stiffer penalties for white collar crimes may look good on paper, but the general public may cast a skeptical eye on whether fraud actually will be personally punished. Yet time will tell as several investigations are under way of fraudulent

reporting and alleged CEO perpetrators of this fraud. While the bill's intent to make it easier for employees to step forward without fear of reprisal is noble, it is unclear whether employees will now have the courage to blow the whistle on their companies. Yet courageous examples such as Cynthia Cooper, Gene Morse, and Glyn Smith, the internal auditors who uncovered the largest fraud in corporate history at WorldCom, may do more to encourage people to take the necessary steps to stop fraud than any new legislation from Congress.[3]

Summary

Will the Sarbanes-Oxley Act of 2002 hurt or help the accounting industry? Richard Phillips, a former SEC official, recently commented, "The new scheme for regulating auditors will profoundly alter the relation between auditor and client. But stiffer penalties for officer and director crimes aren't likely to deter misconduct any more than prosecutions under existing law."[4] Yet by stepping up penalties on corporate executives, the bill makes life easier for accountants because corporate executives will be less likely to pressure them to sign off on questionable financial statements.

Along with changing the relationship between auditor and client, the bill may help restore investor confidence. The conflict of interests of auditors who audit and provide non-audit services to the same client has been severely limited. Presumably, this helps eliminate the inclination of auditors to be less skeptical about the financial condition of the issuer for fear of losing lucrative non-audit services. Also, the certification of the accuracy of financial statements by the CEO may give the investor additional assurance as to propriety of the financial statements. Time will tell as to the real effects on investor confidence, the accounting industry, and issuers.

References

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