New Laws, New Challenges

IMPLICATIONS OF SARBANES-OXLEY

BY ANDREW J. FELO, CMA, CFM, AND STEVEN A. SOLIERI, CMA, CPA

Amid recent corporate scandals, investors, regulators, and politicians have asked, "Where were the auditors?" The Sarbanes-Oxley Act of 2002 was designed to combat the perceived ineffectiveness of the external audit.

"This is the most fundamental, far-reaching legislation to affect the accounting profession since the 1930s," says Dana Hermanson, director of research at the Corporate Governance Center at Kennesaw State University and member of the National Association of Corporate Directors' (NACD) Blue Ribbon Committee on Audit Committees. "Its impact will be felt for years," he emphasizes.

Outspoken educator Dr. Abraham J. Briloff, Emanuel Saxe Distinguished Professor Emeritus at Baruch College in New York, applauds Congress for passing the law. But he adds that its success or failure will be in the detailed implementation and administration. "If political judgments prevail, instead of market and professional forces as were stated in the original objectives, I am afraid that we will inevitably be back at our original starting point, and we will be no better off for all our efforts," Briloff says.

Probably the Act's single most significant component is the creation of the Public Company Accounting Oversight Board (PCAOB). The Board will establish standards, perform quality reviews of auditing firms, and investigate and discipline firms and individuals. Since Congress believed that having an oversight board dominated by CPAs might be too close for comfort, only two of five members can be CPAs, even though some argue that this restricts accounting and auditing expertise. Board members are required to serve full-time, and they are prohibited from receiving payments (other than retirement payments) from public accounting firms.

The Act also requires public accounting firms to retain documents prepared to support their audit reports for at least seven years. That may make it easier for the Board to determine if audits were conducted improperly.

NEW INDEPENDENCE

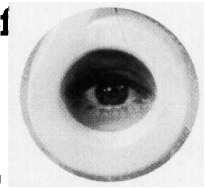
Impaired auditor independence is commonly cited as a major factor in the recent scandals, based on the assumption that cozy relationships between auditors and clients increases the likelihood that auditors may "look the other way" or, worse, help falsify financial reports. Lead auditing or coordinating partners and reviewing partners must now rotate off an audit engagement every five years, and the General Accounting Office (GAO) will study the possibility of mandatory firm rotation.

At a roundtable on Sarbanes-Oxley hosted by the Technology Executives Roundtable in Atlanta, Tim Bentsen, partner-in-charge of KPMG's MidSouth Business Unit, noted that the law will change both the expectations and costs of auditing. "The cost of auditor rotation—the five-year requirement—that's an added cost in terms of bringing somebody back up to speed and having the right person with the right experience," Bentsen said.

Although more manageable than requiring companies to rotate audit firms on a predetermined schedule, the provision could result in executives (particularly CFOs) spending additional time on the annual audit in order to help audit firm personnel get up to speed. If having a "fresh set of eyes" involved in an audit improves auditor independence, however, this may be time well spent.

Another restriction is likely to have a significant impact on how companies fill key positions. A company is prohibited from hiring anyone who has worked for its audit firm during the one-year period preceding an audit. The affected positions are CEO, CFO, controller, chief accounting officer, and equivalent jobs. The prohibition isn't limited to the audit team; it covers any former employee of the audit firm.

If having a "fresh set of eyes" involved in an audit improves auditor independence, however, this may be time well spent.



When audit firms provide nonaudit services to clients, auditor independence appears to be impaired. Even if an auditor's judgments aren't clouded, the *appearance* of a conflict may be problematic. Put simply, appearances matter. "The time of using the audit as a loss-leader to secure more lucrative consulting work are over," Hermanson says.

The Act also prohibits audit firms from designing and implementing financial information systems, providing internal audit services, and providing valuation and appraisal services to audit clients (see Table 1).

But the Act doesn't prohibit *all* nonaudit services. Nonaudit services are allowed if a firm's audit committee

Proposed List of Prohibited Services

- Bookkeeping
- Information Technology
- Appraisal or Valuation
- Actuarial
- Internal Audit
- Management
- Investment Banking
- Legal
- Any service prohibited by the company's board of directors

preapproves services not on the prohibited list and discloses its decision to investors. Preapproval isn't necessary if fees for nonaudit services are less than 5% of the total paid to the audit firm in the year in which the services are provided.

AUDIT COMMITTEES

In addition to asking, "Where were the auditors?" people have also been asking, "Where were the audit committees?" All audit committee members must now be "independent" and are prohibited from receiving compensation from the firm other than for board service. The intention is to increase the likelihood that audit committee members won't be influenced to approve questionable practices to protect consulting or advisory fees.

Although the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASD) have similar provisions, codifying them in federal law increases the penalty for violations.

Firms must also disclose whether at least one audit committee member is a "financial expert." If no member meets the definition of an expert, firms must explain why. The NYSE and NASD have similar provisions, but the Act seems to tighten the definition.

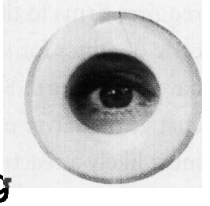
Exchange listing requirements consider past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience, such as being a CEO or senior officer with financial oversight responsibilities. In determining expertise, the Act also refers to education or experience as an accountant, auditor, principal financial officer, comptroller, or chief accounting officer. Experience in preparing or auditing financial statements, the application of accounting estimates and accruals, internal accounting controls, or an understanding of audit committee functions also indicate expertise.

Being a CEO is *not* listed as an indicator of financial expertise under the law. This doesn't stop the Securities & Exchange Commission (SEC) from adopting rules to define CEOs as financial experts, but the lack of mention might be seen as an attempt to tighten the definition. In a recent proposal, the SEC did not specifically define CEOs as financial experts, but the proposal does give a board the discretion to consider an individual's past employment experience.

The Act also gives audit committees direct responsibility for the appointment, oversight, and compensation of registered public accounting firms the company hires. Audit committees must establish procedures (such as whistleblower hotlines) to receive and act on anonymous complaints concerning accounting, internal control, and auditing.

Jeff Schulte, a partner at law firm Morris, Manning & Martin, LLP, notes that many private companies may be surprised to find a whistleblower provision applies to them. "The very last section of this Act applies to private companies also," Schulte says, adding that the law makes it a crime to retaliate against whistleblowers. "Retaliation is a criminal act, and it's lying there in the weeds for private companies who thought Sarbanes-Oxley didn't have anything to do with them."

Audit committees must establish procedures (such as whistleblower hotlines) to receive and act on anonymous complaints concerning accounting, internal control, and auditing.



To help audit committees carry out their responsibilities, the Act gives them the authority to hire independent advisors, at firm expense, to provide counsel or other advice. This kind of advice and counsel can be particularly important given the limited time they have to perform their duties.

IMPROVING DISCLOSURES

Both investors and regulators have questioned the quality and quantity of firm disclosures. It is theorized that firms were allowed to hide problems from investors and regulators because they weren't required to disclose certain information or could disclose misleading information.

Now CEOs and CFOs must certify that they've reviewed all quarterly and annual reports filed with the SEC. In addition, they must state that, to the best of their knowledge, the reports present fairly the financial condition and operations of the firm and don't omit material information. Individuals can be fined up to $5 million and be sentenced to up to 20 years in prison for violating this requirement.

Also, a strong internal control environment is vital to preventing fraud. As part of the certification of quarterly and annual reports, the Act requires the CEO and CFO to

discuss a firm's internal control environment. Firms must also report on the policies and procedures in place to prevent fraud in each annual report. CEOs and CFOs are required to state that establishing and maintaining the internal control structure is their responsibility and to provide an annual assessment of the effectiveness of those policies and procedures.

The external auditor is also required to include a report on management's annual assessment of the internal control system as part of the audit report. And the Act requires firms to disclose whether they have adopted a code of ethics for senior officers. In addition, they will have to file Form 8-K with the SEC whenever there is a change or waiver of the code. The immediate disclosure is most likely a reaction to the Enron board twice waiving its conflicts-of-interest policy to facilitate the establishment of special-purpose entities involving its CFO.

When preparing pro forma earnings figures, firms typically omit or reformulate information required under generally accepted accounting principles (GAAP). If investors aren't aware that the figures are not prepared according to GAAP, they could be misled. The Act requires firms to explain how pro forma figures differ from GAAP figures, making it less likely that investors will confuse the two. The Act specifically prohibits firms from omitting material facts that might make pro forma information misleading.

Even figures based on GAAP can confuse investors. This is true if a firm has significant off-balance-sheet transactions (such as Enron's special-purpose entities) that don't have to be included in a firm's consolidated statements under GAAP. Now firms are required to disclose information concerning significant off-balance-sheet transactions with unconsolidated entities. Specifically, firms will be required to disclose their obligations under leases, lines of credit, guarantees, and straight debt that will mature over the next five years.

In addition, managers may have an incentive to commit accounting fraud to receive bonuses or to profit from equity-based compensation. To reduce this incentive, the Act calls for the forfeiture of bonuses and profits from equity sales by CEOs and CFOs when firms restate financial statements. The Act also gives the SEC the power to bar, temporarily or permanently, individuals from serving as officers or directors of public companies if the individual has committed securities fraud.

RELATIONSHIPS WITH OFFICERS AND DIRECTORS

As a result of recent scandals, it has become widely known that corporations make loans to their officers and directors, usually on quite favorable terms. The generous terms can be thought of as an additional source of compensation that may be largely unseen by shareholders. The Act effectively bans this practice.

During the investigation of Enron, it was learned that employees were prohibited from selling Enron shares invested in their 401(k) plans while the plan administrator changed. During this "blackout period," Enron came under investigation by the SEC. Consequently, the share price plummeted, but employees couldn't sell the rapidly declining shares. Yet senior officials weren't subject to the blackout restriction. These officials were able to avoid the large losses that ordinary employees couldn't avoid. To prevent a repeat of this, the Act prohibits officers and directors from purchasing or selling company stock during blackout periods.

INCREASING CONFIDENCE

Without a doubt, investor confidence in corporate executives, boards of directors, audit committees, financial accounting, and external auditing has been damaged. This loss of confidence has translated into uneasiness in capital markets. To combat this problem, the Sarbanes-Oxley Act of 2002 places additional responsibilities on key participants in the financial reporting process, restricts their activities, and mandates additional and more timely disclosures.

"For those of us who are sick enough to actually enjoy reading the Act, it is interesting to go through and with limited exceptions peg exactly what it was designed to do," says attorney David Calhoun of Morris, Manning & Martin. "You can say 'all right, this was WorldCom; this was Enron; this was Waste Management.' The law was clearly a reaction and was, in some cases, more far-reaching than the drafters had intended," he concludes.

Although it may not be possible to improve investor confidence solely through legislation, the Sarbanes-Oxley Act of 2002 is a step in the right direction. ■

Andrew J. Felo, CMA, CFM, Ph.D, is with the School of Graduate Professional Studies at Penn State Great Valley. He can be reached at (610) 648-3380 or ajf14@psu.edu.

Steven A. Solieri, CPA, CMA, CIA, CISA, Ph.D., is an assistant professor of accounting and information systems at the Kania School of Management at the University of Scranton and can be contacted at (570) 941-4192 or solieris2@uofs.edu.