SARBANES - OXLEY ACT OF 2002

On July 25, 2002, in the wake of recent scandals involving some of the nation's biggest corporations, Congress overwhelmingly approved reform legislation known as the Sarbanes - Oxley Act of 2002 (the "Act").[1] On July 30 President Bush signed it into law. The Act is primarily directed at officers, directors, and auditors of publicly traded corporations.

The Act directly targets conduct which has received the most media attention. Members of Congress hailed the Act as perhaps the most significant economic legislation since FDR, perhaps even the securities acts of 1933 and 1934. In signing the bill the president said the Act "says to every American: there will not be a different ethical standard for corporate America than the standard that applies to everyone else."

History will determine how much of the Act is substance and how much is election year public relations. However, the response by Congress was summed up by Senator Phil Gramm on the floor of the Senate: "The American people expect Congress to respond to a problem. We may not know the answer. We may not have perfect knowledge. But they expect us to try to do something about it. That in and of itself is an argument to which we should respond."

The purpose of this article is to summarize some of the key provisions of the Act. It is intended only as an overview. The Act is complex. It revises provisions in various parts of the existing United States code, including the securities acts of 1933 and 1934. It is also lengthy, covering 60 pages. For a more detailed review you should refer to the Act itself, which can be accessed from our website at:

http://www.adamsjones.com/publications.html

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[1] The vote in the Senate was 99-0 and in the House 423-3.

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TITLE I - PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The Act creates a new "public company accounting oversight board" (Board), to oversee audits of companies subject to the securities laws. It will be a nonprofit corporation (not an agency of the government) subject to oversight by the Securities and Exchange Commission (SEC). The Board will have five members. A maximum of two members can be CPAs, and the chairperson cannot have been a practicing CPA for at least five years. The Board is charged with the duties of registering public accounting firms that prepare audit reports for companies that issue publicly traded stock, and establishing rules for auditing, quality control, ethics, and other standards for the preparation of audit reports. The Board is authorized to inspect and discipline registered public accounting firms.

An accounting firm that performs an audit for a publicly traded company (referred to in the Act as "Issuer"[2]) must register with the Board. Section 102 of the Act sets out the requirements for registration, although the Board is empowered to add to those requirements.

A number of provisions in the Act are clearly designed to address some of the abuses arising out of the Enron debacle. For example, §102 provides that in applying to register the accounting firm must execute a consent to cooperate and comply with any request for testimony or the production of documents made by the Board. The accounting firm is also required to submit at least annual reports to the Board to update the information in its application, and the Board can request additional information.

Section 103 requires the Board to establish standards for auditing attestation, quality control, and ethics to be used by registered public accounting firms in the preparation of audit reports. These standards shall require at a minimum the accounting firm to prepare work papers and maintain them for five to seven years, depending on the circumstances as described in the Act. The firm must provide a second partner review and approval of the audit report by a qualified person associated with the firm. The firm must describe in

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[2] "Issuer" means an issuer as defined in § 3 of the Securities Exchange Act of 1934, the securities of which are registered under that act.

each audit report the scope of the auditor's testing of internal controls, and evaluate whether the internal controls include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of the assets of the issuer. Finally, the firm must state in the audit report that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer.

Inspections of Accounting Firms

Section 104 provides that the Board will inspect registered public accounting firms. The Board will annually inspect firms which regularly do more than 100 audits of publicly traded companies. Firms that regularly perform less than 100 audits of such companies will be inspected at least once every three years. The inspection will include the review of engagements of the firm, the firm's quality control system, and documentation. A written report of the inspection shall be transmitted to the SEC and each appropriate state regulatory authority. The report will be available to the public, except to the to the extent the firm addresses the criticisms of its quality control systems.

Frustrated by refusal of some accountants to testify, § 105 provides that if a registered public accounting firm or any associated person in that firm "refuses to testify, produce documents, or otherwise cooperate with the board in connection with an investigation," the Board may suspend the person from being associated with a registered public accounting firm or require the firm to "end such association" with the person, or even suspend or revoke the registration of the firm.

Sanctions for Accountants

If the conduct of an accountant or firm is intentional, reckless, or involves repeated instances of negligence, the Board can suspend or revoke registration, or suspend or bar a person from further association with any registered public accounting firm. The Board can impose fines on individual accountants up to $100,000 for negligence and $750,000 for intentional conduct. Fines against firms range from $2 million to $15 million respectively. Section 105 also provides that the firm or one of its supervisory personnel can be sanctioned for failing to properly supervise an offending accountant.

Accounting Standards Body

Section 108 of the Act authorizes the SEC to recognize as "generally accepted" for purposes of the securities laws any accounting principles established by a standard-setting body as described in the Act. This standard-setting body is to be organized as a private entity. The majority of the trustees of this body cannot have been associated with a registered accounting firm for at least two years. Section109 imposes an accounting

support fee to help fund both the Board and the standard-setting body. Each "issuer" will pay a fee based upon its average monthly equity market capitalization as compared to other issuers.

TITLE II - AUDITOR INDEPENDENCE

Bifurcating Non-Audit Services

Accounting firms that provide audit services have been criticized for providing the same customers with other, sometime more lucrative, services which may inhibit the accountant's independence. This title is directed at these perceived conflicts of interest by major accounting firms. Section 201 states that it is unlawful for a registered public accounting firm that performs an audit to provide to an issuer "contemporaneously with the audit," any non-audit service including: (1) bookkeeping or services relating to accounting records, (2) financial information systems design, (3) appraisal or evaluation services, (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, and (9) any other service that the Board determines by regulation is impermissible. Again, this only pertains to audits for publicly traded companies.

There are exceptions, however, including one that allows the Board to exempt, on a case-by-case basis, any issuer or accounting firm to the extent that such exemption is necessary or appropriate in the public interest for the protection of investors. There is also an exception that allows the audit committee to approve non-audit services that are not specifically prohibited, as well as a "*de minimis*" exception.

Rotation of Audit Partners

One criticism of auditors is that they may become too close to management by conducting audits year after year. Section 203 makes it unlawful for a registered public accounting firm to provide services to an issuer if the lead or coordinating audit partner, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years.

TITLE III - CORPORATE RESPONSIBILITY

Title III attempts to deal with perceived problems in the internal operations of corporations directly by regulating officers and directors in a new way. The audit committee of the board of directors is responsible for the appointment, compensation, and oversight of the accounting firm performing the audit. The Act creates new requirements as to the independence of a member of the audit committee. The audit

committee will have authority to engage independent counsel and other advisors as it determines necessary to carry out its duties.

Certifications by the CEO and CFO

One of the most publicized aspects of the Act is the new requirement that the principal executive officer and the principal financial officer make certifications in reports submitted under the 1934 act. These certifications include that the officer has reviewed the report and that based upon his or her knowledge (1) the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to prevent the statements made from being misleading; and (2) the financial statements fairly present in all material respects the financial condition and results of operations of the issuer for the periods presented in the reports.

The signing officers must also certify that they have disclosed to the auditors and the audit committee all significant deficiencies in the internal controls which could adversely affect the issuer's ability to "record, process, summarize, and report financial data", and identify any material weaknesses in internal controls and any fraud, whether or not material.

Disgorgement of Insider Profits

Another issue that has received great attention is the amount of money company insiders have received shortly before revealing accounting improprieties or bankruptcy. Section 304 of the Act provides that if the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, the CEO and CFO shall reimburse the company for (1) any bonus or incentive-based or equity-based compensation received by that person during the previous 12 months and (2) any profits realized from the sale of securities during the previous 12 months. Whether this turns out to be a strong disincentive to abuses remains to be seen.

Insider Trades

Section 306 is a lengthy and complex set of provisions relating to insider trades during "pension fund black out periods." This is directed at specific Enron practices. The basic intent is to make it unlawful for any director or executive officer to purchase or sell any equity security during the "blackout period" if the security was acquired by that person as compensation. This apparently excludes those securities that were purchased on the market. The blackout period is defined as any period of more than three consecutive business days during which the ability of at least 50 percent of the plan participants to purchase or sell the company's stock has been temporarily suspended. If an officer or director violates this provision, any profit realized is recoverable by the company or even

an owner of the securities.

Protection for Whistleblowers

Section 306 protects employees of public companies who provide evidence of fraud. Neither the company nor any officer or employee may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee because of any "lawful act" done by the employee to provide information or assist in an investigation which the employee reasonably believes constitutes a violation of the securities laws.

TITLE V - ANALYST CONFLICTS OF INTEREST

Section 501 requires the SEC to adopt rules to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances. It requires securities analysts who make public appearances, and brokers and dealers who disclose research reports, to disclose conflicts of interest at the time of the appearance or the report. This includes disclosing the extent to which the person has investments in the issuer that is the subject of the appearance or research report, or whether that person has received any compensation.

AND FINALLY....

Title X states that it is "the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation." It is not required. The Senate just wanted to let us know how they felt.