

The Sarbanes-Oxley Act and Corporate Governance

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Course Description

The past years has witnessed a number of high-profile corporate scandals: Enron, Tyco International, Healthsouth, Global Crossing, and WorldCom (now-MCI). While these are the most glaring, there are many more companies whose shareholders and employees have suffered as stock prices have fallen, such as Cisco, Nokia, Lucent Technologies, and most internet-related businesses. The course examines recent developments in finance and accounting and a series of corporate accounting scandals on the heels of the Enron debacle that have led to new sweeping accounting guidelines, proposals, and legislation—most notably, the Sarbanes-Oxley (SOX) Act. Many of the issues surrounding the SOX Act—especially Section 402, Internal Control over Financial Reporting and Sections 302 and 906, Management Certifications —are discussed. The general issues on corporate governance and corporate social responsibility (CSR), including stock option expensing, are also covered. The illegal practice of stock option backdating is described as well.

Field of Study	Accounting
Level of Knowledge	Overview
Prerequisite	None
Advanced Preparation	None

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Learning Objectives:

After studying this course you will be able to:

1. Recognize the sources of accounting irregularities, including the Enron scandal and Special Purpose Entities (SPEs).
2. Identify the controversy with expensing stock options and specific issues addressed by FASB No. 123R.
3. Recognize different rules and regulations put out by the FASB, NYSE, SEC, and AIMR.
4. Identify key elements of corporate governance and which software and technologies can be helpful in implementing the SOX Act.
5. Identify attributes of good governance, social responsibility and other ethical standards.
6. Recognize the major features of the Sarbanes-Oxley (SOX) Act of 2002 Corporate Responsibility Law.

Chapter 1:

Points of Controversy

The past 15 years have included a number of high-profile corporate scandals: Enron, Tyco International, K-mart, and WorldCom (now MCI). While these are the most glaring, there are many more companies whose shareholders and employees have suffered as stock prices have fallen, such as Cisco, Nokia, Lucent Technologies, and most internet-related businesses. Here is a list of developments in finance and accounting and a series of corporate accounting scandals on the heels of the Enron debacle that have led to new sweeping accounting guidelines, proposals, and legislation. Each of these developments is discussed in detail in this course.

During the past decade, the role of financial executives—primarily CFOs—has changed from that of primarily an accountant and controller to that of a “business partner” and “strategist.” Due to the pressures on them in their emerging role as strategic partners, the CFO and finance team can also lose their objectivity and independence. This shift might have prompted the CFOs to use aggressive accounting and reporting practices. A CFO.com survey (www.cfo.com or CFO Magazine) revealed that 17 percent of all respondents report being pressured to misrepresent their results by their companies' CEOs during the five years before 2002. A key factor in recent corporate scandals was a failure of financial functions to spot the signs of malpractice.

Over the period 2000-2002, volumes of shareholder wealth evaporated as the audited financial statements of certain companies were revealed as creative fiction. The most distressing example was the scandal surrounding Enron Corp.: the Houston-based energy trader overstated profits and hid debt from investors for years, its audit committee permitted obfuscation in public disclosures, and auditors at Arthur Andersen (one of the world’s “Big Five” accounting firms, a group that also included Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, and KPMG) approved Enron’s false financial statements. After Enron’s malady came to light, Andersen employees went so far as to destroy documents. The fact that Enron’s imaginative accounting went on for so long exposes an end-to-end failure of the system — and, predictably, the tab has been left with investors, creditors and employees. The damage to its reputation meant Arthur Andersen was unable to recover and eventually sold most of its business to members of what would come to be known as the Big 4

More detailed sources of accounting irregularities and scandals are summarized below.

Moving Debt off the Balance Sheet

The accounting technique made infamous by Enron (and the main reason for its downfall) was its use of special purpose entities (SPE) to move debt off its balance sheet. A lot of debt was carried, but not reflected on its balance sheet. Much of it was collateralized with Enron stock. As the stock price fell, the house of cards came down.

Many U.S. companies have for a long time used special-purpose entities to finance projects in a way that allows tax benefits without visibly impairing balance sheets. This is perhaps the most dangerous accounting gimmick, because it is very difficult to determine from financial filings exactly when a company has entered into these agreements. The lack of disclosure makes it impossible for investors to determine how much the company must pay to fully service its debt or to fulfill other contractual obligations.

Earnings "Management" and the Use of Pro Forma Results

Many companies have used the "complicated accounting ledger domain" to avoid disappointing investors and brokerage analysts from quarter to quarter, potentially at the expense of a long-term focus. Companies use so-called pro forma earnings to spruce up their results. The problem with pro forma results is that they are too often promotional, eliminating the negative and emphasizing the positive. Companies in the tech sector perfected the practice, but it has spread well beyond Silicon Valley.

Overstated Pension Plan Assumptions

Pension plan accounting is complicated, esoteric and not entirely logical. But what every shareholder needs to understand is that most companies have obligations to fund their pension plan to a certain level. Any shortfall must eventually be made up by contributions from the company's coffers. During the bull market of the past few years, companies were able to cut back on contributions, as gains in the stock market helped keep pension plans healthy. But even as stock prices stumbled, or fell dramatically, many firms kept on predicting robust growth of their pension investments to help boost their bottom line.

Some companies are using rosy projected returns for their employee pension plans to buff their financial statements. Many firms still assume 9 percent to 10 percent annual returns on their pension plans in coming years, when 5 percent would be more realistic. The higher the assumed long-term returns, the lower the annual pension plan contributions a company is required to make in the near term. Instead, money that would have been earmarked for a pension plan accrues to the company's bottom line.

Underreporting of Executive Compensation

Most major companies do not treat the costs of employee stock options (stock-based compensation) as an official expense on income statements. That has contributed to an overstatement of earnings in recent years. When options involve no charge to earnings, they are considered a "cheap" form of compensation--when in fact they represent a cost to shareholders. A recent survey found company after company that would have seen reported earnings slashed by as much as 200 percent had they been forced to expense stock option plans.

Revenue accounting

Basic accounting practices must be the bedrock of every finance department and one of the most basic issues is revenue recognition — when to recognize revenue, at what amount and the degree of provision for future reversals. Many of the recent failures came from this issue. Enron, acting as a broker between sellers and buyers of energy, took sales credits for the total size of the transaction rather than only the fee involved, which made

the company's size and growth rate look much stronger than it really was. Global Crossing and Qwest Communications, among other companies, bought and sold capacity from each other and took sales credit at both ends, overstating both companies' revenues.

Expense Accounting

The basic tenet of the matching principle in accounting is that expenses must be matched with their corresponding revenues. It doesn't always happen — for example, research and development expenditure is written off when incurred even though the product sales to which it relates may occur many years later. However, the accounting intent is to match. WorldCom clearly violated the matching principle by considering the fees paid for line usage bought from local carriers every month as a capital expenditure, not an operating expense.

Channel Stuffing

Another gray area involves "inventory management." Old tricks include "channel stuffing"—or shifting surplus finished goods to distributors' shelves. Nothing will destroy a company's ability to meet analysts' earnings expectations more than having a warehouse full of unsold goods. Rather than come clean and tell shareholders they have not met sales expectations, some companies are tempted to move their merchandise to the market knowing that much of it is going to come back unsold or will have to be sold at a massive discount. Investors looking for evidence of channel stuffing should look for large changes to stated inventory levels, or an increase in the contingencies set aside for bad accounts.

The most powerful example of the practice was the fall from grace of Al Dunlap, the former head of Sunbeam Corp. He allegedly moved millions of dollars in merchandise onto the hands of distributors and retailers using discounts and other inducements. That, along with the use of cash reserves to pump up the company's operating earnings, resulted in a record-breaking \$189 million in reported earnings in fiscal 1992. But when the scheme was uncovered, Sunbeam was forced to restate its earnings from the fourth quarter of 1996 to the first quarter of 1998; the SEC alleges that \$60 million of that record-breaking profit was the result of accounting fraud. CFO magazine (January 15, 2002) stated that "Chainsaw" Al Dunlap agreed to pay \$15 million to settle a shareholder lawsuit alleging inflated stock prices. Sunbeam's auditor at the time was Andersen.

Inappropriate Earnings Management Practices

Earnings management includes both legitimate and less than legitimate efforts to smooth earnings over accounting periods or to achieve a forecasted result. It is the responsibility of the audit committee members to identify, by appropriate questioning and their good faith judgment, whether particular earnings management techniques, accounting estimates and other discretionary judgments are legitimate or operate to obscure the true financial position of the company. The line between appropriate earnings management techniques and "cooking the books" can be a blurry one, notwithstanding the plethora of detailed rules that are currently in place to deter malfeasance. If audit committees fail to make this distinction, further intrusive regulation could follow. There will always be a temptation to manage earnings inappropriately because meeting projections and

“guidance” suits everyone, from executives whose compensation may be based on earnings-driven performance measures, to holders of options and Wall Street analysts.

The following are some of the techniques, which were being used by some companies inappropriately to manage earnings in response to analyst and market pressure:

- Deliberately overstating one-time “big bath” restructuring charges to provide a cushion to satisfy future Wall Street earnings estimates;
- Misusing acquisition accounting, particularly improper write-offs of acquired in-process research and development, to overstate future earnings inappropriately;
- Over-accruing charges for items such as sales returns, loan losses or warranty costs when the company is profitable and using those reserves to smooth future earnings when the company is not so profitable — known as “cookie jar reserves”;
- Prematurely recognizing revenue — for instance, before a sale is complete, before a product is delivered to a customer or at a time when it is possible that the customer may still terminate, void or delay the sale;
- Improperly deferring expenses to improve reported results;
- Misusing the materiality concept to mask inappropriate accounting treatment.

Auditor Independence

Auditors must recognize that their ultimate client is not management. In fact, they’re supposed to serve shareholders. But in practice, auditors are paid by the very companies whose books they’re supposed to scrutinize. And in recent years, that relationship has become even more complicated. The Big Four routinely perform lucrative management, information technology, tax and other consulting work for the companies they audit.

According to the Investor Responsibility Research Center (IRRC) (www.irrc.com), a Washington D.C.-based advocacy group for institutional investors, large accounting firms receive just 28 percent of their fees from auditing work. Non-audit fees significantly exceed the amount paid for auditing services.

Corporate Governance Issue

A company’s audit committee has a myriad of responsibilities, the most important being to oversee the presentation and honesty of financial statements. Members are appointed by the board of directors. The problem is, many company audit committees include directors who also serve on the executive team. Because management are insiders who are paid out of the funds of the company, there’s a need for a check on management. Audit committees comprising directors should not be tied to management in any way. More corporations are complying in the wake of Enron—but until the guidelines become mandatory, some could continue to ignore them.

Chapter 1 Review Questions

1. The role of chief financial executive (CFO) has changed in the past decade to
 - A. Accountant
 - B. Business partner/strategist
 - C. Controller
 - D. Chief risk officer

2. Corporate scandals have been a result of the following accounting irregularities EXCEPT
 - A. Financial failure to spot signs of malpractice
 - B. Audited financial statements as creative fiction
 - C. Aggressive moral leadership
 - D. Overstated profits and hidden debt

3. Some of the infamous accounting techniques used by Enron include
 - A. Tax benefits
 - B. Moving debt off the balance sheet
 - C. Outside audits
 - D. Aggressive public disclosure

4. The accounting technique used to avoid disappointing investors and brokerage analysts is the use of
 - A. Full accrual basis
 - B. Cash basis of accounting
 - C. Pro-forma earnings
 - D. External audits

5. The methods or strategies used to move debt off the balance sheet or to boost the bottom line include all the following EXCEPT
 - A. Overstated pension plan assumptions
 - B. Underreporting of executive compensation
 - C. Revenue recognition

D. Channel stuffing (inventory management)

6. The company that allegedly schemed to move millions of dollars of merchandise into the hands of distributors and retailers using discounts and other inducements along with the use of cash reserves to pump up the company's operating earnings is

- A. Sunbeam Corporation
- B. WorldCom (MCI)
- C. Adelphi Communications
- D. Enron

Chapter 2:

Financial Restatements and Stock Option Expenses

Financial Restatements

The largest write-downs to net income caused by restatements over the last eleven years of New York Stock Exchange registered companies were:

- 2012: JPMorgan Chase, \$459 million
- 2011: China Unicom (Hong Kong) Ltd., \$1.56 billion
- 2010: Telecom Italia, S.p.A., \$717 million
- 2009: USB AG, \$357 million
- 2008: TMST Inc., \$671 million
- 2007: General Electric, \$341 million
- 2006: Navistar International Corp., \$2.4 billion
- 2005: American International Group Inc., \$5.2 billion
- 2004: Fannie Mae, \$6.3 billion
- 2003: HealthSouth Corp., \$3.5 billion
- 2002: Tyco International Ltd., \$4.5 billion

Below is a sample list of the details behind the prior earnings restatements from 2002-2005:

- GE, 2005: GE restated financial statements and other financial information for the years 2004, 2003 and 2002 and financial information for the year 2001 and for each of the quarters in the years 2004 and 2003 with respect to the accounting for certain derivatives transactions. These transactions relate to treasury operations at GE Capital Corporation (GECC).
- Household International, August 2002: The nation's No. 2 consumer finance concern disclosed that it earned \$386 million less than previously reported over the last nine years. The company, which issues MasterCard and Visa credit cards and makes home equity and car loans, said the restatement came after its new auditors reviewed its accounting for "complex" credit-card contracts.

- The Pantry Inc., August 2002: The convenience-store retailer said it had found an "inadvertent" \$8 million accounting error in its reports for the first and second quarters.
- Interpublic Group of Companies, August 2002: A major advertising business, said it had identified \$68.5 million in expenses that had not been properly accounted for. The company is restating its earnings back to 1997 to reflect the overlooked expenses, mostly incurred in its European operations.
- Xerox, June 2002: The Company disclosed that it inflated revenue by \$6.4 billion over five years. Anne Mulcahy, CEO of Xerox, announced a \$1.9 billion reversal of revenues and a \$1.4 billion restatement of profits for the past 5 years.
- WorldCom, June 2002: The telecommunications company announced that an internal audit found \$3.9 billion in accounting irregularities.
- Qwest Communications International, June 2002: The Company's chief executive was forced out because of concern that a federal investigation would result in a restatement of revenue for 2000 and 2001.
- Tyco International, June 2002: The company said it would restate its second-quarter earnings by \$4.5 billion.
- Adelphia Communications, May 2002: The cable television company, which filed for bankruptcy protection this month, announced that it would restate earnings for the last three years. Federal investigators also are looking into \$3 billion in off-the-books loans made to the company's founders.
- CMS Energy, May 2002: The company announced it would restate \$1 billion of "round-trip" trades for 2000 and \$4.2 billion for 2001. CEO William T. McCormick Jr. resigned.
- Network Associates, May 2002: The company restated results for 1998, 1999 and 2000, blaming the problems on intentional errors made by a single employee, who was fired. The errors overstated income by \$4 million in 1998.

Even though it has been years since the passage of the 2002 Sarbanes-Oxley Act, a very high number of companies are revising their financials. According to a report by GAO (www.gao.gov/products/GAO-06-678), entitled, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities*, 1,390 financial restatement announcements had been made because of financial reporting fraud and/or accounting errors between July 1, 2002, and September 30, 2005. The three most frequent causes of financial restatements were *revenue recognition*, which accounted for 20.1 percent of all restatements.

According to Huron Consulting Group (www.huronconsultinggroup.com), five categories of accounting issues caused nearly 60 percent of the problems in 2004 financial restatements. The three leading causes were: revenue recognition; equity accounting; and reserves, accruals and contingencies.

The Audit Analytics® has financial restatement database that includes data from all electronic filings of SEC registrants since January 1, 2001 and includes more than 7,500 public company financial restatements and/or non-reliance filings (big and small, foreign and domestic) that have taken place. In 2012, Audit Analytics reported 768 restatements were made. When considering the adverse effects of restatements filed in 2012, Audit Analytics found low indicators of severity with respect to each of the following criteria:

- Negative impact on net income
- Average cumulative impact on net income per restatement
- Percentage of restatements with no impact on income statements
- Average number of days restated
- Average number of issues identified in restatements

The most common accounting issues that resulted in restatements in 2012 and the rate of their occurrence were:

- Improper measurement of debt, stock warrants, and equity: 15 percent
- Tax expense/benefit/deferral and other (FAS 109) issues: 14.6 percent
- Cash flow statement classification errors: 13.3 percent
- Acquisitions, mergers, and reorganization accounting issues: 12.1 percent
- Revenue recognition issues: 9.5 percent
- Accounts/loans receivable, investments, and cash valuation issues: 8.7 percent
- Liabilities, payables, reserves, and accrual estimate failures: 8.3 percent

Stock Options Expensing

To Expense or Not to Expense

The whole premise behind expensing options is to further clarify a company's accounting, making its numbers more transparent to the public and thereby boosting investors' confidence, which has been ravaged by corporate scandals.

Executives involved in those scandals were often lavished with options that made them fabulously rich and allegedly prompted the financial abuses that were aimed at keeping the companies' profits--and stock prices--as high as possible. So options came under assault, and now treating them as a cost to be deducted from earnings is seen as one solution to curbing the abuses.

The debate primarily rages over the effect the accounting change might have on the companies' financial results, their stock prices and their employees. The following summarizes the opposing views:

Arguments to expense

- Since options are now all but free to companies, excessive grants to top execs have been encouraged. But options do have costs: They dilute shareholders' stakes and deprive companies of the funds they

would otherwise get by selling those shares in the open market. Such costs should be reflected in earnings.

- Bringing more discipline to option grants will also reduce the incentives top executives now have to pump their stocks through short-term earnings maneuvers in hopes of cashing in big option gains.
- Some 75% to 80% of executive pay used to comes in the form of options. Since all other forms of compensation must be deducted from earnings, options should be treated the same.
- Deducting the cost of options will yield more accurate earnings figures, which should help restore investor confidence.

Arguments not to expense

- Unlike salaries or other perks, granting options requires no cash outlay from companies. Since there is no real cost for the company to deduct, doing so will unjustly penalize earnings.
- Deducting the cost of options will slash earnings, which is likely to drive down share prices.
- Companies will issue far fewer options. That will hurt morale, limit a key tool used to lure talent, and inhibit companies from aligning employee and shareholder interests.
- Tech firms contend that generous option grants have attracted and retained talent and spurred the risk-taking and entrepreneurship so crucial to innovation. Expensing options would sharply reduce their reported profits.
- There are no universal models for expensing options; all valuation methods require major assumptions and estimates. An unreliable estimate of the fair value of options in the income statement would distort earnings.

Option Pricing Models

The big problem with option pricing is that corporations can't predict what will happen to share prices, who will leave the company before their options vest, and which options will expire underwater—that is, with no value. Hence they have no way of knowing what options will be worth when they're exercised many years after issue. Unlike shares, which have a market value at all times, the true value of options is only known when they're cashed in, in some cases long after the employees who received them provided their service to the company.

The well-known option-pricing formula, the Black-Scholes option pricing model, uses option terms such as the strike price and life span of the option, stock price, volatility, and dividend yield to estimate future value. The Black-Scholes model and its many variants have, over the years, become the most widely used methods of valuing employee options for disclosure in financial footnotes.

But they are far from perfect. Designed for valuing options traded in open stock exchanges, the standard Black-Scholes model isn't adjusted to account for the added restrictions of employee options, such as vesting and lack of transferability. Those limits make employee options worth considerably less than exchange-traded options. In fact, firms that use the model to expense options would take a much bigger charge to earnings than is necessary. For example, Bear, Stearns & Co. estimates that using the Black-Scholes model to expense options would have trimmed 20% off the earnings per share of the Standard & Poor's 500-stock index in 2002. Also, 13 companies,

including Microsoft Corp. and Cisco Systems Inc., would each have had to deduct pretax options expenses in excess of \$1 billion in 2001 alone.

By waiting until employees exercise their options, then booking the difference between the exercise price and the stock price as an expense, companies would record the precise cost of the options. That sum would equal the amount the company would spend to buy those shares on the open market, or the amount the company is forgoing by not selling the shares and pocketing the funds itself. And options that never get exercised never get expensed. This is the only way of accurately stating the true cost of options to the company.

Simply waiting violates, however, most of the accounting principles about expense recognition. Companies are required to deduct expenses during the period in which they are incurred—that's why equipment is amortized over its useful life instead of being expensed when it's purchased or sold. Expensing options only when they are exercised violates that basic principle, sometimes requiring companies to deduct the option expense long after the employee's period of service. An executive who retires with a boatload of vested options would, in this scenario, create a huge expense when she exercises them—one that should properly have been taken throughout the period of employment.

To achieve much the same result of expensing at the time of exercising, the intrinsic value method can be employed. Under this approach, a firm expenses the difference between the exercise price and the stock price throughout the vesting life of the option, repeatedly updating it as the stock moves. As the stock price rises, options become more valuable, and that additional value is charged to earnings. If the stock declines, options decrease in value, and the charge to earnings evaporates.

Companies that use this method benefit greatly. Unlike Black-Scholes, the simplicity of intrinsic value makes it tough to manipulate. Since the charge to earnings is considerably lower than any of the Black-Scholes variants, it's less disruptive to earnings—and the stock price. In a declining market, it's also the only accounting method that doesn't create a charge for underwater options. Further, the approach may discourage massive option grants to underperforming executives, who frequently get rewarded for failure with grants designed to match the Black-Scholes value of last year's grant. Note: for volatile stocks, the earnings charge is hard to predict, which is why this method is not widely used.

Chapter 2 Review Questions

1. _____ was NOT one of corporations listed that restated their revenues.
 - A. Xerox
 - B. Reliance
 - C. Homestore.com
 - D. GM

2. Points of controversy were corrected or addressed by having recent financial statements restated for
 - A. Over reporting of executive compensation
 - B. Understating pension plan assumptions
 - C. Earnings “management” and the use of pro-forma results
 - D. None of the above

3. Expensing stock options to prevent financial abuses results in
 - A. Inflated shareholders’ stakes
 - B. Allowing companies to benefit from funds received from the sale of option shares
 - C. Increased incentives to top executives
 - D. Treating stock options like all other forms of compensation and deducts them from earnings

4. Which of the following is NOT true regarding stock options?
 - A. Granting options unjustly penalize earnings
 - B. Expensing options would attract and retain talent especially in the tech sector and entrepreneurship
 - C. Expensing options is likely to drive down share prices
 - D. Expensing options will discourage firms to issue more options.

5. The major problem with option pricing using the Black-Sholes option pricing model in determining the option value is
 - A. The use of strike price and life span to the option
 - B. The use of the stock price and the volatility of the stock
 - C. That the true value of the worth of the option is only known when they are cashed in (expensed)

D. The dividend yield

6. The intrinsic value method approach allows firms to

- A. Expense the additional value of the stock option as the price rises
- B. Decrease the charge to earnings as a stock declines
- C. Expense the difference between the exercise price and the stock price throughout the existing life of the option
- D. Expense options lower than the Black-Scholes Model

Chapter 3:

FASB No. 123 and 123R

FASB No. 123 Accounting for Stock-Based Compensation

In October 1995, the FASB issued FASB No. 123, *Accounting for Stock-Based Compensation*. This Statement establishes financial accounting and reporting standards for stock-based employee compensation plans. Those plans include all arrangements by which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. Examples are stock purchase plans, stock options, restricted stock, and stock appreciation rights.

In its final form, FASB No. 123 represented a compromise between the FASB and industry in which companies could choose to record compensation expense using an external fair value model or the intrinsic method. If the intrinsic method was used, the company was required to provide the pro forma fair value information in the footnotes. Specifically, FASB No. 123, which remained GAAP for stock options until the implementation date of FASB 123R, required the following accounting and disclosure procedures:

An entity had a choice of two methods to account for stock options:

- Implement a fair-value based method for accounting for compensation for employee stock options: Options were valued at the grant date based on their fair value based on an externally generated, option-pricing model such as the Black-Scholes or binomial model; or
- Maintain the existing intrinsic value method used in APB No. 25, *Accounting for Stock-Based Compensation*. If the intrinsic method continued to be used, the entity had to disclose additional pro forma disclosures “as if” the entity had implemented the fair value based method: The pro forma information had to include:
 - ✓ Pro forma net income; and
 - ✓ Earnings per share (if presented).

On March 31, 2004, the FASB issued an exposure draft entitled, *Share-Based Payment*, an Amendment of FASB Statements No. 123 and 95 and resulted in the issuance of FASB No. 123R, *Share-Based Payment*, in December 2004.

FASB No. 123R (revised 2004) (ASC 718-10-05)

Requires Options Expensing

FASB 123R now requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). In summary, FASB No.123R does the following:

1. Requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using the grant-date fair value as the measurement of cost. The grant date is the date at which an employer and employee reach a mutual understanding of the key terms of a share-based payment award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to an employee who renders the requisite service.
2. Requires all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees (except for equity instruments held by ESOPs) and those in which an entity acquires goods or services from nonemployees in share-based payment transactions.
3. Provides that fair value is measured based on an observable value, using an option model (such as the Black-Scholes or the Lattice method of valuation).
4. Provides certain exceptions to the fair value measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date.
5. Provides a nonpublic entity with the use of modified fair value method (the calculated value method) when it is not practicable to estimate stock volatility in determining fair value.
6. Amends FASB No. 95, *Statement of Cash Flows*, to require that excess tax benefits be reported as a cash inflow from a financing activity rather than as a reduction of taxes paid in the operating activities section.
7. Establishes criteria as to when a plan is noncompensatory and thus not subject to FASB No. 123R.
8. Expands disclosures required for share-based payments.
9. Allows a nonpublic entity to use an intrinsic method to value measure and record instruments that are categorized as liabilities (not as equities).

Note:

1. FASB 123R eliminates the alternative to use the intrinsic value method of accounting that was provided in FASB 123 as originally issued.
2. FASB No. 123R became effective as follows:
 - *Publicly held entities that do not file as small business issuers.* As of the beginning of the first interim or annual reporting period beginning after June 15, 2005;
 - *Publicly held entities that file as small business issuers.* As of the beginning of the first interim or

- annual reporting period beginning after December 15, 2005; and
- *Nonpublic entities*. As of the beginning of the first interim or annual reporting period beginning after December 15, 2005.
3. Companies will have to report all *new* stock-option grants immediately. Options awarded during the past three years will be phased in on a prorated basis.

Alternatives to Stock Options: Restricted Stock and Stock Appreciation Rights

In anticipation of the FASB's new statement (FASB 123R), many companies already restructured their compensation packages to eliminate stock options altogether as a compensation incentive. Other forms of compensation—such as restricted stock and stock appreciation rights—that created less of an impact on earnings have replaced stock options. *Restricted Stock* is used by companies to award shares of stock under share-based compensation plans while placing various restrictions on the recipients. With restricted stock, (1) employee cannot sell stock for a specified period of time, (2) employee may forfeit the shares if they leave employer, and (3) awards may be linked to financial goals. Some firms grant key employees stock appreciation rights instead of stock options. *Stock appreciation rights* give the employee the right to receive compensation in cash, stock, or a combination of cash and stock at some future date, based on the difference between the market price of the stock at the date of exercise over a pre-established price.

The Black-Scholes Problem and Other Lattice-based Option Models

The Black-Scholes Model, however, is widely considered to overstate the value of employee stock options by an unacceptable margin. That's because the model does not take into account the essential differences between traditional exchange-traded stock options and those granted to employees.

Unlike conventional options, employee options are subject to vesting schedules and forfeiture conditions, and cannot be transferred. As a result, they are invariably exercised before their usual 10-year term expires. These characteristics reduce the value of an option. *Note:* The FASB does not specify a preference for a particular valuation technique or model in estimating the fair values of employee share options. It recognizes, however, that a lattice-based method can take into account assumptions that reflect the conditions under which employee options are typically granted. The binomial model is the most commonly used lattice-based method, but other methods may be better suited to compensation programs that link vesting to specific performance objectives. Each of these models is outlined below.

Binomial. Unlike Black-Scholes the binomial method divides the time from the option's grant date to the expiration date into small increments. Since the share price may increase or decrease during any interval, the binomial model takes into account how changes in price over the term of the option would affect the employee's exercise practice during each interval. The binomial model can also consider an option grant's lack of

transferability, its forfeiture restrictions, and its vesting restrictions — even for options with more-complicated terms such as indexed and performance-based vesting restrictions.

Trinomial. The trinomial model goes a step further by allowing for the underlying stock price to either remain unchanged or move up or down. That's useful for valuing performance-based options that vest only if the stock price exceeds a certain level over time.

Multinomial. This model can take many more factors into account than either the binomial or trinomial framework. Such additional flexibility may be required to value options that cannot be exercised unless the underlying stock price exceeds the performance of one or more indices. But when there are more than two such sources of uncertainty, a Monte Carlo simulation may be preferable, since it is easier to apply than lattice models.

Note: For one thing, the new models are far less familiar than Black-Scholes, so users must spend considerable time figuring out how to use it. Black-Scholes is so widely used that there are lots of software packages, for laptops and handheld computers, to run the model.

The Binomial Model

Lattice-based option pricing models, such as the binomial model, can explicitly capture assumptions about employee exercise behavior over the life of each option grant, expected changes in dividends, and stock volatility over the expected life of the options, in contrast to the Black-Scholes model, which uses weighted average assumptions about option characteristics.

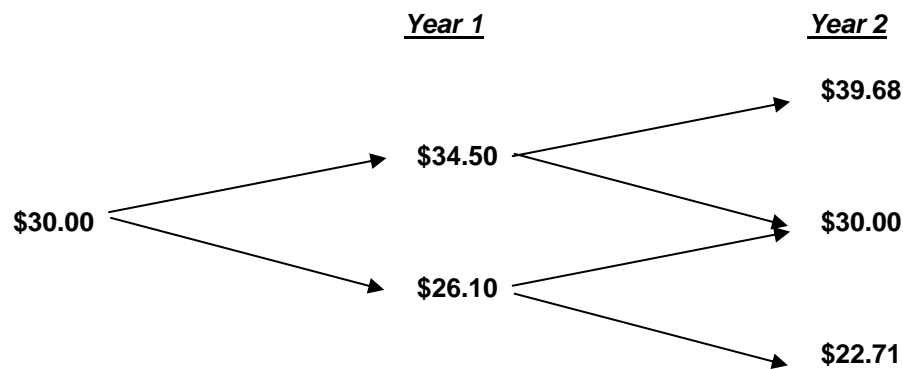
Example*: The Binomial Model

Exhibit 2 illustrates a simple two-year lattice model that portrays the expected price changes of the security, along with their chance of occurrence. Each node of the lattice reflects an expected share price at year-end. These expectations are developed through analysis of the security's historical volatility and its expected future volatility. Volatility, measured by the expected standard deviation of the returns of a security, then determines expected share price fluctuations over time. In turn, these potential share price fluctuations are a major factor in estimating option value. Exhibit 3 presents an example with a 64% probability that the price of the security will increase 15% (from \$30.00 to \$34.50) and a 36% chance that the price will decline by 13% (from \$30.00 to \$26.1). Assume that the probabilities and percentage price increases are the same for each of the two years. For example, if the price does go up to \$34.50 in year 1, there is a 64% chance that it will go up again in year 2 (to \$39.68) and a 36% chance that it will decline in year 2 (back to \$30.00).

Exhibit 3 shows how option values are determined. Assume that fully vested stock options have been granted with an exercise price of \$30.00 and a term of two years. Therefore, the holder of the option can buy shares of stock for \$30.00 until the option expires in two years. If the share price increases in both years 1 and 2, the option holder will net \$9.68 (\$39.68 - \$30.00) upon exercise of the option. If the share price stays at \$30.00 a

share or falls to \$22.71 at the end of year 2, the option holder will not exercise, as the share price does not exceed the exercise price.

Exhibit 2
Two-year Binomial Lattice



If the share price has a value of \$30.00 or less at the end of the two-year period, there is neither gain nor loss for the holder. The option simply expires unexercised. At the time of the option grant, the option clearly has value. It is more likely that the stock will have a value greater than \$30.00 at the end of two years, and the holder will not suffer any loss if it does not.

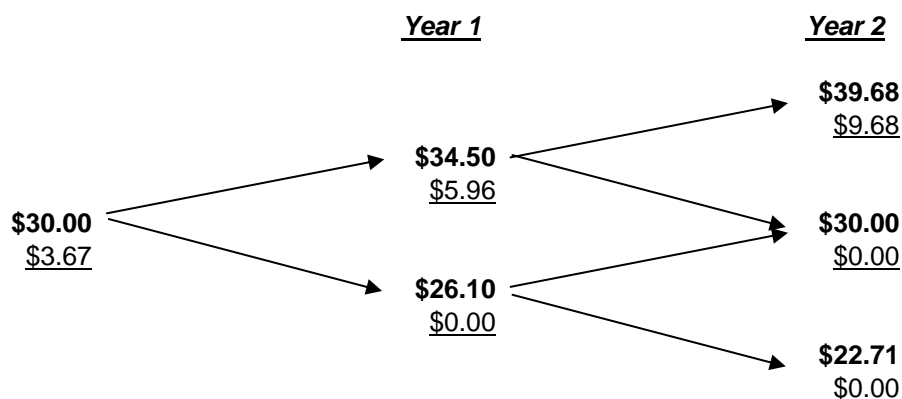
The mechanics of calculating the option value at the time of grant begin by determining the option value at the expiration period and working backward to the date of the grant. At the end of year 1, the share price will have either increased to \$34.50 or fallen to \$26.10. If the share price is \$34.50 at the end of year 1, the option holder has an asset that will either rise to \$9.68 (share price of \$39.68) or fall to \$0 (share price of \$30.00). The respective probability of these outcomes is 64% and 36%. Using a 4% risk-free rate as a time value of money discount rate, the value of the option in year 1 will be \$5.96:

$$[(64\% \times \$9.68) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$5.96$$

Continuing to work backward in time, the value of the option at the grant date is based upon the option values at the end of year 1. The calculation is the same as in the previous example, and yields an option value of \$3.67, the present value of \$5.96 and \$0 weighted by the probabilities of each outcome occurring:

$$[(64\% \times \$5.96) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$3.67$$

Exhibit 3
Two-year Binomial Lattice with Option Values



Thus, the option value is based upon the expected share price at each node on the lattice. If the historical volatility is higher, and the future volatility is projected to be higher, other things being equal, the option will have more value; the higher the probability of an increase in stock price, the higher the value of the option. There is no real risk of loss to the option holder, who will simply not exercise the option if the stock price declines. Therefore, as long as there is a positive probability that the price will rise above the exercise price, the option has value.

The analysis above illustrates the value of transferable options at the grant date. Employee stock options, however, are not transferable, and this affects their value.

Nontransferability and Early Exercise

In the above example, if the share price has risen to \$34.50, the option would be worth \$5.96, factoring in the possibility of a rising price in year 2. But if the option cannot be sold, the option holder must choose between exercising the option at the end of year 1 and holding it until the end of year 2. If the holder opts to exercise the option at the end of year 1, the proceeds would be only \$4.50.

Because they cannot sell the option in the open market, many employees will exercise their options early to realize a gain rather than take the chance that the share price will fall. In other words, the option is worth only \$5.96 at the end of year 1 if it can be sold. There is a positive probability that the stock will rise in year 2 and be worth \$9.68, but it also might decline and become worthless. Employees may prefer to take a profit of \$4.50 rather than risk losing all the potential value. The result of the potential early exercise is that the grant date value of the option falls from \$3.67 to \$2.77:

$$[(64\% \times \$4.50) \div 1.04] + [(36\% \times \$0) \div 1.04] = \$2.77$$

The reduced option value is due to the increased likelihood of early exercise that nontransferability represents.

*This example was adapted from Barenbaum, et. al, "Valuing Employee Stock Options Using a Lattice Model," *The CPA Journal*, December 2004, pp. 16-20.

Under the fair value method, the *fair value of employee stock options* at the date of grant would be amortized as compensation expense over the compensatory period (from the date of grant to the date the options are initially exercisable).

Stock Options Backdating: Illegal Practice

Stock option backdating occurs when a stock option's exercise price is not the stock's actual closing price on the date the option was granted, but rather is set at a lower price which corresponded to the stock's closing price on a previous date. For instance, if a stock option is granted on July 1, when the stock price closed at \$5.00 per share, then the option exercise price should be \$5.00 per share. However, if the option was backdated, it might be assigned the exercise price of \$3.00 per share, which might correlate to the stock's closing price on June 1, one month earlier.

Backdating an option in this way ensures that the option is "in the money" on the date of its grant, thereby increasing not only the likelihood that the option will be exercised at a profit by the officer to whom the option was granted, but also increasing the amount of the profit that its exercise would yield. This benefit to the officer being granted stock options comes at the direct expense of the corporation, which runs a greater risk of having the options it has granted be exercised in a manner that generates less money for the corporation (due to the lower exercise) than had the option not been backdated. Thus, backdated options unjustly enrich the officer or director to whom they are granted, causing him or her to breach their fiduciary duties of care, loyalty, and good faith.

Backdating an option so as to be "in the money" on the date of its grant also creates accounting improprieties. Under generally accepted accounting principles (GAAP), options that are "in the money" when granted are the equivalent of compensation and therefore must be treated as an expense by the corporation. If the corporation fails to properly account for the "in the money" options as an expense in its public filings with the Securities and Exchange Commission (SEC), it overstates profits. This practice can hurt a company's shareholders in other ways. If the grant dates of options aren't accurately disclosed in a company's regulatory filings, they could create liabilities that shareholders won't know about. Also, if a company is buying its own shares on the open market to deliver to employees exercise options, the company would receive less than it should for those shares if option dates were manipulated.

This practice is so widespread that more than 130 companies are under investigation by U.S. authorities for backdating or otherwise manipulating stock option grants, the biggest corporate-fraud probe in decades. To date, more than 60 executives and directors have lost their jobs.

FASB Issues Consolidation Principles for Special-Purpose Entities

ASC 850-10-05 (FASB Interpretation 46 (revised December 2003), *Consolidation of Variable Interest Entities*—An Interpretation of Accounting Research Bulletin (ARB) No. 51 applies to any business enterprise—whether a public or private company—that has an ownership interest, contractual relationship, or other business relationship with an SPE. The guidance does not apply to not-for-profit organizations.

The objective of this proposed Interpretation is to improve financial reporting by enterprises involved with SPEs—not to restrict the use of SPEs. However, it is expected that when this proposal is implemented, more SPEs will be consolidated than in the past. Most SPEs serve valid business purposes, for example, by isolating assets or activities to protect the interests of creditors or other investors, or to allocate risks among participants. Many SPEs that were unconsolidated prior to the issuance of this proposed Interpretation were reported according to the guidance and accepted practice that existed prior to this proposed Interpretation.

The Financial Accounting Standards Board's proposed rules on "special-purpose entities" would cover the partnerships that Enron created, but their greatest effect would be on "synthetic leases" used by many companies to finance property. In a synthetic lease arrangement, a financial institution sets up a special-purpose entity that borrows money to finance new construction or to purchase an existing building for a company. AOL Time Warner, for example, is financing construction of its new Manhattan headquarters with a synthetic lease arrangement set up by Bank of America Corp.

The FASB is calling for special-purpose entities to be included on a company's balance sheet if less than 10 percent of the equity in an entity is from outside investors. Under existing rules, Enron was able to keep its partnerships off its books even though outsiders' capital was less than 3 percent of the total.

Apart from a specific percentage of outside interest, special-purpose entities should have to be consolidated on companies' books if it's evident that the entities aren't truly independent.

Note: FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, establishes the conditions an entity must meet to be a qualifying special-purpose entity (SPE) (www.fasb.org) and establishes isolation of transferred assets as a condition for derecognition of the transferred assets. As long as the entities meet the criteria set out in FASB 140, they don't have to be consolidated and don't require a third-party investment. Essentially, a qualifying SPE has to stick closely to its special purpose. It can engage only in the activities it was set up to perform; that is, buy assets from the sponsoring company (usually with the proceeds of commercial paper), package them into securities, and sell them to investors.

Chapter 3 Review Questions

1. FASB No. 123 (*Accounting for Stock-Based Compensation*), the pre-FASB No. 123R (*Share-Based Payment* (ASC 718-10-05)), allowed companies the choice to record compensation expense using an external fair value model or the intrinsic method. True or False?

2. FASB No. 123R (ASC 718-10-05) requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using the grant-date fair value as the measurement of cost. True or False?

3. FASB No. 123R maintains use of the intrinsic method for nonpublic entities for share-based equity awards. True or False?

4. _____ is NOT an employee compensation incentive.
 - A. Corporate buyback (repurchase)
 - B. Stock options
 - C. Restricted stock
 - D. Stock appreciation rights

5. An example of a type of option pricing model identified by FASB No. 123R is
 - A. Linear programming
 - B. Monte Carlo simulation
 - C. Lattice Model
 - D. Internal rate of return model

6. Backdating an option so as to be “in the money” on the date of its grant also creates accounting improprieties. True or False?

Chapter 4:

New York Stock Exchange and SEC Rules

The New York Stock Exchange's Corporate Governance Rules

The NYSE's corporate governance rules include:

- An independent majority on a company's board, with no current or recent affiliations to the company.
- A stricter definition of director independence.
- Regular executive sessions of nonmanagement directors.
- The appointment of a lead director solely to run those meetings.
- Investor approval of all equity-based pay plans.
- A ban on broker votes for such plans unless they get customers' approval.

The new rules would weaken the control that management currently enjoys at many companies. Stronger governance standards will give directors better tools to empower them.

SEC Approves Rules to Address Analyst Conflicts

(www.sec.gov/news/press/2002-63.htm)

On May 8, 2002, the SEC approved proposed changes to the rules of the National Association of Securities Dealers and the New York Stock Exchange to address conflicts of interest that are raised when research analysts recommend securities in public communications. These conflicts can arise when analysts work for firms that have investment banking relationships with the issuers of the recommended securities, or when the analyst or firm owns securities of the recommended issuer.

These rules now in effect include the following provisions, among others:

Promises of Favorable Research. The rule changes will prohibit analysts from offering or threatening to withhold a favorable research rating or specific price target to induce investment banking business from companies. The rule changes also impose "quiet periods" that bar a firm that is acting as manager or co-manager of a securities offering from issuing a report on a company within 40 days after an initial public offering or within 10 days after a secondary offering for an inactively traded company. Promising favorable research coverage to a company will not be as attractive if the research follows research issued by other analysts.

Limitations on Relationships and Communications. The rule changes will prohibit research analysts from being supervised by the investment banking department. In addition, investment banking personnel will be prohibited from discussing research reports with analysts prior to distribution, unless staff from the firm's legal/compliance department monitor those communications. Analysts will also be prohibited from sharing draft research reports with the target companies, other than to check facts after approval from the firm's legal/compliance department. This provision helps protect research analysts from influences that could impair their objectivity and independence.

Analyst Compensation. The rule changes will bar securities firms from tying an analyst's compensation to specific investment banking transactions. Furthermore, if an analyst's compensation is based on the firm's general investment banking revenues, that fact will have to be disclosed in the firm's research reports. Prohibiting compensation from specific investment banking transactions significantly curtails a potentially major influence on research analysts' objectivity.

Firm Compensation. The rule changes will require a securities firm to disclose in a research report if it managed or co-managed a public offering of equity securities for the company or if it received any compensation for investment banking services from the company in the past 12 months. A firm will also be required to disclose if it expects to receive or intends to seek compensation for investment banking services from the company during the next 3 months. Requiring securities firms to disclose compensation from investment banking clients can alert investors to potential biases in their recommendations.

Restrictions on Personal Trading by Analysts. The rule changes will bar analysts and members of their households from investing in a company's securities prior to its initial public offering if the company is in the business sector that the analyst covers. In addition, the rule changes will require "blackout periods" that prohibit analysts from trading securities of the companies they follow for 30 days before and 5 days after they issue a research report about the company. Analysts will also be prohibited from trading against their most recent recommendations. Removing analysts' incentives to trade around the time they issue research reports should reduce conflicts arising from personal financial interests.

Disclosures of Financial Interests in Covered Companies. The rule changes would require analysts to disclose if they own shares of recommended companies. Firms will also be required to disclose if they own 1% or more of a company's equity securities as of the previous month end. Requiring analysts and securities firms to disclose financial interests can alert investors to potential biases in their recommendations.

Disclosures in Research Reports Regarding the Firm's Ratings. The rule changes will require firms to clearly explain in research reports the meaning of all ratings terms they use, and this terminology must be consistent with its plain meaning. Additionally, firms will have to provide the percentage of all the ratings that they have assigned to buy / hold / sell categories and the percentage of investment banking clients in each category. Firms will also be required to provide a graph or chart that plots the historical price movements of the security and indicates those points at which the firm initiated and changed ratings and price targets for the company. These disclosures will assist investors in deciding what value to place on a securities firm's ratings and provide them with better information to assess its research.

Disclosures during Public Appearances by Analysts. The rule changes will require disclosures from analysts during public appearances, such as television or radio interviews. Guest analysts will have to disclose if they or their firm have a position in the stock and also if the company is an investment banking client of the firm. This disclosure will inform investors who learn of analyst opinions and ratings through the media, rather than in written research reports, of analyst conflicts. The Commission will request the NASD and NYSE to report within a year of implementing these rules on their operation and effectiveness, and whether they recommend any changes or additions to the rules.

These rules are part of an ongoing process by the Commission, NASD, NYSE, and the states to address conflicts of interest affecting the production and dissemination of research by securities firms. On April 24, 2002, the Commission announced that it had commenced a formal inquiry into market practices concerning research analysts and the conflicts that can arise from the relationship between research and investment banking.

SEC Tightens Its Deadlines for Disclosure

(www.sec.gov/news/press/2002-128.htm)

The Securities and Exchange Commission voted on August 27, 2002 to shorten the amount of time companies have to report earnings and to require stock trades by corporate insiders to be disclosed within two days. The changes, approved unanimously by the five-member SEC, come on two fronts:

1. Detailed quarterly and annual financial statements will have to be filed more quickly with the SEC. That will reduce the risk that companies will issue rosy news releases about their earnings, only to reveal problems important to investors months later in their official SEC filings.
2. The rules will require company insiders--high-ranking executives, directors and major shareholders--to report the details of their stock trades more quickly.

The Association for Investment Management and Research's Proposal: The objectivity of analysts' stock research.

(www.aimr.org/pdf/standards/aimr-ros.pdfll-side)

On August 19, 2002, the AIMR has proposed some of the key ideas to improve the objectivity of analysts' stock research. They are:

- Brokerages should establish "three-dimensional" stock rating systems that incorporate measures of risk and a time horizon to help investors assess the suitability of a security for their own circumstances, rather than rely on simple "buy," "sell" or "hold" ratings.

- When discontinuing coverage of a stock, a brokerage should issue a "final" research report and recommendation, explaining the reasons for dropping the issue. Many brokerages have preferred to quietly end coverage of stocks to avoid offending the issuing companies.
- Brokerages should prohibit research analysts from participating in marketing activities, including "road shows," for corporate clients that are issuing new shares.
- Analysts who give media interviews or make other public appearances discussing their stock recommendations should make the full research reports available to the public at a reasonable price.
- Corporations should refrain from making accusations against research analysts in the media. Some companies have publicly criticized analysts when the firms haven't liked an analyst's rating of the company.
- Fund managers and other "buy side" investment professionals should be prohibited from threatening to reduce their companies' trading business with a brokerage in an effort to secure a more favorable rating on a security they hold.
- News media should establish formal policies for disclosing conflicts of interest, or potential conflicts, when interviewing analysts or portfolio managers.

Chapter 4 Review Questions

1. New York Corporate Accountability and Listing Standards' new requirements include all the following EXCEPT
 - A. An independent majority on a company's board
 - B. A stricter definition of director independence
 - C. Approval of all equity-based pay plans by the CEO
 - D. The appointment of a lead director solely to run those meetings

2. The new rules by NYSE for corporate governance would
 - A. Weaken the control management currently employs
 - B. Give management stronger governance standards
 - C. Not require investor's approval on any equity-based pay plans
 - D. Allow brokers to vote on equity-based pay plans without client approval

3. Rules approved by SEC to address analyst's conflicts include all the following EXCEPT
 - A. Disclosure during public appearances by analysts
 - B. Disclosure of financial interests in covered companies
 - C. Permission of analyst's compensation for specific investment banking transactions
 - D. Restrictions on personal trading by analysts

4. The SEC rules do NOT encompass
 - A. Conflicts of interest affecting research
 - B. Conflicts of interest affecting dissemination of research
 - C. Conflicts of interest affecting production of research
 - D. Methods of research and investing banking

Chapter 5:

The Sarbanes-Oxley Act and Corporate Governance

The Sarbanes-Oxley Act (Corporate Responsibility Law)

The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act or Corporate and Auditing Accountability and Responsibility Act, commonly called Sarbanes–Oxley, Sarbox or SOX, is a federal law enacted on July 30, 2002, which set new or enhanced standards for all U.S. public company boards, management and public accounting firms. President George W. Bush signed the Sarbanes–Oxley Act of 2002 (Public Law 107-204) on July 30, 2002 (www.whitehouse.gov/infocus/corporate-responsibility/). Congress presented the Act to the president on July 26, 2002, after passage in the Senate by a 99-0 vote and in the House by a 423-3 margin. The law will directly impact the following groups:

1. CPAs and CPA firms auditing public companies;
2. Publicly traded companies, their employees, officers, and owners—including holders of more than 10 percent of the outstanding common shares. This category would include CPAs employed by publicly traded companies as chief financial officers (CFOs) or in the finance department;
3. Attorneys who work for or have as clients publicly traded companies; and
4. Brokers, dealers, investment bankers and financial analysts who work for these companies.

The Act changes how publicly traded companies are audited, and reshapes the financial reporting system. This Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensures justice for wrongdoers, and protects the interests of workers and shareholders.

This bill improves the quality and transparency of financial reporting, independent audits, and accounting services for public companies. It also:

- Creates a Public Company Accounting Oversight Board (www.pcaobus.org) to enforce professional standards, ethics, and competence for the accounting profession;
- Strengthens the independence of firms that audit public companies;
- Increases corporate responsibility and the usefulness of corporate financial disclosure;
- Increases penalties for corporate wrongdoing;

- Protects the objectivity and independence of securities analysts; and
- Increases Securities and Exchange Commission resources.

Note: A summary of the Act is provided in Chapter 8 I while the full text is given In Appendix I.

Under this law, CEOs and chief financial officers must personally vouch for the truth and fairness of their company's disclosures. And those financial disclosures will be broader and better than ever before.

Corporate officials will play by the same rules as their employees. In the periods when workers are prevented from buying and selling company stock in their pensions or 401 (k)s, corporate officials will also be banned from any buying or selling.

Corporate misdeeds will be found and punished. This law authorizes new funding for investigators and technology at the SEC to uncover wrongdoing. The SEC will now have the administrative authority to bar dishonest directors and officers from ever again serving in positions of corporate responsibility. The penalties for obstructing justice and shredding documents are greatly increased.

Specifics

New Public Company Accounting Oversight Board (PCAOB)

- Violations of the Board's rules are deemed to be violations of the Securities Exchange Act of 1934 and are subject to the same penalties. The PCAOB will
 - 1) Register public accounting firms;
 - 2) Establish or adopt by rule standards concerning audit reports;
 - 3) Inspect and investigate accounting firms;
 - 4) Conduct disciplinary proceedings;
 - 5) Impose sanctions; and
 - 6) Enforce compliance with its rules, the act, professional standards, and securities laws relevant to audit reports and the obligations of accountants.
- The audit committee must be directly responsible for appointing, compensating, and overseeing the work of the public accounting firm employed by the issuer. In addition, this audit firm must report directly to the audit committee, not to management. The act requires that each member of the audit committee, including at least one who is a financial expert, be an independent member of the issuer's board of directors. An independent director is not affiliated with, and receives no compensation (other than for service on the board) from, the issuer.
- **Registration with the Board Is Mandatory.** Public accounting firms must register with the FCAOB and be subject to inspection every three years (one for large firms). Furthermore, they must adopt quality control standards.
- **Seven-Year Record Retention Requirement.** PCAOB must adopt a rule to require registered CPA firms to prepare and maintain audit work papers and other information related to an audit for at least seven years in sufficient detail to support the conclusions reached in the audit report. (A separate criminal provision

requires retention of all audit and review workpapers for five years from the end of the fiscal year in which the audit or review was completed.)

- **Cooperation with CPA Groups.** The board will cooperate with professional accountant groups and advisory groups to increase the effectiveness of the standards setting process. (The PCAOB may cooperate, but authority to set standards rests with the PCAOB, subject to SEC review.)
- **Annual Inspections.** Inspection of registered public accounting firms shall occur annually for every registered public accounting firm that regularly provides audit reports for more than 100 issuers (at least once every three years for registered firms that audit fewer than 100 issuers).
- **Investigations.** The board may investigate any act, omission or practice by a registered firm or an individual associated with a registered firm for any possible violation of the act, the board's rules, professional standards, or provisions of the securities laws relating to the preparation and issuance of audit reports.
 - (a) The board may require testimony or documents and information (including audit work papers) from a registered firm or individual associated with a registered firm or in the possession of any other person.
- Sanctions for violations that the board finds may include:
 - (a) Suspension or revocation of a registration;
 - (b) Suspension or bar of a person from further associating with any registered public accounting firm;
 - (c) Limitations on the activities of a firm or person associated with the firm; and
 - (d) Penalize the firm up to \$2 million per violation, up to a maximum of \$15 million.
 - (e) Individuals employed or associated with a registered firm who violate the act can face penalties that range from required additional continuing professional education (CPE) or training, disbarment of the individual from further association with any registered public accounting firm, or even a fine up to \$100,000 for each violation, up to a maximum of \$750,000. (1) A portion of the penalties collected will go to accounting scholarships.
- **Funding.** The law also provides independent funding for the Financial Accounting Standards Board (FASB). While the SEC and American Institute of CPAs (AICPA) both have recognized FASB as the standard setting body for accounting principles, federal authority to issue auditing, quality control, ethics and independence standards may seriously impact the AICPAs' role in official pronouncements.
 - (a) **Source.** The budget for the board and FASB will be payable from "annual accounting support fees" set by the board and approved by the Commission. The fees will be collected from publicly traded companies and will be determined by dividing the average monthly equity market capitalization of the company for the preceding fiscal year by the average monthly equity market capitalization of all such companies for that year.

Other Requirements for CPA Firms

- **Most Consulting Banned for Audit Clients.** Title II of the act prohibits most "consulting" services outside the scope of practice of auditors.
 - (a) These services are prohibited even if pre-approved by the issuer's audit committee.
 - (b) Prohibited services include:
 - Bookkeeping and related services,
 - Design and implementation of financial information systems,

- Appraisal or valuation services (including fairness opinions and contribution-in-kind reports),
- Actuarial services,
- Internal audit outsourcing,
- Services that provide any management or human resources,
- Investment or broker/dealer services, and
- Legal and “expert services unrelated to the audit.”
- Any other service that the board determines, by regulation, is impermissible.

(c) **Services Not Prohibited.** Firms, however, may provide tax services (including tax planning and tax compliance) or others that are not listed, provided the firm receives pre-approval from the board. However, certain tax planning products, like tax avoidance services, may be considered prohibited nonaudit services.

- **Audit Reports Require Concurring Partner Review.** Requires a concurring or second partner’s review and approval of all audit reports and their issuance.
- **“Revolving Door” Employment of CPAs with Audit Clients Is Banned.** A registered CPA firm is prohibited from auditing any SEC registered client whose chief executive, CFO, controller or equivalent was on the audit team of the firm within the past year.
- **Audit Partner Rotation Required.** Audit partners who either have performed audit services or been responsible for reviewing the audit of a particular client must be rotated every five consecutive years. CPAs should read carefully the requirements for rotation of both the partner-in-charge and the concurring review partner for certain organizational constraints.
 - (a) **No Firm Rotation Requirement.** Firm rotation is not required. However, the U.S. Comptroller General will study and review the potential effects of mandatory rotation and will report its findings to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.
- **CPA Firms Are Required to Report Directly to the Audit Committee.** Audit reports to audit committees must include
 1. All critical accounting policies and practices to be used.
 2. All material alternative treatments of financial information within GAAP discussed with management.
 3. Ramifications of the use of alternative disclosures and treatments.
 4. The treatment preferred by the external auditors.
- **CPA Firm Consolidations to Be Studied.** The U.S. Comptroller General will conduct a study analyzing the impact of the merger of CPA firms to determine if consolidation leads to higher costs, lower quality of services, impairment of auditor independence, or lack of choice.
- **Corporate and Criminal Fraud Accountability.** Changes to the securities laws can penalize anyone found to have destroyed, altered, hid or falsified records or documents to impede, obstruct or influence an investigation conducted by any federal agency, or in bankruptcy, with fines or up to 20 years imprisonment, or both.
- **Current Requirements for Audit Firms.** Accountants are required to maintain all audit or review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded.

- **Additional Rules.** The law requires the SEC to promulgate rules and regulations on the retention of any and all materials related to an audit, including communications, correspondence and other documents created, sent or received in connection with an audit or review.
 - (a) **Penalties.** Violating the requirement or the rules that will be developed will result in a fine, or up to 10 years imprisonment, or both.
- **SEC regulations** promulgated under the act prohibit auditors of public companies from performing certain nonaudit services:
 1. Appraisal and other valuation services.
 2. Designing and implementing financial information systems.
 3. Internal auditing or actuarial functions unless the firm reasonably concludes it will not examine such work during the financial statement audit. The Federal Reserve, Federal Deposit Insurance Corporation, Comptroller of the Currency, and Office of Thrift Supervision prohibit public companies and depository institutions with \$500,000,000 or more in assets from outsourcing internal auditing to external auditors.
 4. Management services.
 5. Human resource services.
 6. Bookkeeping if the firm also conducts an audit.
 7. Expert services not pertaining to the audit.
 8. Investment banking or advisory services.
 9. Broker-dealer services.
- Audit firms may continue to provide conventional tax planning and other nonaudit services not listed above to audit clients if preapproved by the audit committee. Moreover, the Board may grant exemptions from these prohibitions on a case-by-case basis subject to approval by the SEC.
- The act created a new 25-year felony for defrauding shareholders of publicly traded companies. This measure is a broad, generalized provision that criminalizes the knowing execution or attempted execution of any scheme or artifice to defraud persons in connection with securities of publicly traded companies or to obtain their money or property in connection with the purchase or sale of such securities. It is intended to give prosecutors flexibility to protect shareholders and prospective shareholders against any frauds that inventive criminals may devise.

Internal Control Report.

Under Section 404 of the act, management must establish and document internal control procedures and include in the annual report a report on the company's **internal control over financial reporting**. This report is to include

1. A statement of management's responsibility for internal control;
2. Management's assessment of the effectiveness of internal control as of the end of the most recent fiscal year;
3. Identification of the framework used to evaluate the effectiveness of internal control (such as the report of the Committee of Sponsoring Organizations);

4. A statement about whether significant changes in controls were made after their evaluation, including any corrective actions; and
5. A statement that the external auditor has issued an attestation report on management's assessment.

Because of Section 404, two audit opinions are expressed: one on **internal control** and one on the **financial statements**. The auditor must attest to and report on management's assessment.

The auditor must evaluate whether the structure and procedures

- Include records accurately and fairly reflecting the firm's transactions.
- Provide reasonable assurance that transactions are recorded so as to permit statements to be prepared in accordance with GAAP.

The auditor's report also must describe any material weaknesses in the controls. The evaluation is not to be the subject of a separate engagement but be in conjunction with the audit of the financial statements.

Of Note to Industry Members—Requirements for Corporations, Their Officers and Board Members

- **No Lying to the Auditor.** The act makes unlawful for an officer or director or anyone acting for a principal to take any action to fraudulently influence, coerce, manipulate or mislead the auditing CPA firm.
- **Code of Ethics for Financial Officers.** The SEC is mandated to issue rules adopting a code of ethics for senior financial officers.
- **Financial Expert Requirement.** The SEC is required to issue rules requiring a publicly traded company's audit committee to be comprised of at least one member who is a financial expert.
- **Audit Committee Responsible for Public Accounting Firm.** The Act vests the audit committee of a publicly traded company with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
- **Audit Committee Independence.** Requires audit committee members to be members of the board of directors of the company, and to otherwise be independent.
- **CEOs & CFOs Required to Affirm Financials.** Chief executive officers (CEOs) and CFOs must certify in every annual report that they have reviewed the report and that it does not contain untrue statements or omissions of material facts.
 - (a) **Penalty for Violation.** If material noncompliance causes the company to restate its financials, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials.
- **CEOs & CFOs Must Enact Internal Controls.** CEOs and CFOs will be responsible for establishing and maintaining internal controls to ensure they are notified of material information.
- **Penalties for Fraud.** The act also has stiffened penalties for corporate and criminal fraud by company insiders. The law makes it a crime to destroy, alter or falsify records in a federal investigation or if a company declares bankruptcy. The penalty for those found guilty includes fines, or up to 20 years imprisonment, or both.

- **Companies Affected by the Act.** Publicly traded companies affected by the Act are those defined as an “issuer” under Section 3 of the Securities Exchange Act of 1934, whose securities are registered under Section 12 of the 1934 Act. An issuer also is considered a company that is required to file reports under Section 15(d) of the Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933. The SEC has yet to provide further guidance as to entities covered by the Act.
- **Debts Not Dischargeable in Bankruptcy.** Amends federal bankruptcy law to make non-dischargeable in bankruptcy certain debts that result from a violation relating to federal or state securities law, or of common law fraud pertaining to securities sales or purchases.
- **Expanded Statute of Limitations for Securities Fraud.** For a civil action brought by a non-government entity or individual, an action involving a claim of securities fraud, deceit or manipulation may be brought not later than the earlier of two years after discovery or five years after the violation.
- **No Listing on National Exchanges for Violators.** The SEC will direct national securities exchanges and associations to prohibit the listing of securities of a noncompliant company.
- **No Insider Trading.** No insider trading is permitted during pension fund blackout periods. The insider must forfeit any profit during this period to the company.
- **SEC Rules on Enhanced Financial Disclosures.**
 - (a) Off-Balance Sheet Transactions: All quarterly and annual financial reports filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities. Disclosure must be made on significant aspects relating to financial condition, liquidity, capital expenditures, resources, and components of revenue and expenses.
 - (b) Pro Forma Figures: Pro forma financial information in any report filed with the SEC or in any public release cannot contain false or misleading statements or omit material facts necessary to make the financial information not misleading.
- **No Personal Loans.** No personal loans or extensions of credit to company executives either directly or through a subsidiary, except for certain extensions of credit under an open-ended credit plan or charge card, home improvement and manufactured home loans, or extensions of credit by a broker or dealer to its employee to buy, trade or carry securities.
 - (a) The terms of permitted loans cannot be more favorable than those offered to the general public.

Criminal Penalties Enhanced*

BEHAVIOR	SENTENCE
The alteration, destruction, concealment of any records with the intent of obstructing a federal investigation.	Fine and/or up to 10 years imprisonment.
Failure to maintain audit or review “workpapers” for at least five years.	Fine and/or up to 5 years imprisonment.
Anyone who “knowingly executes, or attempts to execute, a scheme” to defraud a purchaser of securities.	Fine and/or up to 10 years imprisonment.
Any CEO or CFO who “recklessly” violates his or her certification of the company’s financial statements. If violation is willful.	Fine of up to \$1,000,000 and/or up to 10 years imprisonment. Fine of up to \$5 million and/or up to 20 years imprisonment.
Two or more persons who conspire to commit any offense against or to defraud the U.S. or its agencies.	Fine and/or up to 10 years imprisonment.
Any person who “corruptly” alters, destroys, conceals, etc., any records or documents with the intent of impairing the integrity of the record or document for use in an official proceeding.	Fine and/or up to 20 years imprisonment.
Mail and wire fraud.	Increase from 5 to 20 years imprisonment.
Violating applicable Employee Retirement Income Security Act (ERISA) provisions.	Various lengths depending on violation.

* Source: Sarbanes-Oxley Act of 2002 and New York City Office of the Comptroller.

Analyst Conflicts of Interest

There are two major provisions regarding analyst conflicts of interest. They are: no retaliation against analysts and conflict-of-interest disclosures.

- **No Retaliation against Analysts.** Brokers and dealers of securities are not allowed to retaliate or threaten to retaliate against an analyst employed by the broker or dealer as a result of an adverse, negative or unfavorable research report on a public company.
- **Conflict of Interest Disclosures.** Securities analysts and brokers or dealers are required to disclose conflicts of interest, such as:
 - (a) Whether the analyst has investments or debt in the company she is reporting on;

- (b) Whether any compensation received by the broker, dealer or analyst is “appropriate in the public interest and consistent with the protection of investors;”
- (c) Whether an issuer has been a client of the broker or dealer; and
- (d) Whether the analyst received compensation with respect to a research report based on investment banking revenues.

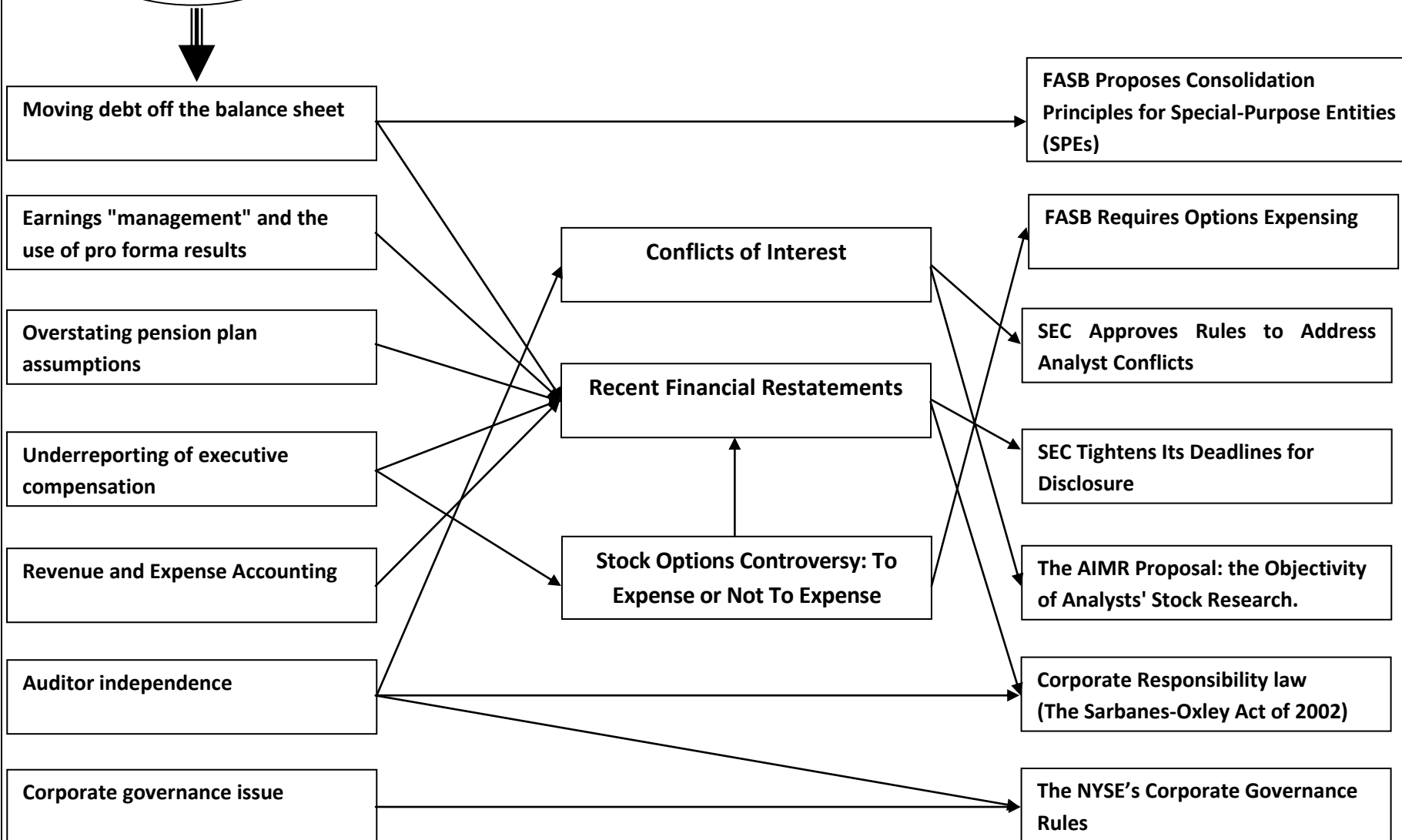
Attorney Requirements

- **Requirement on Attorneys to Report Violations.** The SEC is required to issue rules setting forth minimum standards of professional conduct for attorneys appearing and representing a public company in any manner in front of the Commission. As part of this requirement, the SEC will be required to issue rules on the following:
 - (a) Requiring attorneys employed by a public company to report to the chief counsel or CEO of the company, evidence of a “material” violation of securities law, breach of fiduciary duty, or similar violation by the company or its agent.
 - (b) Once reported, if the counsel or CEO does not appropriately respond to the evidence, the attorney must report the evidence to the board of directors or its audit committee.

Exhibit 1 summarizes points of controversy and related proposals and legislation.

**Points of
Controversy**

Exhibit 1
Points of controversy and related proposals and legislation



Corporate Governance

In the heels of corporate scandals including the Enron debacle in 2002, a series of sweeping changes were sought, such as forcing boards to have a majority of independent directors, granting audit committees power to hire and fire accountants, banning sweetheart loans to officers and directors, and requiring shareholders' approval for stock option plans.

Landmarks in Corporate Governance

The following is a list of key landmarks that transpired in chronological order, in corporate governance.

November 2001

Enron, one of the world's largest energy companies, admits to irregularities in its accounts between 1997 and 2000, reporting that the special-purpose entities (SPEs) should have been consolidated on its balance sheet, substantially reducing earnings for those years. On December 2, Enron files for bankruptcy.

January 2002

Andersen, the Chicago-based accounting firm and auditor of Enron, admits shredding or deleting thousands of documents relating to Enron. In 2001, Enron paid Andersen \$25 million for audit services and another \$27 million for non-audit services. On June 15, a court finds Andersen guilty of obstructing justice.

March 2002

U.S. telecommunications group WorldCom admits that the SEC is conducting an informal investigation into its accounting practices. Founder and chief executive **Bernie Ebbers** steps down in April, followed by CFO Scott Sullivan in June, amid claims of a \$3.8 billion fraud at the company.

April 2002

Eliot Spitzer, the attorney general for the State of New York, presents the results of an investigation into conflicts of interest among Wall Street analysts. He reveals internal e-mails from investment banks showing that analysts denigrated companies in private while issuing public recommendations to buy.

July 2002

The U.S. Congress passes the **Sarbanes-Oxley Act**, the most significant change to U.S. business regulations in 70 years. The Act creates tough new penalties for corporate fraud, prevents accounting firms from offering consulting services to audit clients and places restrictions on financial analysts.

January 2003

The U.K.'s **Higgs Report**, a government-sponsored review of non-executive directors, proposes reforms to corporate governance rules to strengthen the role of independent directors. The Smith Report published at the same time, clarifies the relationships between auditors, boards and audit committees.

May 2003

Investors revolt against **GlaxoSmithKline's pay policy** for CEO Jean-Pierre Gamier, which included a two-year notice period and a generous severance package. This is the first time U.K. shareholders have rejected a compensation package. It signals a new readiness for intervention among institutional investors.

July 2003

Microsoft announces that it will henceforth reflect the cost of stock option awards in its accounts, becoming the first large technology company to do so, and it will also cease awards of stock options to employees instead awarding restricted stock that would pass into employees' ownership after five years.

July 2003

Alan Greenspan, chairman of the Federal Reserve, warns Congress that a "pervasive sense of caution" is stifling entrepreneurial risk-taking investment and job creation. William Donaldson, chairman of the SEC, the chief financial regulator in the U.S., voices concern about "the loss of risk-taking zeal."

August 2003

In his report on corporate governance reforms at MCI (formerly, WorldCom), former SEC chairman **Richard Breen** recommends 77 measures to prevent corporate governance failure at the company including all board members except the CEO to be independent and one new director to be nominated each year.

September 2003

A public uproar over the **NYSE's CEO Richard Glasso's** \$139.5 million payout of accumulated benefits and other savings and additional \$48 million obliged Glasso to resign on September 17, 2002, and changes in the board are expected to follow. Just one month before, SEC Chairman William H. Donaldson had taken on the issue in the bluntest possible terms. "One of the great, as-yet-unsolved problems in the country today is executive compensation and how it is determined," he told a National Press Club audience in August. Regulators and shareholders want compensation committees to explain why CEOs make so much.

September 2003

New York State Attorney General Eliot Spitzer, Massachusetts regulators and the SEC are on a rampage against mutual fund firms for allowing illegally market-timed trades. The first to be charged: **Putnam Investments**.

May, 2004

The SEC ruled that mutual fund managers must report any personal trading they do in the funds they oversee, counting on greater disclosure to help prevent trading abuses that plunged the industry into scandal last year. In a separate action, the SEC ordered mutual fund companies to clearly inform customers of discounts for which they may qualify; the agency had found that many customers missed out on lower rates they should have gotten. The SEC and the National Assn. of Securities Dealers levied penalties of \$21.5 million on 15 firms, including **Wachovia Securities**, **UBS Financial Services** and **American Express Financial Advisors**, to settle charges that they did not provide breakpoints to eligible customers in 2001 and 2002.

March 29, 2005

Regulatory investigations launched by the Securities and Exchange Commission and New York State Attorney General Eliot Spitzer into financial deals **AIG** structured for customers forced **American Insurance Group Inc. (AIG)** Chairman Maurice "Hank" Greenberg to retire, effective either March 30 or 31. Greenberg, 79, is generally credited with building AIG into a global insurance powerhouse during his 37 years at the company. But he leaves amid a hornet's nest of controversy. Those deals include transactions related to finite insurance products—a nontraditional insurance offering.

May 25, 2006

Enron former chief executive **Jeffrey Skilling** and founder **Kenneth Lay** were both found guilty Thursday of conspiracy and fraud in the granddaddy of all corporate fraud cases.

On the sixth day of deliberations, a jury of eight women and four men convicted the former executives of

misleading the public about the true financial health of Enron, whose collapse in late 2001 symbolized the wave of corporate fraud that swept the United States early this decade.

Skilling was found guilty on 19 counts of conspiracy, fraud, false statements and insider trading. He was found not guilty on nine counts of insider trading. Lay was found guilty on all six counts of conspiracy and fraud. In a separate bench trial, Judge Sim Lake ruled Lay was guilty of four counts of fraud and false statements. Both Lay and Skilling could face 20 to 30 years in prison, legal experts say. And Lay will also face an additional hefty term in prison for his conviction in the bank fraud case.

September 26, 2006

Former **WorldCom Corp.** chief **Bernard Ebbers** starts a 25-year federal prison sentence on this day for his role in the \$11 billion accounting fraud that toppled a company he had built from a tiny telecommunications firm to an industry giant.

August 8, 2007

The founder and former chairman, **Ryan Brant**, of **Take-Two Interactive Software Inc.**, publisher of the “Grand Theft Auto” video games, became the first CEO to be convicted of backdating stock options to boost their value. Companies open themselves up to a host of possible criminal penalties by backdating options, such as falsification of business records, wire fraud, and mail fraud. Take-Two Interactive Software’s former general counsel, **Kenneth I. Selterman**, was sentenced to three years of probation for falsifying a letter to regulators. **Gregory L. Reyes**, the former head of **Brocade Communications Systems**, was convicted of conspiracy and securities fraud related to options backdating. More than 200 companies have disclosed internal or federal investigations into whether they inflated the value of options awarded to executives by backdating or timing the grants to coincide with relatively low stock prices.

January 9, 2009

Satyam Computer Services Chairman Ramalinga Raju confessed that Satyam's balance sheet as of the September 30, 2008, carried inflated figures for cash and bank balances of INR 5,040 crore (as against INR 5,361 crore reflected in the books). On 7 January 2009, Raju resigned after notifying its board members that he had falsified Satyam's accounts. The World Bank has banned Satyam from doing business with it for 8 years due to inappropriate payments to the World Bank's staff. UK mobile payments company Upaid Systems is suing Satyam for over 1 billion dollars on complaints of fraud, forgery and breach of contract.

Financial Literacy Training Can Be Very Helpful

The NYSE and NASDAQ require a financial literacy requirement on the rest of the audit committee for all companies that list on the markets. Corporate governance may benefit from management's financial literacy training. Corporate governance experts are alarmed about the low rates financial literacy found on boards and among senior executives. An accounting and finance course will prepare board members to pose tougher questions during internal control panel meetings. Financial literacy generally means knowing how to read financial statements, exposing to financial and accounting concepts (for example, weighted average cost of capital (WACC), and understanding financial metrics (for example, economic value added (EVA)) used to evaluate business performance.

SEC Approves New Listing Standards

In September, 2004, the SEC approved new listing standards for the NYSE and NASDAQ that require companies to have regular meetings of nonmanagement directors.

SEC Restricts Mutual Funds' Broker Rewards

The new rule (www.sec.gov/rules/) bars asset managers from giving business to brokerages for promoting their investment offerings. Federal regulators voted in August 18, 2004 to bar mutual fund companies from giving brokers lucrative trading business as an incentive to peddle their funds. So-called directed brokerage arrangements have been criticized as thinly disguised kickbacks that inflate trading costs and encourage brokers to tout funds based on how much trading business they get, instead of recommending funds that are best for their clients. The Securities and Exchange Commission voted unanimously to ban the practice and separately voted to require fund companies to disclose more information on fund managers. It was the latest step aimed at ending conflicts of interest in the \$7.6-trillion mutual fund industry.

The ban on directed brokerage deals will take effect in about three months. In a separate action Wednesday, the commission voted to require fund companies to disclose new information about their portfolio managers, including how they determine their pay.

The disclosure is intended to help shareholders figure out whether managers are paid based on whether they improve the performance of the fund (which helps shareholders), or whether pay is for what they do to improve fund-company earnings, such as boosting assets.

Fund groups also would have to reveal whether managers own stakes in their funds. In addition, companies would have to tell investors if managers handle other accounts, such as hedge funds, that could create a conflict.

Finally, investors would receive detailed information about the top five people responsible for the investment decisions of each fund.

Mandatory Evaluation of Board Performance

Corporate governance guidelines now require or encourage companies to evaluate board performance. The NYSE's guidelines on corporate governance require companies to "address" evaluation. In the United Kingdom, under the Combined Code, evaluation is mandatory. Elsewhere, evaluation is becoming best practice for company boards. However, for boards wondering how to go about the task, the regulatory authorities and stock exchanges provide frustratingly little guidance. But opinions differ on how this should be done: by self-assessment or with independent evaluators.

Pros of outside evaluators include:

- *Improved market perception.* Companies that initiate a board review are likely to be looked on favorably by investors.
- *Lower governance risk.* Corporate insurers may regard external review as a risk-reducing measure.
- *Detecting problems.* Obstacles are more likely to be identified and addressed.

Cons of external assessors include:

- *Costs.* Consultancy fees for a review of board performance can be high.
- *Quality.* External review of board performance is a relatively young discipline, raising doubts about its efficacy.
- *Confidentiality.* Many boards are wary of revealing details of meetings and working processes.

FASB Affirms Securitization Changes Effective 2010; Releases Proposal On FIN 48 For Pass-Throughs

On May 18, 2009, FASB voted to retain the effective date of its upcoming amendments to FAS 140, Transfers of Assets, and FIN 46R, Consolidation of Variable Interest Entities, such that the new standards - widely reported* to potentially place billions of dollars of off-balance sheet securitizations back on the balance sheet – will be effective as of the beginning of 2010. (Technically, the effective date is as of the beginning of the first fiscal year beginning after Nov. 15, 2009.) * The 'billions' amount was cited most recently in Ian Katz' report in Bloomberg earlier today: FASB Will Force Banks To Move Assets to Balance Sheets. The change could result in about \$900 billion in assets being brought onto the balance sheets of the nation's 19 largest banks, according to federal regulators. The information was provided by Citigroup Inc., JPMorgan Chase & Co. and 17 other institutions during the government's recent "stress tests," which were designed to determine which banks would need more capital if the economy worsened. In its quarterly regulatory filing earlier this month, Citigroup said the rule change could have "a significant impact" on its financial statements. Citigroup estimated it would result in the recognition of \$165.8 billion in additional assets, including \$90.5 billion in credit card loans. JPMorgan estimated

in its quarterly filing that the impact of consolidation of the bank's qualifying special purpose entities and variable interest entities could be up to \$145 billion.

Computer Software and Information Technologies That Lends a Helping Hand to Compliance

Technology would seem the obvious solution to the corporate governance and compliance problem. Much of governance is a matter of putting rules in place and ensuring that they are followed. Corporate finance systems, historically among the first business systems to be computerized, have always worked in just such a fashion. Why shouldn't they merely be tweaked to take new rules into account?

Unfortunately, it's not quite that simple. The first problem is that the scale of new governance standards brings many different corporate systems — not just the finance function —into the picture. Customer databases, human resources systems, document management and electronic collaboration tools - all can contain data relevant to corporate governance. In addition, the ever-changing nature of regulation means that systems have to be kept up-to-date. This requires constant planning and monitoring on the part of the IT director.

The main problem for companies is documentation, including internal controls and the retention of documents. For this reason, good document management systems—which trace the history of all documents and allow for their fast retrieval—are key to any company seeking to comply with corporate governance standards. Specialized secure electronic storage areas must be established to store documents, a task made slightly less onerous thanks to the falling price of storage hardware. In addition, corporate policies on the retention of documents must be clearly articulated, when in the past they may have been only implicit.

Even e-mail has fallen under scrutiny. New accounting standards mean that audit trails must be established showing exactly how executives arrived at conclusions such as the valuation of assets. As such discussions are now just as likely to take place electronically as at physical meetings, any e-mails in which valuation was discussed would also be implicated. At present, these vital communications are simply thrown onto a server along with every other e-mail and, after a period of time, deleted to make room for more. Rooting out and keeping these documents can be an IT management nightmare.

Compliance with corporate governance standards is likely to be costly. Gartner Group estimates that Fortune 1000 companies have each spent about \$2 million bringing themselves into line with the Sarbanes-Oxley Act, and about 20 per cent of that expenditure is reckoned to have gone on software.

The most important issue [with corporate governance] is trying to make the accounts that companies present as meaningful and accurate as possible, so that investors and auditors can have confidence in what's being presented. In achieving this, one of the greatest difficulties that companies face is grappling with the subtle distinctions between accounting and finance systems in different countries. Companies need to put in place systems that allow them to compare apples with apples across different territories. That can be very detailed, but if you don't do that, you won't have the transparency you need.

The sheer volume of data presents further problems. Companies should try to simplify their systems, bringing more of their databases within a single overarching structure and reducing the number of points at which data enters the system. At all costs, companies must avoid rigid IT systems that will become a headache to change every time the accounting regulations are tweaked or new regulations come into force. You need flexibility and anything hardcoded is a dead end.

Technology is just an enabler. Once you have a governance structure agreed at a corporate level, you can use IT to support it. Don't build governance around the IT that you have; your IT systems should be made to fit your business.

Policies and procedures need to be worked out first, in detail, to calculate the best ways of complying with all the regulations that pertain to your company. Only then should the IT department be brought in to figure out what updates need to be made to the existing systems, to decide whether new technology investments are needed and to implement the changes and the procedures that have been deemed necessary.

To a large degree, successful corporate governance depends on people: This is a management issue. People need training around governance. They need to be given the skills. People are central.

For a company specializing in electronic invoicing, however, the real answer may not lie with people, or with the strict implementation of dedicated compliance systems to enforce every detail of corporate governance regulation. Instead, it's about eliminating manual intervention. If you automate your existing processes, you can achieve this. Automated systems, such as enterprise resource planning applications, are more transparent than those requiring manual intervention, and less prone to fraud.

Whatever path to compliance companies choose, timing is an important factor. Many companies have already fallen behind in complying with key governance regulations, such as Sarbanes-Oxley and the forthcoming Basel II rules. But, they need to get to grips with the issues before it is too late. The financial community alone isn't spending anything like the money it should if it's going to take Basel II, Sarbanes-Oxley and other legislation seriously. Why not? Are they waiting for the first bloke to go to jail?

Six Technologies That Can Assist with Compliance

Much of governance is a matter of putting rules in place and ensuring that they are followed. Technology can provide the solutions to the corporate governance and compliance problem. It includes computer software for: business intelligence, business process management, document management, e-mail management, financial and accounting software, and enterprise resource planning.

Business intelligence: Regulatory requirements for "real-time" disclosure of factors that affect financial performance mean that executives need access to timely, relevant data from all areas of the business. By drilling down into financial and company data and providing sophisticated reporting and analysis tools, business intelligence software can help ensure the accessibility of information.

Business process management (BPM): Businesses have traditionally been built around functional "silos", making it difficult to share information and obtain a consistent, enterprise-wide view. By extracting businesses processes from the underlying application code into an independent management layer, BPM software can help improve visibility.

Document management: New corporate governance standards mean that companies need an efficient system for storing and retrieving important records and documents. Software packages that maintain audit trails of documents and set controls over how, where and for how long files are stored can help companies meet these obligations.

E-mail management: As the volume of e-mail continues to soar, the logistics of storing essential e-mails and being able to retrieve them quickly become increasingly complex. And with new regulatory requirements around internal controls and disclosure obligations, the need for comprehensive e-mail management software becomes ever-more compelling.

Financial and accounting software: To help comply with new standards such as Sarbanes-Oxley, many vendors are giving their traditional financing and accounting software a boost with additional modules that help with risk management, more accurate budgeting and forecasting, financial analysis and the establishment of internal financial controls.

Enterprise resource planning (ERP): ERP software can give organizations a consistent financial view across all divisions, thereby helping to maintain the accuracy of financial information. Many ERP providers are adding modules to their software to assist with compliance with Sarbanes-Oxley and other corporate governance standards.

Chapter 5 Review Questions

1. The Sarbanes-Oxley Act of 2002 adopted tough new legislation to
 - A. Deter and punish accounting fraud and corruption
 - B. Ensure justice for wrongdoers
 - C. Protect the interest of workers and shareholders
 - D. All the above

2. _____ admitted to accounting irregularities, such as using special purpose entities (SPE) to move debt off its balance sheet.
 - A. Microsoft
 - B. Enron
 - C. Andersen
 - D. Glaxo-SmithKline

3. In 2002 an investigation of U.S. telecommunications group (WorldCom) led to claims of accounting irregularities and 3.8 billion frauds against
 - A. Eliot Spitzer
 - B. Chief Executive Ebberts
 - C. CEO Jean-Pierre Gamier
 - D. Alan Greenspan

4. Regulatory bodies responsible for monitoring and enforcing the Sarbanes-Oxley Act are
 - A. SEC, PCAOB
 - B. CEO, CFO
 - C. DBA, MBA
 - D. S&P, Moody's

5. Which section of the Sarbanes-Oxley Act requires the CEO and CFO to certify the fairness of a company's financial information?
 - A. Section 302

- B. Section 906
- C. Section 404
- D. Section 101

6. _____ was the first CEO to be convicted of backdating stock options to boost their value.

- A. Kenneth I. Seltermann
- B. Gregory L. Reyes
- C. Ryan Brant
- D. Bernard Ebbers

7. The obvious solution to the corporate governance compliance problem would seem to be

- A. Putting rules in place
- B. Use technology to assist with compliance
- C. Estimating the cost of compliance
- D. Developing a manual file system

8. Which of the following is *NOT* a new technology that can assist with SOX compliance?

- A. Business intelligence
- B. Business process management
- C. Microfiche
- D. Document and e-mail management

Chapter 6:

Section 404, 302 and 906

Section 404 of the Sarbanes-Oxley Act

Section 404 of the Sarbanes-Oxley Act — "Enhanced Financial Disclosures, Management Assessment of Internal Control" — mandates sweeping changes. Section 404, in conjunction with the related SEC rules and Auditing Standard (AS) No. 5, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (Auditing Standard No. 2), established by the Public Company Accounting Oversight Board (PCAOB), requires management of a public company and the company's independent auditor to issue new reports at the end of every fiscal year. These reports must be included in the company's annual report filed with the Securities and Exchange Commission (SEC).

- Management must report annually on the effectiveness of the company's internal control over financial reporting.
- In conjunction with the audit of the company's financial statements, the company's independent auditor must issue a report on internal control over financial reporting, which includes both an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting.

In the past, a company's internal controls were considered in the context of planning the audit but were not required to be reported publicly, except in response to the SEC's Form 8-K requirements when related to a change in auditor. The new audit and reporting requirements have drastically changed the situation and have brought the concept of internal control over financial reporting to the forefront for audit committees, management, auditors, and users of financial statements.

The Auditing Standard No. 5 highlight the concept of a significant deficiency in internal control over financial reporting, and mandate that both management and the independent auditor must publicly report any material weaknesses in internal control over financial reporting that exist as of the fiscal year-end assessment date. Under both PCAOB Auditing Standard No. 2 and the SEC rules implementing Section 404, the existence of a single material weakness requires management and the independent auditor to conclude that internal control over financial reporting is not effective. The main features of the AS No. 5 are summarized later in the chapter.

Internal Control over Financial Reporting

Internal control over financial reporting is a process designed and maintained by management to provide

reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with United States GAAP. It encompasses the processes and procedures management has established to:

- Maintain records that accurately reflect the company's transactions
- Prepare financial statements and footnote disclosures for external purposes and provide reasonable assurance that receipts and expenditures are appropriately authorized
- Prevent or promptly detect unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements

Internal control over financial reporting is defined more narrowly than the general term "internal control," which includes controls associated with the effectiveness and efficiency of operations and compliance with laws and regulations that are not directly related to the financial statements. For example, controls to improve safety or streamline manufacturing processes are not considered part of internal control over financial reporting.

An effective internal control structure involves people at all levels of the organization. It includes those who maintain accounting records, prepare and disseminate policies, monitor systems, and function in a variety of operating roles. In addition, a company's internal control over financial reporting is influenced significantly by its board of directors and the audit committee, which has ultimate responsibility for oversight of the financial reporting process.

The concept of reasonable assurance is integral to the definition of internal control over financial reporting and to management's assessment and the independent: auditor's opinions.

Reasonable assurance refers to the fact that internal controls — even when they are appropriately designed and operating effectively — cannot provide absolute assurance of achieving control objectives. Inherent limitations include the potential for human error or circumvention of controls. Reasonable assurance is a high level of assurance, but it is not absolute — it recognizes that even with an effective system of internal control over financial reporting, there is a possibility that material misstatements, including misstatements due to management fraud, may occur and not be prevented or detected on a timely basis.

It should be noted that the role of internal control over financial reporting is to support the integrity and reliability of the company's external financial reporting processes. It is not intended to provide any assurances about the company's operating performance, its future results, or the quality of its business model.

Responsibilities of Management and the Independent Auditor with Respect to Internal Control over Financial Reporting

Management is responsible for designing and implementing the system of internal control over financial reporting, for evaluating the effectiveness of internal control over financial reporting, and for issuing a public

report on that assessment. Management is to base its assessment on a suitable, recognized control framework, such as that established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and support its evaluation with sufficient documented evidence.

Auditor's role. Before the Sarbanes-Oxley Act was passed, the auditor was required to obtain an understanding of internal control sufficient to plan the audit of the financial statements. If material weaknesses were identified, they ordinarily were reported only to management and the audit committee. Section 404 now requires the auditor to perform an independent audit of internal control over financial reporting and to issue a report including two opinions — one on management's assessment and one on the effectiveness of internal control over financial reporting.

Audit of Internal Control over Financial Reporting

The auditor's attestation of management's assessment and the auditor's independent procedures to test internal control over financial reporting are collectively referred to in Auditing Standard No. 2 as the "audit of internal control over financial reporting." The objective of the audit of internal control over financial reporting is to obtain reasonable assurance about whether any material weaknesses exist as of the date of management's assessment.

Structure of the New Reporting Model

In the past, the independent auditor provided an opinion on whether the company's financial statements were presented fairly in all material respects, in accordance with United States GAAP. The new reporting model maintains this historical requirement for the auditor to express an opinion on the financial statements. Section 404 also institutes additional requirements for management and the independent auditor to report on the effectiveness of internal control over financial reporting, as shown below:

Historical Reporting

- Independent auditor's opinion on 'whether the financial statements are presented fairly in all material respects, in accordance with United States GAAP

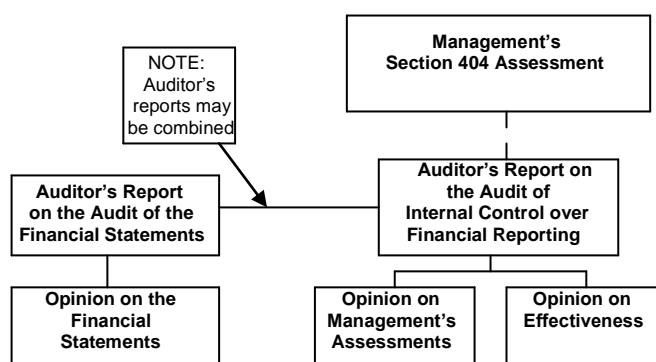
New Reporting

- *Management's report* on its assessment of the effectiveness of the company's internal control over financial reporting
- *Independent auditor's report* on internal control over financial reporting, including the auditor's opinions on: (1) whether management's assessment is fairly stated in all material respects (i.e., whether the auditor concurs with management's conclusions about the effectiveness of internal control, over financial reporting), and (2) the effectiveness of the company's internal control over financial reporting

The independent auditor's opinions on the financial statements and on internal control over financial reporting may be issued in a combined report or in separate reports. Exhibit 4 identifies the various reports, and reflects the fact that management's assessment of internal control over financial reporting constitutes the starting point for the auditor's reporting.

Exhibit 4

Section 404 Reporting



Management's Report

Neither the Sec nor the PCAOB has issued a standard or illustrative management report on internal control over financial reporting; thus, there may be differences in the nature and extent of the information companies provide. We advise companies to consult with legal counsel on these matters. At a minimum, management's report on internal control over financial reporting should include the following information:

- Statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting.
- Statement identifying the framework used by management to evaluate the effectiveness of internal control over financial reporting.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control is effective and disclosing any material weaknesses identified by management in that control.
- Statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's internal control assessment.

Management's report must indicate that internal control over financial reporting is either:

- *Effective* — Internal control over financial reporting is effective (i.e., no material weaknesses in internal control over financial reporting existed as of the assessment date); or
- *Ineffective* — Internal control is not effective because one or more material weaknesses existed as of management's assessment date.

Management is required to state *whether or not* the company's internal control over financial reporting is effective. A negative assurance statement, such as "nothing has come to management's attention to suggest internal control is ineffective" is not acceptable.

If a material weakness exists as of the assessment date, management is required to conclude that internal control over financial reporting is not effective and to disclose all material weaknesses that may have been identified. The SEC Chief Accountant has stated publicly that he expects management's report to disclose the nature of any material weakness in sufficient detail to enable investors and other financial statement users to understand the weakness and evaluate the circumstances underlying it.

Management may not express a qualified conclusion, such as stating that internal control is effective except to the extent certain problems have been identified. If management is unable to assess certain aspects of internal control that are material to overall control effectiveness, management must conclude that internal control over financial reporting is ineffective. Although management cannot issue a report with a scope limitation, under specific conditions newly acquired businesses or certain other consolidated entities may be excluded from the assessment.

SOX in Action:

In response to the requirements of the Sarbanes-Oxley Act of 2002, companies have placed a renewed focus on their accounting systems to ensure relevant and reliable information is reported in financial statements. One study of first compliance with the internal-control testing provisions of the SOX documented material weaknesses for about 13 percent of companies reporting in 2004 and 2005. In 2006, material weaknesses declined, with just 8.33 percent of companies reporting internal control problems. At the same time, companies reported a 5.4 percent decline in audit costs to comply with Sarbanes-Oxley internal control audit requirements.

Sources: L. Townsend, "Internal Control Deficiency Disclosures—Interim Alert," Yellow Card—Interim Trend Alert (April 12, 2005), Glass, Lewis & Co., LLC. K. Pany and J. Zhang, "Current Research Questions on Internal Control over Financial Reporting Under Sarbanes-Oxley," The CPA Journal (February 2008), p. 42. FEI Audit Fee Survey: Including Sarbanes-Oxley Section 404 Costs (April 2008).

The Independent Auditor's Report

Under Auditing Standard No. 2, the auditor is required to evaluate management's assessment and to express an opinion on that assessment. In addition, the auditor must independently audit and report on the effectiveness of internal control over financial reporting. The content of the auditor's report on internal control over financial reporting is prescribed by Auditing Standard No. 2. Although there are many nuances to the auditor's reporting, the most common external auditor reports are likely to be:

- *Unqualified opinions* on both management's assessment and on the effectiveness of internal control over financial reporting.

An opinion that management's assessment is fairly stated in all material respects, along with an opinion that internal control over financial reporting is effective in all material respects as of the assessment date.

- *Unqualified opinion* on management's assessment that internal control over financial reporting is ineffective and adverse opinion on the effectiveness of internal control over financial reporting.

An opinion that management's assessment (that internal control over financial reporting is not effective) is fairly stated in all material respects, along with an opinion that internal control over financial reporting is ineffective because of one or more material weaknesses.

When one or more material weaknesses exist as of the assessment date, the auditor must express an adverse opinion on the effectiveness of the company's internal control over financial reporting. The auditor will still render an unqualified opinion on management's assessment if management properly reported the material weakness and concluded in its assessment that internal control over financial reporting was ineffective.

If the auditor disagrees with management about whether a material weakness exists (i.e., the auditor concludes a material weakness exists but management does not), the auditor will render an adverse opinion on management's assessment.

Auditing Standard No. 2 indicates that when expressing an adverse opinion on the effectiveness of internal control over financial reporting, the auditor should provide specific information about the nature of the material weakness and its actual and potential effect on the company's financial statements. The PCAOB has also stated that it expects disclosure sufficient to allow users to understand the weakness and its actual and potential implications on the financial statements.

Exhibit 5 summarizes the most likely reporting scenarios:

Exhibit 5
Most Likely Reporting Scenarios - Internal Control over Financial Reporting

	Auditor's Report			
	Management's Report	Management's Assessment	Effectiveness of ICR(2)	Financial Statement
No material weakness identified	Effective	Unqualified	Unqualified	Unqualified

Material weakness identified by management and the auditor	Not Effective	Unqualified	Adverse	Unqualified(1)
Material weakness identified by the auditor, not by management (3)	Effective	Adverse	Adverse	Unqualified

1 Presumes; the auditor is able to perform sufficient procedures to conclude that the financial statements are fairly stated

2 Internal control over financial reporting

3 In this situation, management and the auditor disagree on whether a control deficiency constitutes a material weakness.

Disclaimer of opinion. A disclaimer of opinion is a report stating that because of restrictions on the scope of the auditor's work, the auditor is unable to, and does not, express an opinion on management's assessment or on the effectiveness of internal control over financial reporting.

A disclaimer may be issued in situations where the auditor believes management's assessment process is inadequate or where there are restrictions on the scope of the auditor's work. In a disclaimer situation, the auditor's report must also disclose, any material weaknesses that have been identified.

If management simply decides to forgo the required testing or documentation needed to form a sufficient basis for management's assessment, the auditor is precluded from rendering an opinion, because management, did not fulfill its responsibilities. In these instances, the auditor either disclaims an opinion both on management's assessment and on the effectiveness of internal control over financial reporting, or withdraws from the engagement.

Material Weakness

Effective internal control over financial reporting encompasses management policies and procedures to provide reasonable assurance about the reliability of a company's financial reporting and its processes for preparing financial statements in accordance with GAAP. A control deficiency exists when the design or operation of a control does not allow for the prevention or detection of misstatements on a timely basis. Companies may have control deficiencies in the design of a control or in its operation.

- **Design** — A deficiency in design exists when a necessary control is missing or is not designed in a manner that enables the control objective to be met.
- **Operating Effectiveness** — A deficiency in operating effectiveness exists when a properly designed control is not operating as intended or when the person performing the control lacks the authority or qualifications to do so effectively.

The seriousness of a given deficiency or combination of deficiencies depends on both (i) the likelihood that a misstatement of an account balance or disclosure could result and (ii) the magnitude of the related potential misstatement.

Deficiencies in internal control over financial reporting may be assessed as control deficiencies, significant deficiencies, or material weaknesses. These varying levels of deficiency are discussed in Auditing Standard No. 2, as follows:

- *Control deficiency* — A deficiency when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- *Significant deficiency* — A control deficiency or combination of control deficiencies that adversely affects the company's ability to record or report external financial data reliably in accordance with GAAP, such that there is more than a remote likelihood that a misstatement of a company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. Significant deficiencies will be reported to a company's audit committee.
- *Material weakness* — A significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Essentially, a material weakness is a deficiency that could result in a material misstatement. It does not mean that a material misstatement has occurred or that it will occur, but that it could occur. Material weaknesses existing at the fiscal year-end assessment date will be reported publicly.

Significant judgment goes into evaluating whether deficiencies in controls rise to the level of a material weakness. Management and the auditor must consider the following factors when evaluating control deficiencies:

- *Likelihood of a misstatement* — Including consideration of factors such as susceptibility to fraud; the cause and frequency of exceptions in the operating effectiveness of the control; possibility of future consequences; the nature of the affected accounts and disclosures; the subjectivity, complexity, or extent of judgment required to determine the amount involved; the interaction or relationship of the control with other controls; and the interaction of deficiencies.
- *Related magnitude of a potential misstatement* — Including the financial statement amounts or total of transactions exposed to the deficiency and/or the volume of activity in the account: balance or class of transactions exposed to the deficiency in the current period or expected in future periods.

In addition, management and the auditor will consider the effect of compensating controls: that is, whether other effective controls are in place that would identify an error and address the objective not being met by the deficient control.

Exhibit 6 illustrates these concepts.

Exhibit 6 Internal Control Deficiencies

Type	Likelihood	Magnitude	
Control Deficiency	Remote	and/or	Inconsequential
Significant Deficiency	More than Remote	and	More than inconsequential (but less than material)

Material Weakness	More than Remote	and	Material to Financial Statements
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Key Points of Auditing Standard No. 5

1. Focus the audit of internal control over financial reporting on the most important matters

AS5 articulates a key principle that a direct relationship exists between the risk of material weakness and the amount of auditor attention given to that area. It requires auditors to use a top-down, risk-based approach, beginning with the financial statements and company-level controls, and requires the auditor to perform a walk-through for each significant process before selecting the controls to test. Using this assessment, the auditor selects the controls to test based on the risk of a material weakness. AS5 emphasizes the integration of the financial statement audit with the audit of internal control over financial reporting.

2. Provide explicit and practical guidance on scaling the audit to fit the size and complexity of the company

These provisions do not create a separate standard for smaller companies. Instead, AS5 explicitly requires the auditor to tailor the nature, extent and timing of testing to meet the unique characteristics of smaller companies.

3. Eliminate procedures that are unnecessary to achieve the intended benefits

AS5 links the testing of specific controls to a risk assessment of that control. This means that the risk of a specific control not being effective should drive the nature, extent and timing of testing performed and evidence of effectiveness obtained for that control.

4. Require auditors to consider whether and how to use the work of others

AS5 allows auditors to place greater reliance on testing completed by management and the internal audit function. The scope of the new Auditing Standard applies to both the audit of internal control over financial reporting as well as the audit of financial statements -- eliminating a barrier to the integrated audit.

4. Incorporate guidance on efficiency

Many of the audit efficiency practices outlined in its May 16, 2005, guidance are contained in the new Standard. AS5 specifically includes the language from the May 16 guidance regarding the baselining of IT controls. As a result, companies can leverage this guidance to reduce compliance costs on a year-over-year basis.

5 A simplified standard

AS5 changes the definitions of material weakness from “more than remote” to “reasonably possible” and significant deficiency from “more than inconsequential” to “significant.” AS5 defines “significant” as “less than material but merits the attention of those with the responsibility for the oversight of financial reporting.” In

other words, significant deficiencies are not material weaknesses but items that those responsible for oversight need to know about.

The SOX Section 302 and Section 906 Considerations

How do the Section 302 and Section 906 certifications relate to the Section 404 reports? How do they overlap and how do they differ?

Although Section 404 is one widely known aspect of the Sarbanes-Oxley Act, two other sections of the Act — Sections 302 and 906 — have significantly increased the awareness of management's responsibility for reviewing and understanding its financial reporting and internal control structure. Specifically:

- Section 302 requires the chief executive officer (CEO) and the chief financial officer (CFO) to certify to the SEC both the fairness of the financial information in each quarterly and annual report and their responsibility for maintaining adequate disclosure controls and procedures.
- Section 906 requires the CEO and CFO to certify the fairness of the financial information in the report, as well as the compliance of the report with the requirements of the Securities Exchange Act of 1934. Section 906 provides criminal penalties for knowing or willful failure to comply.

Section 302 - Management Certifications

Section 302(a) of the Sarbanes-Oxley Act requires a company's CEO and CFO to certify each quarterly and annual report. They are required to certify that the financial statements and other financial information included in the report are fairly presented in all material respects. The officers must also state that the report does not contain any untrue statement of material fact or omit to state a material fact. In addition, the certifying officers must state that the company has established and maintained "disclosure controls and procedures" sufficient to ensure that the financial and nonfinancial information required to be disclosed in SEC reports is recorded, processed, summarized and reported within the specified time periods.

Disclosure controls and procedures typically include, but are broader than, internal control over financial reporting. For instance, disclosure controls extend to controls over disclosure included in SEC annual and interim reports outside the financial statements. They also encompass controls to monitor compliance with laws and regulations, other than those that directly affect the financial statements.

After the company files its first annual report pursuant to Section 404, Section 302 requires the certifying officers to state that they are responsible for establishing and maintaining internal control over financial reporting, and that such internal control is designed to provide reasonable assurance as to the reliability of financial reporting and the preparation of financial statements in accordance with GAAP. Further, they must disclose any change in the company's internal control over financial reporting during the most recent quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control.

As part of the certification, the CEO and CFO must also indicate that they have disclosed to the auditors and audit committee of the company all significant deficiencies and material weaknesses in internal control and any fraud that involves management or other employees who have a significant role in internal control.

Section 906 - Management Certifications (Criminal Provision)

Section 906 of the Sarbanes-Oxley Act requires the CEO and the CFO to certify each periodic report that includes financial statements. The certification, which is separate from the Section 302 certification, may state that the periodic report fully complies with the requirements of the Securities Exchange Act of 1934 and that "information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."

Section 906 provides for criminal penalties for an officer who provides the certification knowing it to be untrue, with harsher penalties for willful violations. Section 906 certifications may be "furnished," versus filed, as an exhibit to annual and quarterly SEC reports. As furnished information, the Section 906 certification is not subject to the civil liability provisions of Section 18 of the Securities Exchange Act of 1934, and will not be incorporated by reference into registration statements unless the company expressly specifies otherwise.

Exhibit 7 summarizes the key provisions of Section 302, Section 404, and Section 906.

Exhibit 7 Certification Requirements of Sarbanes-Oxley

Key Requirement	Implication
302 CEO and CFO certification of periodic SEC filings (quarterly and annual)	Requires certification of the fairness of the financial statements and the operating effectiveness of disclosure controls and procedures
404 Management's assessments of internal controls with auditor attestation (annual)	Requires annual assessment and reporting by both management and the auditor on the effectiveness of internal control over financial reporting
906 Financial reporting certification and criminal penalties (quarterly and annual)	In all SEC reports that include financial statements, requires the CEO and CFO to certify the fairness of the financial statements and the report's compliance with the requirements of the Security Exchange Act of 1934. Criminal penalties for willful violations.

A list of questions you need to answer for Sarbanes-Oxley compliance

Here is the list of questions that need to be answered in order to gauge a company's compliance with the Sarbanes-Oxley act. Would your company have the answers?

1. How are off-balance-sheet transactions and commitments tracked and reported?
2. Are payments to the external auditing firm monitored through the transactional flags on purchase orders, check requests, or other means within the system?
3. Are rolling forecasts deployed throughout the business (business unit, product line, functional levels)?
4. How many tools are used in the forecasting process? The budgeting process?
5. Do the reporting systems trace back to the general ledgers?
6. Is cash flow from operations and United States GAAP cash flow automatically calculated?
7. Are key measures (drivers of financial results) delivered to operational manager's desktops daily, weekly, and monthly?
8. Are tax reporting systems integrated with the company's consolidation system?
9. Are consolidation and reporting activities performed on spreadsheets?
10. Do transactional reporting systems have agent-based alerts?
11. How are manual entries identified and approved?
12. How much time is spent compiling data and the financial statements versus analyzing the data?
13. How many top-level adjustments are made in the consolidation process?
14. Are reporting activities performed on spreadsheets?
15. How often is control documentation updated for new changes to the internal controls (transactional and financial statement)?
16. Are controls in place to ensure that any off-balance-sheet items are properly approved?
17. Do reporting systems flag reserves and other estimated accounts?
18. Have the systems been updated to identify new responsibilities under the Sarbanes-Oxley Act?
19. Are earnings forecasts tied to predictive models?
20. Do you forecast your business on cash flow drivers?
21. Are variance between the forecast and actual results reviewed and causes identified?
22. How long is the process to develop forecasts? Budgets?
23. Is there a significant difference between financial statements depending on timing, function, or system?
24. Are standard charts of accounts used across the company?
25. How long does it take the company to get the results of operations?
26. What procedures are in place by the company to detect and prevent fraud?
27. Has the company identified high risk areas where fraud may occur and developed controls to prevent this from occurring?
28. Are the following categories of non-financial drivers measured: Leadership, communication, brand equity, reputation, networks/alliances, technology, human capital, culture, innovation, intellectual capital, or adaptability?
29. Do sales systems flag quarter-end sales volumes over selected limits?
30. How long does it take to develop ad hoc reports?

31. Do you model the sensitivity of your off-balance-sheet commitments (swap agreements, foreign exchange risk, purchase commitments, etc.)? How often?
32. Does the company have the ability to determine the profitability by using "what if" scenarios?
33. Have financial models been created for all high-risk operations, programs, etc.?
34. How long does it take to create the management package?
35. Does each operating unit have a financial model for the key drivers of its business?
36. Are documents backed up periodically to ensure significant reports and information are maintained?
37. Does the company have a retention policy for electronic information?
38. Are internal control reviews incorporated into all new system implementations (financial and non-financial)?
39. How often do you back up your data?
40. What controls are in place over record retention to avoid tampering with the data?
41. What best describes your IT capabilities related to financial transaction processing in your company?
42. How many control weakness/changes have there been to the financial statements controls (including in the authorization of transactions, safeguarding assets, maintaining records and over the reconciliation process) in the past year?
43. How many different systems are involved in the financial statement development process?
44. Are IRS and other data retention requirements being met?
45. Is your starting point for your tax return GAAP-audited financial statements?
46. Are there flags in place to alert key resources of specific transactions taking place in the company?
47. Does the company review its transactions for unusual entries?
48. What controls are in place to detect wire/mail?

Note: Appendix II provides a practice aid set that contains self-assessment questionnaires regarding Auditor Independence and Corporate Responsibility under Title III of the Sarbanes-Oxley Act of 2002.

Chapter 6 Review Questions

1. The Commission requires each annual report to contain an internal control report, which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. True or False?

2. If the auditor disagrees with management about whether a material weakness exists, the auditor will render a(n) _____ on management's assessment.
 - A. Adverse opinion.
 - B. Qualified opinion.
 - C. Disclaimer of opinion.
 - D. Unqualified opinion.

3. Section 906 requires the chief executive officer (CEO) and the chief financial officer (CFO) to certify to the SEC both the fairness of the financial information in each quarterly and annual report and their responsibility for maintaining adequate disclosure controls and procedures. True or False?

Chapter 7:

Good Governance and Other Ethical Standards

Good Governance

The following principles constitute good governance:

1. To avoid conflicts of interest, a company's board of directors should include a substantial majority of independent directors--"independent" meaning that directors don't have financial or close personal ties to the company or its executives.
2. A company's audit, nominating, and compensation committees should consist entirely of independent directors.
3. A board should obtain shareholder approval for any actions that could significantly affect the relationship between the board and shareholders, including the adoption of anti-takeover measures such as "poison pills."
4. Companies should base executive compensation plans on pay for performance and should provide full disclosure of these plans.
5. To avoid abuse in the use of stock options (and executive perquisites), all employee stock option plans should be submitted to shareholders for approval.

Corporate Social Responsibility

The food industry is blamed for obesity. Mobile phone operators are challenged to protect teenagers from online pornography. Record companies are attacked when they sue music-lovers for sharing illegal files on the internet. Fair or not, big business is being called to justify its approach to a growing array of social, environmental and ethical concerns. Despite the economic downturn, many companies are concluding that they cannot afford not to invest in being seen as responsible.

Business for Social Responsibility (BSR), a non-profit advisory organization reports that its membership includes many top multinationals, such as Microsoft, General Electric, Altria, and IBM. Altria has been a more traditional target for pressure groups and litigation as the parent company of both Kraft Foods and Philip Morris.

Financial constraints have forced companies to think more carefully about where to put scarce resources, he says. Their priority is to embed social, environmental and ethical considerations in every operation, including their supply chain. This is a long-term task requiring sensitive antennae.

This is pushing many more companies to have a serious engagement with their stakeholders so that they can anticipate some of these issues and deal with them proactively, rather than waiting until they reach the front pages of journals and then appearing to be acting only under pressure.

The financial sector, tarnished by Wall Street's conflicts of interest and role in corporate scandals, has come under scrutiny over lending to controversial projects in the developing world. A group of leading banks including Citigroup, Barclays and ABN Amro, pledged to avoid loans for socially or environmentally questionable projects under the so-called "Equator Principles".

The concept of corporate social responsibility involves more than serving the interests of the organization and its shareholders. Rather, it is an extension of responsibility to embrace service to the public interest in such matters as environmental protection, employee safety, civil rights, and community involvement. Socially responsible behavior clearly has immediate costs to the entity, for example, the expenses incurred in affirmative action programs, pollution control, and improvements in worker safety. When one firm incurs such costs and its competitor does not, the other may be able to sell its products or services more cheaply and increase its market share at the expense of the socially responsible firm. The rebuttal argument is that in the long run the socially responsible company may maximize profits by creating goodwill and avoiding or anticipating governmental regulation.

If corporations want to stay on the right side of the global economy's growing protest movement what can they do? Here are some suggestions for corporate social responsibility (CSR).

1. First and foremost, a company should match its words with deeds. CSR is not a box-ticking exercise. Do not nominate a CSR director as an afterthought and then forget about the subject until the next annual report.
2. It is easy to become tarnished by bad practice via a business association, so check that suppliers and contractors share your standards. Any group within your supply chain should comply with the best CSR practice. If not, it could drag an otherwise ethical business into trouble.
3. Remember that no business acts in isolation and all should behave as responsible members of a wider society. Your employees see themselves as part of that society. So a strong lead in CSR will motivate them. The decision of South African mining company Anglo American in August 2002 to provide free HIV/Aids drugs for its vast workforce is an example of this.
4. Join forces with the CSR movement - it is not going away. The issues it raises involve too many interest groups across the world to be temporary phenomena.

5. Remember Machiavelli. CSR could be a defining attribute of winning companies in the 21st century.

Executives are fond of the saying "what gets measured, gets managed" - and measuring corporate social responsibility (CSR) performance has been a boom industry in the past few years.

Specialist rating agencies have now taken this kind of approach further. Organizations assign CSR ratings in the style of the debt markets, with a pinnacle of AAA, down through AA, A to BBB, and so on. These grades are based on in-depth analysis of the issues facing companies and how well they deal with them.

These approaches are all aimed specifically at investors. Business in the Community (BitC) has developed an index for wider consumption, which aims to create responsibility league tables, based on information supplied by the participating companies. It covers companies' impacts in the community, the environment, the market and the workplace and aims to assess the extent to which companies translate strategy into responsible practice.

The first Corporate Responsibility Index was published earlier this year, and proved highly controversial, especially among companies which were ranked at the bottom of the league, despite what they regarded as important social responsibility initiatives.

Measuring corporate social responsibility: basic indicators

Here are basic core indicators that count, according to Business in the Community (BitC)

In the marketplace:

- Customer complaints
- Advertising complaints upheld
- Upheld cases of anti-competitive behavior
- Customer satisfaction levels
- Provision for customers with special needs

Indicators in the workplace include:

- Workforce profiles by gender, race, disability, age
- Staff absenteeism
- Number of legal non-compliances on health and safety, plus equal opportunities legislation
- Number of staff grievances
- Upheld of cases of corrupt or unprofessional behavior
- Number of recordable safety incidents, (fatal and non-fatal)
- Staff turnover
- Value of training and development provided to staff
- Perception measures of the company by its employees
- Existence of confidential grievance procedures for workers

Community indicators:

- Cash value of company support as a percentage of pre-tax profit
- Individual value of staff time, gifts in kind, and management costs

Environmental indicators:

- Energy consumption

- Water usage
- Solid waste produced
- Successful environmental prosecutions
- CO₂/greenhouse gas emissions
- Other emissions, such as ozone, radiation CO₂/greenhouse gas measures and offsetting effect

CSR Best Practice

Many CSR specialists recommend that, as a first step, companies join one or more of the international organizations devoted to CSR, including the United Nations' Global Compact or the Global Reporting Initiative (GRI). Other recommendations from CSR specialists include:

- Engaging stakeholders in a dialogue
- Establishing principles and procedures for addressing difficult issues such as labor standards for suppliers, environmental reporting and human rights
- Adjusting reward systems to reflect the company's commitment to CSR
- Collecting, maintaining and publishing data relevant to CSR
- Having the senior leadership team and members of the board of directors engage regularly in an ongoing process of CSR risk and evaluation
- Establishing anonymous reporting and whistle-blowing policies and procedures
- Educating employees and managers about CSR policies and the company's commitment to CSR
- Having the senior leadership team communicate CSR priorities and set an example through their own behavior.

One of the most recent recommendations for best practice invokes creative philanthropy. It involves engaging in "Corporate social initiatives". Corporate social initiatives differ from traditional philanthropy by being linked to the company's core values in a way that leverages core competencies. For example, in response to the recent Asian tsunami disaster, UPS, the logistics company, agreed to ship without charge up to £1m of emergency relief supplies from around the world; Johnson&Johnson distributed medical supplies throughout the affected region; and pharmaceutical giants, Novartis and GlaxoSmithKline contributed antibiotics, adult nutritional supplements and infant formula. In a globalize market economy, CSR is part of modern business.

Business Ethics

Ethics is the "science of morals". A moral is an accepted rule or standard of human behavior. The understanding of "accepted" is "accepted by society", and accepted only insofar as the behavior in question being behavior that affects others in the society, even if only indirectly. The implication of this definition is therefore that

private actions that have no impact on others are a matter for personal morality, which is not of business or organizational concern.

However, the distinction between personal morality and business morality may not always be so clearly defined. This is because individuals bring personal values to their jobs and to the real or perceived problems of moral choice that confront them at work. Moral choices sometimes must be made because of tensions within individuals, between individuals, or between individuals and what they believe to be the values that drive their organizations.

Furthermore, business organizations do not operate in a social vacuum. Because of the ways business organizations can and do affect the lives and livelihoods of society at large, some would argue that business organizations are kind of “moral agents” in society. Therefore managers and general publics alike often wrestle with defining exactly what constitutes the ethical way of doing business, and what constitutes proper constraints on individual self-interests, and by whom shall these constraints be imposed.

A further complexity results from the fact that businesses are increasingly becoming global in nature. Different countries have or seem to have vastly different customs and values. Understanding and assessing whether and how these different cultural and ethical conflicts should be taken into account is often most difficult.

Increased Concern for Business Ethics

Electrical-equipment conspiracy cases in 1960 caused public concern and creation of the Business Ethics Advisory Council (BEAC) in 1961 under the Secretary of Commerce. BEAC pointed out areas needing self-evaluation by the business community:

- General business understanding of ethical issues
- Compliance with laws
- Conflicts of interest
- Entertainment and gift expenses
- Relations with customers and suppliers. Should gifts or kickbacks be given or accepted?
- Social responsibilities

BEAC's recommendations generated business interest, especially from big business, in problems of ethical behavior.

Factors That May Lead to Unethical Behavior

In any normal population, some people have less than desirable levels of ethics. If these people hold leadership positions, they will adversely influence subordinates.

1. Organizational factors may lead to unethical behavior.

2. Pressures for short-run performance in decentralized return on investment (ROI) centers may inhibit ethical behavior.
3. Emphasis on strict adherence to chain-of-command authority may provide excuses for ignoring ethics when following orders.
4. Informal work-group loyalties may subvert ethical behavior.
5. Committee decision processes may make it possible to abstain from or dodge ethical obligations.

External factors may lead to unethical behavior.

1. Pressure of competition may compromise ethics in the interest of survival.
2. Unethical behavior of others may force a compromise of ethics.
3. Definitions of ethical behavior may vary from one culture to another. Bribes to overseas officials or buyers may be consistent with some countries' customary business practices, but such a practice is not considered ethical among U.S. purchasing agents. Bribes are now considered illegal under the Foreign Corrupt Practices Act.
4. The propriety of superimposing our cultural ethical standards (by refusing to bribe) on another culture may be controversial.

General Guides to Ethics

- Golden Rule—Do unto others as you would have others do unto you.
- Maximize good—Act to provide the greatest good for the greatest number.
- Fairness—Act in ways that are fair or just to all concerned.
- Maximize long-run outcomes—Act to provide the best long-range benefits to society and its resources.
- General respect—Act to respect the planet all humans share and the rights of others because corporate and individual decisions affect them.

Simplified Criteria for Evaluating Ethical Behavior

1. Would this behavior be acceptable if people I respect knew I was doing this?
2. What are the consequences of this behavior for myself, other employees, customers, and society?

Ethics are individual and personal, influenced by

1. Life experiences (rewards for doing right, punishment for doing wrong)
2. Friendship groups (professional associations, informal groups)

3. Organizational pressures (responsibilities to superiors and the organization)

Codes of Ethical Conduct

An organization's code of ethical conduct is the established general value system the organization wishes to apply to its members' activities through

1. Communicating organizational purposes and beliefs
2. Establishing uniform ethical guidelines for members, including guidance on behavior for members in making decisions

Laws and written rules cannot cover all situations. However, organizations can benefit from having an established ethical code because it

1. Effectively communicates acceptable values to all members, including recruits and subcontractors
2. Provides a method of policing and disciplining members for violations
 - Through review panels (formal)
 - Through group pressure (informal)
3. Establishes high standards against which individuals can measure their own performance
4. Communicates to those outside the organization the value system from which the organization's members must not be asked to deviate

A typical code for accounting activities (note similarities to the Standards for the Professional Practice of Internal Auditing, GAAP, GAAS, etc.) holds that a financial manager must have

1. Independence from conflicts of economic interest
2. Independence from conflicts of professional interest
 - a). Responsibility to present information fairly to shareholders/owners and not intentionally protect management
 - b). Responsibility to present data to all appropriate managers and not play favorites with information or cover up bad news
 - c). Responsibility to exercise an ethical presence in the conduct of professional activities

- Ensuring organizational compliance with spirit as well as letter of pertinent laws and regulations
 - Conducting oneself according to the highest moral and legal standards
 - Reporting to appropriate internal or external authority any illegal or fraudulent organizational act
- d). Integrity in not compromising professional values for the sake of personal goals
- e). Objectivity in presenting information, preparing reports, and making analyses

IMA's Standards of Ethical Conduct for Accountants and Financial Professionals

Accountants and financial professionals have an obligation to the public, their profession, the organizations they serve, and themselves, to maintain the highest standards of ethical conduct. In recognition of this obligation, the *Institute of Management Accountants (IMA)* has promulgated the following standards of ethical conduct for accountants and financial professionals. Accountants and financial professionals shall not commit acts contrary to these standards nor shall they condone the commission of such acts by others within their organizations.

IMA Statement of Ethical Professional Practice

Members of IMA shall behave ethically. A commitment to ethical professional practice includes overarching principles that express our values, and standards that guide our conduct.

Principles

IMA's overarching ethical principles include: Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.

Standards

A member's failure to comply with the following standards may result in disciplinary action.

I. COMPETENCE

Each member has a responsibility to:

1. Maintain an appropriate level of professional expertise by continually developing knowledge and skills.
2. Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3. Provide decision support information and recommendations that are accurate, clear, concise, and timely.
4. Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

II. CONFIDENTIALITY

Each member has a responsibility to:

1. Keep information confidential except when disclosure is authorized or legally required.
2. Inform all relevant parties regarding appropriate use of confidential information. Monitor subordinates' activities to ensure compliance.
3. Refrain from using confidential information for unethical or illegal advantage.

III. INTEGRITY

Each member has a responsibility to:

1. Mitigate actual conflicts of interest, regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
3. Abstain from engaging in or supporting any activity that might discredit the profession.

IV. CREDIBILITY

Each member has a responsibility to:

1. Communicate information fairly and objectively.
2. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.

Resolution of Ethical Conflict

In applying the Standards of Ethical Professional Practice, you may encounter problems identifying unethical behavior or resolving an ethical conflict. When faced with ethical issues, you should follow your organization's established policies on the resolution of such conflict. If these policies do not resolve the ethical conflict, you should consider the following courses of action:

1. Discuss the issue with your immediate supervisor except when it appears that the supervisor is involved. In that case, present the issue to the next level. If you cannot achieve a satisfactory resolution, submit the issue to the next management level. If your immediate superior is the chief executive officer or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with your superior's knowledge, assuming he or she is not involved. Communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate, unless you believe there is a clear violation of the law.
2. Clarify relevant ethical issues by initiating a confidential discussion with an IMA Ethics Counselor or other impartial advisor to obtain a better understanding of possible courses of action.
3. Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

(Source: Ima Statement of Ethical Professional Practice).

Conflict of Interest

1. Conflict of interest is a conflict between the private and the official responsibilities of a person in a position of trust, sufficient to affect judgment, independence, or objectivity in conducting the affairs of the business.
2. Examples of Conflict of Interest
 - a. Having a substantial financial interest in a supplier, customer, or distributor
 - b. Using privileged information gained from one's official position to enter transactions for personal gain
3. Methods for Control
 - a. Provide a code of conduct provision applying to conflicts of interest.
 - b. Require full financial disclosure by managers.
 - c. Require prior notification of any transaction that may raise conflict of interest.
 - d. Prohibit financial ties to any supplier, customer, or distributor.
 - e. Encourage adherence to strong ethical behavior through corporate actions, policies, and public communications.

Legal Aspects of Social Responsibility

1. The *Racketeer Influenced and Corrupt Organization (RICO) Act* was passed in 1970 as an attempt to combat the problem of organized crime and its infiltration of legitimate enterprises.
 - a. Its goals were to eliminate organized crime by concentrating on the illegal monies through the use of civil and criminal forfeitures.
 - b. Criminal penalties can be levied up to \$25,000 and 20 years in jail. Civil penalties include the awarding of treble damages and attorney's fees to the successful plaintiff.
 - c. RICO specifically makes the following activities unlawful:

- 1) Using income derived from a pattern of racketeering activity to acquire an interest in an enterprise.
 - 2) Acquiring or maintaining an interest in an enterprise through a pattern of racketeering activity.
 - 3) Conducting the affairs of an enterprise through a pattern of racketeering activity.
 - 4) Conspiring to commit any of these offenses.
- d. RICO has been used against white-collar criminals, terrorists, Wall Street insider trading, anti-abortion protesters, local law enforcement agencies, and public accounting firms—none of which was intended by Congress when the law was passed.

2. The *Foreign Corrupt Practices Act (FCPA) of 1977* regulates payments by U.S. firms operating in other nations.

- a. The act is a reaction to publicity over questionable foreign payments.
- b. The FCPA makes it a criminal offense to make payments to a foreign government or representative thereof to secure or retain business.
- c. It prohibits payments of sales commissions to independent agents, if the commissions are knowingly passed to foreign officials.
- d. Corporations are required to establish internal accounting controls to assure that all overseas payments are proper.
- e. The FCPA applies even if payment is legal in the nation where it is made.
- f. The rationale for the FCPA is that the international reputation of the United States is affected by its international business conduct, which should reflect the best of the United States' ethics.

3. The *SEC* mandates that the composition of boards of directors include outside directors to create diversity and broaden the overview of a company's place in the market and in society.

4. Courts are increasingly willing to hold boards of directors and auditors liable for problems.

Chapter 7 Review Questions

1. Principles of good governance imply that
 - A. Directors should have close relationships with the company executives
 - B. Executive compensation plans should be based solely on stock option packages
 - C. A company's audit, nominating committee and compensation committee should consist entirely of independent directors
 - D. All employees stock option plans should be reviewed by the CEO and CFO

2. Which of the following is NOT a corporate social responsibility activity?
 - A. Acting in isolation to protect the company's name and reputation
 - B. Matching words with deeds
 - C. Complying with ethical behavior standards
 - D. Motivating the employees to behave as responsible members of society

3. Corporate social responsibility is
 - A. Effectively enforced through the controls envisioned by classical economics
 - B. Defined as the obligation to shareholders to earn a profit
 - C. More than the obligation to shareholders to earn a profit
 - D. Defined as the obligation to serve long-term, organizational interests

4. A common argument against corporate involvement in socially responsible behavior is that
 - A. It encourages government intrusion in decision making
 - B. In a competitive market, such behavior incurs costs that place the company at a disadvantage
 - C. As a legal entity, a corporation is accountable for its conduct
 - D. It creates goodwill

5. If a financial manager/management accountant discovers unethical conduct in his/her organization and fails to act, (s)he will be in violation of which ethical standard(s)?
 - A. "Actively or passively subvert the attainment of the organization's legitimate and ethical objectives"
 - B. "Communicate unfavorable as well as favorable information"

- C. "Condone the commission of such acts by others within their organizations"
- D. All of the answers are correct

6. In which situation is a financial manager/ management accountant permitted to communicate confidential information to individuals or authorities outside the firm?

- A. There is an ethical conflict and the board has refused to take action
- B. Such communication is legally prescribed
- C. The financial manager/management accountant knowingly communicates the information indirectly through a subordinate
- D. An officer at the financial manager/ management accountant's bank has requested information on a transaction that could influence the firm's stock price

7. A financial manager/management accountant discovers a problem that could mislead users of the firm's financial data and has informed his/her immediate superior. (S)he should report the circumstances to the audit committee and/or the board of directors only if

- A. The immediate superior, who reports to the chief executive officer, knows about the situation but refuses to correct it
- B. The immediate superior assures the financial manager/management accountant that the problem will be resolved
- C. The immediate superior reports the situation to his/her superior
- D. The immediate superior, the firm's chief executive officer, knows about the situation but refuses to correct it

8. Ivy is a financial manager who has discovered that her company is violating environmental regulations. If her immediate superior is involved, her appropriate action is to

- A. Do nothing since she has a duty of loyalty to the organization
- B. Consult the audit committee
- C. Present the matter to the next higher managerial level
- D. Confront her immediate superior

9. Which ethical standard is most clearly violated if a financial manager/management accountant knows of a problem that could mislead users but does nothing about it?

- A. Competence
- B. Legality

- C. Objectivity
- D. Confidentiality

Chapter 8:

Summary of Sarbanes-Oxley Act of 2002

The following is a summary of the Sarbanes-Oxley Act of 2002.

Section 3: Commission Rules and Enforcement.

A violation of Rules of the Public Company Accounting Oversight Board ("Board") is treated as a violation of the Securities Exchange Act of 1934, giving rise to the same penalties that may be imposed for violations of that Act.

Section 101: Establishment; Board Membership.

The Board will have five financially-literate members, appointed for five-year terms. Two of the members must be or have been certified public accountants, and the remaining three must not be and cannot have been CPAs. The Chair 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.

The Board's members will serve on a full-time basis.

No member may, concurrent with service on the Board, "share in any of the profits of, or receive payments from, a public accounting firm," other than "fixed continuing payments," such as retirement payments.

Members of the Board are appointed by the Commission, "after consultation with" the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

Members may be removed by the Commission "for good cause."

Section 103: Auditing, Quality Control, and Independence Standards and Rules.

The Board shall:

- (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 accounting firms;

- (4) Conduct investigations and disciplinary proceedings, and impose appropriate sanctions;
- (5) Perform such other duties or functions as necessary or appropriate;
- (6) Enforce compliance with the act, the rules of the board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto;
- (7) Set the budget and manage the operations of the Board and the staff of the Board.

Auditing standards. The Board would be required to "cooperate on an on-going basis" with designated professional groups of accountants and any advisory groups convened in connection with standard-setting, and although the Board can "to the extent that it determines appropriate" adopt standards proposed by those groups, the Board will have authority to amend, modify, repeal, and reject any standards suggested by the groups. The Board must report on its standard-setting activity to the Commission on an annual basis.

The Board must require registered public accounting firms to "prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report."

The Board must require a 2nd partner review and approval of audit reports. Registered accounting firms must adopt quality control standards.

The Board must adopt an audit standard to implement the internal control review required by section 404(b). This standard must require the auditor evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transactions of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.

Section 104: Inspections of Registered Public Accounting Firms

Annual quality reviews (inspections) must be conducted for firms that audit more than 100 issues, all others must be conducted every 3 years. The SEC and/or the Board may order a special inspection of any firm at any time.

Section 105(d): Investigations and Disciplinary Proceedings; Reporting of Sanctions.

All documents and information prepared or received by the Board shall be "confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, unless and until presented in connection with a public

proceeding or [otherwise] released" in connection with a disciplinary action. However, all such documents and information can be made available to the SEC, the U.S. Attorney General, and other federal and appropriate state agencies.

Disciplinary hearings will be closed unless the Board orders that they be public, for good cause, and with the consent of the parties.

Sanctions can be imposed by the Board of a firm if it fails to reasonably supervise any associated person with regard to auditing or quality control standards, or otherwise.

No sanctions report will be made available to the public unless and until stays pending appeal have been lifted.

Section 106: Foreign Public Accounting Firms.

The bill would subject foreign accounting firms who audit a U.S. company to registration with the Board. This would include foreign firms that perform some audit work, such as in a foreign subsidiary of a U.S. company, which is relied on by the primary auditor.

Section 107(d): Censure of the Board and Other Sanctions.

The SEC shall have "oversight and enforcement authority over the Board." The SEC can, by rule or order, give the Board additional responsibilities. The SEC may require the Board to keep certain records, and it has the power to inspect the Board itself, in the same manner as it can with regard to SROs such as the NASD.

The Board, in its rulemaking process, is to be treated "as if the Board were a 'registered securities association'" - that is, a self-regulatory organization. The Board is required to file proposed rules and proposed rule changes with the SEC. The SEC may approve, reject, or amend such rules.

The Board must notify the SEC of pending investigations involving potential violations of the securities laws, and coordinate its investigation with the SEC Division of Enforcement as necessary to protect an ongoing SEC investigation.

The SEC may, by order, "censure or impose limitations upon the activities, functions, and operations of the Board" if it finds that the Board has violated the Act or the securities laws, or if the Board has failed to ensure the compliance of accounting firms with applicable rules without reasonable justification.

Section 107(c): Commission Review of Disciplinary Action Taken By The Board.

The Board must notify the SEC when it imposes "any final sanction" on any accounting firm or associated person. The Board's findings and sanctions are subject to review by the SEC.

The SEC may enhance, modify, cancel, reduce, or require remission of such sanction.

Section 108: Accounting Standards.

The SEC is authorized to "recognize, as 'generally accepted'... any accounting principles" that are established by a standard-setting body that meets the bill's criteria, which include requirements that the body:

- (1) Be a private entity;
- (2) Be governed by a board of trustees (or equivalent body), the majority of whom are not or have not been associated persons with a public accounting firm for the past 2 years;
- (3) Be funded in a manner similar to the board;
- (4) Have adopted procedures to ensure prompt consideration of changes to accounting principles by a majority vote;
- (5) Consider, when adopting standards, the need to keep them current and the extent to which international convergence of standards is necessary or appropriate.

Section 109(d): Funding; Annual Accounting Support Fee For The Board.

In order to audit a public company, a public accounting firm must register with the Board. The Board shall collect "a registration fee" and "an annual fee" from each registered public accounting firm, in amounts that are "sufficient" to recover the costs of processing and reviewing applications and annual reports.

The Board shall also establish by rule a reasonable "annual accounting support fee" as may be necessary or appropriate to maintain the Board. This fee will be assessed on issuers only.

Section 201: Services outside the Scope of Practice of Auditors; Prohibited Activities.

It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission.

It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services. Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval.

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5 % of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed), such services were not recognized by the issuer at the time of the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

The authority to pre-approve services can be delegated to 1 or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.

Section 203: Audit Partner Rotation.

The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.

Section 204: Auditor Reports to Audit Committees.

The accounting firm must report to the audit committee all "critical accounting policies and practices to be used...all alternative treatments of financial information within [GAAP] that have been discussed with management...ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Section 206: Conflicts of Interest.

The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period preceding the audit.

Section 207: Study of Mandatory Rotation of Registered Public Accountants.

The GAO will do a study on the potential effects of requiring the mandatory rotation of audit firms.

Section 209: Consideration by Appropriate State Regulatory Authorities.

State regulators are directed to make an independent determination as to whether the Boards standards shall be applied to small and mid-size non-registered accounting firms.

Section 301: Public Company Audit Committees.

Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"Independent" is defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.

The SEC may make exemptions for certain individuals on a case-by-case basis.

The audit committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.

The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

Each issuer shall provide appropriate funding to the audit committee.

Section 302: Corporate Responsibility for Financial Reports.

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 periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A violation of this section must be knowing and intentional to give rise to liability.

Section 303: Improper Influence on Conduct of Audits

It shall be unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.

Section 304: Forfeiture of Certain Bonuses and Profits.

Section 305: Officer and Director Bars and Penalties; Equitable Relief.

If an issuer is required to prepare a restatement due to "material noncompliance" with financial reporting requirements, the chief executive officer and the chief financial officer shall "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" during the twelve months following the issuance or filing of the non-compliant document and "any profits realized from the sale of securities of the issuer" during that period.

In any action brought by the SEC for violation of the securities laws, federal courts are authorized to "grant any equitable relief that may be appropriate or necessary for the benefit of investors."

Section 305: Officer and Director Bars and Penalties.

The SEC may issue an order to prohibit, conditionally or unconditionally, permanently or temporarily, any person who has violated section 10(b) of the 1934 Act from acting as an officer or director of an issuer if the SEC has found that such person's conduct "demonstrates unfitness" to serve as an officer or director of any such issuer.

Section 306: Insider Trades During Pension Fund Black-Out Periods Prohibited.

Prohibits the purchase or sale of stock by officers and directors and other insiders during blackout periods. Any profits resulting from sales in violation of this section "shall inure to and be recoverable by the issuer." If the issuer fails to bring suit or prosecute diligently, a suit to recover such profit may be instituted by "the owner of any security of the issuer."

Section 401(a): Disclosures in Periodic Reports; Disclosures Required.

Each financial report that is required to be prepared in accordance with GAAP shall "reflect all material correcting adjustments . . . that have been identified by a registered accounting firm . . ."

"Each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

The SEC shall issue rules providing that pro forma financial information must be presented so as not to "contain an untrue statement" or omit to state a material fact necessary in order to make the pro forma financial information not misleading.

Section 401 (c): Study and Report on Special Purpose Entities.

SEC shall study off-balance sheet disclosures to determine a) extent of off-balance sheet transactions (including assets, liabilities, leases, losses and the use of special purpose entities); and b) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion and make a report containing recommendations to the Congress.

Section 402(a): Prohibition on Personal Loans to Executives.

Generally, it will be unlawful for an issuer to extend credit to any director or executive officer. Consumer credit companies may make home improvement and consumer credit loans and issue credit cards to its directors and executive officers if it is done in the ordinary course of business on the same terms and conditions made to the general public.

Section 403: Disclosures of Transactions Involving Management and Principal Stockholders.

Directors, officers, and 10% or greater owners must report designated transactions by the end of the second business day following the day on which the transaction was executed.

Section 404: Management Assessment of Internal Controls.

Requires each annual report of an issuer to contain an "internal control report", which shall:

- (1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- (2) Contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this section shall be in accordance with standards for attestation engagements issued or adopted by the Board. An attestation engagement shall not be the subject of a separate engagement.

The language in the report of the Committee which accompanies the bill to explain the legislative intent states, "--- the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."

Directs the SEC to require each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

Directs the SEC to revise its regulations concerning prompt disclosure on Form 8-K to require immediate disclosure "of any change in, or waiver of," an issuer's code of ethics.

Section 407: Disclosure of Audit Committee Financial Expert.

The SEC shall issue rules to require issuers to disclose whether at least 1 member of its audit committee is a "financial expert."

Section 409: Real Time Disclosure.

Issuers must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

Section 501: Treatment of Securities Analysts by Registered securities Associations.

National Securities Exchanges and registered securities associations must adopt conflict of interest rules for research analysts who recommend equities in research reports.

Section 601: SEC Resources and Authority.

SEC appropriations for 2003 are increased to \$776,000,000. \$98 million of the funds shall be used to hire an additional 200 employees to provide enhanced oversight of auditors and audit services required by the Federal securities laws.

Section 602(a): Appearance and Practice Before the Commission.

The SEC may censure any person, or temporarily bar or deny any person the right to appear or practice before the SEC if the person does not possess the requisite qualifications to represent others, lacks character or integrity, or has willfully violated Federal securities laws.

Section 602(c): Study and Report.

SEC is to conduct a study of "securities professionals" (public accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys) who have been found to have aided and abetted a violation of Federal securities laws.

Section 602(d): Rules of Professional Responsibility for Attorneys.

The SEC shall establish rules setting minimum standards for professional conduct for attorneys practicing before it.

Section 701: GAO Study and Report Regarding Consolidation of Public Accounting Firms.

The GAO shall conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems discovered.

Title VIII: Corporate and Criminal Fraud Accountability Act of 2002.

- It is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation.
- Auditors are required to maintain "all audit or review work papers" for five years.
- The statute of limitations on securities fraud claims is extended to the earlier of five years from the fraud, or two years after the fraud was discovered, from three years and one year, respectively.
- 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.
- A new crime for securities fraud that has penalties of fines and up to 10 years imprisonment.

Title IX: White Collar Crime Penalty Enhancements

- Maximum penalty for mail and wire fraud increased from 5 to 10 years.
- Creates a crime for tampering with a record or otherwise impeding any official proceeding.

- SEC given authority to seek court freeze of extraordinary payments to directors, officers, partners, controlling persons, agents of employees.
- US Sentencing Commission to review sentencing guidelines for securities and accounting fraud.
- SEC may prohibit anyone convicted of securities fraud from being an officer or director of any publicly traded company.
- Financial Statements filed with the SEC must be certified by the CEO and CFO. The certification must state that the financial statements and disclosures fully comply with provisions of the Securities Exchange Act and that they fairly present, in all material respects, the operations and financial condition of the issuer. Maximum penalties for willful and knowing violations of this section are a fine of not more than \$5,000,000 and/or imprisonment of up to 20 years.

Section 1001: Sense of Congress Regarding Corporate Tax Returns

It is the sense of Congress that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.

Section 1102: Tampering With a Record or Otherwise Impeding an Official Proceeding

Makes it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine.

Section 1103: Temporary Freeze Authority

The SEC is authorized to freeze the payment of an extraordinary payment to any director, officer, partner, controlling person, agent, or employee of a company during an investigation of possible violations of securities laws.

Section 1105: SEC Authority to Prohibit Persons from Serving as Officers or Directors

The SEC may prohibit a person from serving as an officer or director of a public company if the person has committed securities fraud.

Chapter 8 Review Questions

1. Which of the following is NOT true about financial disclosures?
 - A. Each financial report that is required to be prepared in accordance with GAAP shall "reflect all material correcting adjustments"
 - B. Each financial report shall disclose all material off-balance sheet transactions
 - C. Financial reports shall include pro forma figures that do not contain untrue statements or omit material fact statements or data
 - D. Pro forma financial information needs not to be reconciled with the financial condition and results.

2. The duties of the Board under SOX Act 2002 include all the following EXCEPT
 - A. Prepare all audits by in-house CPAs
 - B. Establish, adopt rules for: auditing, quality control, ethics and independence
 - C. Conduct inspections of registered public accounting firms
 - D. Conduct investigations and disciplinary proceedings for concerned activities and impose appropriate sanctions for any violations

3. Registration with the Board does NOT require
 - A. Mandatory registration
 - B. Prescribed forms of application
 - C. Compliance with sox act that precludes the need for periodic reports
 - D. Consent statements agreeing to cooperate and be in compliance with requests for testimony, or supplying documents

4. Which one of the following is NOT true regarding the Board's investigations and disciplinary proceedings?
 - A. The Board shall establish fair procedures for investigation
 - B. The Board shall make all investigations without any referral to any other state or federal regulator
 - C. The Board shall establish procedures for disciplining public accounting firms for digressions
 - D. The Board shall institute fair procedures for disciplining individuals for involvement in digressions at public accounting firms

5. The Commission shall have oversight and enforcement authority over the board for censure of the board members or removal from office

- A. For willful violations of the SOX Act of 2002
- B. At the Commission's discretion
- C. Without reasonable justification
- D. At the AICPA's recommendation

6. A registered public accounting firm may engage in any non-audit service, including _____.

- A. Bookkeeping services to the audit client
- B. Financial information systems and design
- C. Appraisal or valuation services
- D. Tax services

7. The Securities Exchange Act of 1934 has been amended by SOX Act 2002 to adding preapproval of

- A. Management activities
- B. Delegation of authority from staff to line personnel
- C. All auditing services
- D. Disclosure of all services to investors

8. The principal executive officers are responsible for the following EXCEPT

- A. Reviewing the final reports
- B. Administering penalties for misinformation and questionable financial data
- C. Verifying that the report is true and does not omit any material facts or offer misleading data
- D. Ensuring that the report includes a fair presentation of the financial conditions and operations of the issuer for the periods represented

Appendix I:

Full Text of Sarbanes-Oxley Act Of 2002

Section 1 -- Short Title

This Act may be cited as the "Sarbanes-Oxley Act of 2002".

Section 2 -- Definitions

a. **In General.** In this Act, the following definitions shall apply:

1. **Appropriate state regulatory authority.** The term "appropriate State regulatory authority" means the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the State or States having jurisdiction over a registered public accounting firm or associated person thereof, with respect to the matter in question.
2. **Audit.** The term "audit" means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under [section 103](#), in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements.
3. **Audit committee.** The term "audit committee" means--
 - A. a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
 - B. if no such committee exists with respect to an issuer, the entire board of directors of the issuer.
4. **Audit report.** The term "audit report" means a document or other record--
 - A. prepared following an audit performed for purposes of compliance by an issuer with the requirements of the securities laws; and
 - B. in which a public accounting firm either--

- i. sets forth the opinion of that firm regarding a financial statement, report, or other document; or
 - ii. asserts that no such opinion can be expressed.
- 5. **Board.** The term "Board" means the Public Company Accounting Oversight Board established under [section 101](#).
- 6. **Commission.** The term "Commission" means the Securities and Exchange Commission.
- 7. **Issuer.** The term "issuer" means an issuer (as defined in [section 3](#) of the Securities Exchange Act of 1934), the securities of which are registered under [section 12](#) of that Act, or that is required to file reports under [section 15\(d\)](#), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.
- 8. **Non-audit services.** The term "non-audit services" means any professional services provided to an issuer by a registered public accounting firm, other than those provided to an issuer in connection with an audit or a review of the financial statements of an issuer.
- 9. **Person associated with a public accounting firm.**
 - A. **In general.** The terms "person associated with a public accounting firm" (or with a "registered public accounting firm") and "associated person of a public accounting firm" (or of a "registered public accounting firm") mean any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report--
 - i. shares in the profits of, or receives compensation in any other form from, that firm; or
 - ii. participates as agent or otherwise on behalf of such accounting firm in any activity of that firm.
 - B. **Exemption authority.** The Board may, by rule, exempt persons engaged only in ministerial tasks from the definition in subparagraph (A), to the extent that the Board determines that any such exemption is consistent with the purposes of this Act, the public interest, or the protection of investors.
- 10. **Professional standards.** The term "professional standards" means--
 - A. accounting principles that are--

- i. established by the standard setting body described in [section 19\(b\)](#) of the Securities Act of 1933, as amended by this Act, or prescribed by the Commission under section 19(a) of that Act or [section 13\(b\)](#) of the Securities Exchange Act of 1934; and
 - ii. relevant to audit reports for particular issuers, or dealt with in the quality control system of a particular registered public accounting firm; and
- B. auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing title II) that the Board or the Commission determines--
 - i. relate to the preparation or issuance of audit reports for issuers; and
 - ii. are established or adopted by the Board under [section 103\(a\)](#), or are promulgated as rules of the Commission.

11. **Public accounting firm.** The term "public accounting firm" means--

- A. a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports; and
- B. to the extent so designated by the rules of the Board, any associated person of any entity described in subparagraph (A).

12. **Registered public accounting firm.** The term "registered public accounting firm" means a public accounting firm registered with the Board in accordance with this Act.

13. **Rules of the board.** The term "rules of the Board" means the bylaws and rules of the Board (as submitted to, and approved, modified, or amended by the Commission, in accordance with [section 107](#)), and those stated policies, practices, and interpretations of the Board that the Commission, by rule, may deem to be rules of the Board, as necessary or appropriate in the public interest or for the protection of investors.

14. **Security.** The term "security" has the same meaning as in [section 3\(a\)](#) of the Securities Exchange Act of 1934.

15. **Securities laws.** The term "securities laws" means the provisions of law referred to in [section 3\(a\)\(47\)](#) of the Securities Exchange Act of 1934, as amended by this Act, and includes the rules, regulations, and orders issued by the Commission thereunder.

16. **State.** The term "State" means any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other territory or possession of the United States.

- b. **Conforming Amendment.** Section 3(a)(47) of the Securities Exchange Act of 1934 is amended by inserting "the Sarbanes-Oxley Act of 2002," before "the Public".

Title I: Public Company Accounting Oversight Board

Section 101 -- Establishment; Administrative Provisions

- a. **Establishment of Board.** There is established the Public Company Accounting Oversight Board, to 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 the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.
- b. **Status.** The Board shall not be an agency or establishment of the United States Government, and, except as otherwise provided in this Act, shall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act. No member or person employed by, or agent for, the Board shall be deemed to be an officer or employee of or agent for the Federal Government by reason of such service.
- c. **Duties of the Board.** The Board shall, subject to action by the Commission under section 107, and once a determination is made by the Commission under subsection (d) of this section--
 - 1. register public accounting firms that prepare audit reports for issuers, in accordance with section 102;
 - 2. establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers, in accordance with section 103;
 - 3. conduct inspections of registered public accounting firms, in accordance with section 104 and the rules of the Board;
 - 4. conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms, in accordance with section 105;
 - 5. perform such other duties or functions as the Board (or the Commission, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and

associated persons thereof, or otherwise to carry out this Act, in order to protect investors, or to further the public interest;

6. enforce compliance with this Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons thereof; and
 7. set the budget and manage the operations of the Board and the staff of the Board.
- d. **Commission Determination.** The members of the Board shall take such action (including hiring of staff, proposal of rules, and adoption of initial and transitional auditing and other professional standards) as may be necessary or appropriate to enable the Commission to determine, not later than 270 days after the date of enactment of this Act, that the Board is so organized and has the capacity to carry out the requirements of this title, and to enforce compliance with this title by registered public accounting firms and associated persons thereof. The Commission shall be responsible, prior to the appointment of the Board, for the planning for the establishment and administrative transition to the Board's operation.
- e. **Board Membership.**
1. **Composition.** The Board shall have 5 members, appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.
 2. **Limitation.** Two members, and only 2 members, of the Board shall be or have been certified public accountants pursuant to the laws of 1 or more States, provided that, if 1 of those 2 members is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board.
 3. **Full-time independent service.** Each member of the Board shall serve on a full-time basis, and may not, concurrent with service on the Board, be employed by any other person or engage in any other professional or business activity. No member of the Board may share in any of the profits of, or receive payments from, a public accounting firm (or any other person, as determined by rule of the Commission), other than fixed continuing payments, subject to such conditions as the Commission may impose, under standard arrangements for the retirement of members of public accounting firms.
 4. **Appointment of board members.**
 - A. **Initial board.** Not later than 90 days after the date of enactment of this Act, the Commission, after consultation with the Chairman of the Board of Governors of the

Federal Reserve System and the Secretary of the Treasury, shall appoint the chairperson and other initial members of the Board, and shall designate a term of service for each.

- B. **Vacancies.** A vacancy on the Board shall not affect the powers of the Board, but shall be filled in the same manner as provided for appointments under this section.

5. **Term of service.**

- A. **In general.** The term of service of each Board member shall be 5 years, and until a successor is appointed, except that--

- i. the terms of office of the initial Board members (other than the chairperson) shall expire in annual increments, 1 on each of the first 4 anniversaries of the initial date of appointment; and
- ii. any Board member appointed to fill a vacancy occurring before the expiration of the term for which the predecessor was appointed shall be appointed only for the remainder of that term.

- B. **Term limitation.** No person may serve as a member of the Board, or as chairperson of the Board, for more than 2 terms, whether or not such terms of service are consecutive.

6. **Removal from office.** A member of the Board may be removed by the Commission from office, in accordance with section 107(d)(3), for good cause shown before the expiration of the term of that member.

- f. **Powers of the Board.** In addition to any authority granted to the Board otherwise in this Act, the Board shall have the power, subject to section 107--

1. to sue and be sued, complain and defend, in its corporate name and through its own counsel, with the approval of the Commission, in any Federal, State, or other court;
2. to conduct its operations and maintain offices, and to exercise all other rights and powers authorized by this Act, in any State, without regard to any qualification, licensing, or other provision of law in effect in such State (or a political subdivision thereof);
3. to lease, purchase, accept gifts or donations of or otherwise acquire, improve, use, sell, exchange, or convey, all of or an interest in any property, wherever situated;
4. to appoint such employees, accountants, attorneys, and other agents as may be necessary or appropriate, and to determine their qualifications, define their duties, and fix their salaries or other compensation (at a level that is comparable to private sector self-regulatory, accounting, technical, supervisory, or other staff or management positions);

5. to allocate, assess, and collect accounting support fees established pursuant to section 109, for the Board, and other fees and charges imposed under this title; and
 6. to enter into contracts, execute instruments, incur liabilities, and do any and all other acts and things necessary, appropriate, or incidental to the conduct of its operations and the exercise of its obligations, rights, and powers imposed or granted by this title.
- g. **Rules of the Board.** The rules of the Board shall, subject to the approval of the Commission--
1. provide for the operation and administration of the Board, the exercise of its authority, and the performance of its responsibilities under this Act;
 2. permit, as the Board determines necessary or appropriate, delegation by the Board of any of its functions to an individual member or employee of the Board, or to a division of the Board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any matter, except that--
 - A. the Board shall retain a discretionary right to review any action pursuant to any such delegated function, upon its own motion;
 - B. a person shall be entitled to a review by the Board with respect to any matter so delegated, and the decision of the Board upon such review shall be deemed to be the action of the Board for all purposes (including appeal or review thereof); and
 - C. if the right to exercise a review described in subparagraph (A) is declined, or if no such review is sought within the time stated in the rules of the Board, then the action taken by the holder of such delegation shall for all purposes, including appeal or review thereof, be deemed to be the action of the Board;
 3. establish ethics rules and standards of conduct for Board members and staff, including a bar on practice before the Board (and the Commission, with respect to Board-related matters) of 1 year for former members of the Board, and appropriate periods (not to exceed 1 year) for former staff of the Board; and
 4. provide as otherwise required by this Act.
- h. **Annual Report to the Commission.** The Board shall submit an annual report (including its audited financial statements) to the Commission, and the Commission shall transmit a copy of that report to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, not later than 30 days after the date of receipt of that report by the Commission.

Section 102 -- Registration with the Board

- a. **Mandatory Registration.** Beginning 180 days after the date of the determination of the Commission under [section 101\(d\)](#), it shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.
- b. **Applications for Registration.**
1. **Form of application.** A public accounting firm shall use such form as the Board may prescribe, by rule, to apply for registration under this section.
 2. **Contents of applications.** Each public accounting firm shall submit, as part of its application for registration, in such detail as the Board shall specify--
 - A. the names of all issuers for which the firm prepared or issued audit reports during the immediately preceding calendar year, and for which the firm expects to prepare or issue audit reports during the current calendar year;
 - B. the annual fees received by the firm from each such issuer for audit services, other accounting services, and non-audit services, respectively;
 - C. such other current financial information for the most recently completed fiscal year of the firm as the Board may reasonably request;
 - D. a statement of the quality control policies of the firm for its accounting and auditing practices;
 - E. a list of all accountants associated with the firm who participate in or contribute to the preparation of audit reports, stating the license or certification number of each such person, as well as the State license numbers of the firm itself;
 - F. information relating to criminal, civil, or administrative actions or disciplinary proceedings pending against the firm or any associated person of the firm in connection with any audit report;
 - G. copies of any periodic or annual disclosure filed by an issuer with the Commission during the immediately preceding calendar year which discloses accounting disagreements between such issuer and the firm in connection with an audit report furnished or prepared by the firm for such issuer; and
 - H. such other information as the rules of the Board or the Commission shall specify as necessary or appropriate in the public interest or for the protection of investors.
 3. **Consents.** Each application for registration under this subsection shall include--

- A. a consent executed by the public accounting firm to cooperation in and compliance with any request for testimony or the production of documents made by the Board in the furtherance of its authority and responsibilities under this title (and an agreement to secure and enforce similar consents from each of the associated persons of the public accounting firm as a condition of their continued employment by or other association with such firm); and
- B. a statement that such firm understands and agrees that cooperation and compliance, as described in the consent required by subparagraph (A), and the securing and enforcement of such consents from its associated persons, in accordance with the rules of the Board, shall be a condition to the continuing effectiveness of the registration of the firm with the Board.

c. Action on Applications.

- 1. **Timing.** The Board shall approve a completed application for registration not later than 45 days after the date of receipt of the application, in accordance with the rules of the Board, unless the Board, prior to such date, issues a written notice of disapproval to, or requests more information from, the prospective registrant.
 - 2. **Treatment.** A written notice of disapproval of a completed application under paragraph (1) for registration shall be treated as a disciplinary sanction for purposes of sections [105\(d\)](#) and [107\(c\)](#).
- d. Periodic Reports.** Each registered public accounting firm shall submit an annual report to the Board, and may be required to report more frequently, as necessary to update the information contained in its application for registration under this section, and to provide to the Board such additional information as the Board or the Commission may specify, in accordance with subsection (b)(2).
- e. Public Availability.** Registration applications and annual reports required by this subsection, or such portions of such applications or reports as may be designated under rules of the Board, shall be made available for public inspection, subject to rules of the Board or the Commission, and to applicable laws relating to the confidentiality of proprietary, personal, or other information contained in such applications or reports, provided that, in all events, the Board shall protect from public disclosure information reasonably identified by the subject accounting firm as proprietary information.
- f. Registration and Annual Fees.** The Board shall assess and collect a registration fee and an annual fee from each registered public accounting firm, in amounts that are sufficient to recover the costs of processing and reviewing applications and annual reports.

Section 103 -- Auditing, Quality Control, and Independence Standards and Rules

a. Auditing, Quality Control, and Ethics Standards.

1. **In general.** The Board shall, by rule, establish, including, to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4), and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.
2. **Rule requirements.** In carrying out paragraph (1), the Board--
 - A. shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall--
 - i. prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report;
 - ii. provide a concurring or second partner review and approval of such audit report (and other related information), and concurring approval in its issuance, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board); and
 - iii. describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by [section 404\(b\)](#), and present (in such report or in a separate report)--
 - I. the findings of the auditor from such testing;
 - II. an evaluation of whether such internal control structure and procedures--
 - (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are

being made only in accordance with authorizations of management and directors of the issuer; and

III. a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.

B. shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to--

- i. monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;
- ii. consultation within such firm on accounting and auditing questions;
- iii. supervision of audit work;
- iv. hiring, professional development, and advancement of personnel;
- v. the acceptance and continuation of engagements;
- vi. internal inspection; and
- vii. such other requirements as the Board may prescribe, subject to subsection (a)(1).

3. Authority to adopt other standards.

A. **In general.** In carrying out this subsection, the Board--

- i. may adopt as its rules, subject to the terms of [section 107](#), any portion of any statement of auditing standards or other professional standards that the Board determines satisfy the requirements of paragraph (1), and that were proposed by 1 or more professional groups of accountants that shall be designated or recognized by the Board, by rule, for such purpose, pursuant to this paragraph or 1 or more advisory groups convened pursuant to paragraph (4); and
- ii. notwithstanding clause (i), shall retain full authority to modify, supplement, revise, or subsequently amend, modify, or repeal, in whole or in part, any portion of any statement described in clause (i).

B. **Initial and transitional standards.** The Board shall adopt standards described in subparagraph (A)(i) as initial or transitional standards, to the extent the Board determines necessary, prior to a determination of the Commission under [section 101\(d\)](#), and such standards shall be separately approved by the Commission at the time of that

determination, without regard to the procedures required by section 107 that otherwise would apply to the approval of rules of the Board.

4. **Advisory groups.** The Board shall convene, or authorize its staff to convene, such expert advisory groups as may be appropriate, which may include practicing accountants and other experts, as well as representatives of other interested groups, subject to such rules as the Board may prescribe to prevent conflicts of interest, to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section.
- b. **Independence Standards and Rules.** The Board shall establish such rules as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, title II of this Act.
- c. **Cooperation With Designated Professional Groups of Accountants and Advisory Groups.**
 1. **In general.** The Board shall cooperate on an ongoing basis with professional groups of accountants designated under subsection (a)(3)(A) and advisory groups convened under subsection (a)(4) in the examination of the need for changes in any standards subject to its authority under subsection (a), recommend issues for inclusion on the agendas of such designated professional groups of accountants or advisory groups, and take such other steps as it deems appropriate to increase the effectiveness of the standard setting process.
 2. **Board responses.** The Board shall respond in a timely fashion to requests from designated professional groups of accountants and advisory groups referred to in paragraph (1) for any changes in standards over which the Board has authority.
- d. **Evaluation of Standard Setting Process.** The Board shall include in the annual report required by [section 101\(h\)](#) the results of its standard setting responsibilities during the period to which the report relates, including a discussion of the work of the Board with any designated professional groups of accountants and advisory groups described in paragraphs (3)(A) and (4) of subsection (a), and its pending issues agenda for future standard setting projects.

Section 104 -- Inspections of Registered Public Accounting Firms

- a. **In General.** The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers.
- b. **Inspection Frequency.**

1. **In general.** Subject to paragraph (2), inspections required by this section shall be conducted--
 - A. annually with respect to each registered public accounting firm that regularly provides audit reports for more than 100 issuers; and
 - B. not less frequently than once every 3 years with respect to each registered public accounting firm that regularly provides audit reports for 100 or fewer issuers.
2. **Adjustments to schedules.** The Board may, by rule, adjust the inspection schedules set under paragraph (1) if the Board finds that different inspection schedules are consistent with the purposes of this Act, the public interest, and the protection of investors. The Board may conduct special inspections at the request of the Commission or upon its own motion.
- c. **Procedures.** The Board shall, in each inspection under this section, and in accordance with its rules for such inspections--
 1. identify any act or practice or omission to act by the registered public accounting firm, or by any associated person thereof, revealed by such inspection that may be in violation of this Act, the rules of the Board, the rules of the Commission, the firm's own quality control policies, or professional standards;
 2. report any such act, practice, or omission, if appropriate, to the Commission and each appropriate State regulatory authority; and
 3. begin a formal investigation or take disciplinary action, if appropriate, with respect to any such violation, in accordance with this Act and the rules of the Board.
- d. **Conduct of Inspections.** In conducting an inspection of a registered public accounting firm under this section, the Board shall--
 1. inspect and review selected audit and review engagements of the firm (which may include audit engagements that are the subject of ongoing litigation or other controversy between the firm and 1 or more third parties), performed at various offices and by various associated persons of the firm, as selected by the Board;
 2. evaluate the sufficiency of the quality control system of the firm, and the manner of the documentation and communication of that system by the firm; and
 3. perform such other testing of the audit, supervisory, and quality control procedures of the firm as are necessary or appropriate in light of the purpose of the inspection and the responsibilities of the Board.

- e. **Record Retention.** The rules of the Board may require the retention by registered public accounting firms for inspection purposes of records whose retention is not otherwise required by [section 103](#) or the rules issued thereunder.
- f. **Procedures for Review.** The rules of the Board shall provide a procedure for the review of and response to a draft inspection report by the registered public accounting firm under inspection. The Board shall take such action with respect to such response as it considers appropriate (including revising the draft report or continuing or supplementing its inspection activities before issuing a final report), but the text of any such response, appropriately redacted to protect information reasonably identified by the accounting firm as confidential, shall be attached to and made part of the inspection report.
- g. **Report.** A written report of the findings of the Board for each inspection under this section, subject to subsection (h), shall be--
 - 1. transmitted, in appropriate detail, to the Commission and each appropriate State regulatory authority, accompanied by any letter or comments by the Board or the inspector, and any letter of response from the registered public accounting firm; and
 - 2. made available in appropriate detail to the public (subject to [section 105\(b\)\(5\)\(A\)](#), and to the protection of such confidential and proprietary information as the Board may determine to be appropriate, or as may be required by law), except that no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report.
- h. **Interim Commission Review.**
 - 1. **Reviewable matters.** A registered public accounting firm may seek review by the Commission, pursuant to such rules as the Commission shall promulgate, if the firm--
 - A. has provided the Board with a response, pursuant to rules issued by the Board under subsection (f), to the substance of particular items in a draft inspection report, and disagrees with the assessments contained in any final report prepared by the Board following such response; or
 - B. disagrees with the determination of the Board that criticisms or defects identified in an inspection report have not been addressed to the satisfaction of the Board within 12 months of the date of the inspection report, for purposes of subsection (g)(2).
 - 2. **Treatment of review.** Any decision of the Commission with respect to a review under paragraph (1) shall not be reviewable under [section 25](#) of the Securities Exchange Act of 1934, or deemed to be "final agency action" for purposes of section 704 of title 5, United States Code.

3. **Timing.** Review under paragraph (1) may be sought during the 30-day period following the date of the event giving rise to the review under subparagraph (A) or (B) of paragraph (1).

Section 105 -- Investigations and Disciplinary Proceedings

- a. **In General.** The Board shall establish, by rule, subject to the requirements of this section, fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.
- b. **Investigations.**
 1. **Authority.** In accordance with the rules of the Board, the Board may conduct an investigation of any act or practice, or omission to act, by a registered public accounting firm, any associated person of such firm, or both, that may violate any provision of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards, regardless of how the act, practice, or omission is brought to the attention of the Board.
 2. **Testimony and document production.** In addition to such other actions as the Board determines to be necessary or appropriate, the rules of the Board may--
 - A. require the testimony of the firm or of any person associated with a registered public accounting firm, with respect to any matter that the Board considers relevant or material to an investigation;
 - B. require the production of audit work papers and any other document or information in the possession of a registered public accounting firm or any associated person thereof, wherever domiciled, that the Board considers relevant or material to the investigation, and may inspect the books and records of such firm or associated person to verify the accuracy of any documents or information supplied;
 - C. request the testimony of, and production of any document in the possession of, any other person, including any client of a registered public accounting firm that the Board considers relevant or material to an investigation under this section, with appropriate notice, subject to the needs of the investigation, as permitted under the rules of the Board; and
 - D. provide for procedures to seek issuance by the Commission, in a manner established by the Commission, of a subpoena to require the testimony of, and production of any document in the possession of, any person, including any client of a registered public accounting firm, that the Board considers relevant or material to an investigation under this section.

3. **Noncooperation with investigations.**

- A. **In general.** If a registered public accounting firm or any associated person thereof refuses to testify, produce documents, or otherwise cooperate with the Board in connection with an investigation under this section, the Board may--
- i. suspend or bar such person from being associated with a registered public accounting firm, or require the registered public accounting firm to end such association;
 - ii. suspend or revoke the registration of the public accounting firm; and
 - iii. invoke such other lesser sanctions as the Board considers appropriate, and as specified by rule of the Board.
- B. **Procedure.** Any action taken by the Board under this paragraph shall be subject to the terms of [section 107\(c\)](#).

4. **Coordination and referral of investigations.**

- A. **Coordination.** The Board shall notify the Commission of any pending Board investigation involving a potential violation of the securities laws, and thereafter coordinate its work with the work of the Commission's Division of Enforcement, as necessary to protect an ongoing Commission investigation.
- B. **Referral.** The Board may refer an investigation under this section--
- i. to the Commission;
 - ii. to any other Federal functional regulator (as defined in section 509 of the Gramm-Leach-Bliley Act (15 U.S.C. 6809)), in the case of an investigation that concerns an audit report for an institution that is subject to the jurisdiction of such regulator; and
 - iii. at the direction of the Commission, to--
 - I. the Attorney General of the United States;
 - II. the attorney general of 1 or more States; and
 - III. the appropriate State regulatory authority.

5. **Use of documents.**

A. **Confidentiality.** Except as provided in subparagraph (B), all documents and information prepared or received by or specifically for the Board, and deliberations of the Board and its employees and agents, in connection with an inspection under section 104 or with an investigation under this section, shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, and shall be exempt from disclosure, in the hands of an agency or establishment of the Federal Government, under the Freedom of Information Act (5 U.S.C. 552a), or otherwise, unless and until presented in connection with a public proceeding or released in accordance with subsection (c).

B. **Availability to government agencies.** Without the loss of its status as confidential and privileged in the hands of the Board, all information referred to in subparagraph (A) may--

- i. be made available to the Commission; and
- ii. in the discretion of the Board, when determined by the Board to be necessary to accomplish the purposes of this Act or to protect investors, be made available to--

I. the Attorney General of the United States;

II. the appropriate Federal functional regulator (as defined in section 509 of the Gramm-Leach-Bliley Act (15 U.S.C. 6809)), other than the Commission, with respect to an audit report for an institution subject to the jurisdiction of such regulator;

III. State attorneys general in connection with any criminal investigation; and

IV. any appropriate State regulatory authority,

each of which shall maintain such information as confidential and privileged.

6. **Immunity.** Any employee of the Board engaged in carrying out an investigation under this Act shall be immune from any civil liability arising out of such investigation in the same manner and to the same extent as an employee of the Federal Government in similar circumstances.

c. **Disciplinary Procedures.**

1. **Notification; recordkeeping.** The rules of the Board shall provide that in any proceeding by the Board to determine whether a registered public accounting firm, or an associated person thereof, should be disciplined, the Board shall--

- A. bring specific charges with respect to the firm or associated person;
 - B. notify such firm or associated person of, and provide to the firm or associated person an opportunity to defend against, such charges; and
 - C. keep a record of the proceedings.
- 2. **Public hearings.** Hearings under this section shall not be public, unless otherwise ordered by the Board for good cause shown, with the consent of the parties to such hearing.
- 3. **Supporting statement.** A determination by the Board to impose a sanction under this subsection shall be supported by a statement setting forth--
 - A. each act or practice in which the registered public accounting firm, or associated person, has engaged (or omitted to engage), or that forms a basis for all or a part of such sanction;
 - B. the specific provision of this Act, the securities laws, the rules of the Board, or professional standards which the Board determines has been violated; and
 - C. the sanction imposed, including a justification for that sanction.
- 4. **Sanctions.** If the Board finds, based on all of the facts and circumstances, that a registered public accounting firm or associated person thereof has engaged in any act or practice, or omitted to act, in violation of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under this Act, or professional standards, the Board may impose such disciplinary or remedial sanctions as it determines appropriate, subject to applicable limitations under paragraph (5), including--
 - A. temporary suspension or permanent revocation of registration under this title;
 - B. temporary or permanent suspension or bar of a person from further association with any registered public accounting firm;
 - C. temporary or permanent limitation on the activities, functions, or operations of such firm or person (other than in connection with required additional professional education or training);
 - D. a civil money penalty for each such violation, in an amount equal to--
 - i. not more than \$ 100,000 for a natural person or \$ 2,000,000 for any other person; and

- ii. in any case to which paragraph (5) applies, not more than \$ 750,000 for a natural person or \$ 15,000,000 for any other person;
 - E. censure;
 - F. required additional professional education or training; or
 - G. any other appropriate sanction provided for in the rules of the Board.
5. **Intentional or other knowing conduct.** The sanctions and penalties described in subparagraphs (A) through (C) and (D)(ii) of paragraph (4) shall only apply to--
- A. intentional or knowing conduct, including reckless conduct, that results in violation of the applicable statutory, regulatory, or professional standard; or
 - B. repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.
6. **Failure to supervise.**
- A. **In general.** The Board may impose sanctions under this section on a registered accounting firm or upon the supervisory personnel of such firm, if the Board finds that--
 - i. the firm has failed reasonably to supervise an associated person, either as required by the rules of the Board relating to auditing or quality control standards, or otherwise, with a view to preventing violations of this Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under this Act, or professional standards; and
 - ii. such associated person commits a violation of this Act, or any of such rules, laws, or standards.
 - B. **Rule of construction.** No associated person of a registered public accounting firm shall be deemed to have failed reasonably to supervise any other person for purposes of subparagraph (A), if--
 - i. there have been established in and for that firm procedures, and a system for applying such procedures, that comply with applicable rules of the Board and that would reasonably be expected to prevent and detect any such violation by such associated person; and

- ii. such person has reasonably discharged the duties and obligations incumbent upon that person by reason of such procedures and system, and had no reasonable cause to believe that such procedures and system were not being complied with.

7. Effect of suspension.

- A. **Association with a public accounting firm.** It shall be unlawful for any person that is suspended or barred from being associated with a registered public accounting firm under this subsection willfully to become or remain associated with any registered public accounting firm, or for any registered public accounting firm that knew, or, in the exercise of reasonable care should have known, of the suspension or bar, to permit such an association, without the consent of the Board or the Commission.
- B. **Association with an issuer.** It shall be unlawful for any person that is suspended or barred from being associated with an issuer under this subsection willfully to become or remain associated with any issuer in an accountancy or a financial management capacity, and for any issuer that knew, or in the exercise of reasonable care should have known, of such suspension or bar, to permit such an association, without the consent of the Board or the Commission.

d. Reporting of Sanctions.

- 1. **Recipients.** If the Board imposes a disciplinary sanction, in accordance with this section, the Board shall report the sanction to--
 - A. the Commission;
 - B. any appropriate State regulatory authority or any foreign accountancy licensing board with which such firm or person is licensed or certified; and
 - C. the public (once any stay on the imposition of such sanction has been lifted).
- 2. **Contents.** The information reported under paragraph (1) shall include--
 - A. the name of the sanctioned person;
 - B. a description of the sanction and the basis for its imposition; and
 - C. such other information as the Board deems appropriate.

e. Stay of Sanctions.

- 1. **In general.** Application to the Commission for review, or the institution by the Commission of review, of any disciplinary action of the Board shall operate as a stay of any such disciplinary

action, unless and until the Commission orders (summarily or after notice and opportunity for hearing on the question of a stay, which hearing may consist solely of the submission of affidavits or presentation of oral arguments) that no such stay shall continue to operate.

2. **Expedited procedures.** The Commission shall establish for appropriate cases an expedited procedure for consideration and determination of the question of the duration of a stay pending review of any disciplinary action of the Board under this subsection.

Section 106 -- Foreign Public Accounting Firms

a. Applicability to Certain Foreign Firms.

1. **In general.** Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States or any State, except that registration pursuant to [section 102](#) shall not by itself provide a basis for subjecting such a foreign public accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.
2. **Board authority.** The Board may, by rule, determine that a foreign public accounting firm (or a class of such firms) that does not issue audit reports nonetheless plays such a substantial role in the preparation and furnishing of such reports for particular issuers, that it is necessary or appropriate, in light of the purposes of this Act and in the public interest or for the protection of investors, that such firm (or class of firms) should be treated as a public accounting firm (or firms) for purposes of registration under, and oversight by the Board in accordance with, this title.

b. Production of Audit Workpapers.

1. **Consent by foreign firms.** If a foreign public accounting firm issues an opinion or otherwise performs material services upon which a registered public accounting firm relies in issuing all or part of any audit report or any opinion contained in an audit report, that foreign public accounting firm shall be deemed to have consented--
 - A. to produce its audit workpapers for the Board or the Commission in connection with any investigation by either body with respect to that audit report; and
 - B. to be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for production of such workpapers.

2. **Consent by domestic firms.** A registered public accounting firm that relies upon the opinion of a foreign public accounting firm, as described in paragraph (1), shall be deemed--
- A. to have consented to supplying the audit workpapers of that foreign public accounting firm in response to a request for production by the Board or the Commission; and
 - B. to have secured the agreement of that foreign public accounting firm to such production, as a condition of its reliance on the opinion of that foreign public accounting firm.
- c. **Exemption Authority.** The Commission, and the Board, subject to the approval of the Commission, may, by rule, regulation, or order, and as the Commission (or Board) determines necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions exempt any foreign public accounting firm, or any class of such firms, from any provision of this Act or the rules of the Board or the Commission issued under this Act.
- d. **Definition.** In this section, the term "foreign public accounting firm" means a public accounting firm that is organized and operates under the laws of a foreign government or political subdivision thereof.

Section 107 -- Commission Oversight of the Board

- a. **General Oversight Responsibility.** The Commission shall have oversight and enforcement authority over the Board, as provided in this Act. The provisions of [section 17\(a\)\(1\)](#) of the Securities Exchange Act of 1934, and of [section 17\(b\)\(1\)](#) of the Securities Exchange Act of 1934 shall apply to the Board as fully as if the Board were a "registered securities association" for purposes of those sections 17(a)(1) and 17(b)(1).
- b. **Rules of the Board.**
- 1. **Definition.** In this section, the term "proposed rule" means any proposed rule of the Board, and any modification of any such rule.
 - 2. **Prior approval required.** No rule of the Board shall become effective without prior approval of the Commission in accordance with this section, other than as provided in [section 103\(a\)\(3\)\(B\)](#) with respect to initial or transitional standards.
 - 3. **Approval criteria.** The Commission shall approve a proposed rule, if it finds that the rule is consistent with the requirements of this Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors.
 - 4. **Proposed rule procedures.** The provisions of paragraphs (1) through (3) of [section 19\(b\)](#) of the Securities Exchange Act of 1934 shall govern the proposed rules of the Board, as fully as if the

Board were a "registered securities association" for purposes of that section 19(b), except that, for purposes of this paragraph--

- A. the phrase "consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization" in section 19(b)(2) of that Act shall be deemed to read "consistent with the requirements of title I of the Sarbanes-Oxley Act of 2002, and the rules and regulations issued thereunder applicable to such organization, or as necessary or appropriate in the public interest or for the protection of investors"; and
 - B. the phrase "otherwise in furtherance of the purposes of this title" in section 19(b)(3)(C) of that Act shall be deemed to read "otherwise in furtherance of the purposes of title I of the Sarbanes-Oxley Act of 2002".
5. **Commission authority to amend rules of the board.** The provisions of [section 19\(c\)](#) of the Securities Exchange Act of 1934 shall govern the abrogation, deletion, or addition to portions of the rules of the Board by the Commission as fully as if the Board were a "registered securities association" for purposes of that section 19(c), except that the phrase "to conform its rules to the requirements of this title and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this title" in section 19(c) of that Act shall, for purposes of this paragraph, be deemed to read "to assure the fair administration of the Public Company Accounting Oversight Board, conform the rules promulgated by that Board to the requirements of title I of the Sarbanes-Oxley Act of 2002, or otherwise further the purposes of that Act, the securities laws, and the rules and regulations thereunder applicable to that Board".

c. **Commission Review of Disciplinary Action Taken by the Board.**

- 1. **Notice of sanction.** The Board shall promptly file notice with the Commission of any final sanction on any registered public accounting firm or on any associated person thereof, in such form and containing such information as the Commission, by rule, may prescribe.
- 2. **Review of sanctions.** The provisions of sections [19\(d\)\(2\)](#) and [19\(e\)\(1\)](#) of the Securities Exchange Act of 1934 shall govern the review by the Commission of final disciplinary sanctions imposed by the Board (including sanctions imposed under [section 105\(b\)\(3\)](#) of this Act for noncooperation in an investigation of the Board), as fully as if the Board were a self-regulatory organization and the Commission were the appropriate regulatory agency for such organization for purposes of those sections 19(d)(2) and 19(e)(1), except that, for purposes of this paragraph--
 - A. [section 105\(e\)](#) of this Act (rather than that section 19(d)(2)) shall govern the extent to which application for, or institution by the Commission on its own motion of, review of any disciplinary action of the Board operates as a stay of such action;

- B. references in that section 19(e)(1) to "members" of such an organization shall be deemed to be references to registered public accounting firms;
 - C. the phrase "consistent with the purposes of this title" in that section 19(e)(1) shall be deemed to read "consistent with the purposes of this title and title I of the Sarbanes-Oxley Act of 2002";
 - D. references to rules of the Municipal Securities Rulemaking Board in that section 19(e)(1) shall not apply; and
 - E. the reference to section 19(e)(2) of the Securities Exchange Act of 1934 shall refer instead to section 107(c)(3) of this Act.
3. **Commission modification authority.** The Commission may enhance, modify, cancel, reduce, or require the remission of a sanction imposed by the Board upon a registered public accounting firm or associated person thereof, if the Commission, having due regard for the public interest and the protection of investors, finds, after a proceeding in accordance with this subsection, that the sanction--
- A. is not necessary or appropriate in furtherance of this Act or the securities laws; or
 - B. is excessive, oppressive, inadequate, or otherwise not appropriate to the finding or the basis on which the sanction was imposed.
- d. **Censure of the Board; Other Sanctions.**
- 1. **Rescission of board authority.** The Commission, by rule, consistent with the public interest, the protection of investors, and the other purposes of this Act and the securities laws, may relieve the Board of any responsibility to enforce compliance with any provision of this Act, the securities laws, the rules of the Board, or professional standards.
 - 2. **Censure of the board; limitations.** The Commission may, by order, as it determines necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act or the securities laws, censure or impose limitations upon the activities, functions, and operations of the Board, if the Commission finds, on the record, after notice and opportunity for a hearing, that the Board--
 - A. has violated or is unable to comply with any provision of this Act, the rules of the Board, or the securities laws; or
 - B. without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by a registered public accounting firm or an associated person thereof.

3. **Censure of board members; removal from office.** The Commission may, as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act or the securities laws, remove from office or censure any member of the Board, if the Commission finds, on the record, after notice and opportunity for a hearing, that such member--
 - A. has willfully violated any provision of this Act, the rules of the Board, or the securities laws;
 - B. has willfully abused the authority of that member; or
 - C. without reasonable justification or excuse, has failed to enforce compliance with any such provision or rule, or any professional standard by any registered public accounting firm or any associated person thereof.

Section 108 -- Accounting Standards

- a. **Amendment to Securities Act of 1933.** [Section 19](#) of the Securities Act of 1933 is amended--
 1. by redesignating subsections (b) and (c) as subsections (c) and (d), respectively; and
 2. by inserting after subsection (a) the following:
 - 3.

"(b) Recognition of Accounting Standards.--
"(1) In general.-- In carrying out its authority under subsection (a) and under section 13(b) of the Securities Exchange Act of 1934, the Commission may recognize, as 'generally accepted' for purposes of the securities laws, any accounting principles established by a standard setting body--
"(A) that--
"(i) is organized as a private entity;
"(ii) has, for administrative and operational purposes, a board of trustees (or equivalent body) serving in the public interest, the majority of whom are not, concurrent with their service on such board, and have not been during the 2-year period preceding such service, associated persons of any registered public accounting firm;
"(iii) is funded as provided in section 109 of the Sarbanes-Oxley Act of 2002;
"(iv) has adopted procedures to ensure prompt consideration, by

majority vote of its members, of changes to accounting principles necessary to reflect emerging accounting issues and changing business practices; and

"(v) considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors; and

"(B) that the Commission determines has the capacity to assist the Commission in fulfilling the requirements of subsection (a) and section 13(b) of the Securities Exchange Act of 1934, because, at a minimum, the standard setting body is capable of improving the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.

"(2) Annual report.-- A standard setting body described in paragraph (1) shall submit an annual report to the Commission and the public, containing audited financial statements of that standard setting body."

- b. **Commission Authority.** The Commission shall promulgate such rules and regulations to carry out section 19(b) of the Securities Act of 1933, as added by this section, as it deems necessary or appropriate in the public interest or for the protection of investors.
- c. **No Effect on Commission Powers.** Nothing in this Act, including this section and the amendment made by this section, shall be construed to impair or limit the authority of the Commission to establish accounting principles or standards for purposes of enforcement of the securities laws.
- d. **Study and Report on Adopting Principles-Based Accounting.**

1. **Study.**

- A. **In general.** The Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system.
- B. **Study topics.** The study required by subparagraph (A) shall include an examination of--
 - i. the extent to which principles-based accounting and financial reporting exists in the United States;
 - ii. the length of time required for change from a rules-based to a principles-based financial reporting system;

- iii. the feasibility of and proposed methods by which a principles-based system may be implemented; and
- iv. a thorough economic analysis of the implementation of a principles-based system.
 - a. **Report.** Not later than 1 year after the date of enactment of this Act, the Commission shall submit a report on the results of the study required by paragraph (1) to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

Section 109 -- Funding

- a. **In General.** The Board, and the standard setting body designated pursuant to [section 19\(b\)](#) of the Securities Act of 1933, as amended by [section 108](#), shall be funded as provided in this section.
- b. **Annual Budgets.** The Board and the standard setting body referred to in subsection (a) shall each establish a budget for each fiscal year, which shall be reviewed and approved according to their respective internal procedures not less than 1 month prior to the commencement of the fiscal year to which the budget pertains (or at the beginning of the Board's first fiscal year, which may be a short fiscal year). The budget of the Board shall be subject to approval by the Commission. The budget for the first fiscal year of the Board shall be prepared and approved promptly following the appointment of the initial five Board members, to permit action by the Board of the organizational tasks contemplated by [section 101\(d\)](#).
- c. **Sources and Uses of Funds.**
 - 1. **Recoverable budget expenses.** The budget of the Board (reduced by any registration or annual fees received under [section 102\(e\)](#) for the year preceding the year for which the budget is being computed), and all of the budget of the standard setting body referred to in subsection (a), for each fiscal year of each of those 2 entities, shall be payable from annual accounting support fees, in accordance with subsections (d) and (e). Accounting support fees and other receipts of the Board and of such standard-setting body shall not be considered public monies of the United States.
 - 2. **Funds generated from the collection of monetary penalties.** Subject to the availability in advance in an appropriations Act, and notwithstanding [subsection \(i\)](#), 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, which program is to be administered by the Board or by an entity or agent identified by the Board.

d. **Annual Accounting Support Fee for the Board.**

1. **Establishment of fee.** The Board shall establish, with the approval of the Commission, a reasonable annual accounting support fee (or a formula for the computation thereof), as may be necessary or appropriate to establish and maintain the Board. Such fee may also cover costs incurred in the Board's first fiscal year (which may be a short fiscal year), or may be levied separately with respect to such short fiscal year.
2. **Assessments.** The rules of the Board under paragraph (1) shall provide for the equitable allocation, assessment, and collection by the Board (or an agent appointed by the Board) of the fee established under paragraph (1), among issuers, in accordance with subsection (g), allowing for differentiation among classes of issuers, as appropriate.

e. **Annual Accounting Support Fee for Standard Setting Body.** The annual accounting support fee for the standard setting body referred to in subsection (a)--

1. shall be allocated in accordance with subsection (g), and assessed and collected against each issuer, on behalf of the standard setting body, by 1 or more appropriate designated collection agents, as may be necessary or appropriate to pay for the budget and provide for the expenses of that standard setting body, and to provide for an independent, stable source of funding for such body, subject to review by the Commission; and
2. may differentiate among different classes of issuers.

f. **Limitation on Fee.** The amount of fees collected under this section for a fiscal year on behalf of the Board or the standards setting body, as the case may be, shall not exceed the recoverable budget expenses of the Board or body, respectively (which may include operating, capital, and accrued items), referred to in subsection (c)(1).

g. **Allocation of Accounting Support Fees Among Issuers.** Any amount due from issuers (or a particular class of issuers) under this section to fund the budget of the Board or the standard setting body referred to in subsection (a) shall be allocated among and payable by each issuer (or each issuer in a particular class, as applicable) in an amount equal to the total of such amount, multiplied by a fraction--

1. the numerator of which is the average monthly equity market capitalization of the issuer for the 12-month period immediately preceding the beginning of the fiscal year to which such budget relates; and
2. the denominator of which is the average monthly equity market capitalization of all such issuers for such 12-month period.

h. **Conforming Amendments.** [Section 13\(b\)\(2\)](#) of the Securities Exchange Act of 1934 is amended--

1. in subparagraph (A), by striking "and" at the end; and
2. in subparagraph (B), by striking the period at the end and inserting the following: "; and

"(C) notwithstanding any other provision of law, pay the allocable share of such issuer of a reasonable annual accounting support fee or fees, determined in accordance with section 109 of the Sarbanes-Oxley Act of 2002."

- i. **Rule of Construction.** Nothing in this section shall be construed to render either the Board, the standard setting body referred to in subsection (a), or both, subject to procedures in Congress to authorize or appropriate public funds, or to prevent such organization from utilizing additional sources of revenue for its activities, such as earnings from publication sales, provided that each additional source of revenue shall not jeopardize, in the judgment of the Commission, the actual and perceived independence of such organization.
- j. **Start-Up Expenses of the Board.** From the unexpended balances of the appropriations to the Commission for fiscal year 2003, the Secretary of the Treasury is authorized to advance to the Board not to exceed the amount necessary to cover the expenses of the Board during its first fiscal year (which may be a short fiscal year).

Title II: Auditor Independence

Section 201 -- Services outside the Scope of Practice of Auditors

- a. **Prohibited Activities.** [Section 10A](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:
- b.

"(g) Prohibited Activities.--Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board

established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the 'Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including--

"(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

"(2) financial information systems design and implementation;

"(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

"(4) actuarial services;

"(5) internal audit outsourcing services;

"(6) management functions or human resources;

"(7) broker or dealer, investment adviser, 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.

"(h) Preapproval Required for Non-Audit Services.--A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).".

- c. **Exemption Authority.** The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under section 10A(g) of the Securities Exchange Act of 1934 (as added by this section), to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors, and subject to review by the Commission in the same manner as for rules of the Board under [section 107](#).

Section 202 -- Preapproval Requirements

[Section 10A](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(i) Preapproval Requirements.--

"(1) In general.----

"(A) Audit committee action.--All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the

issuer.
"(B) De minimus exception.--The preapproval requirement under subparagraph (A) is waived with respect to the provision of non-audit services for an issuer, if--
"(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the nonaudit services are provided;
"(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and
"(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.
"(2) Disclosure to investors.-- Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a).
"(3) Delegation authority.-- The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant preapprovals required by this subsection. The decisions of any member to whom authority is delegated under this paragraph to preapprove an activity under this subsection shall be presented to the full audit committee at each of its scheduled meetings.
"(4) Approval of audit services for other purposes.-- In carrying out its duties under subsection (m)(2), if the audit committee of an issuer approves an audit service within the scope of the engagement of the auditor, such audit service shall be deemed to have been preapproved for purposes of this subsection."

Section 203 -- Audit Partner Rotation

[Section 10A](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(j) Audit Partner Rotation.--It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has

performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."

Section 204 -- Auditor Reports to Audit Committees

[Section 10A](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(k) Reports to Audit Committees.--Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer--

"(1) all critical accounting policies and practices to be used;

"(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

"(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences."

Section 205 -- Conforming Amendments

a. **Definitions.** [Section 3\(a\)](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

b.

"(58) Audit committee.-- The term 'audit committee' means--

"(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

"(B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

"(59) Registered public accounting firm.-- The term 'registered public accounting firm' has the same meaning as in section 2 of the Sarbanes-Oxley Act of 2002."

c. **Auditor Requirements.** [Section 10A](#) of the Securities Exchange Act of 1934 is amended--

1. by striking "an independent public accountant" each place that term appears and inserting "a registered public accounting firm";
2. by striking "the independent public accountant" each place that term appears and inserting "the registered public accounting firm";
3. in subsection (c), by striking "No independent public accountant" and inserting "No registered public accounting firm"; and
4. in subsection (b)--

- A. by striking "the accountant" each place that term appears and inserting "the firm";
- B. by striking "such accountant" each place that term appears and inserting "such firm"; and
- C. in paragraph (4), by striking "the accountant's report" and inserting "the report of the firm".

Other References. The Securities Exchange Act of 1934 is amended--

in [section 12\(b\)\(1\)](#), by striking "independent public accountants" each place that term appears and inserting "a registered public accounting firm"; and

in subsections (e) and (i) of [section 17](#), by striking "an independent public accountant" each place that term appears and inserting "a registered public accounting firm".

Conforming Amendment. [Section 10A\(f\)](#) of the Securities Exchange Act of 1934 is amended--

by striking "Definition" and inserting "Definitions"; and

by adding at the end the following: "As used in this section, the term 'issuer' means an issuer (as defined in section 3), the securities of which are registered under section 12, or that is required to file reports pursuant to section 15(d), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn."

Section 206 -- Conflicts of Interest

[Section 10A](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(I) Conflicts of Interest.--It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the

issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."

Section 207 -- Study of Mandatory Rotation of Registered Public Accounting Firms

- a. **Study and Review Required.** The Comptroller General of the United States shall conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.
- b. **Report Required.** Not later than 1 year after the date of enactment of this Act, the Comptroller General shall submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the results of the study and review required by this section.
- c. **Definition.** For purposes of this section, the term "mandatory rotation" refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.

Section 208 -- Commission Authority

- a. **Commission Regulations.** Not later than 180 days after the date of enactment of this Act, the Commission shall issue final regulations to carry out each of subsections (g) through (l) of [section 10A](#) of the Securities Exchange Act of 1934, as added by this title.
- b. **Auditor Independence.** It shall be unlawful for any registered public accounting firm (or an associated person thereof, as applicable) to prepare or issue any audit report with respect to any issuer, if the firm or associated person engages in any activity with respect to that issuer prohibited by any of subsections (g) through (l) of section 10A of the Securities Exchange Act of 1934, as added by this title, or any rule or regulation of the Commission or of the Board issued thereunder.

Section 209 -- Considerations by Appropriate State Regulatory Authorities

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms. The standards applied by the Board under this Act should not

be presumed to be applicable for purposes of this section for small and medium sized nonregistered public accounting firms.

Title III: Corporate Responsibility

Section 301 -- Public Company Audit Committees

[Section 10A](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

"(m) Standards Relating to Audit Committees.--
"(1) Commission rules.----
"(A) In general.--Effective not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs (2) through (6).
"(B) Opportunity to cure defects.--The rules of the Commission under subparagraph (A) shall provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition under subparagraph (A), before the imposition of such prohibition.
"(2) Responsibilities relating to registered public accounting firms.-- The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.
"(3) Independence.----
"(A) In general.--Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.
"(B) Criteria.--In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of

directors, or any other board committee--
"(i) accept any consulting, advisory, or other compensatory fee from the issuer; or
"(ii) be an affiliated person of the issuer or any subsidiary thereof.
"(C) Exemption authority.--The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.
"(4) Complaints.-- Each audit committee shall establish procedures for--
"(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
"(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
"(5) Authority to engage advisers.-- Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.
"(6) Funding.-- Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation--
"(A) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and
"(B) to any advisers employed by the audit committee under paragraph (5).".

Section 302 -- Corporate Responsibility for Financial Reports

- a. **Regulations Required.** The Commission shall, by rule, require, for each company filing periodic reports under section [13\(a\)](#) or [15\(d\)](#) of the Securities Exchange Act of 1934, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that--
1. the signing officer has reviewed the report;
 2. based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

3. based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
 4. the signing officers--
 - A. are responsible for establishing and maintaining internal controls;
 - B. have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - C. have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
 - D. have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
 5. the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)--
 - A. all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
 - B. any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
 6. the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.
- b. **Foreign Reincorporations Have No Effect.** Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.
 - c. **Deadline.** The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.

Section 303 -- Improper Influence on Conduct of Audits

- a. **Rules To Prohibit.** It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.
- b. **Enforcement.** In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.
- c. **No Preemption of Other Law.** The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.
- d. **Deadline for Rulemaking.** The Commission shall--
 - 1. propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and
 - 2. issue final rules or regulations required by this section, not later than 270 days after that date of enactment.

Section 304 -- Forfeiture of Certain Bonuses and Profits

- a. **Additional Compensation Prior to Noncompliance with Commission Financial Reporting Requirements.** If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--
 - 1. any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
 - 2. any profits realized from the sale of securities of the issuer during that 12-month period.
- b. **Commission Exemption Authority.** The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

Section 305 -- Officer and Director Bars and Penalties

a. Unfitness Standard.

1. **Securities exchange act of 1934.** [Section 21\(d\)\(2\)](#) of the Securities Exchange Act of 1934 is amended by striking "substantial unfitness" and inserting "unfitness".
2. **Securities act of 1933.** [Section 20\(e\)](#) of the Securities Act of 1933 is amended by striking "substantial unfitness" and inserting "unfitness".

b. Equitable Relief. [Section 21\(d\)](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

c.

"(5) Equitable Relief.-- In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.".

Section 306 -- Insider Trades during Pension Fund Blackout Periods

a. Prohibition of Insider Trading During Pension Fund Blackout Periods.

1. **In general.** Except to the extent otherwise provided by rule of the Commission pursuant to paragraph (3), it shall be unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer.
2. **Remedy.**
 - A. **In general.** Any profit realized by a director or executive officer referred to in paragraph (1) from any purchase, sale, or other acquisition or transfer in violation of this subsection shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such director or executive officer in entering into the transaction.

- B. **Actions to recover profits.** An action to recover profits in accordance with this subsection may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer fails or refuses to bring such action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit shall be brought more than 2 years after the date on which such profit was realized.
3. **Rulemaking Authorized.** The Commission shall, in consultation with the Secretary of Labor, issue rules to clarify the application of this subsection and to prevent evasion thereof. Such rules shall provide for the application of the requirements of paragraph (1) with respect to entities treated as a single employer with respect to an issuer under section 414(b), (c), (m), or (o) of the Internal Revenue Code of 1986 to the extent necessary to clarify the application of such requirements and to prevent evasion thereof. Such rules may also provide for appropriate exceptions from the requirements of this subsection, including exceptions for purchases pursuant to an automatic dividend reinvestment program or purchases or sales made pursuant to an advance election.
4. **Blackout period.** For purposes of this subsection, the term "blackout period", with respect to the equity securities of any issuer--
- A. means any period of more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan; and
- B. does not include, under regulations which shall be prescribed by the Commission--
- i. a regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity of such issuer, if such period is--
- I. incorporated into the individual account plan; and
- II. timely disclosed to employees before becoming participants under the individual account plan or as a subsequent amendment to the plan; or
- ii. any suspension described in subparagraph (A) that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, in an individual account plan by reason of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor.

5. **Individual account plan.** For purposes of this subsection, the term "individual account plan" has the meaning provided in section 3(34) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(34)), except that such term shall not include a one-participant retirement plan (within the meaning of section 101(i)(8)(B) of such Act (29 U.S.C. 1021(i)(8)(B))).
6. Notice to directors, executive officers, and the commission.-- In any case in which a director or executive officer is subject to the requirements of this subsection in connection with a blackout period (as defined in paragraph (4)) with respect to any equity securities, the issuer of such equity securities shall timely notify such director or officer and the Securities and Exchange Commission of such blackout period.

b. Notice Requirements to Participants and Beneficiaries under ERISA.

1. **In general.** Section 101 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1021) is amended by redesignating the second subsection (h) as subsection (j), and by inserting after the first subsection (h) the following new subsection:
- 2.

"(i) Notice of Blackout Periods to Participant or Beneficiary Under Individual Account Plan.--
"(1) Duties of plan administrator.-- In advance of the commencement of any blackout period with respect to an individual account plan, the plan administrator shall notify the plan participants and beneficiaries who are affected by such action in accordance with this subsection.
"(2) Notice requirements.----
"(A) In general.--The notices described in paragraph (1) shall be written in a manner calculated to be understood by the average plan participant and shall include--
"(i) the reasons for the blackout period,
"(ii) an identification of the investments and other rights affected,
"(iii) the expected beginning date and length of the blackout period,
"(iv) in the case of investments affected, a statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets credited to their accounts during the blackout period, and
"(v) such other matters as the Secretary may require by regulation.
"(B) Notice to participants and beneficiaries.--Except as otherwise provided in this subsection, notices described in paragraph (1) shall be furnished to all participants and beneficiaries under the plan to whom the blackout period

applies at least 30 days in advance of the blackout period.
"(C) Exception to 30-day notice requirement.--In any case in which--
"(i) a deferral of the blackout period would violate the requirements of subparagraph (A) or (B) of section 404(a)(1), and a fiduciary of the plan reasonably so determines in writing, or
"(ii) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator, and a fiduciary of the plan reasonably so determines in writing,
subparagraph (B) shall not apply, and the notice shall be furnished to all participants and beneficiaries under the plan to whom the blackout period applies as soon as reasonably possible under the circumstances unless such a notice in advance of the termination of the blackout period is impracticable.
"(D) Written notice.--The notice required to be provided under this subsection shall be in writing, except that such notice may be in electronic or other form to the extent that such form is reasonably accessible to the recipient.
"(E) Notice to issuers of employer securities subject to blackout period.--In the case of any blackout period in connection with an individual account plan, the plan administrator shall provide timely notice of such blackout period to the issuer of any employer securities subject to such blackout period.
"(3) Exception for blackout periods with limited applicability.-- In any case in which the blackout period applies only to 1 or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor and occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of such merger, acquisition, divestiture, or transaction, the requirement of this subsection that the notice be provided to all participants and beneficiaries shall be treated as met if the notice required under paragraph (1) is provided to such participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.
"(4) Changes in length of blackout period.-- If, following the furnishing of the notice pursuant to this subsection, there is a change in the beginning date or length of the blackout period (specified in such notice pursuant to paragraph (2)(A)(iii)), the administrator shall provide affected participants and beneficiaries notice of the change as soon as reasonably practicable. In relation to the extended blackout period, such notice shall meet the requirements of paragraph (2)(D) and shall specify any material change in the matters referred to in clauses (i) through (v) of paragraph (2)(A).
"(5) Regulatory exceptions.-- The Secretary may provide by regulation for additional exceptions to the requirements of this subsection which the Secretary determines are in the interests of participants and beneficiaries.

"(6) Guidance and model notices.-- The Secretary shall issue guidance and model notices which meet the requirements of this subsection.
"(7) Blackout period.-- For purposes of this subsection--
"(A) In general.--The term 'blackout period' means, in connection with an individual account plan, any period for which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of such plan, to direct or diversify assets credited to their accounts, to obtain loans from the plan, or to obtain distributions from the plan is temporarily suspended, limited, or restricted, if such suspension, limitation, or restriction is for any period of more than 3 consecutive business days.
"(B) Exclusions.--The term 'blackout period' does not include a suspension, limitation, or restriction--
"(i) which occurs by reason of the application of the securities laws (as defined in section 3(a)(47) of the Securities Exchange Act of 1934),
"(ii) which is a change to the plan which provides for a regularly scheduled suspension, limitation, or restriction which is disclosed to participants or beneficiaries through any summary of material modifications, any materials describing specific investment alternatives under the plan, or any changes thereto, or
"(iii) which applies only to 1 or more individuals, each of whom is the participant, an alternate payee (as defined in section 206(d)(3)(K)), or any other beneficiary pursuant to a qualified domestic relations order (as defined in section 206(d)(3)(B)(i)).
"(8) Individual account plan.----
"(A) In general.--For purposes of this subsection, the term 'individual account plan' shall have the meaning provided such term in section 3(34), except that such term shall not include a one-participant retirement plan.
"(B) One-participant retirement plan.--For purposes of subparagraph (A), the term 'one-participant retirement plan' means a retirement plan that--
"(i) on the first day of the plan year--
"(I) covered only the employer (and the employer's spouse) and the employer owned the entire business (whether or not incorporated), or
"(II) covered only one or more partners (and their spouses) in a business partnership (including partners in an S or C corporation (as defined in section 1361(a) of the Internal Revenue Code of 1986)),
"(ii) meets the minimum coverage requirements of section 410(b) of

the Internal Revenue Code of 1986 (as in effect on the date of the enactment of this paragraph) without being combined with any other plan of the business that covers the employees of the business,

"(iii) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses),

"(iv) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control, and

"(v) does not cover a business that leases employees."

Issuance of initial guidance and model notice. The Secretary of Labor shall issue initial guidance and a model notice pursuant to section 101(i)(6) of the Employee Retirement Income Security Act of 1974 (as added by this subsection) not later than January 1, 2003. Not later than 75 days after the date of the enactment of this Act, the Secretary shall promulgate interim final rules necessary to carry out the amendments made by this subsection.

a. **Civil penalties for failure to provide notice.** Section 502 of such Act (29 U.S.C. 1132) is amended--

- i. in subsection (a)(6), by striking "(5), or (6)" and inserting "(5), (6), or (7)";
- ii. by redesignating paragraph (7) of subsection (c) as paragraph (8); and
- iii. by inserting after paragraph (6) of subsection (c) the following new paragraph:
- iv.

"(7) The Secretary may assess a civil penalty against a plan administrator of up to \$ 100 a day from the date of the plan administrator's failure or refusal to provide notice to participants and beneficiaries in accordance with section 101(i). For purposes of this paragraph, each violation with respect to any single participant or beneficiary shall be treated as a separate violation."

Plan amendments. If any amendment made by this subsection requires an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after the effective date of this section, if--

. during the period after such amendment made by this subsection takes effect and before such first plan year, the plan is operated in good faith compliance with the requirements of such amendment made by this subsection, and

A. such plan amendment applies retroactively to the period after such amendment made by this subsection takes effect and before such first plan year.

Effective Date. The provisions of this section (including the amendments made thereby) shall take effect 180 days after the date of the enactment of this Act. Good faith compliance with the requirements of such provisions in advance of the issuance of applicable regulations thereunder shall be treated as compliance with such provisions.

Section 307 -- Rules of Professional Responsibility for Attorneys

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule--

1. requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
2. if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Section 308 -- Fair Funds for Investors

- a. **Civil Penalties Added to Disgorgement Funds for the Relief of Victims.** If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in [section 3\(a\)\(47\)](#) of the Securities Exchange Act of 1934) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.
- b. **Acceptance of Additional Donations.** The Commission is authorized to accept, hold, administer, and utilize gifts, bequests and devises of property, both real and personal, to the United States for a disgorgement fund described in subsection (a). Such gifts, bequests, and devises of money and proceeds from sales of other property received as gifts, bequests, or devises shall be deposited in the disgorgement fund and shall be available for allocation in accordance with subsection (a).

c. **Study Required.**

1. **Subject of study.** The Commission shall review and analyze--

- A. enforcement actions by the Commission over the five years preceding the date of the enactment of this Act that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors; and
- B. other methods to more efficiently, effectively, and fairly provide restitution to injured investors, including methods to improve the collection rates for civil penalties and disgorgements.

2. **Report Required.** The Commission shall report its findings to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate within 180 days after of the date of the enactment of this Act, and shall use such findings to revise its rules and regulations as necessary. The report shall include a discussion of regulatory or legislative actions that are recommended or that may be necessary to address concerns identified in the study.

d. **Conforming Amendments.** Each of the following provisions is amended by inserting ", except as otherwise provided in section 308 of the Sarbanes-Oxley Act of 2002" after "Treasury of the United States":

- 1. [Section 21\(d\)\(3\)\(C\)\(i\)](#) of the Securities Exchange Act of 1934.
- 2. [Section 21A\(d\)\(1\)](#) of such Act.
- 3. [Section 20\(d\)\(3\)\(A\)](#) of the Securities Act of 1933.
- 4. [Section 42\(e\)\(3\)\(A\)](#) of the Investment Company Act of 1940.
- 5. [Section 209\(e\)\(3\)\(A\)](#) of the Investment Advisers Act of 1940.

e. **Definition.** As used in this section, the term "disgorgement fund" means a fund established in any administrative or judicial proceeding described in subsection (a).

Title IV: Enhanced Financial Disclosures

Section 401 -- Disclosures in Periodic Reports

- a. **Disclosures Required.** [Section 13](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

b.

"(i) Accuracy of Financial Reports.--Each financial report that contains financial statements, and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles under this title and filed with the Commission shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission.

"(j) Off-Balance Sheet Transactions.--Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

- c. **Commission Rules on Pro Forma Figures.** Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that pro forma financial information included in any periodic or other report filed with the Commission pursuant to the securities laws, or in any public disclosure or press or other release, shall be presented in a manner that-

1. does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and
2. reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.

- d. **Study and Report on Special Purpose Entities.**

1. **Study required.** The Commission shall, not later than 1 year after the effective date of adoption of off-balance sheet disclosure rules required by section 13(j) of the Securities Exchange Act of 1934, as added by this section, complete a study of filings by issuers and their disclosures to determine--
 - A. the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and

- B. whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.
2. **Report and recommendations.** Not later than 6 months after the date of completion of the study required by paragraph (1), the Commission shall submit a report to the President, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, setting forth--
- A. the amount or an estimate of the amount of off-balance sheet transactions, including assets, liabilities, leases, and losses of, and the use of special purpose entities by, issuers filing periodic reports pursuant to section [13](#) or [15](#) of the Securities Exchange Act of 1934;
 - B. the extent to which special purpose entities are used to facilitate off-balance sheet transactions;
 - C. whether generally accepted accounting principles or the rules of the Commission result in financial statements of issuers reflecting the economics of such transactions to investors in a transparent fashion;
 - D. whether generally accepted accounting principles specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity; and
 - E. any recommendations of the Commission for improving the transparency and quality of reporting off-balance sheet transactions in the financial statements and disclosures required to be filed by an issuer with the Commission.

Section 402 -- Enhanced Conflict of Interest Provisions

- a. **Prohibition on Personal Loans to Executives.** [Section 13](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:
- b.

"(k) Prohibition on Personal Loans to Executives.--

"(1) In general.-- It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions

of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.
"(2) Limitation.-- Paragraph (1) does not preclude any home improvement and manufactured home loans (as that term is defined in section 5 of the Home Owners' Loan Act (12 U.S.C. 1464)), consumer credit (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or any extension of credit under an open end credit plan (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602)), or a charge card (as defined in section 127(c)(4)(e) of the Truth in Lending Act (15 U.S.C. 1637(c)(4)(e)), or any extension of credit by a broker or dealer registered under section 15 of this title to an employee of that broker or dealer to buy, trade, or carry securities, that is permitted under rules or regulations of the Board of Governors of the Federal Reserve System pursuant to section 7 of this title (other than an extension of credit that would be used to purchase the stock of that issuer), that is--
"(A) made or provided in the ordinary course of the consumer credit business of such issuer;
"(B) of a type that is generally made available by such issuer to the public; and
"(C) made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.
"(3) Rule of construction for certain loans.-- Paragraph (1) does not apply to any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."

Section 403 -- Disclosures of Transactions Involving Management and Principal Stockholders

- a. **Amendment.** [Section 16](#) of the Securities Exchange Act of 1934 is amended by striking the heading of such section and subsection (a) and inserting the following:
- b.

"Sec. 16. DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS.
"(a) Disclosures Required.--
"(1) Directors, officers, and principal stockholders required to file.-- Every person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security (other than an exempted security) which is registered pursuant to section 12, or who is a director or an officer of the issuer of such security, shall file the

statements required by this subsection with the Commission (and, if such security is registered on a national securities exchange, also with the exchange).
"(2) Time of filing.-- The statements required by this subsection shall be filed--
"(A) at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g);
"(B) within 10 days after he or she becomes such beneficial owner, director, or officer;
"(C) if there has been a change in such ownership, or if such person shall have purchased or sold a security-based swap agreement (as defined in section 206(b) of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note)) involving such equity security, before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the Commission shall establish, by rule, in any case in which the Commission determines that such 2-day period is not feasible.
"(3) Contents of statements.-- A statement filed--
"(A) under subparagraph (A) or (B) of paragraph (2) shall contain a statement of the amount of all equity securities of such issuer of which the filing person is the beneficial owner; and
"(B) under subparagraph (C) of such paragraph shall indicate ownership by the filing person at the date of filing, any such changes in such ownership, and such purchases and sales of the security-based swap agreements as have occurred since the most recent such filing under such subparagraph.
"(4) Electronic filing and availability.-- Beginning not later than 1 year after the date of enactment of the Sarbanes-Oxley Act of 2002--
"(A) a statement filed under subparagraph (C) of paragraph (2) shall be filed electronically;
"(B) the Commission shall provide each such statement on a publicly accessible Internet site not later than the end of the business day following that filing; and
"(C) the issuer (if the issuer maintains a corporate website) shall provide that statement on that corporate website, not later than the end of the business day following that filing."

- c. **Effective Date.** The amendment made by this section shall be effective 30 days after the date of the enactment of this Act.

Section 404 -- Management Assessment of Internal Controls

- a. **Rules Required.** The Commission shall prescribe rules requiring each annual report required by section [13\(a\)](#) or [15\(d\)](#) of the Securities Exchange Act of 1934 to contain an internal control report, which shall--
 - 1. state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - 2. contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- b. **Internal Control Evaluation and Reporting.** With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Section 405 -- Exemption

Nothing in section [401](#), [402](#), or [404](#), the amendments made by those sections, or the rules of the Commission under those sections shall apply to any investment company registered under [section 8](#) of the Investment Company Act of 1940.

Section 406 -- Code of Ethics for Senior Financial Officers

- a. **Code of Ethics Disclosure.** The Commission shall issue rules to require each issuer, together with periodic reports required pursuant to section [13\(a\)](#) or [15\(d\)](#) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefore, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.
- b. **Changes in Codes of Ethics.** The Commission shall revise its regulations concerning matters requiring prompt disclosure on [Form 8-K](#) (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.
- c. **Definition.** In this section, the term "code of ethics" means such standards as are reasonably necessary to promote--

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
 2. full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
 3. compliance with applicable governmental rules and regulations.
- d. **Deadline for Rulemaking.** The Commission shall--
1. propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and
 2. issue final rules to implement this section, not later than 180 days after that date of enactment.

Section 407 -- Disclosure of Audit Committee Financial Expert

- a. **Rules Defining "Financial Expert".** The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections [13\(a\)](#) and [15\(d\)](#) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.
- b. **Considerations.** In defining the term "financial expert" for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions--
1. an understanding of generally accepted accounting principles and financial statements;
 2. experience in--
 - A. the preparation or auditing of financial statements of generally comparable issuers; and
 - B. the application of such principles in connection with the accounting for estimates, accruals, and reserves;
 3. experience with internal accounting controls; and
 4. an understanding of audit committee functions.
- c. **Deadline for Rulemaking.** The Commission shall--

1. propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and
2. issue final rules to implement this section, not later than 180 days after that date of enactment.

Section 408 -- Enhanced Review of Periodic Disclosures by Issuers

- a. **Regular and Systematic Review.** The Commission shall review disclosures made by issuers reporting under section 13(a) of the Securities Exchange Act of 1934 (including reports filed on [Form 10-K](#)), and which have a class of securities listed on a national securities exchange or traded on an automated quotation facility of a national securities association, on a regular and systematic basis for the protection of investors. Such review shall include a review of an issuer's financial statement.
- b. **Review Criteria.** For purposes of scheduling the reviews required by subsection (a), the Commission shall consider, among other factors--
 1. issuers that have issued material restatements of financial results;
 2. issuers that experience significant volatility in their stock price as compared to other issuers;
 3. issuers with the largest market capitalization;
 4. emerging companies with disparities in price to earning ratios;
 5. issuers whose operations significantly affect any material sector of the economy; and
 6. any other factors that the Commission may consider relevant.
- c. **Minimum Review Period.** In no event shall an issuer required to file reports under section [13\(a\)](#) or [15\(d\)](#) of the Securities Exchange Act of 1934 be reviewed under this section less frequently than once every 3 years.

Section 409 -- Real Time Issuer Disclosures

[Section 13](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(l) Real Time Issuer Disclosures.--Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which

may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest."

Title V: Analyst Conflicts Of Interest

Section 501 -- Treatment of Securities Analysts by Registered Securities Associations and National Securities Exchanges

- a. **Rules Regarding Securities Analysts.** The Securities Exchange Act of 1934 is amended by inserting after section 15C the following new section:

"Sec. 15D. SECURITIES ANALYSTS AND RESEARCH REPORTS.

"(a) Analyst Protections.--The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information, including rules designed--

"(1) to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by--

"(A) restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;

"(B) limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and

"(C) requiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an

adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report, except that such rules may not limit the authority of a broker or dealer to discipline a securities analyst for causes other than such research report in accordance with the policies and procedures of the firm;
"(2) to define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities;
"(3) to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and
"(4) to address such other issues as the Commission, or such association or exchange, determines appropriate.
"(b) Disclosure.--The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report, as applicable, conflicts of interest that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report, including--
"(1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;
"(2) whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report, subject to such exemptions as the Commission may determine appropriate and necessary to prevent disclosure by virtue of this paragraph of material non-public information regarding specific potential future investment banking transactions of such issuer, as is appropriate in the public interest and consistent with the protection of investors;
"(3) whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the registered broker or dealer, and if so, stating the types of services provided to the issuer;
"(4) whether the securities analyst received compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either

generally or specifically earned from the issuer being analyzed) of the registered broker or dealer; and
"(5) such other disclosures of conflicts of interest that are material to investors, research analysts, or the broker or dealer as the Commission, or such association or exchange, determines appropriate.
"(c) Definitions.--In this section--
"(1) the term 'securities analyst' means any associated person of a registered broker or dealer that is principally responsible for, and any associated person who reports directly or indirectly to a securities analyst in connection with, the preparation of the substance of a research report, whether or not any such person has the job title of 'securities analyst'; and
"(2) the term 'research report' means a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision."

- b. **Enforcement.** [Section 21B\(a\)](#) of the Securities Exchange Act of 1934 is amended by inserting "15D," before "15B".
- c. **Commission Authority.** The Commission may promulgate and amend its regulations, or direct a registered securities association or national securities exchange to promulgate and amend its rules, to carry out section 15D of the Securities Exchange Act of 1934, as added by this section, as is necessary for the protection of investors and in the public interest.

Title VI: Commission Resources and Authority

Section 601 -- Authorization of Appropriations

[Section 35](#) of the Securities Exchange Act of 1934 is amended to read as follows:

"Sec. 35. AUTHORIZATION OF APPROPRIATIONS.
"In addition to any other funds authorized to be appropriated to the Commission, there are authorized to be appropriated to carry out the functions, powers, and duties of the Commission, \$ 776,000,000 for fiscal year 2003, of which--
"(1) \$ 102,700,000 shall be available to fund additional compensation, including

salaries and benefits, as authorized in the Investor and Capital Markets Fee Relief Act (Public Law 107-123; 115 Stat. 2390 et seq.);
"(2) \$ 108,400,000 shall be available for information technology, security enhancements, and recovery and mitigation activities in light of the terrorist attacks of September 11, 2001; and
"(3) \$ 98,000,000 shall be available to add not fewer than an additional 200 qualified professionals to provide enhanced oversight of auditors and audit services required by the Federal securities laws, and to improve Commission investigative and disciplinary efforts with respect to such auditors and services, as well as for additional professional support staff necessary to strengthen the programs of the Commission involving Full Disclosure and Prevention and Suppression of Fraud, risk management, industry technology review, compliance, inspections, examinations, market regulation, and investment management."

Section 602 -- Appearance and Practice before the Commission

The Securities Exchange Act of 1934 is amended by inserting after section 4B the following:

"Sec. 4C. APPEARANCE AND PRACTICE BEFORE THE COMMISSION.
"(a) Authority To Censure.--The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission, after notice and opportunity for hearing in the matter--
"(1) not to possess the requisite qualifications to represent others;
"(2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or
"(3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.
"(b) Definition.--With respect to any registered public accounting firm or associated person, for purposes of this section, the term 'improper professional conduct' means--
"(1) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; and
"(2) negligent conduct in the form of--
"(A) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the registered public accounting firm or associated person knows, or should know, that

heightened scrutiny is warranted; or

"(B) repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.".

Section 603 -- Federal Court Authority to Impose Penny Stock Bars

- a. **Securities Exchange Act of 1934.** [Section 21\(d\)](#) of the Securities Exchange Act of 1934, as amended by this Act, is amended by adding at the end the following:

"(6) Authority of a court to prohibit persons from participating in an offering of penny stock.----

"(A) In general.--In any proceeding under paragraph (1) against any person participating in, or, at the time of the alleged misconduct who was participating in, an offering of penny stock, the court may prohibit that person from participating in an offering of penny stock, conditionally or unconditionally, and permanently or for such period of time as the court shall determine.

"(B) Definition.--For purposes of this paragraph, the term 'person participating in an offering of penny stock' includes any person engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the purchase or sale of, any penny stock. The Commission may, by rule or regulation, define such term to include other activities, and may, by rule, regulation, or order, exempt any person or class of persons, in whole or in part, conditionally or unconditionally, from inclusion in such term.".

- b. **Securities Act of 1933.** [Section 20](#) of the Securities Act of 1933 is amended by adding at the end the following:

c.

"(g) Authority of a Court To Prohibit Persons From Participating in an Offering of Penny Stock.--

"(1) In general.-- In any proceeding under subsection (a) against any person participating in, or, at the time of the alleged misconduct, who was participating in, an offering of penny stock, the court may prohibit that person from participating in an offering of penny stock, conditionally or unconditionally, and permanently or for such period of time as the court shall determine.

"(2) Definition.-- For purposes of this subsection, the term 'person participating in an offering of penny stock' includes any person engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the

purchase or sale of, any penny stock. The Commission may, by rule or regulation, define such term to include other activities, and may, by rule, regulation, or order, exempt any person or class of persons, in whole or in part, conditionally or unconditionally, from inclusion in such term."

Section 604 -- Qualifications of Associated Persons of Brokers and Dealers

a. **Brokers and Dealers.** [Section 15\(b\)\(4\)](#) of the Securities Exchange Act of 1934 is amended--

1. by striking subparagraph (F) and inserting the following:

"(F) is subject to any order of the Commission barring or suspending the right of the person to be associated with a broker or dealer;" and

2. in subparagraph (G), by striking the period at the end and inserting the following: "; or

"(H) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that--

"(i) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

"(ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct."

b. **Investment Advisers.** [Section 203\(e\)](#) of the Investment Advisers Act of 1940 is amended--

1. by striking paragraph (7) and inserting the following:

"(7) is subject to any order of the Commission barring or suspending the right of the person to be associated with an investment adviser;"

2. in paragraph (8), by striking the period at the end and inserting "; or"; and

3. by adding at the end the following:

"(9) is subject to any final order of a State securities commission (or any agency or officer performing like functions), State authority that supervises or examines banks, savings associations, or credit unions, State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that--

"(A) bars such person from association with an entity regulated by such commission, authority, agency, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

"(B) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct."

c. Conforming Amendments.

1. Securities Exchange Act of 1934. The Securities Exchange Act of 1934 is amended--

A. in [section 3\(a\)\(39\)\(F\)](#)--

- i. by striking "or (G)" and inserting "(H), or (G)"; and
- ii. by inserting ", or is subject to an order or finding," before "enumerated";

B. in each of [section 15\(b\)\(6\)\(A\)\(i\)](#), paragraphs (2) and (4) of [section 15B\(c\)](#), and subparagraphs (A) and (C) of [section 15C\(c\)\(1\)](#)--

- i. by striking "or (G)" each place that term appears and inserting "(H), or (G)"; and
- ii. by striking "or omission" each place that term appears, and inserting ", or is subject to an order or finding,"; and

C. in each of paragraphs (3)(A) and (4)(C) of [section 17A\(c\)](#)--

- i. by striking "or (G)" each place that term appears and inserting "(H), or (G)"; and
- ii. by inserting ", or is subject to an order or finding," before "enumerated" each place that term appears.

Investment Advisers Act of 1940. [Section 203\(f\)](#) of the Investment Advisers Act of 1940 is amended--

- . by striking "or (8)" and inserting "(8), or (9)"; and
- A. by inserting "or (3)" after "paragraph (2)".

TITLE VII: STUDIES AND REPORTS

Section 701 -- GAO Study and Report Regarding Consolidation of Public Accounting Firms

- a. **Study Required.** The Comptroller General of the United States shall conduct a study--
 1. to identify--
 - A. the factors that have led to the consolidation of public accounting firms since 1989 and the consequent reduction in the number of firms capable of providing audit services to large national and multi-national business organizations that are subject to the securities laws;
 - B. the present and future impact of the condition described in subparagraph (A) on capital formation and securities markets, both domestic and international; and
 - C. solutions to any problems identified under subparagraph (B), including ways to increase competition and the number of firms capable of providing audit services to large national and multinational business organizations that are subject to the securities laws;
 2. of the problems, if any, faced by business organizations that have resulted from limited competition among public accounting firms, including--
 - A. higher costs;
 - B. lower quality of services;
 - C. impairment of auditor independence; or
 - D. lack of choice; and
 3. whether and to what extent Federal or State regulations impede competition among public accounting firms.
- b. **Consultation.** In planning and conducting the study under this section, the Comptroller General shall consult with--
 1. the Commission;
 2. the regulatory agencies that perform functions similar to the Commission within the other member countries of the Group of Seven Industrialized Nations;
 3. the Department of Justice; and

4. any other public or private sector organization that the Comptroller General considers appropriate.
- c. **Report Required.** Not later than 1 year after the date of enactment of this Act, the Comptroller General shall submit a report on the results of the study required by this section to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

Section 702 -- Commission Study and Report Regarding Credit Rating Agencies

- a. **Study Required.**
 1. **In general.** The Commission shall conduct a study of the role and function of credit rating agencies in the operation of the securities market.
 2. **Areas of consideration.** The study required by this subsection shall examine--
 - A. the role of credit rating agencies in the evaluation of issuers of securities;
 - B. the importance of that role to investors and the functioning of the securities markets;
 - C. any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers of securities;
 - D. any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers;
 - E. any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; and
 - F. any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts.
- b. **Report Required.** The Commission shall submit a report on the study required by subsection (a) to the President, the Committee on Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate not later than 180 days after the date of enactment of this Act.

Section 703 -- Study and Report on Violators and Violations

- a. **Study.** The Commission shall conduct a study to determine, based upon information for the period from January 1, 1998, to December 31, 2001--
 1. the number of securities professionals, defined as public accountants, public accounting firms, investment bankers, investment advisers, brokers, dealers, attorneys, and other securities professionals practicing before the Commission--
 - A. who have been found to have aided and abetted a violation of the Federal securities laws, including rules or regulations promulgated thereunder (collectively referred to in this section as "Federal securities laws"), but who have not been sanctioned, disciplined, or otherwise penalized as a primary violator in any administrative action or civil proceeding, including in any settlement of such an action or proceeding (referred to in this section as "aiders and abettors"); and
 - B. who have been found to have been primary violators of the Federal securities laws;
 2. a description of the Federal securities laws violations committed by aiders and abettors and by primary violators, including--
 - A. the specific provision of the Federal securities laws violated;
 - B. the specific sanctions and penalties imposed upon such aiders and abettors and primary violators, including the amount of any monetary penalties assessed upon and collected from such persons;
 - C. the occurrence of multiple violations by the same person or persons, either as an aider or abettor or as a primary violator; and
 - D. whether, as to each such violator, disciplinary sanctions have been imposed, including any censure, suspension, temporary bar, or permanent bar to practice before the Commission; and
 3. the amount of disgorgement, restitution, or any other fines or payments that the Commission has assessed upon and collected from, aiders and abettors and from primary violators.
- b. **Report.** A report based upon the study conducted pursuant to subsection (a) shall be submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives not later than 6 months after the date of enactment of this Act.

Section 704 -- Study of Enforcement Actions

- a. **Study Required.** The Commission shall review and analyze all enforcement actions by the Commission involving violations of reporting requirements imposed under the securities laws, and restatements of financial statements, over the 5-year period preceding the date of enactment of this Act, to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities.
- b. **Report Required.** The Commission shall report its findings to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, not later than 180 days after the date of enactment of this Act, and shall use such findings to revise its rules and regulations, as necessary. The report shall include a discussion of regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

Section 705 -- Study of Investment Banks

- a. **GAO Study.** The Comptroller General of the United States shall conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. The study should address the rule of investment banks and financial advisers--
 - 1. in the collapse of the Enron Corporation, including with respect to the design and implementation of derivatives transactions, transactions involving special purpose vehicles, and other financial arrangements that may have had the effect of altering the company's reported financial statements in ways that obscured the true financial picture of the company;
 - 2. in the failure of Global Crossing, including with respect to transactions involving swaps of fiberoptic cable capacity, in the designing transactions that may have had the effect of altering the company's reported financial statements in ways that obscured the true financial picture of the company; and
 - 3. generally, in creating and marketing transactions which may have been designed solely to enable companies to manipulate revenue streams, obtain loans, or move liabilities off balance sheets without altering the economic and business risks faced by the companies or any other mechanism to obscure a company's financial picture.
- b. **Report.** The Comptroller General shall report to Congress not later than 180 days after the date of enactment of this Act on the results of the study required by this section. The report shall include a discussion of regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

Title VIII: Corporate and Criminal Fraud Accountability

Section 801 -- Short Title

This title may be cited as the "Corporate and Criminal Fraud Accountability Act of 2002".

Section 802 -- Criminal Penalties for Altering Documents

- a. **In General.** Chapter 73 of title 18, United States Code, is amended by adding at the end the following:
- b.

"Sec. 1519. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy

"Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.
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"Sec. 1520. Destruction of corporate audit records
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"(a)(1) Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies, shall maintain all audit or review workpapers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded.
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"(2) The Securities and Exchange Commission shall promulgate, within 180 days, after adequate notice and an opportunity for comment, such rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review,
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which is conducted by any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(a)) applies. The Commission may, from time to time, amend or supplement the rules and regulations that it is required to promulgate under this section, after adequate notice and an opportunity for comment, in order to ensure that such rules and regulations adequately comport with the purposes of this section.

"(b) Whoever knowingly and willfully violates subsection (a)(1), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), shall be fined under this title, imprisoned not more than 10 years, or both.

"(c) Nothing in this section shall be deemed to diminish or relieve any person of any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying, any document."

- c. **Clerical Amendment.** The table of sections at the beginning of chapter 73 of title 18, United States Code, is amended by adding at the end the following new items:

"1519. Destruction, alteration, or falsification of records in Federal investigations and bankruptcy.

"1520. Destruction of corporate audit records."

Section 803 -- Debts Nondischargeable if Incurred in Violation of Securities Fraud Laws

Section 523(a) of title 11, United States Code, is amended--

1. in paragraph (17), by striking "or" after the semicolon;
2. in paragraph (18), by striking the period at the end and inserting "; or"; and
3. by adding at the end, the following:

"(19) that--

"(A) is for--

"(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State

securities laws, or any regulation or order issued under such Federal or State securities laws; or
"(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and
"(B) results from--
"(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;
"(ii) any settlement agreement entered into by the debtor; or
"(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor."

Section 804 -- Statute of Limitations for Securities Fraud

a. **In General.** Section 1658 of title 28, United States Code, is amended--

1. by inserting "(a)" before "Except"; and
2. by adding at the end the following:

"(b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of--
"(1) 2 years after the discovery of the facts constituting the violation; or
"(2) 5 years after such violation."

b. **Effective Date.** The limitations period provided by section 1658(b) of title 28, United States Code, as added by this section, shall apply to all proceedings addressed by this section that are commenced on or after the date of enactment of this Act.

c. **No Creation of Actions.** Nothing in this section shall create a new, private right of action.

Section 805 -- Review of Federal Sentencing Guidelines for Obstruction of Justice and Extensive Criminal Fraud

- a. **Enhancement of Fraud and Obstruction of Justice Sentences.** Pursuant to section 994 of title 28, United States Code, and in accordance with this section, the United States Sentencing Commission shall review and amend, as appropriate, the Federal Sentencing Guidelines and related policy statements to ensure that--
1. the base offense level and existing enhancements contained in United States Sentencing Guideline 2J1.2 relating to obstruction of justice are sufficient to deter and punish that activity;
 2. the enhancements and specific offense characteristics relating to obstruction of justice are adequate in cases where--
 - A. the destruction, alteration, or fabrication of evidence involves--
 - i. a large amount of evidence, a large number of participants, or is otherwise extensive;
 - ii. the selection of evidence that is particularly probative or essential to the investigation; or
 - iii. more than minimal planning; or
 - B. the offense involved abuse of a special skill or a position of trust;
 3. the guideline offense levels and enhancements for violations of section 1519 or 1520 of title 18, United States Code, as added by this title, are sufficient to deter and punish that activity;
 4. a specific offense characteristic enhancing sentencing is provided under United States Sentencing Guideline 2B1.1 (as in effect on the date of enactment of this Act) for a fraud offense that endangers the solvency or financial security of a substantial number of victims; and
 5. the guidelines that apply to organizations in United States Sentencing Guidelines, chapter 8, are sufficient to deter and punish organizational criminal misconduct.
- b. **Emergency Authority and Deadline for Commission Action.** The United States Sentencing Commission is requested to promulgate the guidelines or amendments provided for under this section as soon as practicable, and in any event not later than 180 days after the date of enactment of this Act, in accordance with the procedures set forth in section 219(a) of the Sentencing Reform Act of 1987, as though the authority under that Act had not expired.

Section 806 -- Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud

- a. **In General.** Chapter 73 of title 18, United States Code, is amended by inserting after section 1514 the following:

"Sec. 1514A. Civil action to protect against retaliation in fraud cases

"(a) Whistleblower Protection for Employees of Publicly Traded Companies.--No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

"(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

"(A) a Federal regulatory or law enforcement agency;

"(B) any Member of Congress or any committee of Congress; or

"(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

"(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

"(b) Enforcement Action.--

"(1) In general.-- A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief under subsection (c), by--

"(A) filing a complaint with the Secretary of Labor; or

"(B) if the Secretary has not issued a final decision within 180 days of the filing of the complaint and there is no showing that such delay is due to the bad faith of the claimant, bringing an action at law or equity for de novo review in the appropriate district court of the United States, which shall have jurisdiction over such an action without regard to the amount in controversy.

"(2) Procedure.----
"(A) In general.--An action under paragraph (1)(A) shall be governed under the rules and procedures set forth in section 42121(b) of title 49, United States Code.
"(B) Exception.--Notification made under section 42121(b)(1) of title 49, United States Code, shall be made to the person named in the complaint and to the employer.
"(C) Burdens of proof.--An action brought under paragraph (1)(B) shall be governed by the legal burdens of proof set forth in section 42121(b) of title 49, United States Code.
"(D) Statute of limitations.--An action under paragraph (1) shall be commenced not later than 90 days after the date on which the violation occurs.
"(c) Remedies.--
"(1) In general.-- An employee prevailing in any action under subsection (b)(1) shall be entitled to all relief necessary to make the employee whole.
"(2) Compensatory damages.-- Relief for any action under paragraph (1) shall include--
"(A) reinstatement with the same seniority status that the employee would have had, but for the discrimination;
"(B) the amount of back pay, with interest; and
"(C) compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees.
"(d) Rights Retained by Employee.--Nothing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement."

- b. **Clerical Amendment.** The table of sections at the beginning of chapter 73 of title 18, United States Code, is amended by inserting after the item relating to section 1514 the following new item:

"1514A. Civil action to protect against retaliation in fraud cases."

Section 807 -- Criminal Penalties for Defrauding Shareholders of Publicly Traded Companies

- a. **In General.** Chapter 63 of title 18, United States Code, is amended by adding at the end the following:

"Sec. 1348. Securities fraud
"Whoever knowingly executes, or attempts to execute, a scheme or artifice--
"(1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)); or
"(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d));
shall be fined under this title, or imprisoned not more than 25 years, or both."

- b. **Clerical Amendment.** The table of sections at the beginning of chapter 63 of title 18, United States Code, is amended by adding at the end the following new item:

"1348. Securities fraud."

Title IX : White-Collar Crime Penalty Enhancements

Section 901 -- Short Title

This title may be cited as the "White-Collar Crime Penalty Enhancement Act of 2002".

Section 902 -- Attempts and Conspiracies to Commit Criminal Fraud Offenses

- a. **In General.** Chapter 63 of title 18, United States Code, is amended by inserting after section 1348 as added by this Act the following:

"Sec. 1349. Attempt and conspiracy

"Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.

Section 903 -- Criminal Penalties for Mail and Wire Fraud

- a. **Mail Fraud.** Section 1341 of title 18, United States Code, is amended by striking "five" and inserting "20".
- b. **Wire Fraud.** Section 1343 of title 18, United States Code, is amended by striking "five" and inserting "20".

Section 904 -- Criminal Penalties for Violations of the Employee Retirement Income Security Act of 1974

Section 501 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1131) is amended--

- 1. by striking "\$ 5,000" and inserting "\$ 100,000";
- 2. by striking "one year" and inserting "10 years"; and
- 3. by striking "\$ 100,000" and inserting "\$ 500,000".

Section 905 -- Amendment to Sentencing Guidelines Relating to Certain White-Collar Offenses

- a. **Directive to the United States Sentencing Commission.** Pursuant to its authority under section 994(p) of title 18, United States Code, and in accordance with this section, the United States Sentencing Commission shall review and, as appropriate, amend the Federal Sentencing Guidelines and related policy statements to implement the provisions of this Act.
- b. **Requirements.** In carrying out this section, the Sentencing Commission shall--
 - 1. ensure that the sentencing guidelines and policy statements reflect the serious nature of the offenses and the penalties set forth in this Act, the growing incidence of serious fraud offenses which are identified above, and the need to modify the sentencing guidelines and policy statements to deter, prevent, and punish such offenses;
 - 2. consider the extent to which the guidelines and policy statements adequately address whether the guideline offense levels and enhancements for violations of the sections amended by this

Act are sufficient to deter and punish such offenses, and specifically, are adequate in view of the statutory increases in penalties contained in this Act;

3. assure reasonable consistency with other relevant directives and sentencing guidelines;
 4. account for any additional aggravating or mitigating circumstances that might justify exceptions to the generally applicable sentencing ranges;
 5. make any necessary conforming changes to the sentencing guidelines; and
 6. assure that the guidelines adequately meet the purposes of sentencing, as set forth in section 3553(a)(2) of title 18, United States Code.
- c. **Emergency Authority and Deadline for Commission Action.** The United States Sentencing Commission is requested to promulgate the guidelines or amendments provided for under this section as soon as practicable, and in any event not later than 180 days after the date of enactment of this Act, in accordance with the procedures set forth in section 219(a) of the Sentencing Reform Act of 1987, as though the authority under that Act had not expired.

Section 906 -- Corporate Responsibility for Financial Reports

- a. **In General.** Chapter 63 of title 18, United States Code, is amended by inserting after section 1349, as created by this Act, the following:

"Sec. 1350. Failure of corporate officers to certify financial reports
(a) Certification of Periodic Financial Reports.--Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.
"(b) Content.--The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.
"(c) Criminal Penalties.--Whoever--
"(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$ 1,000,000

or imprisoned not more than 10 years, or both; or

"(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$ 5,000,000, or imprisoned not more than 20 years, or both."

- b. **Clerical Amendment.** The table of sections at the beginning of chapter 63 of title 18, United States Code, is amended by adding at the end the following:

"1350. Failure of corporate officers to certify financial reports."

Title X: Corporate Tax Returns

Section 1001 -- Sense of the Senate Regarding the Signing of Corporate Tax Returns by Chief Executive Officers

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.

Title XI: Corporate Fraud and Accountability

Section 1101 -- Short Title

This title may be cited as the "Corporate Fraud Accountability Act of 2002".

Section 1102 -- Tampering with a Record or Otherwise Impeding an Official Proceeding

Section 1512 of title 18, United States Code, is amended--

1. by redesignating subsections (c) through (i) as subsections (d) through (j), respectively; and
2. by inserting after subsection (b) the following new subsection:

"(c) Whoever corruptly--
"(1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or
"(2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so,
shall be fined under this title or imprisoned not more than 20 years, or both."

Section 1103 -- Temporary Freeze Authority for the Securities and Exchange Commission

- a. **In General.** [Section 21C\(c\)](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

"(3) Temporary freeze.----
"(A) In general.--
"(i) Issuance of temporary order.--Whenever, during the course of a lawful investigation involving possible violations of the Federal securities laws by an issuer of publicly traded securities or any of its directors, officers, partners, controlling persons, agents, or employees, it shall appear to the Commission that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the Commission may petition a Federal district court for a temporary order requiring the issuer to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.
"(ii) Standard.--A temporary order shall be entered under clause (i), only after notice and opportunity for a hearing, unless the court determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest.
"(iii) Effective period.--A temporary order issued under clause (i) shall--
"(I) become effective immediately;
"(II) be served upon the parties subject to it; and
"(III) unless set aside, limited or suspended by a court of competent jurisdiction, shall remain effective and enforceable for 45 days.
"(iv) Extensions authorized.--The effective period of an order under this subparagraph may be extended by the court upon good cause shown for not

longer than 45 additional days, provided that the combined period of the order shall not exceed 90 days.

"(B) Process on Determination of violations.--

"(i) Violations charged.--If the issuer or other person described in subparagraph (A) is charged with any violation of the Federal securities laws before the expiration of the effective period of a temporary order under subparagraph (A) (including any applicable extension period), the order shall remain in effect, subject to court approval, until the conclusion of any legal proceedings related thereto, and the affected issuer or other person, shall have the right to petition the court for review of the order.

"(ii) Violations not charged.--If the issuer or other person described in subparagraph (A) is not charged with any violation of the Federal securities laws before the expiration of the effective period of a temporary order under subparagraph (A) (including any applicable extension period), the escrow shall terminate at the expiration of the 45-day effective period (or the expiration of any extension period, as applicable), and the disputed payments (with accrued interest) shall be returned to the issuer or other affected person."

- b. **Technical Amendment.** [Section 21C\(c\)\(2\)](#) of the Securities Exchange Act of 1934 is amended by striking "This" and inserting "paragraph (1)".

Section 1104 -- Amendment to the Federal Sentencing Guidelines

- a. **Request for Immediate Consideration by The United States Sentencing Commission.** Pursuant to its authority under section 994(p) of title 28, United States Code, and in accordance with this section, the United States Sentencing Commission is requested to--
1. promptly review the sentencing guidelines applicable to securities and accounting fraud and related offenses;
 2. expeditiously consider the promulgation of new sentencing guidelines or amendments to existing sentencing guidelines to provide an enhancement for officers or directors of publicly traded corporations who commit fraud and related offenses; and
 3. submit to Congress an explanation of actions taken by the Sentencing Commission pursuant to paragraph (2) and any additional policy recommendations the Sentencing Commission may have for combating offenses described in paragraph (1).
- b. **Considerations in Review.** In carrying out this section, the Sentencing Commission is requested to--

1. ensure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive and appropriate law enforcement action to prevent such offenses;
 2. assure reasonable consistency with other relevant directives and with other guidelines;
 3. account for any aggravating or mitigating circumstances that might justify exceptions, including circumstances for which the sentencing guidelines currently provide sentencing enhancements;
 4. ensure that guideline offense levels and enhancements for an obstruction of justice offense are adequate in cases where documents or other physical evidence are actually destroyed or fabricated;
 5. ensure that the guideline offense levels and enhancements under United States Sentencing Guideline 2B1.1 (as in effect on the date of enactment of this Act) are sufficient for a fraud offense when the number of victims adversely involved is significantly greater than 50;
 6. make any necessary conforming changes to the sentencing guidelines; and
 7. assure that the guidelines adequately meet the purposes of sentencing as set forth in section 3553 (a)(2) of title 18, United States Code.
- c. **Emergency Authority and Deadline For Commission Action.** The United States Sentencing Commission is requested to promulgate the guidelines or amendments provided for under this section as soon as practicable, and in any event not later than the 180 days after the date of enactment of this Act, in accordance with the procedures set forth in section 21(a) of the Sentencing Reform Act of 1987, as though the authority under that Act had not expired.

Section 1105 -- Authority of the Commission to Prohibit Persons from Serving as Officers or Directors

- a. **Securities Exchange Act of 1934.** [Section 21C](#) of the Securities Exchange Act of 1934 is amended by adding at the end the following:

"(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors.--In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 10(b) or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12, or that is required to file reports pursuant to section 15(d), if the conduct of that person demonstrates unfitness to serve as an officer or director of any such

issuer.".

- b. **Securities Act of 1933.** [Section 8A](#) of the Securities Act of 1933 is amended by adding at the end of the following:

"(f) Authority of the Commission to Prohibit Persons From Serving as Officers or Directors.--In any cease-and-desist proceeding under subsection (a), the Commission may issue an order to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who has violated section 17(a)(1) or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934, or that is required to file reports pursuant to section 15(d) of that Act, if the conduct of that person demonstrates unfitness to serve as an officer or director of any such issuer.".

Section 1106 -- Increased Criminal Penalties under Securities Exchange Act of 1934

[Section 32\(a\)](#) of the Securities Exchange Act of 1934 is amended--

1. by striking "\$ 1,000,000, or imprisoned not more than 10 years" and inserting "\$ 5,000,000, or imprisoned not more than 20 years"; and
2. by striking "\$ 2,500,000" and inserting "\$ 25,000,000".

Section 1107 -- Retaliation Against Informants

- a. **In General.** Section 1513 of title 18, United States Code, is amended by adding at the end the following:

"(e) Whoever knowingly, with the intent to retaliate, takes 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, shall be fined under this title or imprisoned not more than 10 years, or both.".

Sections Affected by the Sarbanes-Oxley Act of 2002

Added		
SECTION	DESCRIPTION	SARBANES-OXLEY
Securities Act of 1933		
<u>Sec. 8A(f)</u>	Officer and director bars	<u>Sec. 1105(b)</u>
<u>Sec. 19(b)</u>	Accounting standards	<u>Sec. 108(a)</u>
<u>Sec. 20(g)</u>	Penny stock bars	<u>Sec. 603(b)</u>
Securities Exchange Act of 1934		
<u>Sec. 3(a)(58)</u>	Audit committee	<u>Sec. 205(a)</u>
<u>Sec. 3(a)(59)</u>	Registered public accounting firm	<u>Sec. 205(a)</u>
<u>Sec. 4C</u>	Practice before the SEC	<u>Sec. 602</u>
<u>Sec. 10A(g)</u>	Prohibition on non-audit services	<u>Sec. 201(a)</u>
<u>Sec. 10A(h)</u>	Pre-approval of non-audit services	<u>Sec. 201(a)</u>
<u>Sec. 10A(i)</u>	Pre-approval requirements	<u>Sec. 202</u>
<u>Sec. 10A(j)</u>	Audit partner rotation	<u>Sec. 203</u>
<u>Sec. 10A(k)</u>	Reports to audit committees	<u>Sec. 204</u>
<u>Sec. 10A(l)</u>	Conflicts of interest	<u>Sec. 206</u>
<u>Sec. 10A(m)</u>	Audit committee standards	<u>Sec. 301</u>
<u>Sec. 13(i)</u>	Accuracy of financial reports	<u>Sec. 401(a)</u>
<u>Sec. 13(j)</u>	Off-balance sheet transactions	<u>Sec. 401(a)</u>
<u>Sec. 13(k)</u>	Prohibition on loans to executives	<u>Sec. 402</u>
<u>Sec. 13(l)</u>	Real time disclosures	<u>Sec. 409</u>
<u>Sec. 15(b)(4)(H)</u>	Broker and dealers	<u>Sec. 604(a)</u>
<u>Sec. 15D</u>	Securities analysts	<u>Sec. 501(a)</u>
<u>Sec. 21(d)(5)</u>	Equitable relief	<u>Sec. 305(b)</u>
<u>Sec. 21(d)(6)</u>	Penny stock bars	<u>Sec. 603(a)</u>
<u>Sec. 21C(c)(3)</u>	Temporary freeze of assets	<u>Sec. 1103(a)</u>
<u>Sec. 21C(f)</u>	Officer and director bars	<u>Sec. 1105(a)</u>
Investment Advisers Act of 1940		
<u>Sec. 203(e)(9)</u>	Investment advisor registration	<u>Sec. 604(b)</u>

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Amended		
SECTION	DESCRIPTION	SARBANES-OXLEY
Securities Act of 1933		
<u>Sec. 20(d)(3)(A)</u>	Conforming amendment	<u>Sec. 308(d)(3)</u>
<u>Sec. 20(e)</u>	Officer and director bars	<u>Sec. 305(a)(2)</u>
Securities Exchange Act of 1934		
<u>Sec. 3(a)(39)(F)</u>	Conforming amendment	<u>Sec. 604(c)(1)(A)</u>
<u>Sec. 3(a)(47)</u>	Conforming amendment	<u>Sec. 2(b)</u>
<u>Sec. 10A</u>	Conforming amendments	<u>Sec. 205(b)</u>
<u>Sec. 10A(f)</u>	Conforming amendment	<u>Sec. 205(d)</u>
<u>Sec. 12(b)(1)</u>	Conforming amendment	<u>Sec. 205(c)(1)</u>
<u>Sec. 12(i)</u>	Conforming amendment	<u>Sec. 3(b)(4)</u>
<u>Sec. 13(b)(2)</u>	Conforming amendment	<u>Sec. 109(h)</u>
<u>Sec. 15(b)(4)(F)</u>	Brokers and dealers	<u>Sec. 604(a)(1)</u>
<u>Sec. 15(b)(6)(A)(i)</u>	Conforming amendment	<u>Sec. 604(c)(1)(B)</u>
<u>Sec. 15B(c)(2)</u>	Conforming amendment	<u>Sec. 604(c)(1)(B)</u>
<u>Sec. 15B(c)(4)</u>	Conforming amendment	<u>Sec. 604(c)(1)(B)</u>
<u>Sec. 15C(c)(1)(A)</u>	Conforming amendment	<u>Sec. 604(c)(1)(B)</u>
<u>Sec. 15C(c)(1)(C)</u>	Conforming amendment	<u>Sec. 604(c)(1)(B)</u>
<u>Sec. 16(a)</u>	Insider disclosures	<u>Sec. 403(a)</u>
<u>Sec. 17(e)</u>	Conforming amendment	<u>Sec. 205(c)(2)</u>
<u>Sec. 17(i)</u>	Conforming amendment	<u>Sec. 205(c)(2)</u>
<u>Sec 17A(c)(3)(A)</u>	Conforming amendment	<u>Sec. 604(c)(1)(C)</u>
<u>Sec 17A(c)(4)(C)</u>	Conforming amendment	<u>Sec. 604(c)(1)(C)</u>
<u>Sec. 21(a)(1)</u>	Conforming amendment	<u>Sec. 3(b)(2)(A)</u>
<u>Sec. 21(d)(1)</u>	Conforming amendment	<u>Sec. 3(b)(2)(B)</u>
<u>Sec. 21(d)(2)</u>	Officer and director bars	<u>Sec. 305(a)(1)</u>
<u>Sec. 21(d)(3)(C)(i)</u>	Conforming amendment	<u>Sec. 308(d)(1)</u>
<u>Sec. 21(e)</u>	Conforming amendment	<u>Sec. 3(b)(2)(C)</u>

<u>Sec. 21(f)</u>	Conforming amendment	<u>Sec. 3(b)(2)(D)</u>
<u>Sec. 21A(d)(1)</u>	Conforming amendment	<u>Sec. 308(d)(2)</u>
<u>Sec. 21B(a)</u>	Conforming amendment	<u>Sec. 501(b)</u>
<u>Sec. 21C(c)(2)</u>	Conforming amendment	<u>Sec. 3(b)(3)</u>
<u>Sec. 21C(c)(2)</u>	Technical amendment	<u>Sec. 1103(b)</u>
<u>Sec. 32(a)</u>	Increased criminal penalties	<u>Sec. 1106</u>
<u>Sec. 35</u>	SEC appropriations	<u>Sec. 601</u>
Investment Company Act of 1940		
<u>Sec. 42(e)(3)(A)</u>	Conforming amendment	<u>Sec. 308(d)(4)</u>
Investment Advisers Act of 1940		
<u>Sec. 203(e)(7)</u>	Investment advisor registration	<u>Sec. 604(b)(1)</u>
<u>Sec. 203(f)</u>	Conforming amendment	<u>Sec. 604(c)(2)</u>
<u>Sec. 209(e)(3)(A)</u>	Conforming amendment	<u>Sec. 308(d)(5)</u>

Glossary of Corporate Governance Terms

Accountability The liability of a board of directors to shareholders and stakeholders for corporate performance and actions of the corporation.

Analyst An employee of a bank, brokerage, advisor, or mutual fund that studies companies and makes buy and sell recommendations.

Annual (general) meeting AGM for short, a company gathering, usually held at the end of each fiscal year, at which shareholders and management discuss the previous year and the outlook for the future, directors are elected and other shareholder concerns are addressed.

Annual report An audited document issued annually by all publicly listed corporations to their shareholders in accordance with SEC regulation. Contains information on financial results and overall performance of the previous fiscal year and comments on future outlook.

Audit report Statement of the accounting firm's assessment of the validity and accuracy of a company's financial information and conformity with accepted accounting practices.

Backdating see stock option backdating.

Basel II A new set of regulations designed by the Basel Committee on Banking Supervision to cover operational risk as well as financial risk for the global financial institutions. Set up in 1974, the Basel Committee on Banking Supervision is an international regulatory body for the world's financial institutions. In 1988, it introduced capital adequacy rules for banks in member countries, which required them to implement a financial risk measurement framework. The Committee is currently creating a new set of regulations to replace the original rules that would cover operational risk as well as financial risk. The new framework, usually called Basel II, is based around three "pillars": the first determines minimum capital requirements, the second stipulates an effective supervisory review process; and the third sets out to strengthen market discipline by greater disclosure of banks' financial status. Base 2 is due to come into force in 2006/2007 although regulatory deadlines have traditionally been flexible.

Black-Scholes model A model used to determine the value of option securities prices based on the relationship between six variables—the current underlying asset price, the option strike price, the option time-to-expiration, the riskless return, the underlying asset payout return, and the underlying asset volatility—work together to determine the value of a standard option.

Board of directors The collective group of individuals elected by the shareholders of a corporation to oversee the management of the corporation.

Board of trustees A group of people responsible for the oversight of a non-profit organization.

Bylaws A document stating the rules of internal governance for a corporation as adopted by its board of directors.

Change-in-control arrangements An executive employment contract that provides the executive with a lucrative severance package in the event of his/her termination. May include a continuation of salary, bonus and/or certain benefits and perquisites, as well as accelerated vesting of stock incentives and/or certain retirement benefits.

Chief executive officer (CEO) The highest ranking officer of the company, and is often Chairman of the Board as well.

Chief financial officer (CFO) The corporate executive responsible for the financial planning and record-keeping of a company.

Chief information officer (CIO) The corporate executive responsible for the information systems and information technology (IT) at a company.

Chairman of the Board Highest-ranking director in a corporation's board of directors.

Cookie jar accounting Accounting practice that inflates provisions for expected expenses and later reverses them to boost earnings—in many cases at very convenient times. This is traditionally abused when companies want to push reserves into future earnings. Reserves are set reserves to cover the estimated costs of taxes, litigation, bad debts, job cuts and acquisitions. Company managers estimate reserves and the outside auditor judges whether the reserves are reasonable. Auditors rarely challenge company estimates because there are unclear guidelines for calculating reserves.

Corporate governance The system of checks and balances designed to ensure that corporate managers are just as vigilant on behalf of long-term shareholder value as they would be if it was their own money at risk. It is also the process whereby shareholders—the actual owners of any publicly traded firm—assert their ownership rights, through an elected board of directors and the CEO and other officers and managers they appoint and oversee.

Corporate performance management (cpm) The processes, methodologies, metrics, and technologies used to measure, monitor, and manage business performance. It includes the use of end-user tools for financial consolidation, query, reporting, modeling, planning/budgeting/forecasting, activity-based costing (ABC), business intelligence, and data mining.

Director A person elected by shareholders to serve on the corporation's board of directors.

Directors and officers liability insurance (D&O) Professional liability coverage for legal expenses and liability to shareholders, bondholders, creditors or others due to actions or omissions by a director or officer of a corporation or nonprofit organization.

Disclosure The public dissemination of material, market-influencing information.

Dissident; dissenting shareholder A shareholder who objects to a proposed corporate action or position.

Earnings management see managed earnings.

Earnings Surprises A company's announced net income for the reporting period that is above or below that expected by analysts (i.e., the consensus forecast). Stock price will typically increase if the earnings report is better than anticipated with the opposite effect if the earnings report is less than that expected. In fact, if earnings reported are much lower than that being forecasted by securities' analysts, a drastic falloff in stock price may occur because of the disappointment. An example of a company that closely monitors earnings surprises is *First Call* (www.firstcall.com)

Financial Accounting Standards Board (FASB) (www.fasb.org) Set up to establish best practice for accounting and reporting. It provides guidance on the implementation of transparent and accurate accounting procedures, and promotes the convergence of international accounting standards.

Financial Services Authority (FSA) (www.fsa.gov.uk) The Great Britain's leading financial regulator charged with maintaining market confidence, promoting public understanding of the financial system, protecting customers and combating financial crime.

Financial statements A written report that quantitatively summarizes the financial status of an organization for a stated period of time. Includes an income statement, balance sheet, and statement of cash flows.

Form 10K An audited document issued annually by all publicly listed corporations to their shareholders in accordance with SEC regulation. Contains information on financial results and overall performance of the previous fiscal year and comments on future outlook. It is an annual report.

Form 10Q A report filed quarterly in accordance with SEC regulations containing unaudited financial statements. It is a quarterly report.

Form 8K Form filed by corporations with the SEC to report corporate changes or material events which are important to investors and not previously disclosed in any other form.

Forward looking statement A statement made by an official representative of a corporation concerning future earnings potential or operations.

Golden handshake A clause in an executive employment contract that provides the executive with a lucrative severance package in the event of their termination. May include a continuation of salary, bonus and/or certain benefits and perquisites, as well as accelerated vesting of stock options.

Golden parachute A clause in an executive employment contract that provides the executive with a lucrative severance package in the event of her termination. May include a continuation of salary, bonus and/or certain benefits and perquisites, as well as accelerated vesting of stock options.

Independent director A person elected by shareholders to a corporation's board of directors who is not affiliated with the company in any other capacity.

Inside director A member of a company's board of directors who is also an employee of the company.

International accounting standards (IAS) A set of international accounting and reporting standards that will help to harmonize company financial information, improve the transparency of accounting and ensure that investors receive more accurate and consistent reports.

International accounting standards board (IASB) (www.iasb.org.uk) An independent regulatory body, based in the United Kingdom, which aims to develop a single set of global accounting standards.

Investor responsibility research center (IRRC) (www.irrc.org) Founded in 1972, an independent company that provides research on corporate governance and social responsibility issues for institutional investors.

Managed earnings Manipulating (pumping up or down) earnings to shed a more favorable light on companies. All companies have flexibility in how they account for some revenues and costs. For example, they can depreciate a capital cost (say, a fleet of cars) in one year or over several years. If they take it in one chunk, their earnings look lower that year and larger every year after that. If they report it in many smaller pieces, they avoid the big hit in the first year. Even though earnings are not perfect, investors' love affair with earnings is here to stay.

Option An agreement, or privilege, which conveys the right to buy or sell a specific security or property at a specified price, by a specific date.

Organization for economic development cooperation and development (OECD) (www.oecd.org) A forum set up to discuss, develop, and refine economic and social policies.

Principal shareholder Shareholder owning 10% or more voting stock in a publicly listed company.

Public company accounting oversight board (PCAOB) (www.pcaobus.com) Established in 2002 as a result of the Sarbanes-Oxley Act, a private sector, non-profit corporation set up to oversee the audits of public companies and ensure that accountancy firms should no longer derive non-audit revenue streams, such as consultancy, from their audit clients.

Right to vote The right of holders of common stock to vote on matters of corporate policy at a corporation's annual meeting.

Risk based capital directive (RBCD) The European version of the Basel 2 accord. It incorporates the earlier European Capital Adequacy requirements.

Sarbanes-Oxley (SOX) Act Wide-ranging U.S. corporate reform legislation, coauthored by the Democrat in charge of the Senate Banking Committee, Paul Sarbanes, and Republican Congressman Michael Oxley. The Act, which became law in July 2002, lays down stringent procedures regarding the accuracy and reliability of corporate disclosures, places restrictions on auditors providing non-audit services and obliges top executives to verify their accounts personally. Section 409 is especially tough and requires that companies must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

Securities and Exchange Commission (SEC) (www.sec.gov) A federal agency created by the Securities Exchange Act of 1934 to protect investors from dangerous or illegal financial practices or fraud by requiring full and accurate financial disclosure by companies offering stocks, bonds, mutual funds, and other securities to the public. It is the chief regulator of the U.S. securities market and overseer of the nation's stock exchanges, broker-dealers, investment advisors, and mutual funds.

Special purpose entities (SPEs) a type of corporate entity or limited partnership created for a specific transaction or business, especially one unrelated to a company's main business. Their losses and risks generally aren't recorded on a company's balance sheet.

Stakeholder Any group or individual that has an interest in a company.

Stock option backdating the illegal practice of dating a stock option award with a date from sometime in the past. It is usually done so as to guarantee that the options are valuable as the exercise price is assured to be a price below the actual price of the stock at the actual time of the award.

Stock options An agreement, or privilege, which conveys the right to buy or sell a specific security or property at a specified price, by a specific date.

Transparent market A market in which there is open communication between stakeholders, investors and company officials and current trade and quote information is readily available to the public.

Ultra vires An action outside the proper authority or power of a corporation or corporate officer as established in the corporate charter. (Latin for "beyond the power.")

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Review Question Answers

Chapter 1 Review Questions

1. The role of chief financial executive (CFO) has changed in the past decade to

- A. Incorrect. Financial reporting and financial management were the traditional role of the CFO.
- B. **Correct.** The role of chief financial executive (CFO) has changed in the past decade to business partner/strategist. This shift may have prompted the CFO's to use more aggressive accounting and reporting practices that ultimately resulted in a loss of objectivity and independence.
- C. Incorrect. Controllers were often accountants who held the dual function of primary accountant and the traditional role of the financial executive.
- D. Incorrect. Chief risk officer is responsible for managing various risks, including financial risk, compliance risk, and environmental risk.

2. Corporate scandals have been a result of the following accounting irregularities EXCEPT

- A. Incorrect. Financial failure to spot signs of malpractice resulted in accounting irregularities.
- B. Incorrect. Audited financial statements as creative fiction resulted in accounting irregularities. In some instances audit committees permitted obfuscation in public disclosure
- C. **Correct.** Aggressive and moral leadership enhanced the integrity of corporations and their executives. Scandals have been as a result of the following accounting irregularities: (1) financial failure to spot signs of malpractice, (2) audited financial statements as creative fiction, and (3) overstated profits and hidden debt.
- D. Incorrect. Overstated profits were widespread and hidden debt was not reflected in the balance sheet. Special purpose entities were used to move debt off of the balance sheet.

3. Some of the infamous accounting techniques used by Enron include

- A. Incorrect. Tax benefits are traditional accounting options allowed under Generally Accepted Accounting Principles (GAAP).
- B. **Correct.** Moving debt off the balance sheet is one of the infamous accounting techniques used by Enron.
- C. Incorrect. Outside audits approved by the board are recommendations in the new SOX Act regulations.
- D. Incorrect. Aggressive public disclosure is one of the recommendations under the SOX Act of 2002.

4. The accounting technique used to avoid disappointing investors and brokerage analysts is the use of

- A. Incorrect. Under Generally Accepted Accounting Principles (GAAP), most companies use the accrual basis of accounting. This method requires that revenue be recorded when earned and that expenses be recorded when incurred.
- B. Incorrect. Cash basis of accounting is a method of revenue realization in which revenue is not recognized until cash is actually collected and expenses are recognized as cash is paid. This approach is more useful to internal managers.
- C. **Correct.** Pro-forma earnings have long been a practice used by companies to spruce up their results. The problem with pro forma results is that they are often too promotional, eliminating the negative and emphasizing the positive.
- D. Incorrect. External audits are a standard GAAP accounting practice used to insure audit independence and oversee the presentation and honesty of financial statements.

5. The methods or strategies used to move debt off the balance sheet or to boost the bottom line include all the following EXCEPT

- A. Incorrect. Overstated pension plan assumptions are a strategy to cover up accounting irregularities. Some companies use rosy projected returns for their employee pension plans to buff their financial statements.
- B. Incorrect. Underreporting of executive compensation is a strategy used to cover up accounting irregularities. Most major companies do not treat the costs of employee stock options as an official expense on income statements. This has contributed to an overstatement of earnings in recent years.
- C. **Correct.** Revenue recognition is a basic GAAP accounting practice. The basic issue of revenue recognition is when to recognize revenue, what amount to recognize, and what amount and the degree of provision for future reversals.
- D. Incorrect. "Channel stuffing" (inventory management) is a strategy used to cover up accounting irregularities. It includes shifting surplus finished goods to distributors' shelves. These are unsold goods that reflect unfavorably on expected earnings.

6. The company that allegedly schemed to move millions of dollars of merchandise into the hands of distributors and retailers using discounts and other inducements along with the use of cash reserves to pump up the company's operating earnings is

- A. **Correct.** Sunbeam was forced to restate its earnings from the fourth quarter of 1996 to the first quarter of 1998; the SEC alleges that \$60 million of that record-breaking profit was the result of accounting fraud.
- B. Incorrect. WorldCom used other strategies to cover up accounting irregularities. The telecommunications company announced that an internal audit found \$3.9 billion in accounting irregularities.

- C. Incorrect. Adelphi communications filed bankruptcy after stating it would restate earnings for the last three years. Federal investigators are looking for \$3 billion in off-the-books loans made to the company founders.
- D. Incorrect. The energy trading company filed for bankruptcy protection after off-the-books accounting was uncovered.

Chapter 2 Review Questions

1. _____ was NOT one of corporations listed that restated their revenues.
 - A. Incorrect. Xerox disclosed that it inflated revenue by \$6.4 billion over five years. Anne Mulcahy, CEO of Xerox, announced a \$1.9 billion reversal of revenues and a \$1.4 billion restatement of profits for the past 5 years.
 - B. Incorrect. Reliance admitted \$6 billion in sham trades that inflated revenue by 10%.
 - C. Incorrect. Homestores.com disclosed that revenue had been overstated.
 - D. **Correct.** GM was not one of corporations that restated their sales revenues at the time when many of these other companies were filing earnings restatements.

2. Points of controversy were corrected or addressed by having recent financial statements restated for
 - A. Incorrect. The new guidelines address underreporting of executive compensation. Most major companies were not treating costs of employee stock options as an official expense on income statements.
 - B. Incorrect. The new provisions address overstating of pension plans. Most companies have obligations to fund their pension plans to a certain level. When stock prices dropped dramatically many firms kept on predicting robust growth of their pension investments to help boost the bottom line.
 - C. **Correct.** Earnings "management" and the use of pro-forma results have been points of controversy. Any report filed with the SEC or in any public release cannot contain false or misleading statements or omit material facts necessary to make the financial information not misleading. Many companies have used complicated accounting ledger domain to avoid disappointing investors and brokerage analyst from quarter to quarter and pro-forma earnings to spruce up their results.
 - D. Incorrect. Earnings "management" and the use of pro-forma results are often are too promotional, eliminating the negative aspects and emphasizing the positive to spruce up their results.

3. Expensing stock options to prevent financial abuses results in
 - A. Incorrect. Shareholders' stakes are diluted, not inflated by stock expensing.

- B. Incorrect. Allowing companies to benefit from funds received from the sale of option shares yields a less accurate earning figure and hurts investor confidence.
- C. Incorrect. Increased incentives to top executives dilute shareholders' stakes and deprive companies of funds they would get by selling the shares on the open market.
- D. **Correct.** Expensing stock options to prevent financial abuses resulted in treating stock options like all other forms of compensation and deductions from earnings. The premise behind expense options is to clarify a company's accounting, making its numbers more transparent to the public thereby boosting investor's confidence.

4. Which of the following is NOT true regarding stock options?

- A. Incorrect. Unlike salaries or other perks, granting options requires no cash outlay from companies. Since there is no real cost for the company to deduct, doing so will unjustly penalize earnings.
- B. **Correct.** Tech firms contend that generous option grants have attracted and retained talent and spurred the risk-taking and entrepreneurship so crucial to innovation. Expensing options would sharply reduce their reported profits.
- C. Incorrect. Deducting the cost of options will slash earnings, which is likely to drive down share prices.
- D. Incorrect. Companies will issue far fewer options. That will hurt morale, limit a key tool used to lure talent, and inhibit companies from aligning employee and shareholder interests.

5. The major problem with option pricing using the Black-Scholes option pricing model in determining the option value is

- A. Incorrect. The use of stock price and life span to the option is an element used in evaluating employee's options.
- B. Incorrect. The standard black-Scholes model isn't adjusted to account for the added restrictions of employee options, such as vesting and lack of transferability, but it uses stock price and volatility to estimate future value.
- C. **Correct.** The major problem with option pricing using the Black-Scholes option pricing model in determining the value is that the true value of the worth of the option is only known when they are cashed in (expensed). Corporations cannot predict what will happen to share prices, which will leave the company before their options are vested, and which options will expire with no value.
- D. Incorrect. The dividend yield is an element used in evaluating employee's options. Dividend yield is one of the options used to estimate option value by this option pricing model.

6. The intrinsic value method approach allows firms to

- A. Incorrect. Expensing the additional value of the stock option as the price rises is a method used to establish the intrinsic value of an option. Under this method a firm expenses the difference between the exercise price and the stock price throughout the vesting life of the option.
- B. Incorrect. Decreasing the charge to earnings as a stock declines is a method used to establish the intrinsic value of an option. As stocks decline in value, options decrease in value, and the charge to earnings evaporates.
- C. Incorrect. Expensing the difference between the exercise price and the stock price throughout the existing life of the option is a method used to establish the intrinsic value of an option. This approach may discourage massive option grants to underperforming executives who frequently get rewarded for failure.
- D. **Correct.** Companies that use this method benefit greatly. Since the charge to earnings is considerably lower than any of the Black-Scholes variants, it's less disruptive to earnings—and the stock price. In a declining market, it's also the only accounting method that doesn't create a charge for underwater options. Further, the approach may discourage massive option grants to underperforming executives, who frequently get rewarded for failure with grants designed to match the Black-Scholes value of last year's grant.

Chapter 3 Review Questions

1. FASB No. 123 (*Accounting for Stock-Based Compensation*), the pre-FASB No. 123R (*Share-Based Payment* (ASC 718-10-05), allowed companies the choice to record compensation expense using an external fair value model or the intrinsic method. True or False?

True is correct. FASB No. 123 allowed companies the choice to measure and record compensation expense using either an external fair value model or an intrinsic method. If the intrinsic method was used, the company was required to provide the appropriate fair value information in the footnotes.

False is incorrect. FASB No. 123 gave a choice between two methods to companies.

2. FASB No. 123R (ASC 718-10-05) requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using the grant-date fair value as the measurement of cost. True or False?

True is correct. FASB No. 123R makes several changes to FASB No. 123, one of which is that it requires that the cost resulting from all share-based payment transactions be recognized in the financial statements using the grant-date fair value as the measurement of cost. Other changes made by the Statement include: (1) the requirement for all entities to apply a fair-value-based measurement method in accounting for share-based payment transactions with employees (except for equity instruments held by ESOPs) and those in which an entity acquires goods or services from nonemployees in share-based payment transactions; (2) the provision that fair value is measured based on an observable value, then

using an option model (such as the Black-Scholes Model); and (3) provision of certain exceptions to the measurement method if it is not possible to reasonably estimate the fair value of an award at the grant date.

False is incorrect. The statement does require that cost be recognized using a grant-date fair value. Fair value is generally measured using an observable value following use of an option model.

3. FASB No. 123R maintains use of the intrinsic method for nonpublic entities for share-based equity awards. True or False?

True is incorrect. The statement eliminates use of the intrinsic value method for valuing equity awards that was permitted under FASB No. 123. Now all companies must value stock options using an externally generated fair value method.

False is correct. FASB No. 123R does not permit use of the intrinsic method for nonpublic entities for equity awards. It does allow nonpublic entities to elect to use the intrinsic method for awards classified as liabilities. Moreover, the statement eliminates use of the minimum value method for nonpublic entities that assumed zero volatility in valuing its stock options under FASB No. 123.

4. _____ is NOT an employee compensation incentive.

- A. **Correct.** Corporate buyback is a corporation's repurchase of stock or bonds it has issued. Reasons for buybacks can include obtaining stock for employee stock option plans or pension plans. It is not a compensation incentive.
- B. Incorrect. Stock options have long been used as an incentive. FASB 123R requires corporations to expense them at the grant date.
- C. Incorrect. Restricted stock is used by companies to award shares of stock under share-based compensation plans while placing various restrictions on the recipients.
- D. Incorrect. Stock appreciation rights give the employee the right to receive compensation in cash, stock, or a combination of cash and stock at some future date, based on the difference between the market price of the stock at the date of exercise over a preestablished price.

5. An example of a type of option pricing model identified by FASB No. 123R is

- A. Incorrect. Linear programming is an optimization tool for resource allocation.
- B. Incorrect. Monte Carlo simulation involves adding random numbers to otherwise deterministic models to simulate the uncertainty inherent in real-world situations.
- C. **Correct.** FASB No. 123R provides that fair value is measured based on an observable value, then using an option model (such as the Lattice Model).

D. Incorrect. The internal rate of return model is a method used to evaluate a capital investment project.

6. Backdating an option so as to be “in the money” on the date of its grant also creates accounting improprieties. True or False?

True is correct. Backdating an option so as to be “in the money” on the date of its grant increases not only the likelihood that the option will be exercised at a profit by the officer to whom the option was granted, but also increasing the amount of the profit that its exercise would yield. This benefit to the officer being granted stock options comes at the direct expense of the corporation. Under generally accepted accounting principles (GAAP), options that are “in the money” when granted are the equivalent of compensation and therefore must be treated as an expense by the corporation.

False is incorrect. Without backdating, the option can be “in the money,” “at the money,” or “out of the money.” So the market will determine the option expense, which does not create an accounting irregularity.

Chapter 4 Review Questions

1. New York Corporate Accountability and Listing Standards’ new requirements include all the following EXCEPT

- A. Incorrect. An independent majority on a company's board is a new listing requirement by NYSE. To avoid conflicts of interest a company’s board of directors should include a substantial majority of independent directors.
- B. Incorrect. A stricter definition of director independence is required where “independence” means that directors don’t have financial or close personal ties to the company or its executives.
- C. **Correct.** The CEO’s approval of all equity-based pay plans is not allowed. To avoid abuse in the use of stock options and executive perks, all employee stock option plans should be submitted to shareholders for approval.
- D. Incorrect. The appointment of a lead director solely to run those meetings is a new listing requirement by NYSE. The Corporate Accountability and Listing Standards Committee’s report called for the appointment of a lead director solely to run those meetings.

2. The new rules by NYSE for corporate governance would

- A. **Correct.** The new rules would weaken the control that management currently enjoys at many companies.
- B. Incorrect. Stronger governance standards give directors better tools to empower them. The new rules are part of an ongoing process to address conflicts of interest.

- C. Incorrect. The new rule requires investor approval on any equity based pay plans and the appointment of a lead director solely to run regular executive sessions of nonmanagement directors.
- D. Incorrect. The new rules ban broker's roles in voting on equity-based plans unless approved by clients, and also includes a stricter definition of director independence.

3. Rules approved by SEC to address analyst's conflicts include all the following EXCEPT

- A. Incorrect. Disclosure during public appearances by analysts is a SEC provision requirement. Any public appearance or interview on radio or television requires disclosure during these activities by the analyst.
- B. Incorrect. Disclosure of financial interests in covered companies is a SEC provision. Analysts must disclose if they own shares of recommended companies. This requirement can alert investors to potential biases from analysts who have financial interests in companies.
- C. **Correct.** The rule changes will bar securities firms from tying an analyst's compensation to specific investment banking transactions. Furthermore, if an analyst's compensation is based on the firm's general investment banking revenues, that fact will have to be disclosed in the firm's research reports. Prohibiting compensation from specific investment banking transactions significantly curtails a potentially major influence on research analysts' objectivity.
- D. Incorrect. Restrictions on personal trading by analysts are a SEC provision requirement. The rule bars analysts and members of their household from investing in a company's securities prior to its initial public offering.

4. The SEC rules do NOT encompass

- A. Incorrect. Conflicts of interest affecting research are being addressed by the SEC rules. This disclosure will provide the percentage of all ratings that have assigned to buy/hold/sell categories and the percentage of investment banking clients in each category. This will provide investors with better information.
- B. Incorrect. Conflicts of interest affecting dissemination of research is being addressed by the ongoing SEC rule changes. This rule limits the relationship between analysts and investment banking personnel. It helps to protect research analysts from influence that could impair their objectivity and independence.
- C. Incorrect. Conflicts of interest affecting production of research are being addressed by the ongoing SEC rule changes. The change requires disclosure by firms to clearly explain in research reports the meaning of all ratings terms they use, and this terminology must be consistent with its plain meaning.
- D. **Correct.** The SEC rules address market practices concerning research analysts and the conflicts that can arise from the relationship between research and investment banking. They do not involve the ways in which research and investing banking are conducted.

Chapter 5 Review Questions

1. The Sarbanes-Oxley Act of 2002 adopted tough new legislation to

- A. Incorrect. Deter and punish accounting fraud and corruption is a partial answer. The act changes how publicly traded companies are audited with new provisions to deter and punish corporate and accounting fraud and corruption.
- B. Incorrect. This is a partial answer. The bill creates a Public Accounting Oversight board to ensure justice for wrongdoers, and protects the interest of workers and shareholders.
- C. Incorrect. Protecting the interest of workers and shareholders is a partial answer. The bill improved the quality and transparency of financial reporting, independent audits, and accounting services for public companies, as well as offered increased penalties for corporate wrong doers.
- D. **Correct.** The Sarbanes-Oxley Act of 2002 adopted tough new legislation to: deter corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interest of workers and shareholders.

2. _____ admitted to accounting irregularities, such as using special purpose entities (SPE) to move debt off its balance sheet.

- A. Incorrect. Microsoft ceased awarding of stock options to employees.
- B. **Correct.** Enron, one of the world's largest energy groups, admits to irregularities in its accounts between 1997 and 2000, reporting that the special-purpose entities (SPEs) should have been consolidated on its balance sheet, substantially reducing earnings for those years. On December 2, Enron files for bankruptcy.
- C. Incorrect. Andersen was cited for shredding and deleting thousands of documents relating to Enron's accounting procedures.
- D. Incorrect. Glaxo-SmithKline's shareholders rejected their company's compensation packages.

3. In 2002 an investigation of U.S. telecommunications group (WorldCom) led to claims of accounting irregularities and 3.8 billion frauds against

- A. Incorrect. Eliot Spitzer is Attorney General for NY State. He investigated and reported conflicts of interest among Wall Street analysts.
- B. **Correct.** U.S. telecommunications group WorldCom admitted that the SEC was conducting an informal investigation into its accounting practices. Founder and chief executive Bernie Ebbers stepped down, followed by CFO Scott Sullivan, amid claims of a \$3.8 billion fraud at the company.
- C. Incorrect. Jean-Pierre Gamier was CEO of Glaxo-SmithKline which their shareholders rejected their compensation package. This was the first time U.K. shareholders rejected a compensation package signaling a new readiness for intervention among institutional investors.

- D. Incorrect. Alan Greenspan was the former Chairman of the Federal Reserve System. He warned congress that “a pervasive sense of caution” was stifling entrepreneurial risk-taking investments and job creation.

4. Regulatory bodies responsible for monitoring and enforcing the Sarbanes-Oxley Act are

- A. **Correct.** Regulatory bodies responsible for monitoring and enforcing the Sarbanes-Oxley Act are SEC and PCAOB.
- B. Incorrect. CEO and CFO are management executives who are chiefly responsible for complying with the Sarbanes-Oxley Act. For example, they are the ones who are required to certify their financial statements.
- C. Incorrect. DBA and MBA are degree titles, indicating the level of education attained by the holder.
- D. Incorrect. S&P and Moody’s are well-known credit rating agencies.

5. Which section of the Sarbanes-Oxley Act requires the CEO and CFO to certify the fairness of a company’s financial information?

- A. **Correct.** Section 302 requires the chief executive officer (CEO) and the chief financial officer (CFO) to certify to the SEC both the fairness of the financial information in each quarterly and annual report and their responsibility for maintaining adequate disclosure controls and procedures.
- B. Incorrect. In addition to the Section 302 requirement, Section 906 requires the compliance of the report with the requirements of the Securities Exchange Act of 1934. Section 906 provides criminal penalties for knowing or willful failure to comply.
- C. Incorrect. Section 404 requires management of a public company and the company’s independent auditor to issue new reports at the end of every fiscal year: (1) management’s report on its assessment of the effectiveness of the company’s internal control over financial reporting and (2) independent auditor’s report on internal control over financial reporting.
- D. Incorrect. Section 101 deals with board membership.

6. _____ was the first CEO to be convicted of backdating stock options to boost their value.

- A. Incorrect. Kenneth I. Seltermann is Take-Two Interactive Software’s former general counsel who was sentenced to three years of probation for falsifying a letter to regulators.
- B. Incorrect. Gregory L. Reyes is the former head of Brocade Communications Systems who was convicted of conspiracy and securities fraud related to options backdating.
- C. **Correct.** The founder and former chairman, Ryan Brant, of Take-Two Interactive Software Inc., publisher of the “Grand Theft Auto” video games, became the first CEO to be convicted of backdating stock options to boost their value. Companies open themselves up to a host of possible criminal penalties by backdating options, such as falsification of business records, wire fraud, and mail fraud.

- D. Incorrect. Former WorldCom Corp. chief Bernard Ebbers went to prison for his role in the \$11 billion accounting fraud that toppled a company he had built from a tiny telecommunications firm to an industry giant.

7. The obvious solution to the corporate governance compliance problem would seem to be

- A. Incorrect. Putting rules in place is a factor involved in initiating SOX compliance that depends largely on people being trained to comply with key government regulations.
- B. **Correct.** Technology would seem the obvious solution to the corporate governance and compliance problem. Much of governance is a matter of putting rules in place and ensuring that they are followed. Software solutions are available for disclosure on significant aspects relating to financial conditions, liquidity, capital expenditures, resources, and components of revenue and expense. Also available to enhance disclosure of compliance with regulatory requirements are computer software for business intelligence, business process management, document management, e-mail management, financial and accounting software, and enterprise resource planning.
- C. Incorrect. Compliance with corporate governance is likely to be very costly. Policies and procedures need to be worked out first in detail before deciding which technology investments are needed. To a large extent this is a management issue.
- D. Incorrect. The ideal solution may not lie with people but with eliminating manual intervention. Automated systems, such as enterprise resource planning applications, are more transparent than those requiring manual intervention, and less prone to fraud.

8. Which of the following is *NOT* a new technology that can assist with SOX compliance?

- A. Incorrect. Business intelligence can provide sophisticated reporting and analysis tools and helps ensure the accessibility of information.
- B. Incorrect. Business process management can increase visibility of protected data and easier access to share information.
- C. **Correct.** There are six technologies: business intelligence, document management, e-mail management, financial accounting software, business process management, and ERP software. Microfiche is not a new technology.
- D. Incorrect. Document and e-mail management provides an efficient system for storage and retrieving important records and documents, as data complexity and volume increases e-mails can retrieve the data more quickly. The new requirements for internal control and discovery obligations make the need for e-mail more compelling.

Chapter 6 Review Questions

1. The Commission requires each annual report to contain an internal control report, which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. True or False?

True is incorrect. This statement does not mention an independent auditor's report, including the auditor's opinions on: (1) whether management's assessment is fairly stated in all material respects (i.e., whether the auditor concurs with management's conclusions about the effectiveness of internal control, over financial reporting), and (2) the effectiveness of the company's internal control over financial reporting

False is correct. Each annual report must contain two reports: (1) management's report on its assessment of the effectiveness of the company's internal control over financial reporting and (2) independent auditor's report on internal control over financial reporting.

2. If the auditor disagrees with management about whether a material weakness exists, the auditor will render a(n) _____ on management's assessment.

- A. **Correct.** If the auditor concludes a material weakness exists but management does not, the auditor will render an adverse opinion on management's assessment. Auditing Standard No. 2 indicates that when expressing an adverse opinion on the effectiveness of internal control over financial reporting, the auditor should provide specific information about the nature of the material weakness and its actual and potential effect on the company's financial statements. The PCAOB has also stated that it expects disclosure sufficient to allow users to understand the weakness and its actual and potential implications on the financial statements.
- B. Incorrect. A departure from GAAP may justify a qualified opinion. Management may not express a qualified conclusion, such as stating that internal control is effective except to the extent certain problems have been identified.
- C. Incorrect. A disclaimer of opinion is a report stating that because of restrictions on the scope of the auditor's work, the auditor is unable to, and does not, express an opinion on management's assessment or on the effectiveness of internal control over financial reporting.
- D. Incorrect. An unqualified opinion is twofold : (1) An opinion that management's assessment is fairly stated in all material respects, along with an opinion that internal control over financial reporting is effective in all material respects as of the assessment date. and (2) an opinion that management's assessment (that internal control over financial reporting is not effective) is fairly stated in all material respects, along with an opinion that internal control over financial reporting is ineffective because of one or more material weaknesses.

3. Section 906 requires the chief executive officer (CEO) and the chief financial officer (CFO) to certify to the SEC both the fairness of the financial information in each quarterly and annual report and their responsibility for maintaining adequate disclosure controls and procedures. True or False?

True is incorrect. Section 302(a) of the Sarbanes-Oxley Act requires a company's CEO and CFO to certify each quarterly and annual report. They are required to certify that the financial statements and other financial information included in the report are fairly presented in all material respects.

False is correct. Section 906 provides criminal penalties for knowing or willful failure to comply with Section 302 and the requirements of the Securities Exchange Act of 1934.

Chapter 7 Review Questions

1. Principles of good governance imply that

- A. Incorrect. Directors with close relationships with the company executives can lend itself to a conflict of interest. Directors should not have financial or close personal relationships or ties to the company or its executives.
- B. Incorrect. Executive compensation plans that are based solely on stock option packages have led to conflicts of interest and excessive payment. Executive compensation plans should be based on performance and provide full disclosure of these plans.
- C. **Correct.** Principles of good governance should include a company's audit, nominating committee and compensation committee should consist entirely of independent directors.
- D. Incorrect. Allowing all employee stock option plans should be reviewed by the CEO and CFO can lead to a conflict of interest. All employee stock option plans should be submitted to shareholders for approval.

2. Which of the following is NOT a corporate social responsibility activity?

- A. **Correct.** No business acts in isolation and all should behave as responsible members of a wider society. Corporate responsibility involves service to the public interests such as environmental protection, employee safety, civil rights and community involvement.
- B. Incorrect. Matching words with deeds is responsible action. Many big businesses are being called to justify their approach to a growing array of social and ethical concerns.
- C. Incorrect. Complying with ethical behavior standards is responsible activity. No business acts in isolation and all should behave as responsible members of a wider society.
- D. Incorrect. Motivating the employees to behave as responsible members of society by involving all employees in proactive social, ethical and environmental issues has long term benefits. Short term costs are justified in the long run through maximized profits by creating good will, and avoiding anticipated government regulations.

3. Corporate social responsibility is

- A. Incorrect. Effective enforcement through the controls in a perfectly competitive market was envisioned by classical economics. Modern monopolies and oligopolies often must be subject to regulation to enforce their social responsibilities since the limits imposed by the market are ineffective.
- B. Incorrect. “The obligation to shareholders to earn a profit” is a concept embraced by the public or societal interest groups who often have a financial stake in the companies operation and financial success.
- C. **Correct.** The concept of corporate social responsibility involves more than serving the interests of the organization and its shareholders. Rather, it is an extension of responsibility to embrace service to the public interest in such matters as environmental protection, employee safety, civil rights, and community involvement.
- D. Incorrect. “The obligation to serve long-term, organizational interests” is a concept embraced specifically by investors. Special ratings agencies have targeted investors in the business community to push more companies to seriously engage their stakeholder in societal issues and deal with them proactively.

4. A common argument against corporate involvement in socially responsible behavior is that

- A. Incorrect. Government intrusion can be avoided by taking proactive social responsibility and in the long run socially responsible behavior may prevent governmental action.
- B. **Correct.** Socially responsible behavior clearly has immediate costs to the entity, for example, the expenses incurred in affirmative action programs, pollution control, and improvements in worker safety. When one firm incurs such costs and its competitor does not, the other may be able to sell its products or services more cheaply and increase its market share at the expense of the socially responsible firm. The rebuttal argument is that in the long run the socially responsible company may maximize profits by creating goodwill and avoiding or anticipating governmental regulation.
- C. Incorrect. This is an argument for socially responsible behavior. Laws and written codes cannot cover all situations, however, organizations can benefit from having established legal and ethical codes that police and discipline any violations and establish high standards against which individuals can measure their own performance.
- D. Incorrect. “Creation of goodwill” is an argument for socially responsible behavior. In the long run socially responsible behavior gains the confidence of the public and avoids any restrictions imposed through governmental regulations.

5. If a financial manager/management accountant discovers unethical conduct in his/her organization and fails to act, (s)he will be in violation of which ethical standard(s)?

- A. A is incorrect because each standard is violated by a financial manager/management accountant who fails to act upon discovering unethical conduct.
- B. B is incorrect because each standard is violated by a financial manager/management accountant who fails to act upon discovering unethical conduct.

- C. C is incorrect because each standard is violated by a financial manager/management accountant who fails to act upon discovering unethical conduct.
- D. **Correct.** A financial manager/management accountant displays his/her competence and objectivity and maintains integrity by taking the appropriate action within the organization to resolve an ethical problem. Failure to act would condone wrongful acts, breach the duty to convey unfavorable as well as favorable information, undermine the organization's legitimate aims, discredit the profession, and violate the duty of objectivity owed to users of the subordinate's work product.

6. In which situation is a financial manager/ management accountant permitted to communicate confidential information to individuals or authorities outside the firm?

- A. Incorrect. There is an ethical conflict if a board takes problems to authorities or individuals not employed or engaged by the organization and prior to adhering to the established due process practices established by the company's policy.
- B. **Correct.** According to the IMA Code of Ethics, financial managers/management accountants are responsible for observing the standard of confidentiality. Thus, the financial manager/management accountant should "refrain from disclosing confidential information acquired in the course of his/her work except when authorized, unless legally obligated to do so."
- C. Incorrect. The financial manager/management accountant should "inform subordinates as to what is appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality."
- D. Incorrect. The financial manager/management accountant is required to "refrain from using or appearing to use confidential information acquired in the course of his/her work for unethical or illegal advantage either personally or through third parties."

7. A financial manager/management accountant discovers a problem that could mislead users of the firm's financial data and has informed his/her immediate superior. (S)he should report the circumstances to the audit committee and/or the board of directors only if

- A. Incorrect. In this situation, the chief executive officer is the next higher managerial level to report the problem to.
- B. Incorrect. The immediate superior has promised or taken action toward satisfactory resolution.
- C. Incorrect. The financial manager/management accountant does not need to take any other action because their superior has reported the problem up the chain of management.
- D. **Correct.** According to the IMA Code of Ethics, the financial manager/management accountant should "discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level. If the immediate superior is the chief executive officer, or equivalent,

the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners."

8. Ivy is a financial manager who has discovered that her company is violating environmental regulations. If her immediate superior is involved, her appropriate action is to

- A. Incorrect. "Practitioners of management accounting and financial management have an obligation to the public, their profession, the organization they serve, and themselves, to maintain the highest standards of ethical conduct."
- B. Incorrect. The audit committee would be consulted first only if it were the next higher managerial level.
- C. **Correct.** To resolve an ethical problem, the financial manager/management accountant's first step is usually to consult his/her immediate superior. If that individual is involved, the matter should be taken to the next higher level of management.
- D. Incorrect. If the superior is involved, the next higher managerial level should be consulted first.

9. Which ethical standard is most clearly violated if a financial manager/management accountant knows of a problem that could mislead users but does nothing about it?

- A. Incorrect. The competence standard pertains to the financial manager/management accountant's responsibility to maintain his/her professional skills and knowledge. It also pertains to the performance of activities in a professional manner.
- B. Incorrect. Legality is not addressed in the IMA Code of Ethics.
- C. **Correct.** Objectivity is the fourth part of the IMA Code of Ethics. It requires that information be communicated "fairly and objectively," and that all information that could reasonably influence users be fully disclosed.
- D. Incorrect. Confidentiality standard concerns the financial manager/management accountant's responsibility not to disclose or use the firm's confidential information.

Chapter 8 Review Questions

1. Which of the following is NOT true about financial disclosures?

- A. Incorrect. Each financial report that is required to be prepared in accordance with GAAP shall reflect all material correcting adjustments.
- B. Incorrect. Each annual and quarterly financial report shall disclose all material off-balance sheet transactions and other relationships with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

- C. Incorrect. These statements must not contain untrue statements of a material fact or omit to state a material fact in order to make the pro forma statement not misleading.
- D. **Correct.** The financial report issuer shall reconcile pro-forma statements with the financial condition and results of operations of the issuer under generally accepted accounting principles.

2. The duties of the Board under SOX Act 2002 include all the following EXCEPT

- A. **Correct.** Registered public accounting firms are required to prepare audit reports for issuers. All audits must be prepared by independent CPA firms that have no social or financial relationship to the company's personnel.
- B. Incorrect. Establishing, adopting rules for auditing, quality control, ethics and independence is a Board duty to be in compliance with SOX requirements.
- C. Incorrect. The Board shall conduct inspections of registered public accounting firms in accordance with SOX requirements.
- D. Incorrect. Conducting investigations and disciplinary proceedings for concerned activities and impose appropriate sanctions for any violation is mandated by the rules and regulations and is a Board duty to be in compliance with SOX requirements.

3. Registration with the Board does NOT require

- A. Incorrect. In order to audit public companies a public accounting firm must register with the board.
- B. Incorrect. Prescribed forms of application are required to be in compliance with SOX. The board must establish or adopt by rule auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers. The board may prescribe the forms of application to be used by each public accounting firm.
- C. **Correct.** Periodic reports are mandatory. Each annual and quarterly financial report must disclose all material off-balance sheet transactions and other relationships with unconsolidated entities that may have a material or current or future effect on the issuer's financial condition.
- D. Incorrect. Consent statements agreeing to cooperate and be in compliance with requests for testimony, or supplying documents are required to be in compliance with SOX. Each application shall include a consent to comply with any requested testimony or the production of documents.

4. Which one of the following is NOT true regarding the Board's investigations and disciplinary proceedings?

- A. Incorrect. The board is required to establish fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.
- B. **Correct.** The Board may refer investigations under Section 105 to state or federal authorities. The board may refer an investigation to any other Federal functional regulator, the Attorney General of the USA or to a state Attorney General.

- C. Incorrect. Fair procedures for disciplining public accounting firms for digressions are required under Section 105. The board shall promptly file notice of any final sanctions taken on any registered public accounting firm or any associated person.
- D. Incorrect. Institute fair procedures for disciplining individuals for involvement in digressions at public accounting firms are a requirement under Section 105. The provisions of the Act provide a review of any imposed sanctions to assure their fairness and due regard for public interest and the protection of investors.

5. The Commission shall have oversight and enforcement authority over the board for censure of the board members or removal from office

- A. **Correct.** The Commission may remove from office or censure any member of the board, if the Commission finds, after notice and opportunity for a hearing, that such member has willfully violated any provision of SOX Act, the rules of the Board, or the securities laws.
- B. Incorrect. The commission has oversight for willful violations are limited as provided by the board of SOX Act.
- C. Incorrect. The commission has oversight for willful violation only as authorized by the SOX Act. No rule shall become effective without prior approval of the Commission and in accordance with the Act's rules.
- D. Incorrect. AICPA issues a series of professional codes and ethics for CPAs. It has not oversight for willful violation of the SOX Act and the authority to amend the rules of the board and to assure fair administration.

6. A registered public accounting firm may engage in any non-audit service, including _____.

- A. Incorrect. Bookkeeping services to the audit client are prohibited. This also includes other services related to the accounting records or financial statements of the audit client.
- B. Incorrect. Financial information is included as one of the non-audit services prohibited. Except as provided prohibited activities include all financial statements and any financial related activities.
- C. Incorrect. Appraisal or valuation services are only two of several other service activities prohibited. This includes fairness opinions, or contributions-in-kind reports.
- D. **Correct.** Tax services are permitted as non-audit services.

7. The Securities Exchange Act of 1934 has been amended by SOX Act 2002 to adding preapproval of

- A. Incorrect. The amendment is limited to preapproval of auditing services only.
- B. Incorrect. Preapproval of delegation of authority from staff to line personnel was not recognized by the issuer at the time of the engagement to be an audit service.

- C. **Correct.** The amendment to the Securities Exchange Act of 1934 relates to preapproving auditing services that provide comfort letters in connection with securities underwritings or statutory audits required for insurance companies.
- D. Incorrect. Section 202 of the Act requires the non-audit services performed by the auditor of the issuer to be disclosed to the investors in periodic reports.

8. The principal executive officers are responsible for the following EXCEPT

- A. Incorrect. It is the responsibility of the principal executive officers to review the final reports. The periodic required annual or quarterly reports must be certified by a principal executive officer.
- B. **Correct.** Administration of penalties for violations is the responsibility of the Commission, the Board, and the legal authorities, not the principal executive officers.
- C. Incorrect. The executive office is required to verify the report does not omit any material facts or offer misleading data. The signing officers are responsible for establishing and maintaining internal controls.
- D. Incorrect. Ensuring that the report including a fair presentation of the financial conditions and operations of the issuer for the periods represented is one of the principal executive officer's responsibilities. The signing officers must indicate in the report whether there were any significant changes in internal control or other factors that could significantly affect internal controls including any corrective actions, or significant deficiencies and material weaknesses.