



The Sarbanes Oxley Act of 2002

Developed as a Course of Study with Available CPE Credits

Introduction

The passage of the Sarbanes Oxley Act of 2002 represents a watershed event in the history of the auditing profession. It signals the end of an era. No longer will the profession have effective control over its future. Several of the Act's administrative requirements are onerous and the loss of individual freedoms and protections inherent in the registration section will certainly drive some people out of the business. Like so many things, however, this bill has a history that goes well beyond the Enron, Worldcom and Andersen debacles. The history of this piece of legislation begins in 1977.

In that year, a Senate subcommittee was concerned about whether the government should regulate public accountants. In response to the Senate's concerns the AICPA, in consultation with the Securities Exchange Commission (SEC) created a new self-regulatory framework. Part of that framework included the establishment of an independent Public Oversight Board (POB). The POB was to ensure that the public interest in independent auditing received the appropriate consideration at all times. The POB was created as an independent, private-sector body that was to monitor and report on the self-regulatory programs of the SEC Practice Section (SECPS) of the Division for CPA Firms of the AICPA. The SECPS is currently made up of more than 1,000 firms, the majority of which do not perform any audits of public companies¹.

Despite the promise of a new regulatory oversight body, the POB acted without a charter until February of 2001. Largely pushed by the SEC and its crackdown on "earnings management", the POB was designed to stand atop the self-regulatory framework for accounting and financial reporting matters. Part of the process included the establishment of a special panel, The Panel on Audit Effectiveness ("Panel"). Chaired by Accounting profession patriarch, Sean O'Mally (former Chair of PriceWaterhouseCoopers), this Panel conducted arguably the most comprehensive review of the audit profession in its history.

¹ This is noted so that a typical practitioner can appreciate that these recommendations will likely be applicable to them even if they do not have SEC regulated clients.

The original POB becomes a formalized mechanism long before Enron

According to the Panel's Report, "...the SEC and others have expressed concerns about registrants overreaching in terms of permissible accounting treatments, as well as alleged accounting abuses involving such matters as accounting for business combinations, revenue recognition, and restructurings, along with alleged misuse of the materiality concept. This overreaching often is characterized as "earnings management.""

As a result of the alleged abuses the chairman of the SEC requested that the POB "sponsor a thorough and objective examination of auditing, from top to bottom, in order to explore the efficacy of the audit process." In response to the SEC's request the POB appointed a panel of eight members, known as the "Panel on Audit Effectiveness". According to the Panel's report, issued in September 2000, the Panel "was charged with the responsibility to review and evaluate how independent audits of the financial statements of public companies are performed and to assess whether recent trends in audit practices serve the public interest." "...the Panel studied not only how audits are conducted but also whether non-audit services provided to audit clients pose a threat to auditor independence and whether the system of governance of the auditing profession is adequate or in need of change." It was one of the most extensive reviews of the audit process ever conducted. It began with a review of the overall regulatory process.

Inadequacies of the Regulatory Structure – A System In Need of Change

According to the Panel's Report, "Governance of the Auditing Profession" (Chapter 6), "Auditors are subject to a system of controls that, taken as a whole, constitute the regulation of the profession." The principal elements of the system of self-regulation are the SEC, state boards of accountancy, AICPA, SECPS of the AICPA, ISB, and the POB.

After an extensive review the Panel concluded that there are limitations to the existing system of self-regulation. The Panel noted the following limitations:

"Lack of sufficient public representation on the various self-regulatory bodies

Lack of unified leadership of the various self-regulatory bodies

Constraints on effective communications with the SEC and among the various entities in the current system

Differing interests and divergent views of the AICPA's priorities on the part of the diverse members

A disciplinary system that is perceived to be slow and ineffective"

Accordingly, the Panel made over sixty recommendations to improve the existing system. The Panel's recommendations were directed to the POB, AICPA, SECPS, SEC and the ISB. Primary among them was the formal chartering of the POB.²

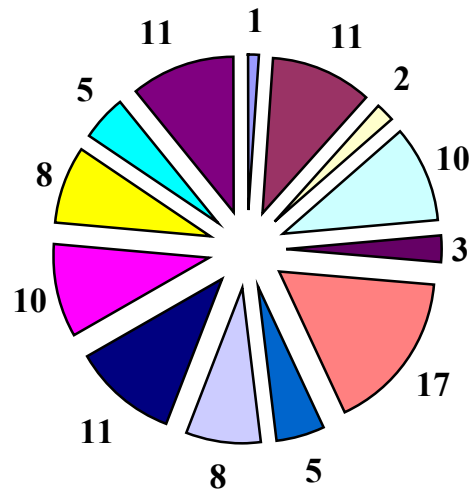
Panel Recommends Substantive and Dramatic Changes to the Audit Process

Two years after the Panel's study began, the Panel issued its Report and Recommendations in September 2000 dated August 31, 2000. The Panel made approximately 259 recommendations to 11 organizations and professional committees. (The Report in its entirety can be found at <http://www.pobauditpanel.org/download.html> or at the POB's site, www.publicoversightboard.org and is summarized in the following table.)

Based on the Panel's findings the Panel submitted over 100 recommendations as to how to improve the conduct of audits. These are also summarized in the following table:

² The Charter provides, among other duties, that "The POB shall oversee the audit and independence standard-setting, peer review, quality control and monitoring bodies relating to SECPS member firms...The POB shall have the authority to take any other action related to its oversight activities, including authorizing any oversight reviews it may determine to be appropriate in order to carry out its responsibilities." The Panel's Charter granted the POB the responsibility in overseeing the SECPS, ISB, and the ASB. And, in order for the POB to carry its responsibilities the SECPS has agreed to fund up to \$5.2 million annually (adjusted annually for inflation).

Areas Recommended for Improvement & Number of Recommendations



- Assessing engagement risk
- Assessing inherent risk
- Multi-location audits
- Assessing control risk
- Communicating and reporting on internal control
- Linking the risk assessments to substantive tests
- Analytical procedures
- Auditing revenue
- Auditing estimates and judgments
- Materiality, waived adjustments and analysts' expectations
- Going-concern considerations
- Internal auditors
- Communicating with audit committees

The Panel's Recommendations - A Paradigm Shift in Attitudinal Beliefs About Reliance on Management Representations, Engagement Risk Assessments and Inherent Risk Evaluations

A Forensic Phase - From Neutral to the Presumption of the Possibility of Dishonesty

In Chapter 3 of the Report the Panel proposed recommendations that will dramatically change how audits are conducted. The Panel recommended that the Accounting Standards Board (ASB) require auditors to conduct a “forensic-type fieldwork phase” in the course of their audits. The Panel recommended that the *“auditor should modify the otherwise neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, override of internal control and falsification of documents.”* As part of the “forensic-type fieldwork phase” the Panel recommended that auditing standards be modified to incorporate the following:

The “performance of substantive tests directed at the possibility of fraud”

Having “auditors consider incorporating a surprise or unpredictability element in their tests” i.e., interviews of financial and non-financial company personnel, recounts of inventory items or unannounced visits to locations, requests for written confirmations from company employees regarding matters about which they have made representations to the auditors, requests for written confirmations from customers or vendors, tests of accounts not ordinarily performed annually, and, tests of accounts traditionally or frequently deemed “low risk.”

Assessing Engagement Risk - New Procedures Required

In recent years claims against accountants often-included items related to an auditors failure to investigate the risks related to accepting and/or continuing to service particular clients. These could include a failure to do background searches on companies, individuals or relevant stakeholders. Engagement Risks can also include understanding emerging competitive, credit, capital, industry and technology risks. A number of insurers now recommend going through a new client acceptance process every year for existing clients. In the past, a practitioner could use a defense, which appealed to the impossibility of being able to find out all of the information necessary to perform such an engagement risk assessment. Today, with the advent of the Internet and readily available specialty databases, these defenses no longer seem plausible. If a practitioner can find out with two clicks of a button what he needs to know, then it is likely he will be held accountable for doing exactly that.

Advancing assessment of Inherent Risk - Greater Sophistication in Assessing Risks

As with the items contained in the engagement risk area, there really are no substantive defenses against doing things like understanding the inherent risks in a particular business

circumstance. There is no defense against not seeking peer financial data, finding out about emerging technology risks or being able to assess the financial status of a large debtor.

The Advent of Enron and Worldcom

Even considering the massive outcry associated with Enron, the original Congressional bill did little other than codify and strengthen the controls that were already being put in place by the POB, AICPA, Big Five and SEC. For the most part, the really hard aspects of the new Act did not arise until after Worldcom and several other prominent failures of financial reporting took place. The Worldcom restatement and failure was particularly difficult to accept because the misrepresentations were very simple but very large. They should have been caught. Public confidence was waning leading to an exodus from the capital markets. The response has been an Act that stands to impose several dramatic changes to the profession with some commentators asking whether this signals the end of the profession as it has been known. While these comments may seem an overreaction, the changes are of such magnitude that they affect every practitioner.

Transitioning from the old POB to the New POB

The New POB is a much more dynamic and powerful version of the old POB. The old POB had little authority in its original form although likely would have grown in stature over time. But time ran out. The new POB has to be understood. It can unilaterally trump any existing professional standard or standard maker. Its existence will affect the audit and non-audit professions for decades to come. This Act is a must read.

Developed into a course and CPE product

In order to make the experience of becoming familiar with this Act as painless as possible, we have developed it as a course and CPE product. The course begins with this introduction and demands that the course taker have some knowledge of the history of this legislative movement and the profession's involvement. Familiarity with the report of the old POB and Panel on Audit Effectiveness is vital to one's understanding of the changes that have been taking place in the profession. The Act speaks for itself and must be read deliberately. Almost every section and paragraph contains some assertion or requirement that needs to be cogitated upon. For those of our members who prefer, this course can also be given as an in-house seminar. We hope you enjoy it.

Course Description

This course helps the reader to understand *Public Company Accounting Reform and Investor Protection Act of 2002*.

After completing this course you will:

- Understand the formation and establishment of the Board and administrative provisions.
- Learn that firms performing services for public companies must register with the Board.
- Understand the new auditing, quality control, and independence standards and rules.
- Understand how the Board will inspect the work of registered public accounting firms.
- Understand the rules governing investigations and disciplinary proceedings.
- Understand what foreign public accounting firms are subject to in the new legislation.
- Understand that the SEC will oversee the Board and further understand the SEC's responsibilities.
- Understand who is responsible for setting accounting standards.
- Understand the funding mechanism of the Board.
- Understand what services are prohibited given in conjunction with audit services and exemptions thereto.
- Understand the pre-approval requirements before an audit firm provides other services. Understand the five-year audit partner rotation.
- Understand what information must be reported to the audit committee.
- Understand what defines a conflict of interest when past employees of the auditing firm are employed by the company to be audited by their past auditing firm.
- Understand how the Act requires a study of mandatory rotation of registered public accounting firms.
- Understand the SEC's authority and implementation dates.
- Understand how considerations by appropriate State regulatory authorities should be given to non-registered public accounting firms
- Understand the standards relating to public company audit committees.
- Understand the responsibilities of corporate members for financial reports.
- Understand how it is improper to influence the conduct of audits and penalties thereof.
- Understand how noncompliance of the SEC's rules may lead to the forfeiture of certain bonuses and profits.
- Understand equitable relief in a SEC prosecution.
- Understand the prohibition of insider trades during pension fund blackout periods.
- Understand the disclosure requirements in periodic reports when material correcting adjustments are determined.

- Understand the SEC's enhanced conflict of interest provisions and the granting of loans to executives.
- Understand the change in rules regarding the disclosure of transactions involving management and principal stockholders.
- Understand the requirements of management relative to the assessment of internal controls.
- Understand the requirement of the adoption and change in a corporation's code of ethics for senior financial officers.
- Understand the requirements of the disclosure of the audit committee financial expert.
- Understand the treatment of securities analysts by registered securities associations.
- Understand the authorization of appropriations process to fund the bill.
- Understand that the SEC may censure anyone that appears and or wants to practice before the SEC for various reasons.
- Understand that the Federal court has authority to impose penny stock bars.
- Understand the newly changed provisions regarding the qualifications of associated persons of brokers and dealers
- Understand that the GAO is to perform a study regarding the consolidation of public accounting firms since 1989.
- Understand that the SEC must perform a review regarding credit rating agencies in the operation of the market.
- Understand the new laws regarding criminal penalties for altering documents.
- Understand that certain debts are not dischargeable if incurred in violation of securities fraud laws.
- Understand the new statute of limitations for securities fraud.
- Understand that a review of Federal sentencing guidelines for obstruction of justice and extensive criminal fraud will be conducted.
- Understand the protection and remedies for employees of publicly traded companies who provide evidence of fraud.
- Understand the new criminal penalties for defrauding shareholders of publicly traded companies.
- Understand the criminal penalties for conspiracy to commit offense or to defraud the United States.
- Understand the criminal penalties for mail and wire fraud.
- Understand the criminal penalties for violations of the Employee Retirement Income Security Act of 1974.
- Understand the amendment to sentencing guidelines relating to certain white-collar offenses.
- Understand the corporations' responsibility and penalties for not certifying financial reports
- Understand that there will be higher maximum penalties for mail and wire fraud.
- Understand the criminal penalties for tampering with a record or otherwise impeding an official proceeding.
- Understand Temporary freeze authority for the Securities and Exchange Commission.

- Understand that there is a request to amend the Federal sentencing guidelines for white-collar crime.
- Understand that the SEC has the authority to prohibit persons from serving as officers or directors.

How To Obtain CPE Credits

Thank you for choosing this self-study CPE course from <http://www.AccountingMalpractice.com>

Our goal is to provide you with current, up-to-date information to help further your professional development, as well as the most convenient method to help you satisfy your continuing professional education requirements. This course is to be used in conjunction with the *Public Company Accounting Reform and Investor Protection Act of 2002*

This course has the following characteristics:

Prerequisites: Basic knowledge of Auditing or other Consulting/Advisory services and background of the Panel on Audit Effectiveness's Report.

<http://www.pobauditpanel.org/download.html>

Recommended CPE Credits:

Public Company Accounting Reform and Investor Protection Act of 2002 – 4 Credits

Level of Knowledge: Intermediate – Builds on a basic level of understanding in order to relate fundamental principles or skills to practical situations and extend them to a broader range of applications. This level is for participants with some exposure to the subject.

Field of Study: Auditing/Consulting/Engagement Risk/Accounting/Fraud/Earnings Management

Credit hours are recommended in accordance with the Statement on Standards for Formal Continuing Professional Education (CPE) programs, published by the AICPA. Individual exams cost \$15 per credit. Payment options are shown on the individual answer sheets for each section. A passing score is 70 percent or above. Participants who pass the test will receive a *Certificate of Completion*.

To begin the course, begin reading the Public Company Accounting Reform and Investor Protection Act of 2002.

<http://www.accountingmalpractice.com/0005/articles/bill-accountability.pdf>