



The Sarbanes-Oxley Act of 2002

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Presenter: Hubert Edwards

bertz@coralwave.com

Group: *Firm X* Partners and Managers Workshop

Turnberry Isles Resort & Club

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Approach

- Open discussion - Interactive
- Analyzing certain “critical” sections of the Act
 - Look at some of the final rules in circulation
 - Evaluating the impact on foreign accounting firm
 - Impact on governance in countries outside USA
 - Impact on financial reporting from a firm’s perspective
- Wrap up

Overview of the Sarbanes-Oxley Act of 2002

- July 25, 2002 – Both Houses of Congress pass the Sarbanes-Oxley Act to provide effective corporate reform and restore confidence in the capital markets
- July 30, 2002 – President Bush signs the Sarbanes-Oxley Act into law
- The Act contains some stand-alone provisions that are effective immediately. Others amend existing securities laws, criminal statutes and other laws. Many call for further action by the SEC.
- The Sarbanes-Oxley Act provides clarity and certainty on a number of highly debated issues by:
 - *Establishing an independent, full-time oversight board (the Public Company Accounting Oversight Board) for capital-market participants; the SEC has oversight of the board*
 - *Establishing new responsibilities for audit committees and corporate officers*

Overview of the Sarbanes-Oxley Act of 2002

- *Establishing several new public-company reporting requirements*
- *Defining “non-audit” services that public accounting firms can provide to audit clients*
- Specifically prohibiting certain services to audit clients
- Permitting all other services, subject to audit committee pre-approval
- *Strengthening penalties for corporate fraud*
- *Requiring rules to address analyst conflict of interest*
- *Significantly increasing the responsibilities and budget of the SEC*

The Sarbanes-Oxley Act is subject to interpretation by the rule-making processes of the SEC and the Public Company Accounting Oversight Board

Key Stakeholders

The Sarbanes-Oxley Act has a broad impact which affects a number of stakeholders and constituencies in the marketplace, including:

- Management of public companies
- Audit committees

- Public accounting firms
- Others:
 - Regulators and standard-setters
 - Investors
 - Investment firms and analysts (see section)
 - Attorneys

Sections Review - Sec.102 – Registration

- Unlawful for firm to perform public company audits without being registered with Board
- Initial and annual registrations to include the following information:
 - Listing of all public company audit clients for last year and expected to be continuing clients
 - Fees for each public company client separated by audit, accounting and non-audit
 - Statement of quality control policies of the audit firm
- Firm must sign consent to cooperate fully with Board and submit to discipline and quality monitoring process and produce documents for investigations, etc.
- Firm must obtain consent from each professional employee that they will in turn cooperate, etc.
- Firm must obtain consent from each associated person that they will cooperate, etc.
Associated person is any person or entity that in connection with the issuance of any audit report shares in the profits or receives any other form of compensation from the firm or participates as agent or otherwise on behalf of the firm in any activity of the firm
- Non proprietary information included in the registration will be publicly available

Sections Review - Sec 103 – Standard Setting

- Board has authority to establish and adopt audit, quality monitoring, ethics and independence standards. Legislation specifically points out the authority of the Board to accept the standard setting of other bodies but retains its final voice
- Audit standards to include (ED out):
 - 7 year work paper retention for all audit and related papers
 - Mandatory second partner or concurring review
 - Rules to describe new requirements for testing of public company system of internal controls
 - Require audit firm to report on the review of internal controls
 - *Internal control system of company must provide reasonable assurance that the company's transactions are recorded as necessary to prepare financial statements in accordance with GAAP (**consider rule expansion internationally outside of US registrant Cos**)*
 - *Audit firm report to include any noted material weaknesses in internal control (section 404)*

Sections Review - Sec 106 – Foreign Accounting Firms

- Any foreign firm that prepares an audit report on a public company must also register with Board
- Board by rule may extend registration requirement to foreign firms that do not issue audit report but who play an important role in preparation of reports for public company
- A foreign firm that issues report or provides material services in connection with an audit is deemed by that action to have consented to produce audit work papers for any investigation
- *If domestic firm uses the opinion of a foreign firm, the domestic firm thereby consents to supplying the work papers of the foreign firm and must have secured agreement of such from the foreign firm*
- *Registration by April 29, 2004 (180 days after US companies)*

NB: These provisions probably clearly speaks to access to foreign work papers. Imposes greater responsibility on the U S firm for work done by affiliated firms.

PCAOB Rulemaking Docket

Who must register?

Any public accounting firm that wishes to prepare or issue any audit report with respect to any issuer must register with the Board. In addition, any public accounting firm that "plays a substantial role in the preparation or furnishing of an audit report" with respect to any issuer must register. The term "issuer" means, in effect, any public company that is required to file reports with the Commission or that has filed a registration statement for a public offering of securities.

The Board's registration requirements do not exempt non-U.S. public accounting firms.

Sections Review (Title II)- Sec 201 – Independence

- Except upon a pre-approval by the audit committee of a public company, it is unlawful for a registered firm to perform non-audit services contemporaneously with the audit
- The following non-audit services are specifically prohibited by law from being provided by the audit firm or associated persons:
 - Bookkeeping
 - Financial information systems design and implementation
 - Appraisal or valuation services
 - Actuarial services
 - Internal audit outsourcing services
 - Management functions of human resources
 - Broker dealer, investment adviser or investment banking
 - Legal services and expert services unrelated to the audit
- Board may establish other prohibited non-audit services
- Any non-audit service not proscribed above may be provided if the audit committee pre-approves the service

Sections Review (Title II)- Sec 202 – Pre-approval

- All services, audit and non-audit must be pre-approved by audit committee or designated person
- Non-audit services that are less than 5% of total fees may be exempted from pre-approval if it was not recognized at the time that they were non-audit services and approval was received from the audit committee before completion of the services
- Audit committees must disclose to investors any approvals they give for non-audit services

Sec 203 – Partner Rotation

Lead and concurring or “coordinating” partner must rotate after five years

Sections Review (Title II)- Sec 204 – Reports to Audit Committee

- Auditor must timely report to audit committee all critical accounting policies and practices used by the issuer
- Auditor must report 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 auditor
- Report any other material communication with management including management letter and passed adjustments

NB: section 205 (A) defines an audit committee as – a committee (or equivalent body) established amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer of the financial statement and

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

Sections Review (Title II) - Sec 206 – Conflicts of Interest

Unlawful for public accounting firm to audit an issuer if the CEO, CFO, Controller, CAO, or other person serving in an equivalent position was employed by the registered firm and participated in the audit of that issuer during the 1-year period preceding the date of initiation of the audit

Sections Review (Title III) - Sec 301 – Audit Committees

- All public companies must have an audit committee
- A/C directly responsible for appointment, compensation, and oversight of the work of the registered public accounting firm including resolution of disagreements between management and the auditor regarding financial reporting
- *Audit Committee members shall be independent, i.e. no consulting or other compensation from company or be an affiliated person of the issuer or any subsidiary*
- Audit Committee must establish procedures for receipt, retention and treatment of complaints received by issuer regarding accounting or internal control or auditing
- Audit Committee must establish procedures to receive confidential anonymous submission by employees of the issuer regarding questionable accounting or auditing
- The audit committee has the authority to engage independent counsel and other advisers as it deems appropriate.
- The audit committee is comprised of at least one “financial expert” (disclosure).

Sections Review (Title III) Sec 302 – Corporate Responsibility

- Principal executive officer and principal financial officer must certify for annual or quarterly reports that they:
- Have reviewed the reports
- Based on their knowledge there are no untrue statements of material fact or omission
- Based on their knowledge financial statements fairly present in all material respects the financial condition and results of operations
- They are responsible for maintaining a system of internal controls and have evaluated the effectiveness of such internal control system within 90 days of the report
- They must report on their conclusions from their review of the system of internal controls
- Confirm that they have disclosed significant deficiencies in internal control and frauds
- They have made disclosures to Board, Audit Committee and Auditors about Internal controls
- Requirement apply to all public corporations whether they are incorporated in the U.S.

Sections Review (Title III) - Sec 906 – Corporate Responsibility

- Section 906 of the Act requires that *all periodic reports* containing financial statements filed with the SEC on or after July 30, 2002 be accompanied by the written certifications of the CEO and CFO.
- “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 (15U.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.”

Sections Review (Title III) - Sec 303 – Improper Influence of Conduct of Auditors

- Unlawful for anyone to fraudulently influence, coerce, manipulate or mislead any auditor

Sections Review - Section 404

Summary of the Requirements

Requires management to annually:

- State their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- Conduct an assessment of the effectiveness of the company's internal controls and procedures for financial reporting

Requires the independent auditor to:

- Attest to management's assertion (requires a framework such as COSO)

Sections Review - Section 404 - final Rules

- Requires the following:
 - Each annual report filed under Section 13(a) or 15(d) of the Exchange Act to include an internal control report
 - Some exceptions for registered investment companies and asset backed issuers
 - External auditor to attest to and report on the assessment made by management in the internal control report
- Effective for:
 - Accelerated filers: first fiscal year ending on or after June 15, 2004
 - Non-accelerated filers and foreign private issuers: first fiscal year ending on or after April 15, 2005

Sections Review - Section 404 - Final Rules

Final rule:

- Uses term “internal control over financial reporting”
- Definition reflects the subset of internal control in COSO report that pertains to financial reporting
- Consistent with Exchange Act Section 13 (b)(2)(B)
- Incorporates requirements under Section 103 of the Act
 - Maintenance of records in reasonable detail
 - Proper recording and authorization of transactions
- Includes safeguarding of assets

Sections Review - Section 404 - Final Rules

Final rule:

- Requires management to identify the framework used to conduct evaluation
 - Must be suitable, recognized framework that is established by a body that has followed due-process procedures
- Company must have evidential matter, including documentation, to provide reasonable support for management's assessment
- Company's assessment must be based on procedures sufficient to both evaluate its design and to test its operating effectiveness
- If one or more material weakness is identified, management is precluded from determining that internal control over financial reporting is effective
- Report should be in close physical proximity of the attestation report

Sections Review - Section 404 – Final Rule

Final rule:

- Management to evaluate changes in internal control over financial reporting
 - That occurred during the quarter and
 - That have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting
- Still required to evaluate disclosure controls and procedures on a quarterly and annual basis
- For those components of internal control over financial reporting that are subsumed within disclosure controls and procedures –
 - Management to decide the extent of the quarterly evaluation

Section Review - Sec 406 & 407 - Final rules

- Sections 406 & 407
 - Need to have a financial expert.
 - Disclosure thereof including if not why not

- Adoption of code of ethics by financial related personnel
 - CFO, CAO, Controller and similar individuals

Section Review – Sec 802 – Final Rules

- Retention of working papers for 7 years
- Definition of working papers
 - Consistent with SAS 96
 - Means the “documentation of auditing or review procedures applied, evidence obtained, conclusions reached by the accountant or adopted by the Commission or by the PCOAB”

WRAP UP

Questions?



INTERNAL CONTROL & AUDIT

IN AN ANTI-MONEY LAUNDER FRAMEWORK

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