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SEC's Office of the Chief Accountant Responds to Questions About Auditor Independence

The Office of the Chief Accountant has updated its responses to frequently asked questions about auditor independence. The updates cover areas related to financial relationships, prohibited and non-audit services, audit committee preapproval, fee disclosures and the cooling off period.

An accountant would not be considered independent if, at any time during the audit and professional engagement period, he or she provided translation services to SEC audit clients based in foreign jurisdictions or U.S. clients with foreign operations.

With respect to financial relationships, OCA advised that second mortgages, home improvement loans, equity lines of credit and similar obligations that are collateralized by a primary residence, are subject to the same exception as mortgages secured by the primary residence if one is not a covered person at the time of the loan origination. If the ownership of the loan changes and the borrower becomes a covered person, the staff would not object to the auditor's independence based solely on the existence of the loan as long as there is no modification in the terms or conditions after the borrower becomes a covered person, or in contemplation of becoming a covered person.

OCA said that a successor auditor's independence would not be impaired in the current period if he or she provided prohibited and non-audit services relating to the financial statements of a prior period that were audited by a predecessor auditor as long as the services related

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Congress

America COMPETES Act Gives SEC and PCAOB Time to Reform Internal Control Mandates

A provision in the American COMPETES Act (PL 110-69) inserted by Senate Banking Committee Chair Christopher Dodd (D-CT) and cosponsored by Richard Shelby (R-AL), the committee's

The provision sends a message to the SEC and the PCAOB that Congress is watching what they do very carefully.

ranking member, would give the SEC and PCAOB more time, but not unlimited time, to reform the internal control reporting mandates under section 404 of the Sarbanes-Oxley Act. Section 8002 of the Act expresses the sense of Congress that the SEC and PCAOB should implement the section 404 mandates in a manner that limits the burdens placed on small and mid-size public companies. The Act was passed by Congress and signed into law on August 9, 2007.

Dodd and Shelby inserted the amendment into the Senate bill (S. 761). The House bill (H.R. 2272) did not have a similar provision, but adopted the Senate provision.

In section 8002, Dodd said that Congress makes a strong statement in two respects. First, Congress will continue to protect investors in public companies. Second, Congress supports efforts currently underway to ensure that small and mid-size businesses are not unduly burdened by rules intended to protect investors.

The Dodd-Shelby provision endorsed section 404 for greatly enhancing the quality of corporate governance and financial reporting for public companies and for increasing investor confidence. They

praised the SEC and the PCAOB for determining that Auditing Standard No. 2 had imposed unnecessary and unintended cost burdens on small and mid-sized public companies. Congress is also pleased that the SEC and the PCAOB completed the adoption of the final guidance and standards under section 404.

Dodd emphasized that the SEC chair has wide latitude within which to operate, since the statute gives broad discretion. Dodd has a long history of involvement in federal securities regulation, particularly in areas involving financial accounting and the audits of public companies. His guiding principle has been that investor confidence

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Paisley Outlines 10 Steps for Management in Implementing AS5

Paisley, a provider of software for governance, risk and compliance, has issued a list of 10 steps to implement the PCAOB's Auditing Standard No. 5 for management, starting with precise entity level controls and a strong control environment. Paisley's checklist recommends that management ask auditors to share their assessment of the reliability of the entity level controls

AS5 is silent on root cause analysis, the checklist notes, so management must fill the gap.

before they begin the process level control testing. To ensure a strong control environment, the checklist urges companies to use COSO, and notes that 55% of reported deficiencies have been linked to control environment breakdowns.

The checklist advises that management should know how it would react to the most common fraud scenarios that it may face. Management should identify the 10 most common fraud scenarios for its industry, which should include revenue overstatement, noncompliance with GAAP and forced adjustments to hit earnings targets. Paisley's checklist recommends that management describe how its controls would prevent, detect or mitigate those risks, and the role the audit committee would play in assessing the effectiveness of the controls.

Paisley reports that 41% of deficiencies relate to problems with periodic financial reporting. The checklist outlines the critical period-end financial reporting risks that should be identified and assessed. Management should focus on significant accounts. The significant risk factors may include

accounts that relate to executive compensation, those with accounting and reporting complexities, and those that involve related party transactions, among others.

Risk assessment should be done by the company, rather than the external auditors, according to Paisley. The checklist explains that external auditors are almost always lacking the necessary insight. The checklist also urges management to limit the relevant assertions, noting that unwarranted assertions drive huge and unnecessary costs. The PCAOB requires a reasonable possibility test for assertion. Paisley said that a senior executive should approve all assertions. Excessive assertions at the account level are a symptom of bad control design or the lack of entity level control assessment, according to the checklist.

Management must identify significant locations, which should be known by the amount of attention they attract from management and the board. The checklist points out that the largest location may not be the most significant. Qualitative factors should carry as much or more weight than quantitative factors.

IT general controls only generate about 5% of deficiencies, according to the checklist. Management should not rely on IT controls that reduce accountability in order to save costs.

Management should track all deficiencies and develop a deficiency reporting policy. The high rate of restatements does not mean that the

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U.S. Solicitor General Says Scheme Liability Is Counter to Congressional Intent

The U.S. Solicitor General has urged the Supreme Court to reject scheme liability for non-speaking secondary actors in private securities fraud actions since such an expansion of liability would upset the delicate balance Congress has crafted. In its brief, the Solicitor General argued that scheme liability runs counter to the congressional balance between exposure to private actions for

when the investors did not even allege that they were aware of the transactions that the vendors executed with the company would be a sweeping expansion of judicially implied private actions that could expose accountants and lawyers who advise issuers, as well as vendors far removed from the market, to billions of dollars in potential liability when issuers make misstatements to the market.

In the Solicitor General's view, scheme liability would considerably widen the pool of deep-pocketed defendants that could be sued for an issuer's misrepresentations.

aiding and abetting and empowering the SEC alone to pursue secondary claims against non-speaking actors, such as lawyers and accountants.

At the same time, the Solicitor General maintained that nonverbal conduct by secondary actors can constitute deception within the meaning of rule 10b-5, but in this particular case, although deception could be alleged, the investors did not rely on any conduct by the non-speaking vendor.

In the case of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (Doc. No. 06-43), the Court is slated to determine whether non-speaking actors, such as investment banks and auditors, that knowingly commit securities fraud, can be held liable for their actions. The brief addressing this question, a concept known as scheme liability, was filed in support of the defendants in the *Stoneridge* case.

In urging the Court to reject scheme liability, the Solicitor General said that allowing liability for a primary violation against a non-speaking vendor

In the Solicitor General's view, scheme liability would considerably widen the pool of deep-pocketed defendants that could be sued for an issuer's misrepresentations, increasing the likelihood that the private right of action would be em-

ployed abusively. This radical expansion of liability is a task for Congress, not the courts, according to the Solicitor General.

In this case, the parties allegedly backdated transactions as part of a scheme to inflate the issuer's operating cash flow in the financial statements. While this alleged conduct could constitute a deception under rule 10b-5, the Solicitor General said it could be no more than aiding and abetting since the investor alleged no reliance on the vendors' alleged deceptive conduct. The investor relied only on the issuer's alleged misstatements. The Solicitor General said that secondary actors cannot be held liable in a private securities action by virtue of an investor's reliance on misstatements made only by the company.

The Solicitor General emphasized that the principle at the heart of the distinction between primary liability and secondary liability of the kind rejected in *Central Bank* is that words or actions by a secondary actor that facilitate an issuer's

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Accounting Firms Support PCAOB Proposal to Remove GAAP Hierarchy From Auditing Standards

Major accounting firms expressed strong support for a PCAOB proposal to remove the GAAP hierarchy from auditing standards and place it in the accounting standards. The Board's proposal is driven by a FASB plan to incorporate the GAAP hierarchy into its accounting standards.

Since the GAAP hierarchy identifies the sources of accounting principles, the PCAOB believes that it is more appropriately placed within FASB's accounting standards.

Currently, the GAAP hierarchy is directed at the auditor despite the fact that it is the company, and not its auditor, that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Since the GAAP hierarchy identifies the sources of accounting principles, the PCAOB believes that it is more appropriately placed within FASB's accounting standards.

The separation of the GAAP hierarchy from the auditing literature is a natural and appropriate change, according to the Crowe Chizek firm, which noted that the overall selection of accounting policies and the application of accounting

rules is a function of the company's management, while the auditing of the application of GAAP is the function of the auditor. In comments supporting the proposal, the GAO also emphasized the importance of recognizing that it is the company, and not the auditor, that must select and apply accounting principles and take ultimate responsibility for the adequacy of financial statement disclosure.

PricewaterhouseCoopers said the Board's proposal is an appropriate response to FASB's proposal on GAAP hierarchy. Grant Thornton agreed that the GAAP hierarchy appropriately belongs

in the accounting literature and should be removed from the auditing standards upon its inclusion in the accounting standards.

Deloitte, while also applauding the removal of the GAAP hierarchy from the auditing standards, asked the PCAOB to consider whether any audits of state, local or federal governmental entities have audits performed in accordance with PCAOB standards and, if so, whether the GAAP hierarchy summary currently in AU section 411 is necessary guidance for those audits. ■

James Hamilton

Steps for Implementing AS5

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Sarbanes-Oxley Act is working, according to Paisley. In order to maintain investor confidence in financial reporting, management must analyze the root causes of any deficiencies. AS5 is

silent on root cause analysis, the checklist notes, so management must fill the gap. ■

Jacquelyn Lumb

August 28, 2007



IOSCO Roundtable on Audits Examines Valuation And Liability Issues

Participants at a recent IOSCO roundtable on public company audits agreed that the current certification is not entirely adequate. They suggested that the auditors' position be expanded to include judgments, with additional information to be provided, such as business matrices and other information used by the industry to estimate the future value of companies. The

successful management team tracks, could be equally useful for investors. He also noted that audit committee chairs could ensure that the information provided is better targeted and more relevant than that provided through a broad general regulation. If companies are unwilling to adopt such an approach, he said it might be necessary for regulators to intervene.

In Cook's view, the large number of material weaknesses and restatements is actually proof that the system is working properly, since people are making significant changes in their reporting systems.

On the question of auditor liability, Turner said that, before applying any liability caps, greater transparency should be required on the part of auditors. Since auditors have not made their financial information public, they have not provided any financial reason for imposing caps. Auditing firms

roundtable participants also believe that audits of large and complex companies could be enhanced through the use of internal auditors. It might also be useful to implement some fraud enhancement mechanisms within the regular audit process, although separate forensic investigations were generally not deemed appropriate.

would not even adopt the good governance practices required of public companies, which Turner sees as problematic, considering the important public function they provide to the worldwide capital markets.

Former SEC Chief Accountant Lynn Turner said it is crucial that the numbers presented in financial statements be accurate. Financial statements are a snapshot of a company at a given moment, he noted, and the role of auditors is to provide a high level of assurance that this snapshot is accurate. If they are unable to offer such assurance, he said, it would significantly change stock pricing and capital allocation activities.

Michael Cook, a former Deloitte CEO, mentioned that, following the financial debacles of Enron and others, there has been a pronounced cultural shift within the financial reporting community from making the numbers to doing it right. Other factors, such as Sarbanes-Oxley and whistleblowing, have also contributed to the enhancement of audit quality.

However, Turner agreed that including additional key measures of performance, which every

The SEC has also made a significant contribution by emphasizing the role of audit committees, Cook said, and the PCAOB has provided helpful support through its guidance and inspection programs. In

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IAASB Redrafts Standard on Independent Auditor's Report on Financial Statements

As part of its ongoing project to redraft and revise international audit standards, the IAASB has proposed a redrafted standard on the independent outside auditor's report on financial statements. The redrafted ISA 700 would require

The auditors should also determine if the information presented in the financial statements is relevant, reliable, comparable and understandable.

the auditor, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements taken as a whole are free from material misstatement.

In addition, the new standard would require that the auditor's evaluation of whether the financial statements are prepared and presented, in all material respects, in accordance with IFRS, for example, includes the consideration of the qualitative aspects of the company's accounting practices and indicators of possible bias in management's judgments.

The standard also requires auditors to evaluate whether the financial statements adequately disclose the significant accounting policies selected and applied, and significant interpretations by management of regulatory or legal requirements. Auditors must also evaluate whether the accounting estimates made by management are reasonable.

The auditors should also determine if the information presented in the financial statements is relevant, reliable, comparable and understandable.

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Auditors must also determine whether the financial statements provide adequate disclosure to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.

The outside auditor must evaluate whether the financial statements achieve fair presentation. In doing so, the auditor must consider the overall presentation, structure and content of the financial statements and whether they faithfully

represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor's report must also include a section on management's responsibility for the financial statements, which must state that management is responsible for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework, such as IFRS, and that this responsibility includes maintaining internal controls, applying appropriate accounting policies and making reasonable accounting estimates.

The current timetable envisions that all international auditing standards will have been revised and redrafted by late 2008. The IAASB has provisionally agreed that the complete set of standards will be effective for audits of financial statements for periods beginning on or after December 15, 2008. The date will depend on satisfactory progress being made, and will be amended to a later date if necessary. ■

James Hamilton



International Developments

PIOB Chair Calls for Transparently Adopted International Audit Standards

Market globalization and the concomitant need of investors for external consistency and cross-border comparisons has fueled the demand for principles-based international audit standards, in the view of Stavros Thomadakis, chair of the Public Interest Oversight Board. At a recent seminar in Mexico City, he said it is important to

Thomadakis also emphasized that international audit standard setting must be a transparent and flexible process administered by transparently selected and independent standard setters.

recognize that traditional national standard setting has limitations that cannot be overcome in this new environment. Thomadakis also emphasized that international audit standard setting must be a transparent and flexible process administered by transparently selected and independent standard setters. The PIOB is the oversight body of the International Audit and Assurance Standards Board.

Financial reporting is much more than a historical representation of economic events over a specified period, Thomadakis noted. It is critical for key financial decisions and influences how these decisions are implemented. Standards governing the production and validation of credible, clear and comprehensive accounts are a critical element in the development of firms, markets and economies.

In 2003, a group of international organizations, including IOSCO, the Basel Committee and the European Commission entered into an agreement

with IFAC, the parent of the IAASB, to substantially reform the international audit standards. The agreement recognized the need to elevate the consciousness of public interest within the standard setting process. It instituted ways in which the public interest could be recognized and explicitly inserted into standard setting activities, starting with the creation of an independent board to oversee all aspects of standard setting.

The reform agreement also called for a shift in the composition of standard setting bodies away from the dominance of practitioners and the creation of consultative stakeholder groups alongside the standard setting bodies to offer ongoing advice to standard setters.

In Thomadakis' view, it is now axiomatic that high quality international standards are indispensable in meeting international public interest objectives. In order to be widely accepted and adopted, he said that the standards must include clear objectives and sound principles. They must be clearly written for ease of understanding and application. In addition, they must operate in widely varying local environments in terms of the level of development and legal and regulatory requirements. They must also be suitable for application in a variety of client and auditor situations.

It is not enough for international standards to be of high quality, Thomadakis said. The process by which the standards are set must also inspire confidence. It must be transparent, forward-looking and

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Choice of Audit Firms Will Remain Market Driven

There should be no regulatory intervention to create a Big Five audit firm. A U.K. audit oversight group's recommendation that increasing the choice of audit firms should be driven by market solutions, not regulation, received the support of a broad industry consensus. Comments on the

One main objective of the FRC report is to reduce the perceived risks to investors of selecting a non-Big Four audit firm to audit the company's financial statements.

report by the Market Participants Group of the Financial Reporting Council, which oversees audits of public company financial statements, expressed the belief that market-based solutions will be more enduring than shorter-term regulatory measures.

In the wake of the implosion of Arthur Andersen, a number of groups are examining the issue of auditor choice, including the European Commission and the U.S. Paulson Committee. A recent survey indicated that global institutional investors would welcome greater auditor choice.

One main objective of the FRC report is to reduce the perceived risks to investors of selecting a non-Big Four audit firm to audit the company's financial statements, as well as to improve the accountability of boards for their auditor selection. Another important objective is to reduce the risk of audit firms leaving the market without good reason and to reduce disruption costs when a firm leaves the audit market.

In its comment letter, Grant Thornton said that market solutions are unlikely to have a dramatic impact upon the structure of the audit market in the short term. However, taken together over time,

they are likely to increase the awareness and quality of information used by those responsible for auditor appointment decisions. The firm recognizes that audit firms seeking to increase their presence in the larger corporate audit market need to invest and be seen to invest in their audit offering in order to continue to persuade more audit committees to use their services.

The Institute of Chartered Accountants in England and Wales believes that market-based actions are the most effective means to achieve an impact. As such

actions tend to involve information dissemination, persuasion and education, they may not have an immediate effect. They tend to be more effective since, once accepted, they work with the market and avoid the unintended consequences that often follow from regulation.

The market group recommended that the FRC provide guidance on a company's use of joint audits in which more than one audit firm network works on the audit. The Institute said there may be circumstances where audit quality would not be harmed by the use of auditors from more than one network.

PricewaterhouseCoopers said that it would generally be unwilling to be the group auditor where its network firms were not also auditors of all or substantially all of the group. There are good reasons why large audit firms developed global networks, said PwC, and good reasons why companies employ a single network as worldwide auditor.

KPMG was concerned that the use of more than one audit network firm would have an adverse impact on audit quality. It is important for the parent

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Auditor Independence

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solely to the prior period audited by the predecessor and were performed before the successor was engaged to audit the current period.

An accountant would not be considered independent if, at any time during the audit and professional engagement period, he or she provided translation services to SEC audit clients based in foreign jurisdictions or U.S. clients with foreign operations. OCA explained that translation services require decisions and judgments on behalf of management with respect to the use of various words and phrases, and specific accounting, business and industry terms. In conveying the meanings as expressed by management in the original language, OCA said it could create a mutual or conflicting interest between the accountant and the audit client and may put the auditor in the position of auditing his or her own work.

Whether the independence of an auditor of a Form 11-K employee benefit plan filer would be impaired when providing prohibited nonaudit services to the nonaudit client sponsor of the plan depends on the type of service provided, according to OCA. The employee benefit plan is a separate issuer but is considered to be an affiliate of the sponsor to the plan, so it is subject to the prohibited services rules. Since the accountant is auditing the plan, and not the plan sponsor, the services would be permissible as long as the services are limited to prohibited nonaudit services that contain the modifier “unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client’s financial statements” and the auditor does not provide any services that would affect the plan’s financial statements or the audit.

OCA advised that auditors of parent financial statements must be independent of entities that are

consolidated due to the application of *FASB Interpretation No. 46, Consolidation of Variable Interest Entities* (“FIN 46R”). An enterprise that consolidates variable interest entities may obtain the ability to make decisions that affect their activities through contracts or their governing documents. OCA added that registrants may wish to consult with the staff if an enterprise believes that it does not control a variable interest entity that it was required to consolidate under FIN 46R.

The audit committee of a plan sponsor of an employee benefit plan does not have to preapprove the audit of the plan. However, audit committees are not precluded from establishing policies for preapproval. Audit committees are required to preapprove services provided by the issuer’s principal accountant to variable interest entities that are consolidated under FIN 46R.

Issuers must include in their fee disclosures any fees paid to the principal auditor of a sponsor for the audit of its employee benefit plan, regardless of whether the fees are paid by the sponsor or the plan. The issuer may identify the fees paid to the accountant that were not paid by the issuer or were not subject to the preapproval requirements if it wishes.

In response to an inquiry about the application of the cooling off period to the three years of audited financial statements included in an initial public offering and periods after a company becomes an issuer, OCA advised that accounting firms must consider their relationship with the client prior to and after the client becomes an issuer. Since the IPO will contain an audit report for three years, the cooling off rules would apply to all years. In applying the cooling off rules for time periods prior to the IPO filing, the day after the audit report release date constitutes the commencement of the audit procedures. ■

Jacquelyn Lumb

America COMPETES Act

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in the accuracy of the outside audit of corporate financial statements is absolutely crucial to the successful functioning of the securities markets. Dodd was a principal architect of Title I of the Sarbanes-Oxley Act, which created the PCAOB.

The Dodd-Shelby provision agrees with recent statements by SEC Chair Christopher Cox that Sarbanes-Oxley did not need to be amended, but that the regulators need to change the way the law is

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America COMPETES Act

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implemented. It is the implementation of the law that has caused the excessive burden, in Dodd's view, not the law itself.

Dodd praised the deliberative process of rulemaking and standard-setting conducted by the SEC and the PCAOB in reforming the internal control mandates of section 404 and commended the SEC for responding very well to the concerns about the section 404 requirements, particularly those of smaller public companies.

Shelby observed that the SEC's management guidance and new PCAOB Auditing Standard No. 5 are mutually reinforceable and should significantly improve the implementation of section 404, making it more efficient and effective for small and medium-sized businesses. Shelby is satisfied that the agencies recognize that the unnecessary costs imposed by section 404 are a real problem for both large and small companies.

Dodd does not believe that Sarbanes-Oxley should be opened up to an amendment at this time. He

believes that it would be irresponsible for Congress at this juncture to jump in and greatly reduce the number of companies that would have to comply with section 404.

The SEC must be allowed to do its job, he said. If the Commission does not do the job, he continued, and the burdens of section 404 still exist, Dodd would welcome an opportunity to address it. In his view, the provision sends a message to the SEC and the PCAOB that Congress is watching what they do very carefully.

Shelby was also willing to give the SEC and the PCAOB time to make the significant changes needed to reduce the unacceptable costs and burdens of section 404 compliance. The problems are very complex, he added, and the regulators should be given a chance to fix them.

While Shelby is willing to give the SEC and PCAOB additional time to fix the problem, he is not willing to give them unlimited time. He said that the Banking Committee will monitor closely their progress. ■

James Hamilton

Scheme Liability

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misstatement, but are not themselves communicated to investors, cannot give rise to reliance, and thus primary liability in a private action.

The Solicitor General contended that the issue has international repercussions. Extending liability to vendors could effectively and substantially expand liability for foreign companies that trade with publicly-listed companies. In a brief filed by international organizations, including the Federation of German Industries, they pointed out that Germany and the U.K. limit liability for misstatements to the issuer and potentially certain of its officers and directors. They do not provide for claims against silent third parties to commercial transactions that the issuer misreports.

Former SEC Chairs Urge Supreme Court to Approve Scheme Liability

Former SEC Chairs William Donaldson and Arthur Levitt have filed a brief on behalf of investors urging the Court to hold that non-speaking actors who engage in deceptive acts as part of a scheme to defraud investors may be liable under rule 10b-5 even if they did not directly issue fraudulent statements. Former SEC Commissioner Harvey Goldschmid also joined the brief.

The battle over scheme liability is joined when investors argue that an investment bank or an

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Scheme Liability

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auditor need not have made misleading statements or omissions to be liable for securities fraud since participating with scienter in a sham transaction with no legitimate business or economic purpose should suffice. The countervailing argument is that the actors must make a misleading statement to be held liable under rule 10b-5 and scheme defendants who remain silent and owe no duty of candor to investors are categorically exempt.

The circuit courts are split on this issue. The Ninth Circuit articulated a test under which participants in schemes with the principal purpose and effect of defrauding investors are held liable whether or not they made misleading statements to investors. By contrast, the Eighth Circuit in *Stoneridge* and the Fifth Circuit in *Enron* have adopted what earlier amici called a narrow interpretation of scheme liability based on an erroneous interpretation of the Supreme Court's 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*.

The former SEC chairs called the action one of the most important securities cases to be heard by the Supreme Court in many years. They believe it is critical to the antifraud purposes of the federal securities laws that actors, other than issuers and their officers and directors, who actively engage in deceptive conduct for the purpose and with the effect of creating a false statement of material fact in the disclosure of a public company, continue to be held liable in private securities fraud actions.

In their view, the Court's reaffirmation of liability for actors such as investment banks and accounting firms that actively engage in deceptive conduct as part of a fraudulent scheme will have a profound effect on the deterrence of fraud and the ability of investors to recover their losses. On the other hand, the rejection of fraudulent scheme liability would make invulnerable those who purposely engage in deception and immunizes non-issuers who commit securities fraud from private liability merely because they were cunning enough to avoid making a public statement.

Non-speaking actors who engage in fraudulent acts as part of a scheme with the issuer to defraud

investors should be held primarily liable, the former chairs said, regardless of whether they speak to the market, assuming all of the other elements of rule 10b-5 are met. In their view, a failure to do so would dramatically undermine private enforcement of the securities laws and investor confidence.

The former SEC chairs pointed out that the Commission's traditional position has been that a person may commit a manipulative or deceptive act constituting a primary violation of the antifraud rule without making a public statement. The SEC has consistently expressed this position through rulemaking, amicus briefs and enforcement actions.

The SEC's disgorgement and civil money penalty powers, while enhanced by the Sarbanes-Oxley Act, generally cover only a fraction of the damage done to investors by serious securities fraud. The SEC, with limited resources, cannot bring actions in every one or even most of the financial fraud cases that have proliferated over the past few years.

The former SEC chairs fear that the elimination of fraudulent scheme liability would mean, in practical terms, that defrauded investors would not be able to recover their losses from any party other than the company that issued the financial statements. Since the issuer often becomes bankrupt or is unable to satisfy a judgment once the fraud is exposed, investors would be unable to recover much of their losses if the issuer is the only party they could proceed against.

Former SEC Chairs Hills, Pitt and Williams Urge Supreme Court to Reject Scheme Liability

Former SEC Chairs Harvey Pitt, Rod Hills and Harold Williams, along with a number of former commissioners, have filed a brief urging the Supreme Court to reject scheme liability for non-speaking secondary actors in private securities fraud actions. The former SEC officials call scheme liability a semantic ploy designed to recast secondary conduct as a primary violation of rule 10b-5 in order to get around the Court's ruling in the *Central*

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Scheme Liability

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Bank case that there is no private right of action against secondary actors who aid and abet securities fraud.

The former chairs warned that the approval of scheme liability would inject confusion into rule 10b-5 actions since not even the proponents of scheme liability can consistently define this amorphous concept. They further contend that scheme liability exposes those engaging in commercial transactions with public companies to disproportionate damages of a magnitude greater than the size of the transaction alleged to give rise to the liability.

Among the former SEC commissioners who joined the three chairs on the brief were Joseph Grundfest, Richard Roberts, Aulana Peters, Edward Fleischman, Stephen Friedman, Isaac Hunt and Laura Unger. Former SEC general counsels James Doty and Simon Lorne also joined the effort.

In interpreting the 1994 *Central Bank* opinion, the former chairs said that scheme liability involves secondary conduct within the meaning of the Court's opinion and that mere knowing participation in another's alleged fraud is not enough for liability to attach. They maintain that Congress has sanctioned this approach since the 1995 Private Securities Litigation Reform Act which specifically gave the SEC enforcement power against secondary actors who aid and abet securities fraud.

Since Congress expressly refrained from similarly empowering private investors, the former SEC officials said the Court should not do by fiat what Congress declined to do by statute. The former SEC officials concluded that *Central Bank* and the congressional reaction to it clarify that the anti-fraud rule does not encompass scheme liability. They emphasized that the implied private right of action under rule 10b-5 is a judicial creation and that the days of judicially implied private actions

are "long past." The Court has recognized that an expansive reading of the implied right is susceptible to abuse, according to the brief.

The former officials pointed out that no express provision in any of the federal securities laws allows investors to sue a non-speaking actor that did not transact in the issuer's securities and owed no duty to investors. Since Congress has never expressly authorized such a private suit, the former SEC officials said there is no reason to assume that Congress implicitly did so in the securities anti-fraud provision.

The former SEC officials reject the idea that the private right of action under rule 10b-5 should be extended to cover secondary actors to promote investor compensation. They noted that there is a broad consensus in the academic community that the out-of-pocket measure of damages used in rule 10b-5 class actions challenging aftermarket fraud is economically irrational because it bears little relation to the actual net harm suffered by investors.

The wisdom of extending the current rule 10b-5 remedy is far from obvious, in the former officials' view, particularly since the money paid to settle the action is most often funded by other innocent investors. They observed that the SEC can now provide investors with meaningful compensation pursuant to its authority under the Fair Funds provision of the Sarbanes-Oxley Act.

The former officials similarly rejected deterrence as a justification for scheme liability since, in their view, substantial deterrents already exist. For example, the SEC and the Department of Justice can pursue claims against aiders and abettors of securities fraud. In addition to financial penalties, the SEC has available to it a panoply of remedies that enable it to perform its deterrent function in a finely calibrated manner, depending on the facts and circumstances of the case, they advised. ■

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his view, the large number of material weaknesses and restatements is actually proof that the system is working properly, since people are making significant changes in their reporting systems.

Paul Koster, chair of CESR-FIN, advised that the European Commission has made great efforts within the Financial Services Action Plan to improve the reliability of financial statements. Many directives have been introduced, such as the Transparency Directive and the Audit Directive.

Koster, who is also a member of the Netherlands Authority for Financial Markets, noted that a recent survey published by CESR on the communication of auditors with the public demonstrates that it might be useful if auditors provided a more detailed explanation of their work in the financial statements. For example, they could explain what actions they have taken to ensure their independence, and the audit's specific risks and focal points of attention.

There are times when the margins of a certain company are rising, while those of most companies in the same sector are declining. In those cases, investors would like the auditors to explain their actions in order to be reassured that the numbers are correct.

Koster also reiterated his position that financial statements should include an accountant's discussion and analysis. Such information would also help the auditing profession make a better impression on the financial markets by communicating how well they are performing their tasks.

EALIC Chair Alain Joly agreed that there has been a dramatic improvement in the reliability of the numbers being produced. At the same time, he believes that there has been an increasing number of disclaimers by auditors. He is concerned about this because shareholders must ultimately rely on the judgment of the auditors.

He disagreed with the suggestion that auditors describe their work in more detail. This would lead to 500-page annual reports, he said, which would become unreadable. At the end of the day,

auditors should stick their necks out, and clearly state whether, to the best of their knowledge and understanding, they believe the company's statements to be fair and honest, in his view.

Joly is also concerned about the IASB-FASB shift towards a full fair value approach. While historical accounting has its limits, he conceded, it is still based on facts. He believes that historical accounting, supplemented by some asset impairment considerations and fair value treatments for some specific instruments, is the optimal solution. A shift to full fair value would destroy the separation of the past and the future, he warned, since a number of judgments on the balance sheet will be based on fancy forecasts, rather than facts.

On the issue of auditor fraud detection, Turner advocated the adoption of a better fraud standard in the context of a regular audit, and dismissed the idea of a separate forensic audit. He also noted that auditors are still not using procedures that are used by other professionals, such as hedge fund analysts, to greatly enhance the possibility of detecting fraud.

Consequently, it is not unusual for an analyst to detect fraud where an auditor failed, although the latter has access to the company records. In Enron, Turner noted, two large hedge funds managed to detect that the company's books were cooked, while the outside auditor did not.

On the issue of cooperating with internal auditors, Koster said that the groundwork has been laid for the examination of a closer relationship between external and internal auditors. First, following Sarbanes-Oxley, companies have invested huge amounts in improving their internal control environment. Second, companies are becoming increasingly complex, particularly in certain sectors, such as the pharmaceutical industry. Cooperation must be conditioned on securing the independence of internal auditors through direct reporting to the audit committee. Audit quality standards should be ensured, and the authorities should probably license some internal auditors. Finally, regulators should perform some oversight on internal auditing.

Turner said it would be extremely useful to have an internal auditor present around the clock. Their

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support can be particularly important in the area of whistleblower programs, since they can offer a quicker and more efficient response to such situations than external auditors.

Concerning valuation issues, Joly noted that components of goodwill valuation models are extremely sensitive to changes. There is concern that, since an increasing amount of goodwill is included in companies' balance sheets, and since goodwill is no longer depreciated, there will be serious problems down the road.

Koster has valuation concerns in the area of private equity and hedge funds. The information used to conduct such valuations is self-reported, he noted, and is thereby subject to selection bias. The valuations are based on both unrealized and realized returns, and are thereby subject to biases due to subjective accounting treatment. He also noted that private equity hedge funds have become liquid pools of money. While returns are said to be exceptional in this area, they are less impressive when the liquidity element is taken into account. ■

James Hamilton

Transparent Audit Standards

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flexible, provide ample opportunity for stakeholder input, and be subject to independent oversight.

The individuals who serve as international standard setters must be experienced and committed to the public interest. They must act independently, be responsive to emerging needs and open to

stakeholder input. They must be drawn from diverse backgrounds in terms of professional experience and affiliation. Finally, they should be a blend of practitioners and non-practitioners who are selected by a transparent process. ■

James Hamilton

Choice of Audit Firms

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company auditor to control the work performed by the auditors of the company's subsidiaries, KPMG advised, and this is enhanced when all the firms involved in the audit use a common methodology. KPMG cited Parmalat as an example of what can go wrong when more than one audit firm is involved. Deloitte said that, in this area, nothing must be done that could damage audit quality.

The U.K. audit firm Mazars supports the recommendation of joint audits as vital to promoting a more competitive audit market. The firm asked the FRC to conduct a study on joint audits. The firm believes that joint audits facilitate the benchmarking of the quality of audit work and client services. They also reduce the risk of systemic instability if a major firm were to

leave the market since issuers would still have an audit firm. Joint audits also allow leading non-Big Four firms to play a substantial role in global audits.

The FRC group also recommended that audit committees communicate with shareholders on the selection of outside auditors. The Institute noted that transparency in the process may encourage audit committees to consider a wider selection of auditors. However, there is concern that this could be counterproductive, with audit committees becoming even more conservative to avoid potential criticism that they are contemplating an auditor which is an unknown quantity. ■

James Hamilton

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