



May 22, 2003

IMPROPER INFLUENCE OF AUDITS

On May 20, 2003, the Securities and Exchange Commission released its final rule implementing the provisions of Section 303(a) of the Sarbanes-Oxley Act of 2002. The final rule prohibits an issuer's officers and directors and persons acting under their direction from taking any action to coerce, manipulate, mislead or fraudulently influence the auditor of an issuer's financial statements if that person knew or should have known that such action, if successful, could result in "rendering the financial statements materially misleading."

Persons Covered

The final rule covers the activities of officers and directors of the issuer as well as any other persons acting under their direction. The term "officer" includes the "company's president, vice-president, secretary, treasurer or chief financial officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated." A person may be acting under the direction of an officer or director even if he or she is under their supervision or control. Not only are the issuer's employees covered, but also customers, vendors and creditors who provide false or misleading confirmations or information to auditors at the request of an officer or director. Persons acting under the direction of officers and director also may include partners and employees of the audit firm who are not directly involved in the audit (such as consultants or forensic accounting specialists retained by counsel of the issuer) and attorneys, securities professionals, or their advisors who may pressure an auditor to limit the scope of an audit, issue an unqualified report, not object to an inappropriate accounting treatment, or not withdraw an issued opinion.

Conduct Prohibited

"Any action to, coerce, manipulate, mislead or fraudulently influence" the auditors of the issuer's financial statements rendering the financial statement materially misleading is prohibited by the final rule. Such conduct already is subject to other provisions of the securities laws and the SEC's regulations, but the final rule provides additional means to address conduct even if such conduct did not succeed in affecting the audit or review.

Engagement in the Performance of an Audit

The definition of an accountant who is "engaged in the performance of an audit" of the issuer's financial statements should be given a broad reading to cover the professional engagement period and any other time the auditor makes decisions regarding the issuer's

financial statements. This includes the period during negotiations for the retention of the auditor and the subsequent professional engagement period. Therefore, the rule applies before the engagement period such as if an officer, director or a person acting under their direction offers to engage an accounting firm on the condition that the firm issue an unqualified report that does not conform to generally accepted accounting principles. The rule also applies throughout the professional engagement period and after the period has ended when the auditor is contemplating whether to consent to the use of, reissue or withdraw a prior audit report.

Actionable Conduct

Conduct must be “for the purpose of rendering [the issuer’s] financial statements materially misleading.” An auditor may be improperly influenced to perform or not perform actions which would result in materially misleading financial statements. Such actions include (1) issuing unwarranted reports on the financial statements including suggesting or acquiescing in the issue of inappropriate accounting treatment or not proposing adjustments required for the statements to conform with generally accepted accounting principles; (2) not performing an audit or review that might divulge material misstatements in the financial statements if performed; (3) not withdrawing a previously issued audit report when required by generally accepted auditing standards; and (4) not communicating an appropriate matter to the audit committee.

Furthermore, the rule is not limited to the audit of annual financial statements but includes activities which are sufficiently connected to the audit process and the harms the Act seeks to prevent such as improperly influencing an auditor during a review of interim financial statements or in connection with the issuance of a consent in connection with a Securities Act filing.

Standard of Liability

The rule prohibits the issuer’s officers and directors and person acting under their direction from taking any action to coerce, manipulate, mislead or fraudulently influence the auditor of the issuer’s financial statements if that person knew or should have known that such action, if successful, could result in rendering the issuer’s financial statements materially misleading. An officer, director, or a person acting under their direction is culpable if he or she knew, or should have known, that if successful, the improper influence could render the financial statements materially misleading. Courts previously have held that this essentially is a negligence standard.

Practical Implications

The new rule certainly is well intentioned, but it does raise two concerns. First, there are instances when an issuer’s management disagrees with the accounting treatment proposed by the issuer’s auditors. Frequently these disagreements are resolved in favor of management’s view. We are concerned that this dialogue -- which we consider healthy and appropriate -- may, when coincident with a change in auditors or a change in the auditor’s engagement, lead to an accusation that the new rule has been violated. These incidents should be rare, but officers and directors must be cautious in their advocacy with their auditors and are well advised to discuss major disagreements with their audit committees. Second, the new rule may impact the cost of director and officer liability insurance or audit fees. Civil liability will ensue from the new rule,

and directly or indirectly the cost of at least a portion of that liability will be borne by insurers and auditors. Recent experience suggests the costs will be passed through to issuers.

This e-mail alert is intended to provide general legal information and does not render legal advice or legal opinion. Such advice may only be given when related to actual fact situations.

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