

**OVERZEALOUS
ABOUT SARBANES-OXLEY?**

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- Talk to the clients – in response to the reported practices of auditors not willing to provide accounting advice to audit clients and not beginning audit work until a client has completed the financial statements and internal control assessment, the PCAOB notes that “such practices are neither necessary nor advisable.” Auditors may provide accounting advice and may also review draft financial statements without having to treat an error discovered in the draft as an internal control deficiency.

A related Q&A sheet issued by the PCAOB staff, also issued Monday, notes that Standard No. 2 “does not contain a presumption that a control is ineffective solely because there is no documentation evidencing the operation of the control.” Instead, the auditor must obtain evidence, such as by actual test, to determine whether a control is operating effectively.

The SEC also noted that neither Section 404 nor SEC rules require that a material weakness in internal controls be found anytime there has been a restatement of financial results, but instead management and the auditors must consider facts and circumstances, including the probability of occurrence and the standard of “reasonable assurance” rather than “absolute assurance”. ■

On Monday, the Securities and Exchange Commission and the Public Company Accounting Oversight Board issued separate statements urging auditors to use better planning and to recognize a “zone of reasonable conduct” by companies when conducting the internal control audits required by the Sarbanes Oxley Act. (See www.sec.gov and www.pcaob.org).

These two sets of statements reflect feedback received from an April 2005 roundtable discussion attended by business, accounting, legal and regulatory representatives following first-time implementation of Section 404 of the Act for the 2004 year.

Under Section 404, auditors must issue an annual report, in addition to the audit report, regarding management’s assessment of whether its internal controls over financial reporting were effective. The PCAOB’s Auditing Standard No. 2 sets rules that auditors must follow in auditing management’s assessment.

The PCAOB noted that various audit practices were found to be ineffective or inefficient, usually the result of poor training and audit planning, and that auditors should do the following:

- Integrate the audits – the internal control audit and the financial statement audit should be designed to use the same evidence gathered and the same tests.
- Tailor the audits – auditors should avoid using standardized audit “checklists” and instead “exercise judgment to tailor their audit plans to the risk facing the individual clients.”
- Use a top-down audit approach –

beginning with company-level controls, auditors should further test only those accounts and processes that are actually relevant to internal control, using a risk assessment analysis to eliminate those accounts (regardless of size) that only have a “remote likelihood of containing a material misstatement.”

- Use the work of others – Statement No. 2 allows auditors to rely upon the testing work of the internal auditors, and the SEC noted that “testing may be done over a period of time” rather than just as of year-end.



The internal control audits required by the Sarbanes-Oxley Act have proved frustrating for both companies and their auditors

**WHO GOVERNS
YOUR COMPANY?**

The Delaware Supreme Court recently affirmed a Court of Chancery decision that the internal affairs of a Delaware corporation are governed by Delaware law regardless of a California statute that would require otherwise.

In the case, Examen, Inc., a Delaware corporation headquartered in California, entered into a merger agreement with a Massachusetts corporation. Prior to the vote of Examen's shareholders, VantagePoint Venture Partners 1996, which controlled 83% of Examen's preferred stock, attempted to block the deal. According to VantagePoint, California law should apply to the vote because

Examen is headquartered in and has other contacts with California and is therefore a "quasi-California corporation". If California law applied,



The Delaware Supreme Court recently found that a DE corporation headquartered in CA is subject to DE law, regardless of what CA says

Examen's shareholders would vote in classes and VantagePoint could block the deal.

In affirming the Court of Chancery's decision, the Supreme Court held that the internal affairs of Delaware corporations, in this case voting rights, must be governed by Delaware law. Moreover, the Supreme Court found that a California statute that requires "quasi-California corporations" to be governed by California law is unconstitutional.

This decision highlights the importance of carefully choosing the right state of organization when forming a new business entity.▣

**BANK AGENCIES CONCERNED
ABOUT AUDITOR INDEPENDENCE**

On May 10, 2005, the Federal Financial Institutions Examinations Council (FFIEC) released a proposed interagency advisory that would cause auditors to lose their independence if they included limitation of liability or indemnification provisions in their audit engagement letters. (www.ffiec.gov).

Accordingly, the advisory noted the following types of provisions would be considered unsafe and unsound if included in an engagement letter:

- Release from liability for auditor negligence;
- No damages
- Limitation of period to file claim



A proposed advisory would detail provisions that could cause the loss of auditor independence

- Losses occurring during periods audited
- No assignment or transfer
- Knowing misrepresentations by management
 - Indemnification for management negligence
 - Damages not to exceed fees paid

If adopted, this guidance would apply to all financial institutions.

While this proposed interagency advisory would only affect banks, the SEC already takes the position that an auditor

is not independent if its liability for negligence is limited by agreement.▣

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