

# **SCHWARTZ & BALLEN LLP**

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## **MEMORANDUM**

May 29, 2003

To Our Clients and Friends

Re: Improper Influence on Conduct of Audits

The Securities and Exchange Commission (“Commission”) has issued a final rule implementing Section 303 of the Sarbanes-Oxley Act of 2002. The rule prohibits officers and directors of an issuer, and persons acting under the direction of an officer or director, 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 financial statements materially misleading.

Examples of actions that could render a financial statement materially misleading include:

- Issuing or reissuing a report on an issuer’s financial statements that is not warranted in the circumstances (due to violations of generally accepted accounting, auditing or regulatory standards);
- Not performing an audit, review or other procedure required by generally accepted accounting, auditing or professional standards;
- Not withdrawing an issued report; or
- Not communicating matters to an issuer’s audit committee.

The rule is effective June 27, 2003 and applies to both domestic and foreign issuers. The rule also applies similar provisions to investment companies.

### **DEFINITIONS**

The SEC commentary on the final rule provides detailed guidance on defining the terms used in the rule. Some of the definitions are summarized below:

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*Issuer* has the same meaning as in section 3 of the Securities and Exchange Act.

*Officer* includes the company's president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization.

*Under the direction* encompasses a broader category of behavior than supervision, and may include the activities of third parties who participate in an effort to improperly influence the auditor when those third parties knew or should have known that the effect of their conduct would be to render an issuer's financial statements materially misleading. As a result a third party such as a customer, vendor or creditor who provides false or misleading confirmations or other information to auditors or who enters into side agreements that mislead auditors could be regarded as acting under the direction of an officer or director.

*Types of conduct* that could constitute improper influence include directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- Providing an auditor with an inaccurate or misleading legal analysis;
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- Blackmailing; and
- Making physical threats.

*Independent Public or Certified Public Accountant* includes all accountants engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the Commission and public accounting firms registered with the Public Company Accounting Oversight Board and persons associated with such public accounting firms.

*Engaged in the performance of an audit* encompasses the entire professional engagement including after the professional engagement has ended when the auditor is called upon to make decisions or judgments regarding the issuer's financial statements or when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports.

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*Knew or should have known* implies the existence of a negligence standard which is consistent with the Commission's enforcement actions in this area.

The final rule can be found at [www.schwartzandballen.com/WhatsNew.htm](http://www.schwartzandballen.com/WhatsNew.htm).

If you have any questions concerning the final rule, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.