

# Report for Congress

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## **The Sarbanes-Oxley Act of 2002: A Side-by-Side Comparison of House, Senate, and Conference Versions**

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# **The Sarbanes-Oxley Act of 2002: A Side-by-Side Comparison of House, Senate, and Conference Versions**

## **Summary**

This report compares the major provisions of three versions of auditor and accounting reform legislation. Set out are the versions of H.R. 3763 passed by the House on April 24, 2002, passed by the Senate on July 15, 2002, and the conference version that was approved by both houses of Congress as the Sarbanes-Oxley Act of 2002 on July 26, 2002. President Bush indicated that he would sign the measure into law within a few days.

The cornerstone of U.S. securities regulation is disclosure. According to this approach, the best way to protect investors from fraud, hype, and irrational exuberance is to require companies selling stocks and bonds to the public to disclose detailed information about their financial strengths and weaknesses. Without complete and accurate information, investors cannot make rational decisions, and the market cannot allocate funds to the most productive users. Ill-informed investment choices hurt individual investors, but there are also costs to the national economy in terms of wasted resources, jobs not created, and innovations forgone. If investors decide they cannot trust corporate disclosures, they will be less likely to buy stocks and bonds, raising the cost of capital for all firms, good and bad. Since the market's peak in early 2000, U.S. stocks have lost about \$7 trillion in value. The share prices of firms that fail to meet their own profit projections, or Wall Street's expectations, are apt to plummet. The desire to avoid or postpone stock market losses creates a powerful incentive for corporate management to engage in accounting practices that conceal bad news. The cases of Enron, WorldCom, and a growing list of others suggest that this incentive is often strong enough to overwhelm the watchdog mechanisms in place to prevent deceptive financial reporting.

The Sarbanes-Oxley Act seeks to restore confidence in corporate reporting by enhancing the oversight of financial accounting. The measure creates a new oversight body to regulate independent auditors (whose certification the law requires to be affixed to the annual reports of all publicly traded corporations). Under previous practice, auditors were regulated mainly by private professional accounting groups; the new board will also be private, but will operate under the direct oversight of the Securities and Exchange Commission. A majority of the five board members will be non-accountants. The board will have sweeping powers to inspect accounting firms, set rules and standards for auditing, and impose sanctions on violators. Auditors will be prohibited from providing certain non-audit consulting services to their audit clients, and the oversight role of the board of directors will be strengthened. Top corporate officials will have to personally attest to the accuracy of their firm's accounting (and face penalties if financial statements are later found to be erroneous). Stock trades by corporate insiders will have to be made public within two days, and most loans by companies to their executives will be prohibited. This report traces the evolution of the Sarbanes-Oxley Act by comparing the major features of the bills passed by the House, the Senate, and the conference committee. It will not be updated further.

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# The Sarbanes-Oxley Act of 2002: A Side-by-Side Comparison of House, Senate, and Conference Versions

The table below presents a side-by-side comparison of three versions of the Sarbanes-Oxley Act of 2002: (1) H.R. 3763 as passed by the House on April 24, 2002; (2) H.R. 3763 as passed by the Senate on July 15, 2002( with the S. 2673 as an amendment in the nature of a substitute); and (3) the conference version approved by both houses of Congress on July 25, 2002.

The provisions are set out in eight categories:

- creation of a new auditor oversight body;
- auditor independence;
- enhanced accounting disclosure requirements;
- stock analysts;
- corporate executive accountability;
- corporate boards;
- increased penalties for securities law violations; and
- other provisions.

The appendix to this report summarizes the two ten-point plans put forward by President Bush.

**Table 1. Comparison of Provisions of the Sarbanes-Oxley Act of 2002: House, Senate, and Conference Versions**

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
<b>I. Creation of a New Auditor Oversight Board.</b>			
Name of new regulator	Public Regulatory Organization	Public Company Accounting Oversight Board	Follows Senate bill
Number of board members	Five	Five	Five
Board composition	Two members would be accountants with recent experience in auditing public companies; two could be CPAs, provided they had not worked in the accounting industry for 2 years; and at least one member must never have been a CPA	Three must never have been accountants; two may be accountants, but if an accountant is to be chairman, he or she must not have been in active practice for 5 years	Follows Senate bill

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Scope of board's activity	(1) to review auditors' work product, (2) to enforce (but not set) standards of competency and professional ethics, and (3) to review conflicts of interest between auditors and their clients.	(1) set auditing, quality control, and independence standards, (2) inspect the auditing operations of public accounting firms (required to register with the board and file annual reports if they audited public companies), and (3) investigate violations of securities laws, standards of ethics, competency, and conduct set by the accounting profession, and the board's own rules	Follows Senate bill
Who must register with the board?	No registration requirements	All accounting firms that audit public companies	Follows Senate bill
Standard-setting powers	None	Would set auditing, quality control, and independence standards	Follows Senate bill
Disciplinary powers	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose fines, censures, and suspend firms from auditing publicly traded corporations. SEC and state boards of accountancy would be notified of final sanctions
SEC to review and possibly reduce board sanctions?	Yes	Yes	Yes

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
SEC oversight authority to abrogate, add to, or modify any of the board's rules?	Yes	Yes	Yes. Further specifies that the SEC can assign to the board duties and responsibilities not included in the statute
Source of funding	Specifies that the board will not be solely dependent on the accounting profession for its funding	Funded (1) by accountants, who would pay the cost of mandatory registration with the board, and (2) by companies that sell securities to the public, who would be assessed a fee proportional to the value of their securities in circulation in the public market.	Follows Senate bill, with further provision that fines collected by the board are to fund merit scholarships for accounting students. Fees that fund the board will also fund FASB

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
<b>II. Auditor Independence.</b>			
Bans on provision of certain non-audit services by auditors to their clients	Directs the SEC to revise its auditor independence rules to prohibit an independent auditor from designing or implementing financial information systems or from performing internal audit work for companies for which it is the outside auditor. (Under current SEC rules, auditors are barred from supervising or managing their clients' information systems, and from performing more than 40% of their clients' internal audits.)	Amends statute to ban financial system design and internal audit work. Existing SEC regulations against provision of certain other non-audit services are also incorporated into the statute. Except in certain cases, the Senate bill stipulates that auditors may provide permitted consulting services (such as tax preparation) to their audit clients only with the approval of the audit committee of the client's board of directors	Follows Senate bill, and adds provision that an audit of an insurance company required by state law meets the definition of an "audit service"
Who would set auditor independence standards?	The SEC	The new board	Follows Senate bill
Auditor rotation	No provision	Requires the rotation of the lead audit partner after auditing a company for five consecutive years. Calls for a study of mandatory rotation of audit firms	Follows Senate bill, and applies rotation requirement to "coordinating" and "reviewing" audit partners, as well as the "lead" partner

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Auditor/client employment relationships	No provision	Bars an accountant from serving as the outside auditor for a company where a top officer had been employed by the accountant within the past year	Follows Senate bill
<b>III. Enhanced Accounting Disclosure Requirements.</b>			
Insider transactions in corporate securities	Stock trades by corporate insiders must be reported electronically to the public on the business day following the transaction. (Under current rules, disclosure may not be required for weeks or months.)	Insider trades must be reported to the public within two business days of the transaction	Insider trades must be reported to the SEC by the second business day after the transaction (unless the SEC finds this is not feasible), and the SEC must display the filings on its web site the day after the filing is received
Require enhanced disclosure of off-balance sheet transactions, and material transactions with unconsolidated subsidiaries?	Yes	Yes	Yes
Require disclosure of any change in a corporation's code of ethics?	Yes	Yes	Yes

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Other disclosures required	Real-time disclosure of events that would be material to investors' decisions to buy or sell. The SEC would determine the kinds of events subject to real-time reporting	Directs SEC to make rules to require that (1) pro-forma financial statements (unaudited reports that do not follow generally accepted accounting principles) must be reconciled with GAAP and that (2) corrections or adjustments of past financial statements that were made at the insistence of a corporation's auditor must be disclosed	Adopts both House and Senate provisions
Enhance SEC review of corporate financial statements	Requires SEC to establish a risk rating system to determine how often a firm's financial statements should be reviewed	No provision	Requires SEC to inspect companies' financial statements at least every 3 years (and more often for large firms)

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Accounting standards setting	No provisions	Directs the SEC to ensure that the Financial Accounting Standards Board, which sets accounting standards, be funded by contributions from securities issuers (rather than by the accounting industry). Also requires FASB to adopt procedures to ensure “prompt consideration” of needed changes to accounting rules	Follows Senate bill
<b>IV. Stock Analysts.</b>			
New disclosure requirements and regulation of Wall Street analysts	Directs the SEC to study conflicts of interest that may affect analysts	Directs the SEC or the NASD (which regulates stockbrokers) to adopt rules of conduct for stock analysts. Mandates that these rules require disclosure of analysts’ (and their firms’) investment in, and business relationships with, the companies they cover	Follows Senate bill

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
<b>V. Corporate Executive Accountability.</b>			
Requires personal certification of financial statements by CEOs and CFOs?	No	Yes. Also requires certification of the adequacy of a company's internal accounting controls, and establishes criminal penalties for violations for knowingly or willfully certifying a false or misleading statement	Directs SEC to make rules requiring CEO certification, specifies the contents of the certification, and imposes a knowledge standard. Follows Senate bill in requiring certification of the adequacy of a company's internal accounting controls, and establishing criminal penalties for violations
Penalties if financial statements are found to be erroneous?	Calls for SEC to study the possibility of requiring disgorgement of profits from insider securities transactions, and to adopt a rule to require disgorgement if needed	CEOs and CFOs would forfeit both trading profits and bonuses received in the 12 months before a financial report was restated as the result of misconduct	Follows Senate bill
Directs SEC to add civil fines to disgorgement funds available to compensate victims of securities fraud	No provision	No provision	Establishes FAIR funds for defrauded investors, consisting of monies disgorged, fines collected through SEC civil or administrative actions against securities law violators, and gifts or donations

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Personal loans by firms to top executives and directors	Must be disclosed	Prohibited, unless the loan is made in the normal course of business on the same terms available to public borrowers	Follows Senate bill, with added exemptions for charge cards and margin loans to employees of securities firms
Authorizes SEC to bar violators of securities laws from serving as officers or directors of any publicly traded company?	Yes	Yes	Yes
Makes it a criminal offense for an officer or director of a corporation to mislead, coerce, manipulate, or fraudulently influence an independent auditor?	Yes	Yes	Yes

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
<b>VI. Corporate Boards.</b>			
Audit committee provisions	None	Makes the audit committee of the board of directors responsible for the hiring, compensation, and oversight of the independent auditor. Audit committee members would be prohibited from accepting consulting fees from the company, and would be required to establish procedures for receiving complaints about accounting and auditing, including anonymous “whistle blower” reports. At least one member of the audit committee would have to be a “financial expert,” to be defined by the SEC	Follows Senate bill

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Auditor report to audit committee	No provision	Requires the independent auditor to report to the audit committee on critical accounting policies followed, disagreements with management over accounting principles, and other matters	Follows Senate bill
<b>VII. Increased Penalties for Securities Law Violations.</b>			
Securities fraud	No provision, but H.R. 5118 (passed House 7/16/02) contains provisions similar to Senate bill, except as regards jail terms (see below)	Increases penalties for altering or destroying documents, protects whistle blowers, and prevents bankruptcy courts from discharging debts incurred through securities fraud	Follows Senate bill
White-collar crime penalties	No provision, but H.R. 5118 (passed House 7/16/02) contains provisions similar to Senate bill, except as regards jail terms (see below)	Raises fines and jail terms for several offenses, including mail and wire fraud, certification of a false financial statement, conspiracy to defraud the United States, ERISA violations, and impeding an official investigation	Follows Senate bill, but see below for changes regarding jail terms
Prison terms	No provision, but H.R. 5118 increases maximum sentence for above offenses from 5 to 20 (or 25) years	Increases maximum sentence for above offenses from 5 to 10 years	Adopts provisions of H.R. 5118

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Statute of limitations in securities fraud cases	No provision	Increases statute of limitations from 1 year of discovery or 3 years of occurrence of fraud, to 2 years or 5 years, respectively	Follows Senate bill
<b>VIII. Other Provisions.</b>			
SEC budget	No provision, but H.R. 3764, passed by the House on 6/26/02, authorizes \$776 million for the SEC in FY2003	Authorizes appropriations for the SEC for FY2003 of \$776 million, as opposed to \$469 million in the Administration's budget request	Follows Senate bill
SEC freeze authority	No provision, but H.R. 5118 (passed House 7/16/02) contains similar language	Allows the SEC to freeze extraordinary payments to corporate insiders during an investigation of securities law violations	Follows Senate bill
Directs SEC to issue rules of professional responsibility for attorneys of firms that sell securities to the public	Yes	Yes	Yes
Prohibits corporate insiders from trading securities while a pension fund is locked down (i.e., when employees cannot access their accounts)	Yes	Yes	Yes

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	Conference Version
Penny stock bar	No provision	No provision	Gives federal courts authority to prohibit securities law violators from participating in offerings of penny stocks
Studies required	Calls for the SEC to study stock analysts, bond rating agencies, SEC enforcement actions, and corporate governance, and for the GAO to study the role of Wall Street investment banks in corporate accounting deceptions	Directs the SEC to study bond rating agencies and mandatory rotation of audit firms, and the GAO to study the effects of mergers in the accounting industry	Calls for the SEC to study special purpose entities, bond rating agencies, principles-based accounting standards, securities law violators and enforcement programs, and mandatory auditor rotation, and for the GAO to study effects of mergers in the accounting industry and the role of Wall Street investment banks in corporate accounting deceptions

## **APPENDIX A. President Bush's 10-Point Plans**

In speeches on March 7, 2002, and July 9, 2002, President Bush set out a ten-point program on accounting and auditing reform (in March) followed by ten enforcement initiatives (in July). There is considerable overlap between the President's proposals and the legislative and regulatory initiatives compared above. Major elements of the President's speech in March included:

- the establishment of an Independent Regulatory Board to develop standards of auditing ethics and competence, under SEC oversight;
- a call for the SEC to improve corporate disclosure and to increase the number of events and kinds of news that must be disclosed immediately;
- a requirement that CEOs personally vouch for the accuracy of their firms' financial statements, and face disgorgement of bonuses if those statements were later found to be erroneous;
- authority for the SEC to bar corporate officers and directors who abuse their power from serving at other publicly traded firms;
- prompt disclosure of corporate insiders' stock transactions;
- more effective oversight of the Financial Accounting Standards Board by the SEC, to ensure that accounting rules respond to the needs of public investors; and
- a requirement that auditors compare a firm's accounting systems to a best practice standard, rather than to minimum requirements.

In July 2002, the President's speech included these elements:

- creation by Executive Order of a financial crimes "swat team" in the Department of Justice to coordinate the investigation and prosecution of securities fraud;
- proposes to increase penalties for wire and mail fraud and crimes committed by corporate officers, and calls on the Federal Sentencing Commission to ensure that corporate insiders convicted of fraud serve longer terms in prison;
- a proposal to allow the SEC to freeze payments to corporate insiders while the company is under investigation;
- proposes to prevent corporate insiders from profiting from erroneous financial statements;
- proposes to allow the SEC to bar corporate officers and directors who abuse their power from serving at other publicly traded firms;

- prompt disclosure of corporate insiders' stock transactions;
- proposes to strengthen laws that criminalize document shredding and other forms of obstruction of justice;
- calls on public companies' compensation committees to prevent corporate officers from receiving loans from their companies;
- challenges CEOs to comply with the spirit of existing disclosure rules by explaining how their compensation packages are in the best interests of their companies' shareholders, and describing in plain English in their companies' annual reports every detail of their compensation packages;
- calls on the nation's stock markets to require that a majority of a company's directors be truly independent so that they have no material relationship with the company;
- calls on the nation's stock markets to require listed companies to receive shareholder approval for all stock option plans; and
- calls for an additional \$100 million (above the \$469 million budget request) for the SEC in FY2003.