SUBJECT: Felony for officer of a public interest entity to lie to an auditor

COMMITTEE: State Affairs — committee substitute recommended

VOTE: 8 ayes — Swinford, Miller, B. Cook, Farrar, J. Keffer, Martinez Fischer, Villarreal, Wong

0 nays

1 absent — Gattis

WITNESSES: For — Billy M. Atkinson, Texas State Board of Public Accountancy; Edward Polansky, Texas Society of Certified Public Accountants

Against — Tracey Hayes, ACLU

BACKGROUND: HB 1218 by Chisum, enacted by the 78th Legislature in 2003, imposes felony penalties for intentional fraud by accountants under the Public Accountancy Act, Occupations Code, ch. 901. The level of the penalty rises from a state-jail felony if the violation resulted in a loss of less than $10,000 to a second-degree felony if the offense resulted in a loss of $100,000 or more.

The bill also directed the Texas State Board of Public Accountancy to study the requirements of the federal Sarbanes-Oxley Act of 2002 (SOX) on public interest entities during the interim and report back to the governor, the lieutenant governor, and the speaker of the House. The board issued its report in November 2004.

SOX was enacted in the wake of several large corporate financial scandals to restore confidence in the accounting industry and improve the quality of corporate reporting. The act regulates public accounting firms and certain actions by corporate officers. Sec. 303 makes it unlawful for an officer or director of a publicly traded company to fraudulently influence, coerce, manipulate, or mislead an independent public or certified accountant. The act does not apply to public interest entities.

DIGEST:

CSHB 2842 would make it an offense for an officer or director of a public interest entity — defined as a financial institution, insurer, issuer of securities, county hospital, pension plan, school district, or city — during an audit of the financial statements of the entity by an accounting firm, to fraudulently:

- influence, coerce, manipulate, or mislead the accounting firm;
- communicate information that the person knew or should have known was false; or
- fail to promptly notify the firm if information supplied is no longer correct.

An offense would be a felony, with the degree of the offense based as follows on the amount of monetary loss:

- $0 - $9,999: state-jail felony (180 days to two years in a state jail and an optional fine of up to $10,000);
- $10,000 - $99,999: third-degree felony (two to 10 years in prison and an optional fine of up to $10,000);
- $100,000 - $999,999: second-degree felony (two to 20 years in prison and an optional fine of up to $10,000);
- $1 million or more: first-degree felony (life in prison or a sentence of five to 99 years and an optional fine of up to $10,000).

The bill would take effect September 1, 2005.

SUPPORTERS SAY:

CSHB 2842 would help ensure the health of financial markets and protect the public by deterring officers of public interest entities from intentionally manipulating an audit of the entity. Accounting scandals in Texas and the country have disturbed financial markets and surprised unaware and ill-equipped regulators. While legislation passed by 78th Legislature increased penalties for abuses by dishonest accountants, no similar state penalties exist for directors or officers of public interest entities who attempt to defraud those accountants. Yet the misrepresentations of the officers of these public interest entities can affect market prices, investment decisions, pension benefits, or public services as seriously as those of accountants.

The criminal penalties in the federal Sarbanes-Oxley Act apply only to officers of publicly traded companies. CSHB 2842 would implement the recommendation of the report of the Texas State Board of Public

Accountancy to impose the same criminal penalties for these officers, including the officers of certain public entities that currently are not covered under state or federal law, as those imposed on accountants.

A public interest entity is one that produces audited financial statements relied upon by stakeholders to make investment, credit, or similar decisions or by regulators in their oversight role. As a result, the extent of harm to the public from an audit failure is potentially great. Examples of public entities include cities, school districts, pension plans, and financial institutions, as well publicly traded companies. The bill would include a specific list of these entities, rather than a general description, because it is vital when imposing criminal penalties that persons and entities know exactly who and what activities would be covered.

The bill would strike an appropriate balance between safeguarding the public's interest and promoting a sound business climate. The financial statements of an entity, together with the culture and demeanor surrounding their derivation, are the responsibility of the entity's governing board and management. They set the strategy and tone at the top that drive the operations and honesty of financial reporting. Consequently, they should be held to the highest standard of ethics in their financial reporting. CSHB 2842 would encourage these officers to be honest and forthright with auditors, thereby improving the audit process.

The federal Sarbanes-Oxley Act did not relieve states of their duty to improve financial reporting and protect the public. Consequently, the bill would not exclude publicly traded companies that also are covered under SOX. Nor would the bill exclude volunteer officers or directors, since volunteerism should not be a shelter from fraudulent activities. No officer or director, volunteer or not, should have the option of being uninformed about the financial records of the entity. If a person is not well informed, that person should not agree to serve. The bill would ensure that accidental misrepresentations would not be subject to penalties by requiring that an action be committed "fraudulently". The term is well defined in federal law and in Texas law.

The bill would not increase demands upon state correctional resources. According to the fiscal note prepared by the LBB, the bill would have no significant fiscal implication on the state nor the programs and workload of state corrections agencies.

OPPONENTS SAY:

CSHB 2842 would increase demands upon state correctional resources at a time when these facilities already are pressed to the limit. Creating a new felony would exacerbate an already serious prison overcrowding problem and increase costs to taxpayers. Expensive prison space should be reserved for violent offenders. The bill should impose more appropriate remedies for these violations, such as fines in the amount of money lost and community service.

Publicly traded companies should be excluded from the bill's provisions, which would be covered under the term "issuer". The actions of the officers of these companies already are covered by SOX, which imposes criminal penalties for intentional fraud by a company's officers. Creating additional penalties could have a chilling effect on people's willingness to serve on boards, especially volunteer boards. Moreover, the bill inexplicably would impose a higher penalty on officers than accountants for fraud that resulted in a loss of more than $1 million. The penalties for officers and accountants should be the same.

OTHER OPPONENTS SAY:

While having a list of public interest entities may be helpful, ultimately any list is likely to be incomplete. The list included in the bill leaves out counties, institutions of higher education, retirement plans, and perhaps many others. Rather than waiting for a scandal at an unlisted entity to occur in order to determine additional entities for inclusion, the bill should use a broad definition of "public interest entity," such as that in the bill as filed, to ensure that all of these entities were covered.

The term "fraudulent" is unclear. The bill should use the more common standard of determining an offense that a person "intentionally and knowingly" violated statute.

NOTES:

The committee substitute:

- specified that an action would have to be "fraudulent" to constitute an offense;
- would make it an offense to influence, coerce, manipulate, or mislead the accounting firm;
- changed the definition of a "public interest entity" and adds definitions of a "financial institution", "insurer", and "issuer";
- changed references to "outside auditor" to "independent public accounting firm"; and
- changed the effective date to September 1, 2005.

The companion bill, SB 1576 by Williams, has been referred to the Senate Criminal Justice Committee.