Legal Opinion Letter

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THE SARBANES-OXLEY ACT: A PERSONAL VIEW

by
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During an otherwise routine quarterly conference call with analysts last spring, I announced my resignation as Chief Financial Officer of Outback Steakhouse, Inc., explaining my discontent with the increasingly negative regulatory environment in which public companies operate. I have received countless notes and emails from my peers and from CFOs of other public companies thanking me for publicly stating what they all feel privately. Much has already been written about the direct financial cost of complying with the Sarbanes-Oxley Act, but what of the hidden costs of the Act? It is hard to find fault with the Act's intent, but are the benefits worth the price being paid?

One of the unintended consequences of Sarbanes-Oxley is that financial executives are actually becoming *less* involved, not more involved, in business decision-making. This is partly the result of the burden that the Act places on a CFO's time: CFOs are now forced to spend their days focusing on the formalities of compliance and not on the substance of important business developments that may improve shareholder value. In addition to time constraints, the decline in the business role of the financial executive is the result of a decline in the trust levels between financial and operational executives. To a non-financial executive, none of today's form-over-substance mania makes any sense. In my own experience, the relationship I had with my CEO became strained to the point of his distrust of me and my loyalty; it seemed that each week I had to deliver more news about what we had to do that was different from what we had been doing for thirty years and I couldn't explain how it made any sense. He viewed it as not meeting a common-sense standard and therefore concluded that I had not fought it hard enough. These kinds of strained relationships will lead to the curtailment or elimination of financial executives' influence in business deliberations, to the detriment of shareholders.

The burdens on companies and financial executives have been made worse by one of the Act's creations, the Public Company Accounting Oversight Board (PCAOB). This under-supervised and overzealous group of bean counters has generated countless regulations and has taken a gun-and-badge attitude toward public company managements, their financial executives, and their auditors. PCAOB seems to be operating under a presumption that financial statements are always "right" or "wrong" based upon a set of complex rules, rather than "presented fairly in all material respects." No serious professional involved in any aspect of generating or using financial statements believes that the numbers are exact, with one and only one correct answer. With the possible exception of cash balances, every number in a set of financial statements is an *estimate*. Despite the fact that the last sentence of every accounting standard ever written that says "these standards need not be applied to immaterial amounts," PCAOB continues to generate standards for auditors that presume an unrealistic level of exactness. This is a presumption that will ultimately lead to greater misunderstandings by the users of financial statements.

Bob Merritt was Chief Financial Officer of Outback Steakhouse, Inc., a $3.4 billion public company, for 15 years prior to his resignation in April of 2005.

I find it ironic that a heavily rules-oriented approach is the path the regulators have chosen, since it was the abusive manipulation of rules that allowed Enron to do what it did. I have not heard one person say that Enron's financial statements were not prepared in accordance with Generally Accepted Accounting Practices as the rules existed and I have not heard of any legal charges to that effect. Enron merely used the detailed rules to their benefit. I maintain that if principles-based accounting standards had been in place rather than a detailed set of rules that could be manipulated, the Enron fiasco might have been avoided.

No set of rules can contemplate every possibility. Once the rules are in place, smart lawyers, accountants, and investment bankers can find ways to make the form of a transaction fit the rules while abusing those rules in substance. I am convinced that if regulators continue down their present course we will have more spectacular failures.

The strong arm of PCAOB has emerged as something akin to a "revenge of the nerds." With the reorganization of accounting firms into silos of authority, the authority and judgment of the practice partners closest to the actual companies and their transactions has been all but eliminated. Academics sitting in their ivory towers now seem to have all of the power. These are the people who were ignored for years because the application of their theories did not result in a material improvement in the financial reporting of public companies. Once, financial reporting decisions were judged based upon whether or not they enhanced financial statement users' understanding of a company's results of operation and financial condition. Now, the nerds get to decide what is "right" based upon their interpretation of the rules, whether or not the outcome enhances the usability of the statements.

The nerds are also going back and reinterpreting rules. New interpretations are being issued frequently. A classic example of this was the recent spate of restatements generated by a change in the interpretation of the consistency between two rules that govern the reporting of lease expenses. No new rules had been issued but an academic in one of the large accounting firms decided that there was an inconsistency between the measurement periods used under two different rules and that they should be consistent. Without running this past the accounting rule makers, the firm forced its clients to restate historical financial results. In response, the other large accounting firms evaluated their positions and decided that the first firm was right, but they had forgotten a couple of other components of lease accounting. Then, hysteria ensued and almost 150 companies were forced to restate historical results. None of this enhanced financial statement users' understanding of the results of operation and financial condition of the companies. But because the first accounting firm had failed to take certain conditions into account, some companies actually had to restate their results twice. In addition, there is now an inconsistency between how retailers report rent expense based upon which measurement period and policy they chose. How is this helpful to financial statement users?

But that is not the end of the story. The auditors then started thinking about PCAOB's standards of internal control weaknesses for Section 404 certification purposes. Under the rules, any restatement was evidence of a material internal control weakness. In PCAOB's defense, they do suggest that the auditor look at the circumstances for the implied rare exception. But in this environment, would you as the auditor want to conclude that an exception had arisen? In today's world, who wants to take that risk? No, it is much safer to make the company admit to a material weakness than to apply judgment. Does anyone really care that it is ridiculous that 150 companies might have a weakness that has been in place for 35 years and missed by the auditors for all of those years? No, the accounting firms are running in such fear of PCAOB that they would rather concede the implied incompetence of 35 years of audits than take the risk that there might be an exception to the rather severe rule.

In the final analysis, the environment created by the Act and its implementation have resulted in a misallocation of managements' time and attention from real shareholder value creation to regulatory risk avoidance that will not improve the chances of avoiding future public company abuses and failures. In the end, I concluded that the personal risk/reward relationship for me was out of balance and that the strain experienced by our financial management team on their personal lives and relationships with non-financial managers was not worth continuing with a public company. I know of no seasoned public company CFO who has not thought of making a career change at this point.

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