The Sarbanes-Oxley Act of 2002

by David B. Braun

Introduction

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002.[1] The act seeks to improve investor confidence by tightening government regulation of the accounting and corporate governance practices of public companies. The act adds new regulation to the public accounting profession by creating a new five-member Public Accounting Oversight Board. The act is broad in scope and creates significant new requirements for public companies, their officers and directors, and the public accountants who audit public companies. Many of the act's provisions require the Securities Exchange Commission (SEC) to adopt implementing rules, so the full breadth of additional regulation remains to be seen.

This article summarizes the portions of the act that directly affect public companies, their officers, and their directors. For ease of analysis, this article is divided into six sections: (1) audit committees, (2) auditor independence, (3) officer certification of SEC reports, (4) corporate governance provisions, (5) enhanced disclosure requirements, and (6) fraud and penalties.

1. Audit Committees

As of April 26, 2003, the national securities exchanges and the national securities associations are prohibited from listing companies that fail to conform to the provisions of the act discussed below.[2]

Committee Composition

The act requires that each audit committee member be independent.[3] Audit committee members may not receive consulting, advisory, or other compensatory fees (other than fees as a director or committee member), and they cannot be an "affiliated person" of the company or any of its subsidiaries.[4] Although "affiliated person" is not a defined term in the act, the SEC is expected to adopt a definition shortly.

The Audit Committee's "Financial Expert"

Current Nasdaq audit committee rules require that at least one member of a listed company's audit committee have financial expertise. The act furthers this concept by requiring that each reporting company disclose, in its periodic reports, whether at least one committee member is a "financial expert" and, if not, the reason that there is no expert. The SEC proposed a preliminary definition of "financial expert" on October 22, 2002, and will adopt a final definition by January 28, 2003. The act states that the SEC must consider certain qualifications in defining a "financial expert," including whether the person has sufficient education or experience (e.g., as a public accountant or auditor), an understanding of generally accepted accounting principles (GAAP) and financial statements, experience in the preparation or auditing of financial statements of generally comparable issuers, experience with internal accounting, and an understanding of audit committee functions.[5]

Engagement of Auditors and Professionals

The act requires audit committees to be directly responsible for the appointment, compensation, and oversight of the work of the company's auditors. Further, auditors of public companies must report directly to the audit committee.[6] The audit committee must also have explicit authority to hire independent counsel and other advisors.[7]

Information Practices

Audit committees are required to establish procedures for handling complaints that the company receives about its accounting, internal accounting controls, or auditing matters. The act also requires the committee to establish whistleblower procedures so that employees can confidentially and anonymously submit concerns about questionable accounting or auditing matters.[8]

The company's public accounting firm is also required to provide a written report to the committee that describes all critical policies and practices to be used in the audit, any alternative treatments of financial information that have been discussed with management, the ramification of the alternative treatment, and the treatment preferred by the auditors. The auditors must also provide the audit committee with all other material written communications between the auditors and management, such as any management letter or schedule of unadjusted differences.[9]

2. Auditor Independence

The act seeks to enhance auditor independence by prohibiting auditors from engaging in nine areas of activities. Auditors that perform any of the following activities contemporaneously with an audit will not satisfy the independence requirement of the federal securities laws and, therefore, will not be able to issue an appropriate audit report.

The prohibited activities are as follows:

1. bookkeeping or other services related to the accounting records or financial statements of the audit client
2. financial information system design and implementation
3. appraisal or valuation services, fairness opinions, or contribution-in-kind reports
4. actuarial services
5. internal audit outsourcing services
6. management functions or human resources
7. broker or dealer, investment adviser, or investment banking services
8. legal services and expert services unrelated to the audit
9. any other service that the board determines, by regulation, is impermissible [10]

Beyond these, a registered public accounting firm may engage in other nonaudit services, including tax services, only if the audit committee approves the activity in advance.[11]

3. Officer Certification of SEC Reports

One of the most significant requirements of the act is that the chief executive officer and chief financial officer of every public company are now required to certify the SEC reports of their company. Previously, the SEC ordered only the largest 947 public companies to provide this certification. Certification for all companies will be required beginning August 29, 2002.

The act requires that the signing officer certify all of the following:

- The officer reviewed the report.
- Based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements not misleading.
- Based on the officer's knowledge, the financial statements and other information included in the report fairly present, in all material respects, the company's financial condition and results of operations for the periods presented in the report.
- The officer is responsible for establishing and maintaining the company's internal controls.
- The officer has designed the internal controls to ensure that material information concerning the company is made known to the signing officers.
- The officer has evaluated the effectiveness of the internal controls and has disclosed to the company's auditors and the audit committee all significant deficiencies in the design or operation of the internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data.
- The officer has disclosed any fraud involving management or other employees having a significant role in the company's internal controls. [12]

4. Corporate Governance Provisions

The act prescribes a variety of corporate governance requirements that public companies, their officers, and directors must meet.

Section 16—Insider Trading Reporting

A significant provision of the act dramatically shortens the reporting time for Section 16 reports on Form 4. For transactions after August 29, 2002, directors, officers, and principal shareholders are required to file any change in the ownership of the company's securities before the end of the second business day following the day the transaction is executed.[13] Previously, insiders were only required to file Form 4s by the tenth day of the month following the month in which the subject transaction was executed.

By July 30, 2003, Form 4s must be filed electronically and posted on the company's Web site not later than the end of the business day following the filing.[14]

Code of Ethics for Senior Financial Officers

Before January 28, 2003, the SEC must issue rules requiring companies to disclose whether the company has adopted a "Code of Ethics" for senior financial officers, i.e., the principal financial officer, principal accounting officer, or persons performing similar functions. If the company has not adopted a code, it must disclose the reasons for not having one. The act provides that the code promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships. The code must also contain provisions to ensure the full, fair, accurate, timely, and under-

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standable disclosure in the company's periodic reports and compliance with applicable governmental rules and regulations.[15]

In addition, by January 28, 2003, the SEC must implement rules that require prompt disclosure on Form 8-K of any change or waiver of the code for senior financial officers.[16]

Related-Party Loan Prohibition

The act forbids any loan by a reporting company to one of its directors or executive officers (with minor exceptions). Extensions of credit in place as of July 30, 2002, are not subject to the act provided that there is no material modification to any term of such extension of credit or any renewal of such credit after July 30, 2002.[17]

Insider Transactions During Pension Fund Blackout Periods

After January 28, 2003, the act forbids any officer or director to purchase, sell, or otherwise acquire or transfer any equity security of the company during a period in which more than 50 percent of the participants in an employee benefit plan are unable to sell or otherwise acquire or transfer an interest in any equity security of the company.[18]

Notice of a blackout period must be sent to all plan participants and beneficiaries at least 30 days before the blackout. This notice must also be given to the SEC and the company's officers and directors. The act specifies that this notice should include the reasons for the blackout period, identification of the investments, and other rights affected. The notice should also contain the expected beginning date and length of the blackout period and a statement that the participants should evaluate the appropriateness of current investment decisions in light of their ability to direct or diversify their assets in their accounts during the blackout period.[19]

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5. Enhanced Disclosure Requirements

"Real Time" Disclosures

The act requires a company to disclose, on a current basis and in plain English, information about material changes in its financial condition or operations.[20] The SEC may require this "real time" disclosure to include trend or qualitative information.

Regular and Systematic Review of Periodic Reports

Historically, the criteria used by the SEC to select periodic reports for review has largely been kept secret and the frequency of the review of a company's periodic filings has been uneven. The act directs the SEC to review the periodic reports of each company at least once every three years and requires the SEC to consider the following factors when selecting which filings to review:

- companies with material restatements of financial results
- companies with significant volatility in their stock price
- companies with the largest market capitalizations
- emerging companies with disparities in price-to-earnings ratios
- companies whose operations significantly affect any material sector of the economy[21]

Disclosures in Periodic Reports

The act amends section 13 of the Securities Exchange Act of 1934 to require that reports containing financial statements prepared in accordance with GAAP reflect all material correcting adjustments identified by a registered public accounting firm.[22]

Before January 28, 2003, the SEC will issue final rules concerning

- the disclosure of all off-balance sheet transactions, arrangements, obligations, and other relationships that may have a material effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses;[23] and
- the disclosure of pro forma information in a manner that (1) does not contain any untrue statement of material fact or omit to state a fact necessary to make the information not misleading and (2) presents a reconciliation to GAAP.[24]

6. Fraud and Penalties

The act significantly increases the civil and criminal penalties for financial fraud that can be imposed on officers and directors of public companies and requires that companies follow certain document retention practices.

Forfeiture of Certain Bonuses and Profits. Beginning July 30, 2002, if a company is required to prepare an accounting restatement due to the company's material noncompliance or because of misconduct with regard to any financial reporting requirement under the securities laws, the chief executive officer and the chief financial officer of the registrant must reimburse the company for

- any bonus or other incentive-based or equity-based compensation the officer received during the 12-month period following the first public issuance or filing with the commission of the financial statements embodying the restated financial information, and
- any profits realized by the officer from the sale of the company's securities during the 12-month period.[25]

Destruction of Records. Any person who knowingly destroys records to impede, obstruct, or influence an investigation is subject to a fine and up to 20 years in prison.[26]

Extension of Statute of Limitations for Securities Fraud. A private lawsuit for securities fraud may be brought no later than two years after the discovery of the facts constituting the fraud or five years after the fraud.[27]

Criminal Penalties for Defrauding Shareholders. If a person knowingly defrauds public company shareholders, the person may be fined and/or imprisoned for up to 25 years.[28] Prison time for mail and wire fraud is extended from 5 to 20 years.[29]

Criminal Penalties for Improper Certification of Company Reports. An officer certifying the financial statements of a company who knows that the company's periodic report does not comport with the requirements of the Securities Exchange Act of 1934 and/or does not fairly present, in all material respects, the company's financial condition and operations, may be fined up to $1 million and/or imprisoned for up to 10 years. If such conduct is willful, the certifying officer faces a fine of $5 million and/or up to 20 years in prison.[30]

Document Retention. Any accountant that conducts an audit of an issuer of securities must keep all audit or review work papers for a period of five years from the end of the fiscal period in which the audit or review was concluded.[31]

NOTES

1. *See* http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf for the full text of this act.
2. 15 USC 78f(m).
3. 15 USC 78f(m)(3)(A).
4. 15 USC 78f(m)(3)(B).
5. Sarbanes-Oxley Act §407.
6. 15 USC 78f(m)(2).
7. 15 USC 78f(m)(5).
8. 15 USC 78f(m)(4).
9. 15 USC 78j-1(k).
10. 15 USC 78j-1(g).
11. 15 USC 78j-1(h).
12. Sarbanes-Oxley Act §302.
13. 15 USC 78p(a).
14. 15 USC 78p(a)(4).
15. Sarbanes-Oxley Act §406.
16. Sarbanes-Oxley Act §406(b).
17. 15 USC 78m(k).
18. Sarbanes-Oxley Act §306.
19. *Id.*
20. 15 USC 78m(l).
21. Sarbanes-Oxley Act §408.
22. 15 USC 78m(i).
23. 15 USC 78m(j).
24. Sarbanes-Oxley Act §401(b).
25. Sarbanes-Oxley Act §304.
26. 18 USC 1519.
27. 28 USC 1658.
28. 18 USC 1348.
29. 18 USC 1341, 1343.
30. 18 USC 1350.
31. 18 USC 1520(a)(1).

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