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Client Advisory

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Next Stage of Sarbanes-Oxley Act Will Impose New Burdens on Audit Committees and Executives

Even as companies cope with the effective or soon-to-be-effective provisions of the Sarbanes-Oxley Act of 2002 (the S-O Act),[1] they must also begin planning for the impact of the S-O Act provisions that become effective six to nine months following its date of enactment. In large part, this "next stage" of the S-O Act deals with the roles and responsibilities of the auditors and audit committees of public companies. The underlying policy of many of these provisions is to reduce or eliminate the perceived conflicts of interest arising, for example, when accounting firms provide non-audit services to their audit clients, or when auditors are selected by the management whose work they are responsible for reviewing. In general, these provisions invest the audit committee with the responsibility for choosing, and managing the relationship with, a company's auditors, and seek to insure that the audit committee will have the information, independence, competence, authority and resources to fulfill these responsibilities.

These "next stage" provisions also address the perceived need for improved transparency of public company operations by requiring new disclosures regarding material correcting adjustments in financial statements, off-balance sheet transactions, reconciliation of pro forma figures to GAAP figures, the status of internal financial controls, and the existence of, and deviations from, codes of ethics applicable to senior financial executives. The Securities and Exchange Commission's initiative to require quicker disclosure of a wider range of information is also given the S-O Act's imprimatur.

The "next stage" of the S-O Act addresses two other issues brought into relief by the Enron debacle. In one of its most complex and detailed provisions, the S-O Act forbids trading in a company's equity securities by directors and executive officers during pension fund blackout periods. Finally, the S-O Act mandates new ethics rules for attorneys practicing before the SEC that may fundamentally alter the attorney-client relationship for public companies and their counsel.

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[1] These provisions are discussed in our Client Advisory "President Bush Signs Sarbanes-Oxley Act of 2002 into Law to Address Accounting and Corporate Governance Concerns" (the "Enactment Advisory"), which may be found on our Web site at http://www.kmzr.com/resource/resource.asp.

Provisions Related to Auditors and Audit Committees

Services Outside the Scope of Practice of Auditors (Section 201). Registered public accounting firms (i.e., audit firms that register with the Public Company Accounting Oversight Board (PCAOB) that is established pursuant to the S-O Act) are prohibited from providing to a company, contemporaneous with any audit, certain enumerated categories of non-audit services. The PCAOB may, however, on a case-by-case basis and subject to review by the SEC, exempt any company, registered public accounting firm or transaction from this prohibition. The following non-audit services will be prohibited:

- bookkeeping or other services related to the accounting records or financial statement of the company;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other services that the PCAOB determines, by regulation, are impermissible.

For the most part, these restrictions mirror the major auditor independence requirements adopted by the SEC in November 2000 and found in Rule 2-01 of Regulation S-X. Rule 2-01 permits the provision of non-audit services described in the first five bullet points, above, including financial information design and implementation and internal audit services, if certain requirements are satisfied. While it seems unlikely, it remains to be seen whether the SEC, in exercising rulemaking authority with respect to this provision, will retain the exceptions and qualifications found in Rule 2-01.

Audit Committee Pre-Approval Requirements (Section 202). The audit committee must pre-approve all audit and non-audit services to be provided to the company by its auditors, unless the non-audit services fall within certain limited exceptions. The S-O Act permits the delegation of pre-approval authority to one or more independent members of a company's audit committee. It is not yet clear whether this approval requirement applies to services already in the process of being performed. The new provision also requires that the pre-approval by the audit committee of non-audit services to be performed by the auditor of a company must be disclosed to investors in that company's periodic reports under the Exchange Act.

As discussed in our Enactment Advisory, because the S-O Act is silent regarding the date of effectiveness of this provision, there is some uncertainty as to whether it was intended to be immediately effective, although the growing consensus among securities law practitioners is that it was not. Some companies may, however, elect to comply immediately with the pre-approval requirement, both because it is simply a good corporate governance practice and because it is a "safe" course of action in the absence of SEC guidance. Such companies may also decide to report any pre-approvals of non-audit services in their next periodic report (e.g., their third quarter 10-Q's).

Audit Partner Rotation (Section 203). Registered public accounting firms must rotate the lead (or coordinating) audit partner and the reviewing audit partner assigned to a company's audit so that neither partner may perform auditing services for the same company for more than five consecutive fiscal years.

It is not clear from the S-O Act whether an audit partner that has been prohibited from performing audit services for a company as a result of this provision will be permitted to resume providing audit services for that company after some period of time has elapsed. The regulations issued by the SEC pursuant to Section 208 of the S-O Act (see discussion below) are likely to address this point.

Auditor Reports to Audit Committees (Section 204). Registered public accounting firms are required to timely report to a company's audit committee the following:

- all critical accounting policies and practices to be used;
- all alternative treatments of financial information within GAAP that have been discussed with management of the company, the ramifications of such treatments, and the treatment preferred by the registered public accounting firm; and
- other material written communications between the registered public accounting firm and the management of the company.

This provision seems to encompass and expand upon the dialogue between the auditor and the audit committee that must take place in order to make the statement regarding SAS 61 (codification of Statements on Auditing Standards, AU §380), that must be included in the audit committee report set forth in annual meeting proxy statements.

Conflicts of Interest (Section 206). A registered public accounting firm may not perform audit services for a company if the chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position, was employed by the registered public accounting firm and participated in any capacity in the audit of that company during the one-year period preceding the date of initiation of the audit.

Commission Authority (Section 208). Not later than January 26, 2003, the SEC must issue regulations to effectuate the provisions of Sections 201, 202, 203, 204, 206 and 207 of the S-O Act. It is unclear at what point these provisions will become effective because each of the relevant Exchange Act provisions amended by these sections is related to "registered public accounting firms," which will not come into existence until the PCAOB is created by the SEC and accounting firms have registered with the PCAOB. The SEC is required to determine, not later than April 26, 2003, that the PCAOB is capable of carrying out and enforcing compliance with the S-O Act, and beginning 180 days after that determination, only registered public accounting firms will be permitted to provide audit services to public companies. The regulations issued by the SEC on or before January 26, 2003, should clarify the timing of the effectiveness of the provisions related to registered public accounting firms.

Public Company Audit Committees (Section 301). Not later than April 26, 2003, the SEC must adopt rules requiring the national securities exchanges and Nasdaq to prohibit the listing of a company if its audit committee does not meet certain criteria. A company's audit committee must:

- have direct responsibility for the appointment, compensation and oversight of the work of the company's public accountants;
- be comprised exclusively of independent members of the company's board of directors (with "independent" defined to preclude such director from accepting any consulting, advisory, or other compensatory fee from the company, or being an affiliated person of the company, subject to SEC exemption on a case-by-case basis);
- establish procedures for receiving, retaining and treating complaints received by the company regarding accounting and auditing matters and for receiving confidential, anonymous submissions by employees of the company of concerns regarding questionable accounting or auditing matters (*this provision is another facet of the "whistle-blower" protections discussed in our Enactment Advisory)*;

- have the authority to engage independent counsel and other advisors as it deems necessary to carry out its duties; and
- be provided by the company with appropriate funding, as determined by the audit committee, for payment of compensation for the accounting firm conducting the audit and for any advisors retained by the audit committee.

Both the NYSE and Nasdaq have announced proposals, consistent with these new requirements, to tighten their rules regarding listed-company audit committees. The Staff of the SEC has indicated that it will take steps to see that the rules adopted by the NYSE and Nasdaq pursuant to the S-O Act provide a consistent regime for all companies, whether listed on the NYSE or Nasdaq.

Improper Influence on Conduct of Audits (Section 303). Not later than October 28, 2002, the SEC must propose rules (with final rules to be issued not later than April 26, 2003) providing that it is unlawful for any officer or director of a company to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that company for the purpose of rendering such financial statements materially misleading.

Management Assessment of Internal Controls (Section 404). The SEC is directed to adopt rules requiring that each annual report required by the Exchange Act contain an internal control report which:

- states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- contains an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the company for financial reporting.

The company's public accountants are required to attest to and report on the assessment made by the management of the company. *This is an entirely new requirement and attestation.* The S-O Act did not specify a date by which the SEC is required to adopt rules related to the internal control report. We note, however, that the certification of periodic reports required by Section 302 of the S-O Act (see our Enactment Advisory) also must address internal controls, although the Staff of the SEC has indicated that the internal controls addressed by Section 404 will be more narrowly defined than those covered by Section 302. The SEC is required to adopt rules related to Section 302 by August 29, 2002.

Disclosure of Audit Committee Financial Expert (Section 407). Not later than October 28, 2002, the SEC must propose rules (with final rules to be issued not later than January 26, 2003) requiring that, in each periodic report required to be filed by the company under the Exchange Act, the company disclose whether or not the audit committee of that company includes at least one member who is a financial expert, and if it does not, the reason that is the case. In defining the term "financial expert" in its rules, the SEC is directed to consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of a company (1) an understanding of GAAP and financial statements, (2) experience in the preparation or auditing of financial statements of generally comparable companies, and the application of such principles in connection with the accounting for estimates, accruals and reserves, (3) experience with internal accounting controls, and (4) an understanding of audit committee functions.

Many commentators have suggested that this provision will present special challenges to companies, particularly in finding qualified candidates (note that, in contrast to current NYSE and Nasdaq rules, chief executive officers are not assumed to have financial expertise). This problem may be exacerbated by the uncertainty regarding the possibility of increased liability assumed by the "financial expert."

Provisions Related to Enhanced Financial Disclosure

Disclosures in Periodic Reports (Section 401). The Exchange Act was amended to require that each financial report of a company filed with the SEC that contains financial statements and is required to be prepared in accordance with (or reconciled to) GAAP reflect all material correcting adjustments that have been identified by the company's registered public accounting firm in accordance with GAAP and the rules of the SEC. The Exchange Act was further amended to provide that not later than January 26, 2003, the SEC must adopt rules requiring that:

- each annual and quarterly financial report required to be filed with the SEC disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the company with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses; and
- pro forma financial information included in any periodic or other report filed with the SEC pursuant to the securities laws, or in any public disclosure or press or other release, be presented in a manner that (1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading, and (2) reconciles it with the financial condition and results of operations of the company under GAAP.

The Staff of the SEC has already signaled its view of the importance of these two topics, having provided "cautionary advise" on the use of pro forma financial information in a release issued in December 2001 (SEC Rel. Nos. 33-8039, 34-45124, FR-59), and having provided "guidance" with respect to MD&A disclosure of off-balance sheet transactions in a release issued in January 2002 (SEC Rel. Nos. 33-8056; 34-45321; FR-61).

Code of Ethics for Senior Financial Officers (Section 406). Not later than October 28, 2002, the SEC must propose rules (with final rules to be issued not later than January 26, 2003) requiring that, in each periodic report required to be filed by a company with the SEC, the company disclose whether or not the company has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer and, if it has not, the reason that is the case. The SEC is also directed to revise its regulations to require that any change in or waiver of a company's code of ethics be promptly disclosed on Form 8-K or by other public dissemination. The term "code of ethics" means standards reasonably necessary to promote (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships, (2) full, fair, accurate, timely and understandable disclosure in periodic reports required to be filed by the company, and (3) compliance with applicable governmental rules and regulations.

Real Time Issuer Disclosure (Section 409). The Exchange Act was amended to require that each company reporting under the Exchange Act disclose on a rapid and current basis, and in plain English, information to be prescribed by the SEC concerning material changes to the company's financial conditions or operation. The S-O Act did not specify a date by which the SEC is required to adopt rules necessary to implement this provision; however, in June 2002, the SEC proposed rules that would require eleven new items and events to be reported on Form 8-K and would accelerate the filing deadline for Form 8-K to within two business days from the triggering event instead of the current five to fifteen day time periods. Examples of the proposed new triggering events include entry into or termination of a material agreement or letter of intent outside of the ordinary course of business, termination of a business relationship that results in a loss of at least 10% of the company's revenue, and an event triggering a material direct or contingent financial obligation, including any default or acceleration of an obligation. The Staff of the SEC has stated that it does not contemplate implementing a "continuous"

disclosure regime in response to Section 409, but rather more timely disclosure as contemplated by the proposed amendments to the Form 8-K. We also anticipate more disclosure emphasis on trend reporting.

Provision Related to Prohibition on Insider Trading during Pension Fund Black-Out Periods

Insider Trading During Pension Fund Blackout Periods (Section 306). On January 26, 2003, the following provisions will take effect:

- no director or executive officer of a company may purchase, sell, or otherwise acquire or transfer any equity security of the company acquired by the officer or director in connection with his or her service or employment as an officer or director during any blackout period (i.e., a period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all individual account plans to acquire or transfer an interest in any equity of the company held in such an individual account plan is temporarily suspended by the company or by a fiduciary of the plan);
- any profits realized by a director or officer who makes a prohibited acquisition or transfer of securities during a blackout period will be recoverable by the company (and the stockholders of the company may require the company to institute an action for recovery); and
- in advance of the commencement of any blackout period, the plan administrator must provide 30 days prior written notice to all participants and beneficiaries to whom the blackout period applies (failure to provide such notice may result in a civil penalty against the plan administrator of up to $100 a day (per participant or beneficiary) from the date of the plan administrator's failure or refusal to provide notice).

The SEC and the Department of Labor were directed to issue clarifying regulations in connection with this section of the S-O Act, and until such regulations are adopted, good faith compliance with the S-O Act provisions will be treated as compliance.

Provision Related to Attorney Professional Responsibility

Rules of Professional Responsibility for Attorneys (Section 307). Not later than January 26, 2003, the SEC is required to adopt rules requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by a company to the chief legal counsel or the chief executive officer of the company, and if such counsel or officer does not appropriately respond to the report, to the audit committee or another committee of the company's board of directors consisting solely of non-employee directors. Although corporate counsel already view the company, as opposed to management, as their client, this provision appears to allow attorneys much less latitude to exercise their judgement in dealing with problematic circumstances than do current ethics rules.

We Can Help

The provisions of the S-O Act discussed in this Advisory will require companies to adopt extensive new procedures to comply with their strictures. Legal counsel can provide valuable guidance to help companies meet these demands. Please direct questions regarding the issues discussed in this Client Advisory to the co-chairs of KMZ Rosenman's Securities Practice:

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