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Acredula®

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Life in a Post-Sarbanes-Oxley Environment

This issue of Acredula contains two articles that begin an examination of life in a post-Sarbanes-Oxley environment. Our first article deals with Congress' message to boards of public reporting companies to retake the reins overseeing the internal control, financial statement preparation, audit, and financial reporting processes. Our second articles deals with the first of the SEC's rules under Sarbanes-Oxley: CEO and CFO certifications.

Editor's Note

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In the next issue of Acredula, we will continue this theme by examining what and when CEOs, CFOs and company lawyers are required to report to audit committees or independent directors of their respective company's board. The issue will also examine how boards should receive such reports and monitor or initiate investigations.

The Message from Congress: Boards Should Retake the Reins

John P. Beavers, Bricker & Eckler LLP

First, Enron captured the headlines. Then, the U.S. House of Representatives passed a bill directing the SEC to determine how to increase accountability. And before the U.S. Senate could consider the House's version of the bill, Adelphia, Dynegy, ImClone, Qwest, Tyco, and WorldCom captured the headlines. The Senate and eventually all of Congress responded beginning with the Sarbanes-Oxley Act of 2002. The Congressional message is clear: American businesses need to do a better job of governing themselves.

The American Corporate Model

Until Enron, the American corporate model was the envy of the world. Stockholders as owners do not directly manage, but elect governing boards to direct management.

A governing board's function is to give direction by decision-making, oversight, and mentoring.

Boards function by delegating. They delegate to management the authority and responsibility for executing and managing the corporation's everyday affairs. In the American corporate model, management is headed by a CEO, who typically has the power to hire, fire, and compensate every other member of management.

With Sarbanes-Oxley, Congress is regulating the delegation of authority and responsibility by the board. Congress believes that too much authority has been given to, or usurped by, management without sufficient accountability to the board and stockholders. Sarbanes-Oxley is Congress' first step to restore authority to the board and increase the accountability of management.

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Restoring the Board's Authority

The Congressional view of board authority is clearly evident in Sarbanes-Oxley's audit committee provisions. Congress is forcing management to return control of the audit process to the board.

In the Congressional view, the audit process is, itself, an oversight function that is to be directed by the board. It defines "audit" in oversight language as "an examination of the financial statements... for the purpose of expressing an opinion on such statements" as to their compliance with generally accepted accounting principles and federal securities laws.[1]

Accordingly, Congress requires that independent board members and ***not*** management are to:

- Hire, fire, and compensate the auditors, subject to shareholder approval;
- Oversee the auditor's work and resolve any disagreements between management and the auditor;
- Establish procedure for and receive complaints, including anonymous submissions by employees;
- Engage independent counsel and other advisers, the fees for which must be provided by the issuer;
- Determine the scope of the auditor's engagement, subject to disclosure to investors;
- Receive reports from the auditor on policies used and alternative treatments discussed with management, as well as those considered preferred; and
- Receive and determine remedial action to take regarding any illegal act brought to its attention by the auditor.[2]

Although much of what Congress has done is consistent with the recommendations in the 1999 *Report of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees*, Congress has gone beyond the Blue Ribbon Committee's recommendations. The importance to Congress of returning authority from management to independent directors is evident by the mandate summarized above that (i) at least the audit committee must have the authority to engage legal counsel and other advisers independent of legal counsel and advisers to the business, as the committee determines necessary to carry out its duties, and (ii) the business must provide for appropriate funding, as determined by the audit committee, for payment of the fees of such counsel or advisers.[3]

Congress has even gone a step farther by directing the SEC to prescribe rules making it unlawful for any officer to fraudulently influence the performance of an audit and by changing the criminal code to make it a crime not to retain audit workpapers and other documents that form the basis of an audit.[4]

In addition, Congress made the audit committee, or otherwise independent directors, the designated recipients of any illegal conduct coming to the attention of outside auditors in the course of an audit; any significant deficiencies in internal accounting controls and any fraud, whether

or not material, involving management having roles with internal accounting controls coming to the attention of the CEO or CFO; and any evidence of material violations of securities laws or breaches of fiduciary duty coming to the attention of legal counsel that are not appropriately responded to by the CEO or chief legal officer.

Increasing Management's Accountability

An under-emphasized part of Sarbanes-Oxley is the requirement for businesses to disclose whether they have adopted a code of ethics for their senior financial officers.[5] Congress is apparently frustrated by the fact that senior financial officers who are not subject to professional codes of ethics are not as accountable as general counsel who are subject to a Code or Model Rules of Professional Responsibility. There is little doubt that the shareholders could bring a derivative action on behalf of the business to hold general counsel responsible for breach of duties of competency and loyalty. Until a code of ethics is imposed contractually by a business, financial officers are not subject to similar fiduciary duties as those imposed on lawyers by their Codes or Model Rules.

Congress has gone even farther in increasing the accountability of CEOs and CFOs by requiring them to certify that:

- Subject to criminal penalties, the financial statement filed with any Form 10-K, 10-Q, or 8-K report with the SEC complies with SEC requirements and fairly presents, in all material respects, the financial condition and results of operations;

- They have read each annual and quarterly report filed with or submitted to the SEC and, based upon the officer's knowledge, the report does not contain any material misstatement or omission and fairly presents in all material respects the financial condition and results of operations;

- They are responsible for establishing and maintaining internal controls; they have designed internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers; they have evaluated the effectiveness of those internal controls at least 90 days prior to the report; and they have presented in the report their conclusions about the effectiveness of their internal controls; and

- They have disclosed to the auditor and the audit committee all significant deficiencies in the design or operation of internal controls and any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.[6]

Congress is requiring each business to force CEOs and CFOs to reimburse the business for all incentive-based or equity based compensation and for profits realized from the sale of the business' securities during the 12-month period after the issuance or filing with the SEC of any financial statement that is required to be restated due to failure to abide by any of the forgoing certifications or other misconduct.

As a means of self-enforcement of these provisions, Congress is requiring each business to force CEOs and CFOs to reimburse the business for all incentive-based or equity based compensation and for profits realized from the sale of the business' securities during the 12-month period after the issuance or filing with the SEC of any financial statement that is required to be restated due to failure to abide by any of the forgoing certifications or other misconduct.[7]

What Congress Did Not Do

Although Congress is restoring authority for oversight to the board, it did not increase the accountability of boards as it did the accountability of CEOs and CFOs. Congress was apparently cognizant of fear that increasing board accountability will make it more difficult to attract independent and competent board members. It did not require boards to review, certify, or become signatories to Form 8-K, Form 10-Q, or Form 10-K reports filed with the SEC or proxy or other materials furnished to security holders. It did not require boards to assume responsibility for implementing or supervising internal accounting controls. It did

not require boards to forfeit compensation if financial statements need to be restated for reasons of noncompliance. Although Congress required the board and its audit committee to be recipients of reports from the outside auditor, Congress did not require boards to have dialog with the outside or internal auditors.

Is There a Change in Standard of Conduct for Boards?

Although Congress may not have intended to increase the accountability of boards, by expressly making the board the authority for oversight of the audit process, Congress has likely raised the bar on the standard of conduct for boards.

Under most corporate statutes, a corporation's board is responsible for the direction of the corporation's management.[8] Congress has now added to that direction express responsibility for hiring, firing, compensating, and overseeing the work of the auditors and the other matters described under "Restoring the Board's Authority."

Under most corporate statutes, a board typically performs its responsibilities by delegating to others, including management, board committees, and professionals such as accountants and legal counsel.[9] Although Congress has allowed the independent members of a board to rely upon an audit committee that is composed of independent members, it can be argued that the board must assume, or assure itself that its audit committee assumes,[10] responsibility for hiring, firing, compensating, and overseeing the work of the auditors and the other matters described under "Restoring the Board's Authority."

1 Section 2(a)(2) and (4) of Sarbanes-Oxley.

2 See Sections 10A(m)(2); 10A(m)(4); 10A(m)(5) and (6); 10A(g), (h) and (i); 10A(k); and 10A(b), respectively, added to the Securities Exchange Act of 1934 by Sarbanes-Oxley.

3 See Section 10A(m) added to the Securities Exchange Act of 1934 by Sarbanes-Oxley.

4 See Section 303 of Sarbanes-Oxley and Section 1520 added to 18 USC by Sarbanes-Oxley.

5 See Section 406 of Sarbanes-Oxley.

6 See Section 1350 added to 18 USC by Sarbanes-Oxley and Section 302 of Sarbanes-Oxley.

7 See Section 304 of Sarbanes-Oxley.

8 See Section 141(a) of Delaware General Corporation Law and Section 1701.59(A) of Ohio General Corporation Law.

9 See Section 141(e) of Delaware General Corporation Law and Section 1701.59(B) of Ohio General Corporation Law.

10 Sarbanes-Oxley defines audit committee as a committee established by the board for the purpose of overseeing the issuer's accounting and financial reporting processes and audits of the financial statements. If no such committee exists, then the entire board is responsible for this oversight.

SEC Rules on Certifications

John P. Beavers, Bricker & Eckler LLP

Perhaps the most significant provision of the Sarbanes-Oxley Act of 2002 is the requirement for CEOs and CFOs of public-reporting companies to make personal certifications regarding the accuracy and completeness of certain reports, the fair presentation of financial statements, the responsibility for internal accounting controls, and disclosures regarding significant deficiencies made to audit committees and outside auditors.[1]

Congress believed these certifications to be so important that it gave the SEC only 30 days to issue and effect rules implementing the certifications. The SEC found the certifications to be essential as well, which is evident by its issuance of the rules within 28 days. The new rules became effective August 29, 2002.

The significance of these certifications to Congress is apparent by the civil and criminal sanctions to which they are subject. These include SEC administrative and judicial enforcement actions against companies' CEOs and CFOs as signatories for disclosures under the Exchange Act; actions for damages, as well as injunctive and administrative sanctions, for material misstatements or omissions under general antifraud standards of the Exchange Act, including rights of private action by shareholders for violating Exchange Section 10(b) Rule 10b-5; and for criminal penalties of up to $1 million and imprisonment for up to 10 years under the criminal penalties of the Exchange Act. In addition, Congress added a new section 1350 to Chapter 63 of the 18 USC criminal code providing additional criminal penalties of up to $5 million and imprisonment for up to 20 years for willful certifications knowing them to be false.

The Required Certifications

Pursuant to the August 29, 2002 rules, each CEO and each CFO of a public-reporting company are required to separately provide the following certification with respect to each Form 10-Q or 10-QSB, Form 10-K or 10-KSB, Form 20-F, and Form 40-F filed with the SEC on or after August 29, 2002:

I, [identify the certifying individual], certify that:

1. I have reviewed this quarterly report on Form [identify report] of [identify registrant];

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

(a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

(c) Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date.

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

(a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls.

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Under these certifications, CEOs and CFOs are subject to civil and criminal sanctions, including SEC administrative and judicial enforcement actions and criminal penalties of up to $1 million and imprisonment for up to 10 years under the criminal penalties of the Exchange Act. Congressional additions to the criminal code provide further criminal penalties of up to $5 million and imprisonment for up to 20 years for willful certifications knowing them to be false.

Date:____________________

[Signature]____________________

[Title]____________________

The new rules make some significant changes to certifications previously filed in response to section 906 of Sarbanes-Oxley and to the initial SEC certification initiative. The first is that the new rules do not permit the certification to be limited by lack of knowledge and require affirmative knowledge of compliance. Most section 906 certifications contained language that the certifications were being made "subject to the best of my knowledge," while the new rules require the certifications to be made "based upon my knowledge" after certifying that "registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures."

New Issuer Responsibilities for Disclosure Controls and Procedures

The new rules go beyond CEO and CFO certifications. To assist CEOs and CFOs in making the required certifications, the new rules include a requirement for reporting companies to maintain disclosure controls and procedures that are to have been periodically evaluated at least 90 days before the filing of each report requiring a certification.

The definition of "disclosure controls and procedures" in the new rules is intentionally broader than the meaning of internal accounting controls currently required by section 13(b) of the Exchange Act. Under the new rules, these controls and other procedures are to be designed to ensure that information required to be disclosed in the reports is:

The new rules do not permit the certification to be limited by lack of knowledge and require affirmative knowledge of compliance. The new rules require the certifications to be made "based upon my knowledge" after certifying that "registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures."

- "Recorded, processed, summarized and reported, within the time periods specified in the [SEC's] rules and forms"; and
- "Accumulated and communi cated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure."[2]

The periodical evaluations required of the disclosure controls and procedures are "to be carried out under the supervision and with the participation of the issuer's management, *including* the issuer's principal executive officer or officers and principal financial officer or officers."[3]

1 See Section 302 of Sarbanes-Oxley.

2 Rules 13a-14(c) and 15d-14(c).

3 Rules 13a-15(b) and 15d-15(b).

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