Counsel for
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Acredula®

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Bricker & Eckler LLP's Acredula is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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

Sarbanes-Oxley Act Will Have Broad Impact on Boards and Executives

Editor's Note

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This issue of Acredula summarizes what executives and boards should know about corporate responsibility and accounting oversight under the new Sarbanes-Oxley Act of 2002. Regardless of whether the Act will have a positive effect on investors, the Act will have a far-reaching effect on boards and executives.

Because of new company reporting requirements and CEO/CFO certifications required by the Act, internal accounting controls will need to be reviewed and fixed where appropriate; off-balance sheet transactions will need to be reviewed and likely to be reported; *pro forma* financial information will need to be reviewed and reconciled with financial statements; and material correcting adjustments recommended as part of the audit process will need to be made or otherwise discussed. In addition, CEOs will want to have accounting and audit compliance procedures in place, with reports directly to the CEOs, as due diligence for the required CEO certification of a reporting company's financial statements.

Existing loans to board members and executives will need to be reviewed because they may not be modified or renewed under the new loan prohibitions. Compensation of executives will need to be reviewed in light of the forfeiture provisions mandated by the Act if financial statements have to be restated as a result of misconduct. Permitted periods for trading by boards and executives in company stock will need to be coordinated with blackout periods on purchases and sales of company securities by 401(k) and other defined contributions and individual account plans.

Audit committees will need to assume authority for the hiring and firing of auditors; they will need to be authorized to hire independent legal counsel and other advisers; and they will need to find at least one member who is a "financial expert" with an understanding of GAAP and audit committee functions and experience in preparing or auditing financial statements and with internal accounting controls.

Document retention policies will need to be reviewed in light of new criminal penalties for destruction, alteration, or falsification of records in federal investigations and bankruptcy and destruction of audit records including work papers.

Because the Act reclassifies certain violations as fraudulent or criminal, D&O policies will need to be reviewed to determine whether there is any long coverage for such actions.

Finally, Congress is not done. Bills are pending focusing on executive compensation and compensation committees. Congress is considering limiting deferred compensation for executives and prohibiting protection of assets through Rabbi trusts or otherwise removing assets from the claims of credits for the benefit of insiders.

Sarbanes-Oxley Act: What Executives and Boards Should Know

The media has summarized what they believe is important for investors to know about the Sarbanes-Oxley Act passed by Congress on July 25, 2002, and signed by the President on July 30, 2002. The purpose of this article is to summarize, from a different viewpoint, what we believe is important for executives and boards to know.

The House of Representatives started the process by adopting the first version of the act, which was a general direction to the Securities and Exchange Commission (SEC) to consider and adopt rules. The Senate rejected *in toto* the House version and replaced it with tougher and more specific provisions of a bill initially proposed by Senator Paul Sarbanes (D-Maryland). The Senate bill was substituted for the House bill in conference. Representative Michael Oxley (R-Ohio) led the conference efforts in cleaning up the Senate version, and the resulting bill was adopted as the Sarbanes-Oxley Act of 2002.

The Act applies only to companies that are subject to the Form 10-K, 10-Q, and 8-K reporting requirements under the Securities Exchange Act of 1934. The Act can be divided into accounting oversight provisions and corporate responsibility provisions. Although the Act only applies to public reporting companies, its accounting oversight provisions will likely have a broader effect because the changes made by the Act will eventually trickle down to all other stock companies. The corporate responsibility provisions will also affect a wider audience, but they will not be as far reaching as the accounting oversight provisions. The changes made by the corporate responsibility provisions will need to be heeded by not only public reporting companies, but also all companies that want to or may become public reporting companies.

What Executives Should Know

CEO/CFO Certifications. The Act directs the SEC to adopt rules within 30 days requiring CEOs and CFOs of each public reporting company to certify in each Form 10-Q and Form-10-K that:

(1) The signing officer has reviewed the report.

(2) Based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading.

(3) Based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the company as of, and for, the periods presented in the report.

(4) The signing officers:

- (a) Are responsible for establishing and maintaining internal controls;
- (b) Have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
- (c) Have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report; and
- (d) Have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

(5) The signing officers have disclosed to the company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

- (a) All significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize, and report financial data and have identified for the company'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 company's internal controls.

(6) The signing officers have indicated in the 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 their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Internal Control Evaluations. The Act directs the SEC to require that each Form 10-K shall contain an internal accounting control report that:

(1) States the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) 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.

Forfeiture of Certain Compensation. The Act requires CEOs and CFOs to forfeit all incentive and equity-based compensation for a 12-month period following publication of any financial statement that is later restated as a result of misconduct.

Prohibition of Loans to Executives. The Act makes it unlawful for companies directly or indirectly to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any executive officer or director. The exceptions to the prohibition only permit home improvement loans, consumer credit, charge cards, and limited broker/dealer loans other than for the purchase of company stock. The prohibition does not apply to any loan made or maintained by an FDIC-insured depository institution if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act. There is a grandfather provision that loans and other extensions of credit in place as of July 30, 2002, will not be subject to this prohibition as long as there is no material modification to any term of any such loan or extension of credit or any renewal thereof after July 30, 2002.

Insider Trading Prohibited During Blackouts. The Act makes it unlawful for any director or executive officer to engage directly or indirectly in any *purchase or sale* of an equity security of the company during any blackout period of more than three consecutive business days applicable to any defined contribution or individual account plan. The Act also sets forth detailed rules for setting blackout periods applicable to employee plans, including notification requirements.

Attorneys' Duties to Boards. The Act directs the SEC to adopt rules within 180 days requiring attorneys to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the CEO of the company and, if such counsel or officer does not appropriately respond, then to the audit committee or another independent board committee or to the board of directors as a whole.

Financial Reporting Requirements. The Act mandates a number of financial reporting requirements including:

- Reflection in all financial statements, included in any report filed, of all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the SEC;
- Disclosure in Forms 10-K and 10-Q of all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the company with unconsoli dated entities or other persons; and
- Reconciliation of *pro forma* financial information with the financial condition and results of opera tions of the company under generally accepted accounting principles.

Reporting of Changes in Ownership of Securities. The Act requires executive officers and directors to report on Form 4 any changes in their ownership of the company's equity securities before the end of the second business day following the day on which the subject transaction has been executed (or within such other period as the SEC may establish by rule) and, within one year, the SEC shall require such reports to be filed electronically.

Management Assessment of Internal Controls. The Act directs the SEC to adopt rules requiring each Form 10-K annual report to contain an internal control report, which shall:

(1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) Contain 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.

Codes of Ethics. The Act directs the SEC to issue rules requiring companies to disclose whether or not, and if not, the reason therefore, such companies have adopted a code of ethics applicable to their principal financial officers and comptrollers or principal accounting officers or persons performing similar functions.

Criminal Penalties. The Act creates criminal penalties for the following:

- Destruction, alteration, or falsification of records in federal investigations and bankruptcy;
- Destruction of audit records including work papers within five years of the end of the fiscal year for which the audit was concluded;
- Certain securities fraud;
- CEO's and CFO's failure to provide certifications discussed above; and
- Retaliation against any whistleblower or informant.

What Boards Should Know

Registered Public Accounting Firms. Only public accounting firms registered with the Public Company Accounting Oversight Board created by the Act may be engaged by companies to prepare or issue, or to participate in the prepa-

ration or issuance of, any audit report with respect to any of those companies. In addition to responsibility for registering, inspecting, investigating, and disciplining public accounting firms, the Oversight Board has broad authority to establish or adopt auditing, quality control, ethics, independence, accounting principles, and other standards.

Audit Committee. The Act statutorily expands the responsibilities of audit committees. The SEC is directed to adopt rules within 270 days that:

- Make audit committees directly responsible for the appointment, compensation, and oversight of the work by that company (including resolution of disagreements between management and the auditor regarding financial reporting);
- Require each member of the audit committee to be independent, meaning that he or she does not receive any consulting, advisory, or other compensatory fee other than directors' fees and is not an "affiliated person" of the company;
- Require each audit committee to establish procedures for handling complaints, including anonymous submissions by employees, regarding accounting, internal accounting controls, or auditing matters;
- Authorize each audit committee to engage independent counsel and other advisers, as it determines necessary to carry out its duties; and
- Provide for appropriate funding, as determined by the audit committee and its functions, including those of the auditors as well as of the committee's independent counsel and other advisers.

Prohibition of Loans to Directors. The Act makes it unlawful for companies directly or indirectly to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or, as discussed above, executive officer. The exceptions to the prohibition only permit home improvement loans, consumer credit, charge cards, and limited broker/dealer loans other than for the purchase of company stock. The prohibition does not apply to any loan made or maintained by an FDIC-insured depository institution if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act. As with loans to executives discussed above, there is a grandfather provision that loans and other extensions of credit in place as of July 30, 2002 will not be subject to this prohibition as long as there is no material modification to any term of any such loan or extension of credit or any renewal thereof after July 30, 2002.

Reporting of Changes in Ownership of Securities. The Act requires directors and, as discussed above, executive officers to report on Form 4 any changes in ownership of the company's equity securities before the end of the second business day following the day on which the subject transaction has been executed (or within such other period as the SEC may establish by rule) and, within one year, the SEC shall require such reports to be filed electronically.

Audit Committee's Financial Expert. The Act directs the SEC to adopt rules for companies to disclose whether or not, and if not, the reasons therefore, the audit committee of the company is comprised of at least one member who is a "financial expert" with an understanding of GAAP and audit committee functions and experience in preparing or auditing financial statements and with internal accounting controls.

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