Responsibilities of Principal Executive Officers Under the Sarbanes-Oxley Act of 2002: *A Compliance Checklist*

DAVID C. FISCHER

DAVID C. FISCHER
is a partner at Loeb & Loeb in New York, NY.
dfischer@loeb.com

Adopted in the summer of 2002 in response to a succession of spectacular business failures and highly publicized accounting scandals, the Sarbanes-Oxley Act made mandatory what, in many cases, previously had been corporate governance and disclosure "best practices" among public companies. The act outlawed some of the worst practices of the failed companies, and imposed significant changes in accounting and auditing rules, as well as oversight of public accounting.

Implementation of Sarbanes-Oxley provisions applicable to public companies required adoption of a host of rules by the Securities and Exchange Commission and stock markets (e.g., New York Stock Exchange, Nasdaq Stock Market, and American Stock Exchange), which the SEC calls self-regulatory organizations, or SROs, and was completed essentially only at the end of 2003. Phase-in periods for some of the rules have yet to expire.

This checklist is intended to provide principal executive, financial, and accounting officers with a catalog of, and brief commentary on, new or amended rules that may require changes in procedures or duties within their respective areas of responsibility. Given the breadth and complexity of the new rules, no attempt is made to recite them exhaustively—reference to SEC rules and other authorities is necessary in many cases. A summary checklist with references to authorities is appended.

CERTIFICATION REQUIREMENTS

Sarbanes-Oxley created two sets of certifications that must accompany reports filed with the SEC.

Sarbanes-Oxley Section 302 Certifications. These certifications, referred to by the SEC as "Rule 13a-14(a)/15d-14a Certifications," must be signed separately by the CEO and the CFO, and filed as an exhibit to quarterly reports on Form 10-Q or 10-Q(SB) and to annual reports on Form 10-K or Form 10-KSB, as Exhibit 31, or, for foreign private issuers, as an exhibit to Form 20-F. The SEC has specified the form and wording of these certifications, which cannot be changed.

Briefly, the signing officer certifies, with respect to the report, that he has reviewed the report; that he believes that it does not contain any misleading misstatement or omission; and that it fairly presents the company's financial position and results of operations; the officer also certifies his responsibility for the company's disclosure controls and procedures and internal controls over financial reporting and as to their effectiveness.

Note: The term "internal controls over financial reporting" refers to the familiar concept of "internal controls" or "internal accounting controls." Sarbanes-Oxley introduced "disclosure controls and procedures," which are intended to assure that information (financial or otherwise) that must be disclosed under the Exchange Act of 1934 (e.g.,

quarterly and annual reports and current reports on Form 8-K) is brought to the attention of those in management responsible for preparing the disclosure.

To validate the disclosure controls and procedures certification, among other methods, companies have adopted sub-certification procedures or appointed disclosure committees (or both). In the former, those in charge of business units or functions are required to certify the accuracy of the SEC report in question insofar as it relates to a particular business unit or function. "Disclosure committees" consist of corporate personnel in positions to know of events that would require disclosure, and who sign off or meet to discuss the report before it is filed.

Sarbanes-Oxley Section 906 Certifications. These certifications are "furnished" as Exhibit 32 to Form 10-Q(SB) or Form 10-K(SB), or as an exhibit to Form 20-F and referred to by the SEC as "Section 1350 Certifications." The CEO and CFO certify in this case as to the fairness, in all material respects, of the financial statements in the report and that the report "fully complies" with its requirements.

Note: Unlike the certification Rule 13a-14(a)/15d-14a Certifications, which are requirements of the Exchange Act, the Section 1350 Certifications were enacted under the ***criminal*** *code. Penalties for false certifications are potentially severe, with maximum fines ranging from $1 million to $5 million and maximum prison sentences of 10 to 20 years.*

There is another distinction that, from my experience, may be lost on some executives: The standard for liability is *not* materiality; the certification is that the report *fully complies* with the report requirements. Whereas in the past a CEO and/or CFO might decide not to comply strictly with all details of a disclosure requirement, if they believed that all material information otherwise had been disclosed, this avenue is potentially foreclosed to a CEO or CFO who does not want to risk a stiff fine and long prison sentence. Because the SEC has not prescribed the form of certification, some companies limit the certification to the knowledge of the certifying officer, or modify it to read that the report fully complies in all material respects.

REPORTS ON DISCLOSURE AND FINANCIAL CONTROLS

Quarterly Reports. As of the end of each fiscal quarter, management—with participation of the CEO and CFO—must evaluate the company's disclosure controls and procedures, and changes in the company's internal control over financial reporting. The Form 10-Q(SB) for that quarter (Form 10-K(SB)) respecting the fourth quarter (or Form 20-F for the entire year, in the case of a foreign private issuer) must include as a separate item the conclusions reached in the evaluation.

Annual Reports. Annual reports on Form 10K(SB) and 20-F must include reports on internal control over financial reporting containing:

- a statement of management's responsibility for internal control over financial reporting;
- a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control;
- management's assessment of the effectiveness of the internal control; and
- a statement that the company's auditor has included an attestation report on management's assessment.

Note: The requirement for annual reports on internal control over financial reporting generally is considered the most costly to implement, because of both the need to establish the system of controls and the added annual expense that the auditor's attestation report will entail. Only a few observations on these requirements can be made here.

The SEC considers the COSO Internal Control—Integrated Framework as suitable for evaluating financial statement internal controls. (COSO is The Committee of Sponsoring Organizations of the Treadway Commission, formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, chaired by James C. Treadway, Jr. COSO's overview of the framework, as well as instructions for buying the entire report and descriptions of other of its activities, is available at www.coso.org.) The SEC summarizes what it considers necessary to management's conduct of the assessment in its release adopting the rule, which is available at www.sec.gov/rules/final/33-8238.htm.

Regarding the auditor's role in the assessment, the SEC stated that the auditor may assist management in documenting the controls, but management must participate and cannot delegate its assessment obligations, so as to avoid questions regarding the auditor's independence. Likewise, the auditor may review and make recommendations regarding design and implementation of financial and accounting controls, but cannot undertake the process itself.

Management's assessment must include discussion of any material weakness in the company's internal con-

trol that management identifies, and that will preclude management from concluding that the internal control is effective.

Management's assessment and auditor's attestation first must be included in annual reports of "accelerated filers" (generally, issuers having a market capitalization in excess of $75 million, excluding securities held by affiliates) for fiscal years ending after November 15, 2004, and for fiscal years of others ending after July 15, 2005.

FINANCIAL REPORTING

Sarbanes-Oxley regulates the form of some types of financial disclosure that it believes misled investors and the act requires disclosures relating to transactions that have been used to disguise a company's true financial condition.

Disclosure of Off-Balance-Sheet Arrangements and Contractual Obligations. Companies must disclose and discuss in a separately captioned section of "Management's Discussion and Analysis of Financial Condition and Results of Operations" material off-balance-sheet arrangements having or likely to have an effect on reported results. An off-balance-sheet arrangement is defined to include:

- any guarantee having characteristics identified in paragraph 3 of FASB Interpretation No. ("FIN") 45 and not excluded from reporting by paragraphs 6 or 7;
- a retained or contingent interest in assets transferred to an unconsolidated entity to provide credit, liquidity, or market-risk support to the entity;
- any contingent obligation that generally would be accounted for as a derivative instrument, except that it is indexed to the company's stock, included in stockholders equity, and therefore excluded from FAS No. 133, *Accounting for Derivative Instruments and Hedging Activities;* or
- any obligation arising out of an unconsolidated variable interest entity (as referenced in FIN 46) held by and material to the company, if the entity provides financing, liquidity, or market- or credit-risk support to the company or engages in leasing, hedging, or R&D services with the company.

The particular matters to be disclosed are included in the SEC's MD&A requirements. The MD&A also must contain a tabular presentation of long-term contractual obligations, similar to long-term lease commitments required to be disclosed in financial statement footnotes, except that the kinds of contracts that must be disclosed are broader, and the information about the contracts is more detailed, as set forth in the MD&A requirements. This disclosure is not required of small business filers.

Use of Non-GAAP Financial Measures. SEC rules cover use of non-GAAP measures both in informal financial disclosure, e.g., in earnings releases, and in SEC reports. With specified exceptions, a non-GAAP financial measure, e.g., EBITDA, is defined to mean a financial measure that excludes items required to be included in the most directly comparable GAAP measure, e.g., in this case, operating income. Store-for-store sales comparisons and the like do not constitute non-GAAP measures, for example, because there is no GAAP equivalent.

In all disclosure, the non-GAAP figure must be accompanied by the comparable GAAP measure and a reconciliation. If the non-GAAP figure is disclosed orally or by broadcast, the required accompanying information can be presented at the company's website, if the disclosure includes a statement to such effect. In any case, a non-GAAP measure cannot be used if its use would be misleading.

In addition, more restrictive rules apply to use of disclosure in an SEC report. For example, a justification of the use of the non-GAAP measure is required; non-GAAP measures may not be placed on the same page as a required financial statement or *pro forma* information or in accompanying notes; and certain adjustments, for example, to smooth out earnings are not permitted.

Earnings Releases Furnished on Form 8-K. Companies must "furnish" on Form 8-K a copy of any public announcement or release disclosing quarterly results, within four business days of publication. An exception is made for information provided orally, such as in an earnings telephone conference or broadcast, if the information is made available on the company's website and other conditions are met. (Note that, effective August 23, 2004, the SEC has adopted extensive amendments to Form 8-K that were proposed before Sarbanes-Oxley was adopted.)

REQUIREMENTS RELATING TO AUDIT COMMITTEES

Sarbanes-Oxley replaces some audit-committee common practices with legal requirements, which are subject to limited exemptions. Management must be familiar with the rules, because it is required to report

any material non-compliance with the Sarbanes-Oxley audit committee rules to the applicable SRO. In addition, these rules are likely to change the division of authority between the audit committee and management regarding certain matters, as well as create new management tasks or responsibilities, as described below.

Audit Committee Authority and Responsibility. Sarbanes-Oxley makes the audit committee "directly responsible for the appointment, compensation, and oversight of the work of any . . . public accounting firm employed by [the] issuer (including resolutions of disagreements between management and the auditor regarding financial reporting) . . . and each such . . . public accounting firm shall report directly to the audit committee."

Note: Whereas, previously, management may have taken the initiative for and led the process of engaging the auditor each year, subject to the audit committee's supervision or approval, it is clear that the audit committee must assume this role. Management should be prepared to assist the audit committee in these endeavors, but also should take care not to dominate the process.

Likewise, management should apply a light touch in attempting to resolve accounting disputes with the company's auditors. Although immaterial matters should not reach the audit committee for resolution, neither should the auditor feel that there is any restriction on its freedom to contact the audit committee at any time, and management should never try to interpose itself between a company's audit committee and its auditor.

Sarbanes-Oxley requires the auditors to report directly to the audit committee regarding critical accounting policies and practices. By involving the audit committee, as well as the auditor, in the adoption of these policies and practices and changes therein, management most likely will forestall management-auditor disputes over accounting matters. Management should take note that, before enactment of Sarbanes-Oxley, the SEC proposed a rule requiring discussion in the MD&A of critical accounting policies that has not been adopted, but the SEC considers that compliance with current MD&A provisions inherently requires such discussion. In the proposing release, available at www.sec.gov/rules/proposed/33-8098.htm, the SEC provides model examples of this kind of disclosure.

I've seen accounting controversies arise frequently in connection with acquisitions. Treatment of post-acquisition results is an area in which boards of directors generally are interested, and management should use the audit committee as a sounding board. A question often arises regarding the kind and availability of financial information about the target that must be included in SEC reports. Allowing the audit committee to arbitrate such matters potentially could prevent CEOs and CFOs from signing false 906 certifications.

AUDIT COMMITTEE PREAPPROVAL REQUIREMENTS

Prohibitions on Auditor's Services. Subject to a *de minimis* exception, under Sarbanes-Oxley rules, an auditor will not be considered independent, unless, before its engagement for either audit or non-audit related services, the engagement was approved by the audit committee or pursuant to procedures adopted by the audit committee. Management, obviously, must keep these requirements in mind, when seeking services from its auditor (*see sidebar*).

Confidential Complaints System. Each audit committee is required to establish procedures for the confidential, anonymous submission of complaints regarding accounting, internal accounting controls, auditing matters, or questionable accounting or auditing matters.

Authority Concerning Funding and Advisers. The audit committee must be given authority to engage the company's auditors, as well as such legal, accounting, or other experts or advisers that the committee determines to be appropriate, as well as to pay their fees and expenses and the ordinary expenses the committee incurs in its operation. Management should establish procedures to give the audit committee access to funds without requiring compliance with the company's ordinary cash disbursement procedures, so as to avoid any appearance of impairment of the audit committee's discretion. Establishing a separate checking account for the audit committee, replenished under authority of the board of directors, for example, might be a suitable approach.

Audit Committee Composition; Reporting; Charter. Audit committee members must be independent within the applicable SRO's standard for director independence, generally, but also within the Sarbanes-Oxley definition, which prohibits a committee member from receiving any compensation from the company, except in the member's capacity as such or otherwise as a member of the board.

Changes in disclosure about audit committees under the Sarbanes-Oxley rules are as follows:

- The annual meeting proxy statement must identify any exemption from the Sarbanes-Oxley independence or other rules that the audit committee is

SARBANES-OXLEY RESTRICTIONS ON AUDITOR ROLES

Keeping Sarbanes-Oxley requirements in mind, management should be aware that SEC rules under the act prohibit the auditor from performing a number of services for a client, including:

- Management functions—acting as an employee, officer, or director;
- Human resources—engaging in activities relating to hiring managerial personnel, or officers or directors;
- Broker-dealer, etc.—acting as broker-dealer, investment adviser, or providing investment banking services;
- Legal—providing services for which licensing as a lawyer would be required;
- Expert services—providing expert services in which the auditor would be serving as advocate for its client; and
- Any of the following, unless such service would not be subject to financial audit procedures:
    - Bookkeeping or other services related to accounting records or financial statements;
    - Providing appraisal, valuation, fairness opinions, or the like;
    - Actuarial services; and
    - Internal audit outsourcing services.

Although an auditor is not prohibited from providing tax services, the SEC advises audit committees to scrutinize such engagements.

relying on and the effect such reliance will have on the committee's discharge of its duties. This discussion is in addition to the existing disclosure of "exceptional or limited" circumstances justifying a non-independent director's membership on the committee.

- The annual meeting proxy statement must identify any "audit committee financial expert" on the audit committee and, if there is none, disclose why not. SEC rules set forth the qualifications of an audit committee financial expert, which are more stringent than SRO "financial literacy" criteria.
- The foregoing disclosures must be included in the Form 10-K(SB) or incorporated therein from the proxy statement.

The audit committee's charter should be amended to reflect the change in audit committee rules. Note that the audit committee charter is required to be published in the annual meeting proxy statement at least every three years.

Although not required by Sarbanes-Oxley, the SEC has recently expanded proxy-statement disclosure regarding nominating committees and board nomination procedures, and the SROs have made significant changes in their listing rules relating to corporate governance.

RELATIONS WITH AUDITOR

Rules relating to auditor independence, in addition to those mentioned earlier, have been adopted under Sarbanes-Oxley. These require rotation out of various members of a client's engagement team after specified periods of service and a "cooling off" period before the client can employ an engagement team member.

Proxy statement disclosure regarding audit and non-audit services provided and related fees has been made more detailed, and any audit committee policy for engaging auditors for non-audit services must be disclosed. This information must be included or incorporated as a new item in Part III of Form 10-K(SB).

MANAGEMENT CONDUCT

Several Sarbanes-Oxley provisions directly regulate conduct of officers and directors:

Expedited Beneficial Ownership Reporting. Changes in beneficial ownership of company securities held by executive officers, directors, and holders of greater than 10% of a class of company equity security must be reported electronically within two days of the change. Reports must be made available on the company's website.

Senior Management Code of Ethics. A company must disclose in its Form 10-K(SB) or 20-F whether it has a code of ethics applicable to its CEO, CFO, and principal accounting officer. The company must file the code

of ethics as an exhibit to the annual report; include in the annual report a statement as to how one can obtain from the company a copy of the code of ethics; or post the code of ethics on the company's website and include in the report a statement that the code of ethics is posted there. Domestic issuers must report changes to or waivers of the code of ethics within four business days on Form 8-K, or if the code of ethics is posted on the issuer's website, by posting the change or waiver within that period. The rules of the stock markets may restrict in various ways the publication options that the SEC rules allow.

Prohibition on Insider Trading During Pension Fund Blackout Periods. Directors and officers are prohibited from trading in a company security during "blackout" periods exceeding three business days in which transactions in company securities in plan participant accounts are prohibited. These blackout periods must be reported on Form 8-K. Blackout periods do not include regularly scheduled periods in which such transactions are prohibited.

Prohibition on Loans to Directors and Executive Officers. Sarbanes-Oxley makes it unlawful for a company to "directly or indirectly . . . extend or maintain credit . . . arrange for the extension of credit, or . . . renew any extension of credit in the form of a personal loan to or for any director or executive officer" of that company. The lack of any exception, other than a narrow one, and the somewhat odd wording of the provision has generated a great deal of literature as to its precise meaning.

Prohibition on Improper Influence on Conduct of Audits. Officers and directors are prohibited from improperly influencing the auditor in the performance of its engagement (including, for example, the auditor's review of interim financial information), as elaborated in SEC rules.

Editor's Note

The author practices in corporate and securities law and mergers and acquisitions. He has written a number of articles on securities law and corporate governance and has been awarded two patents covering electromechanical measuring devices.

To order reprints of this article, please contact Ajani Malik at amalik@iijournals.com or 212-224-3205.

Reprinted with permission from the Fall 2004 issue of *The Journal of Investment Compliance.* Copyright 2004 by Institutional Investor Journals, Inc. All rights reserved. For more information call (212) 224-3066. Visit our website at www.iijournals.com.

APPENDIX

Summary Sarbanes-Oxley Checklist for Executive Officers Cross-Referenced to Authorities

Checklist Item	Sarbanes-Oxley, Exchange Act Section No.	SEC, SRO Rule No.
Certification Requirements		
Section 302 Certification	S-O 302	SEC 13a-14(a) SEC 15d-14(a) SEC S-K 601(31) SEC S-B 601(31)
Section 906 Certification	S-O 906	SEC 13a-14(b) SEC 15d-14(b) SEC S-K 601(32) SEC S-B 601(32)
Reports on Disclosure and Financial Controls		
Quarterly Reports	S-O 302	SEC 13a-15 SEC 15d-15 SEC S-K 307 SEC S-B 307
Annual Reports	S-O 404	SEC 13a-15 SEC 15d-15 SEC S-K 308 SEC S-B 308
Off-Balance-Sheet Arrangements	S-O 401(a) Exch. 13(j)	SEC S-K 303(a)(4) SEC S-B 303(c)
Contractual Obligations	S-O 401(a) Exch. 13(j)	SEC S-K 303(a)(5)
Non-GAAP Financial Measures	S-O 401(b)	SEC Reg. G SEC S-K 10(e) SEC S-B 10(h)
Earnings Releases Furnished on Form 8-K	S-O 409 Exch. 13(l)	SEC Form 8-K Item 12

APPENDIX (Continued)

Summary Sarbanes-Oxley Checklist for Executive Officers Cross-Referenced to Authorities

Requirements Relating to Audit Committees		
Audit Committee Authority and Responsibility	S-O 301 Exch. 10A(m)(2)	SEC 10A-3(b)(2) NYSE 303A.06, .07(c)(iii) NASD 4350(d)(3) AMEX 121B(4)
Audit Committee Pre-Approval	S-O 202 Exch. 10A(i)	SEC S-X 2-01(c)(7)
Prohibited Auditor Services	S-O 201 Exch. 10A(g)	SEC S-X 2-01(c)(4)
Confidential Complaints System	S-O 301 Exch. 10A(m)(4)	SEC 10A-3(b)(3) NYSE 303A.06, .07(c)(iii) NASD 4350(d)(3) AMEX 121B(4)
Authority re Funding and Advisers	S-O 301 Exch. 10A(m)(5) & (6)	SEC 10A-3(b)(4) & (5) NYSE 303A.06, .07(c)(iii) NASD 4350(d)(3) AMEX 121B(4)
Audit Committee Composition	S-O 301 Exch. 10A(m)(3)	SEC 10A-3(b)(1) NYSE 303A.06, .07(b) NASD 4350(d)(2) AMEX 121B(2)
Reporting re Audit Committee • Exemptions	S-O 301 Exch. 10A(m)(3)(C)	SEC 10A-3(b)(iv) &(c) SEC 10A-3(d) SEC S-K 401(h) SEC S-B 401(f)
• Audit Committee Financial Expert	S-O 407	SEC S-K 401(h) SEC S-B 401(e)

APPENDIX (Continued)

Summary Sarbanes-Oxley Checklist for Executive Officers Cross-Referenced to Authorities

Relations with Auditor		
∞ Engagement team rotation	S-O 203 Exch. 10A(j)	SEC S-X 2-01(c)(6)
∞ "Cooling-off" period	S-O 206 Exch. 10A(l)	SEC S-X 2-01(c)(2)(iii)
∞ Enhanced disclosure	S-O 202 Exch. 10A(i)(2)	SEC 14A 9(e)
Management Conduct		
Expedited § 16 Reporting	S-O 403 Exch. 16(a)	SEC 16(k) SEC S-T 101(a)(iii)
Sr. Management Code of Ethics	S-O 406	SEC S-K 406 SEC S-B 406 SEC Form 8-K Item 10 NYSE 303A.10 NASD 4350(n) AMEX 807
Pension Fund Black-out Periods	S-O 306	SEC BTR
Insider Loans	S-O 402	
Improper Influence on Audits	S-O 303	SEC 13b2-2