

## Overview of Sarbanes-Oxley

By Gordon Price

A Summary of the Sarbanes-Oxley of 2002

### Title I – Public Company Accounting Oversight Board

**Section 101** creates a new oversight body (the PCAOB).

**Section 102** requires public accounting (audit) firms to register with the PCAOB and to submit annual reports to the Board.

**Section 103** charges the PCAOB with setting audit standards, quality controls, ethics and auditor independence standards. This includes setting standards for internal controls testing required by Section 404 of the Act.

**Section 104** requires the PCAOB to conduct regular inspections of audit firms to assess compliance with the Act, the rules of the Board, the SEC and other rules or laws related to auditing standards.

**Section 105** establishes the Board's disciplinary powers and sets penalty parameters.

### Title II – Auditor Independence

**Section 201** prohibits auditors from providing non-audit services contemporaneously with audit services. The prohibitions include:

- (1) Bookkeeping services
- (2) Financial information systems 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 advisor or investment banking services
- (8) Legal services and expert services unrelated to the audit
- (9) Any other services the Board determines by regulation is impermissible

Any non-audit services not listed above, including tax services, must be pre-approved by the Board.

Section 202 requires the audit committee to approve all audit and non-audit services with the exception of certain *de minimus* services.

**Section 203** requires audit firms to rotate the lead audit partner for each audit client every 5 years.

**Section 204** requires the audit firm to report to the audit committee of an issuer:

- (1) all critical accounting policies and practices to be used;
- (2) all alternative treatments of financial information within GAAP that have been discussed with management . . . ramifications of the use of such alternative disclosures or treatments, and the treatment preferred by the public accounting firm; and
- (3) other material written communications between the registered public accounting firm and the management of the company, such as a management letter or a schedule of unadjusted differences.

**Section 206** prohibits the CEO, CFO, Controller, Chief Accounting Officer, etc. from having been employed by the company's audit firm within one year preceding the audit.

**Section 207** provides that the Comptroller General of the U.S. will study the effects of requiring audit firm rotation.

### **Title III – Corporate Responsibility**

**Section 301** sets standards for composition of company audit committees:

Each member of the audit committee shall be a member of the board of directors and shall be otherwise independent (cannot accept consulting, advisory or compensatory fees from the company or be affiliated with the company or a subsidiary of the company).

The audit committee shall be directly responsible for the appointment, compensation and oversight of the public accounting firm for purposes of preparing or issuing an audit report.

**Section 302** requires the CEO and CFO (or equivalent officers) to certify in each annual and quarterly report that:

- (1) the signing officer has reviewed the report
- (2) based on his knowledge, the report contains no untrue statements of material fact or omits to state a material fact which would make statements misleading
- (3) based on his knowledge, the financial statements and all other information included in the report present fairly the financial condition of the company.
- (4) the signing officers:
  - (A) are responsible for establishing and maintaining internal controls
  - (B) have designed such internal controls to ensure material information is made known to the signing officers by others within the company
  - (C) have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the report
  - (D) have presented in the report their conclusions as to the effectiveness of the internal controls as of that date
- (5) the signing officers have disclosed to the auditors and the audit committee
  - (A) all significant deficiencies in the design or operation of the internal controls, and have identified for the auditors any material weaknesses in internal controls
  - (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 any significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions taken.

**Section 303** makes it unlawful for an officer or director of a company to fraudulently influence or mislead or deceive an auditor for the purpose of rendering the financial statements materially misleading.

**Section 304** calls for forfeiture of bonuses and profits from sale of company securities received by the CEO or CFO prior to issuing a restatement of a financial report due to material non-compliance of the company, due to misconduct by the officer, with any financial reporting requirement under the securities laws.

**Section 305** allows the SEC to seek and any federal court to grant any equitable relief that may be appropriate or necessary for the benefit of investors.

**Section 306** prohibits insiders from buying or selling company stock during pension fund blackout periods.

#### **Title IV – Enhanced Financial Disclosures**

**Section 401** Each financial report required to be prepared under GAAP shall reflect all material correcting adjustments identified by the auditors.

Each annual and quarterly financial report shall disclose all material off-balance sheet transactions, arrangements or obligations, or other relationships of the company with unconsolidated entities that may have a material current or future effect on financial condition.

The SEC shall issue final rules providing that pro-forma financial information does not contain an untrue statement of a material fact or omit a material fact, and reconciles the pro-forma information with financial information under GAAP.

The SEC shall study off-balance sheet disclosures and the use of special purpose entities to determine if GAAP rules result in transparent financial reports, and make recommendations to Congress.

**Section 402** prohibits a company from making loans to its executive officers and directors. Consumer credit companies may make loans if done in the course of their normal business and on terms not more favorable than transacted with the public.

**Section 403** requires reporting within two business days of transactions in company stock by any officer, director or 10% shareholder.

**Section 404** the SEC shall prescribe rules requiring each annual report 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 effectiveness of the internal control structure and procedures of the company for financial reporting.

With respect to the internal control assessment required, each registered public accounting firm that prepares or issues an audit report shall attest to, and report on, the assessment made by the management of the company.

**Section 405** exempts investment companies registered under the Investment Company Act of 1940 from rules in Sections 401, 402 and 404.

**Section 406** requires the SEC to issue rules to require each company to disclose in financial reports whether or not it has adopted a code of ethics for senior financial officers.

**Section 407** requires the SEC to issue rules to require each company to disclose in financial reports whether or not, and the reasons therefor, the audit committee is comprised with at least one member who is a financial expert. A financial expert shall be defined as a person with education and experience as a public accountant or auditor or a principal financial officer, etc. of a public company.

**Section 408** requires the SEC to review, at least once every three years, publicly traded firms financial reports and to consider certain securities trading and economic sector criteria with regard to the protection of investors.

**Section 409** requires companies disclose to the public, on a rapid and current basis, information concerning material changes in financial condition or operations.

#### **Title V – Analyst Conflicts of Interest**

**Section 501** requires national securities exchanges and registered securities associations to adopt conflict of interest rules for research analysts recommending equity securities in research reports or in public appearances.

#### **Title VI – Commission Resources and Authority**

**Section 601** sets increased SEC appropriations and allows for the hiring of 200 additional staff.

**Section 602** allows the SEC to censure or deny any person from appearing or practicing before the Commission if such person lacks proper qualifications or integrity or has willfully violated securities laws.

#### **Title VII – Studies and Reports**

**Section 701** calls for the GAO to study the consolidation within the public accounting industry and to assess the present and future impact of such consolidation.

**Section 702** calls for the SEC to study the role and function of credit rating agencies in the operation of securities markets.

**Section 703** requires the SEC to conduct a study of securities professionals to determine unpunished violations from the period Jan. 1, 1998 to Dec. 31, 2001.

**Section 704** requires the SEC to review all enforcement actions over a five-year period to determine areas of reporting most susceptible to fraud, inappropriate earnings management and accounting treatment of off-balance sheet special purpose entities.

**Section 705** requires a GAO study of whether investment banks and financial advisers assisted public companies in manipulating earnings, in particular in the Enron and Global Crossing cases.

#### **Title VIII – Corporate and Criminal Fraud and Accountability**

**Section 802** amends Chapter 73 of title 18, United States Code:

“Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

Auditors are required to maintain all audit or review workpapers for five years. Whoever knowingly and willfully violates this rule shall be fined or imprisoned not more than ten years, or both.

**Section 804** extends the statute of limitations for securities fraud to the earlier of two years after discovery or five years after the violation.

**Section 805** requires the United States Sentencing Commission to review and enhance sentencing requirements to adequately deter and punish obstruction of justice.

**Section 806** grants “whistleblower” protection to employees of publicly traded companies who provide evidence of fraud.

**Section 807** defines the crime of securities fraud and sets penalties of fines or imprisonment for not more than 25 years, or both.

### **Title IX – White-Collar Crime Penalty Enhancements**

**Section 902** states the attempt or act of conspiring to commit any offense shall be punishable the same as the commission of the offense.

**Section 903** increases penalties for mail fraud and wire fraud.

**Section 904** increases penalties for violations of ERISA.

**Section 905** calls for amending sentencing guidelines for “white-collar” crimes to reflect the serious nature of the offenses to deter, prevent and punish such offenses.

**Section 906** requires the CEO and CFO to certify the financial statements fairly present, in all material respects, the financial condition and results of the company. Criminal penalties are established for knowingly violating the certification requirements of fines of not more than \$1,000,000 or imprisonment for not more than 10 years, or both. Willful certification of improper financial reports carries fines of not more than \$5,000,000 or imprisonment for not more than 20 years, or both.

### **Title X – Corporate Tax Returns**

**Section 1001** requires the federal corporate income tax return be signed by the CEO.

### **Title XI – Corporate Fraud Accountability**

**Section 1102** makes it a crime to corruptly alter, destroy, mutilate, or conceal a record, document, or other object, or attempt to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding. Penalties are fines or imprisonment for not more than 20 years, or both.

**Section 1103** allows the SEC to freeze extraordinary payments to any officer or director, etc. of a company during an investigation for possible securities laws violations.

**Section 1104** calls for amending federal sentencing guidelines for securities and accounting fraud and assuring they are adequate and sufficient regarding the serious nature of the crime.

**Section 1105** allows the SEC to prohibit any person from serving as an officer or director of a public company if he has committed securities fraud.

**Section 1106** increases criminal penalties under the Securities Exchange Act of 1934.

**Section 1107** sets penalties for retaliation against any person providing law enforcement with truthful information relating to the commission or possible commission of any federal offense.

## PROTECTING ENTERPRISE VALUE

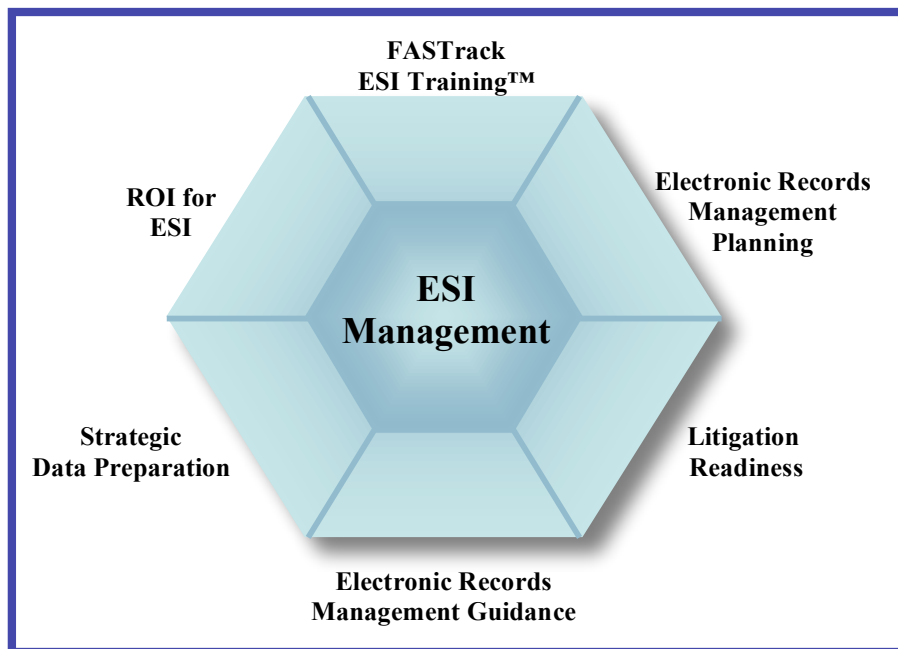
### #8. Overview of Sarbanes-Oxley

#### About FMDC

Founded in 1987, FMDC has focused on the issues relating to the processing and management of information in regulated environments. Since its inception, FMDC has been at the nexus of regulation, industry and information technology. With projects in over twenty countries, FMDC professionals have gained first hand knowledge of the nuances of the different regulatory jurisdictions and how they impact the use of technology. In early 2002, FMDC turned its attention to the issues relating to the handling of e-mail, instant messaging and other records in the context of regulatory requirements and litigation.

The advent of laws and rules such as SEC Rule 17a-4, the Sarbanes Oxley Act, State and Federal privacy legislation, industry standards such as PCIDSS and most recently, court rules or guidelines such as FRCP, CCJ-ED, local federal district rules and the Sedona Conference has changed the standards by which companies must manage their information. FMDC professionals work to guide companies through the morass of regulations to find cost effective solutions for the management of ESI. Our services include:

- FASTrack ESI Training™
- Electronic Records Management Guidance and Policy Development
- Strategic Data Preparation
- Litigation Readiness
- ROI for ESI
- Electronic Records Management Planning



If you are concerned about ensuring that your ESI management meets your business, litigation and regulatory obligations or if you must find ways to reduce the associated costs contact FMDC.

**Western US Region**

**Joseph Santoro, VP**  
Newport Beach, CA  
949 231-9602

[joseph.santoro@fmdc.com](mailto:joseph.santoro@fmdc.com)

**CEO**

**Thomas Bookwalter**  
Santa Fe, NM  
908 812-5000

[thomas.bookwalter@fmdc.com](mailto:thomas.bookwalter@fmdc.com)

**Eastern US Region**

**Michael Shope, VP**  
Middletown, NJ  
732 687-2680

[michael.shope@fmdc.com](mailto:michael.shope@fmdc.com)