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THE U.S. SARBANES-OXLEY ACT OF 2002: REFORMING CORPORATE GOVERNANCE AND DISCLOSURE

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INTRODUCTION

On 30 July 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act" or "Sarbanes-Oxley"). Described as one of the most far-reaching and significant changes to the corporate governance and disclosure obligations of publicly traded companies as well the responsibilities of their directors and officers, Sarbanes-Oxley also has profound implications for the accounting profession.

Sarbanes-Oxley, which received almost unprecedented bipartisan support in the U.S. House of Representatives and the Senate, was a direct response to the Enron debacle and the spate of corporate scandals that have shaken public confidence in financial markets around the world.

Although the recent episodes of corporate chicanery have been largely confined to the United States, their impact has extended well beyond U.S. borders. And in the wake of these events, many countries, including Canada, are reviewing their corporate governance and accounting practices.

At present, there is a rather lively debate among those interested in corporate governance about whether Canada should follow Sarbanes-Oxley. Some argue that Canada should take a serious look at legislating corporate governance standards in much the same way as the United States has. Others, however, contend that our principles-based approach to governance through voluntary guidelines has served us well and should be continued.

The Ontario Securities Commission is undertaking consultations to determine whether Sarbanes-Oxley, the New York Stock Exchange corporate governance requirements and the Nasdaq listing rules should be adopted in whole or in part in Ontario. These consultations will, undoubtedly, canvass a wide range of views about the present and future state of corporate governance in Canada. Sarbanes-Oxley is certain to figure prominently in the discussions.

This paper summarizes some of the main provisions of Sarbanes-Oxley in relation to the following subjects:

1. enhancing the accountability of corporate officers;
2. disclosure requirements;
3. audit committee standards and responsibilities;
4. auditor oversight and independence;
5. accountability for wrongdoing;
6. analyst conflicts of interest/attorneys' responsibilities.

ENHANCING THE ACCOUNTABILITY OF CORPORATE OFFICERS

Certification of Financial Statements: One of the most talked about Sarbanes-Oxley reforms is its requirement for certain corporate executives to vouch for the accuracy of their company's financial statements and disclosures.

The Act imposes two certification requirements. First, the chief executive officer (CEO) and chief financial officer (CFO) of a publicly traded company (including non-U.S. companies) must certify that the company's financial statements fairly present, in all material respects, the company's financial condition and results of operations. Second, under new Securities and Exchange Commission (SEC) rules, promulgated under the Act, the CEO and CFO will be required to certify in each quarterly and annual report filed with the SEC that:

- they have reviewed the report;
- based on their knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements not misleading;
- based on their 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;
- they are responsible for the company's internal controls, have designed such controls to ensure material information is made known to them, have evaluated their effectiveness and have provided their conclusions about the effectiveness in the report;

- they have disclosed to the company's auditors and audit committee any significant deficiencies in the internal controls, and any fraud by management or employees who have a significant role in the company's internal controls; and

- they have indicated whether or not there were any significant changes to the internal controls or changes in other factors that could significantly affect such controls, after the date of their evaluation.

Disgorgement of Bonuses and Profits: Another measure receiving considerable public attention is the requirement for certain corporate executives to forfeit bonuses and profits in the event of an accounting restatement. If a company has to restate its financial information because of the company's material noncompliance (as a result of misconduct) with any financial reporting requirements, Sarbanes-Oxley requires the CEO and CFO to forfeit to the company:

- any equity-based bonus or incentive-based compensation paid by the company during the 12-month period after the release or filing of the financial information; and

- any profits realized from the sale of the company's securities during that period.

Personal Loans to Officers and Directors: The Act prohibits companies from providing or arranging for personal loans to any director or executive officer, directly or indirectly. Loans in existence when the Act became law are not prohibited, as long as they are not materially changed, extended or renewed.

Insider Trades During Pension Fund Blackout Periods: In response to concerns about directors and officers trading company shares when employees may not be able to do so, Sarbanes-Oxley will prohibit any officer or director of a public company from buying or selling company securities during any period when a majority of the participants in a company's individual savings plans (such as 401(k) plans) are suspended from trading.

DISCLOSURE REQUIREMENTS

Sarbanes-Oxley imposes a number of new disclosure requirements on publicly traded companies, a number of which are outlined below.

Disclosure of Code of Ethics: Companies are required to state in their periodic reports whether or not they have adopted a code of ethics for senior financial officers, and if not, the reasons for not having done so.

Internal Control Report: Companies are required to provide an internal control report as a part of their annual reports. This report must:

- state that management is responsible for establishing and maintaining adequate internal control structures and procedures for financial reporting; and
- contain an assessment, as of the end of the most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting.

The company's auditor is required to attest to and report on management's assessment.

Disclosure of Material Off-Balance Sheet Transactions: In response to the revelations of off-balance sheet accounting techniques employed by Enron, Sarbanes-Oxley requires the SEC to issue rules providing that quarterly and annual financial reports filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations and relationships that may have a material current or future impact on a company's financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenue or expenses.

Pro Forma Financial Information: The Act mandates the SEC to adopt rules requiring that pro forma financial information included in SEC filings or company press releases be presented in a manner that: (i) is not misleading; and (ii) reconciles it with the financial condition and results of operations of the company under Generally Accepted Accounting Principles (GAAP).

Real Time Disclosure: One of Sarbanes-Oxley's most important reforms is the imposition of rapid disclosure requirements. Companies must disclose to the public "on a rapid and current basis" material changes in their financial condition or operations. The additional information must be presented in plain English and may include trend and quantitative information.

Reporting Insider Trades: Sarbanes-Oxley makes significant changes to the insider trading reporting rules. The Act requires insider trades of public company shares to be reported no later than the end of the second business day after the transaction. By August 2003, insider reports will have to be filed electronically and posted on the company's web site.

Enhanced Periodic SEC Review of Company Filings: The Act steps up SEC monitoring activity. The SEC must undertake "regular and systematic" reviews of company disclosures. Although the SEC currently reviews company filings, the Act goes further by setting out a number of factors that will trigger a review, including:

- material restatements of a company's financial results;
- significant volatility in a company's stock price;
- companies with the largest market capitalization;
- emerging companies with disparities in their price-to-earnings ratios; and
- companies whose operations significantly affect any material sector of the economy.

In addition to the foregoing, the Act mandates regular SEC reviews of all public companies at least once every three years.

AUDIT COMMITTEE STANDARDS AND RESPONSIBILITIES

Recognizing that audit committees have a critical role to play in overseeing a company's financial information, Sarbanes-Oxley makes a number of significant additions and changes to audit committee responsibilities and independence standards. The Act includes several provisions that increase the responsibility of audit committees.

Under SEC rules, no company will be allowed to have its securities listed on national securities exchanges unless it complies with the following audit committee requirements:

- the audit committee must be directly responsible for the appointment, compensation and oversight of the company's external auditor;
- the audit committee must be composed entirely of independent directors (a director will not be considered independent if he or she has accepted consulting, advisory or other fees [other than director's compensation] from the company, or is affiliated with the company);
- the audit committee must establish procedures for dealing with complaints received about the company's accounting, internal controls or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to hire independent counsel and advisors; and
- the audit committee must have funding to undertake its duties and to compensate hired advisors.

In addition, new SEC rules require companies to disclose whether or not their audit committee has a "financial expert" among its members, and if not, the reasons why.

AUDITOR OVERSIGHT AND INDEPENDENCE

The Enron fiasco has focused attention on the role of auditors. The company's rapid collapse and the apparent failure of its auditors to forewarn of the impending disaster have prompted widespread calls for rules to improve auditor oversight and limit conflicts of interest. Sarbanes-Oxley makes a number of changes on both fronts.

A. Auditor Oversight

With respect to auditor oversight, the Act creates the Public Company Accounting Oversight Board (PCAOB), a five-member panel funded primarily by assessments on public companies, charged with monitoring the audit of public companies that are subject to securities laws.

Authority of the Public Company Accounting Oversight Board: The responsibilities of the PCAOB include:

- registering accounting firms that audit publicly traded companies;
- establishing or adopting standards rules for auditing, quality control, ethics, and independence relating to the preparation of audit reports;
- conducting inspections of registered accounting firms; and
- conducting investigations and disciplinary proceedings and imposing sanctions against accounting firms.

B. Conflicts of Interest

Sarbanes-Oxley sets out a number of measures to promote auditor independence and address concerns about conflicts of interest.

Restricting Non-Audit Services: The Act prohibits audit firms from providing certain non-audit services to their audit clients. These include:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- design and implementation of financial information systems;

- appraisal or valuation services, and fairness opinions;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment advisor, or investment banking services; and
- legal services and expert services unrelated to the audit.

Other non-audit services, including tax services, are permitted, but only if pre-approved by a company's audit committee. Pre-approval is not required for non-audit services if: the aggregate amount of such services is less than five percent of the total amount paid by the company to the auditor; the services were not recognized by the company at the time of the audit engagement to be non-audit services; and the services were promptly brought to the attention of the audit committee and approved prior to the completion of the audit.

Audit Partner Rotation: Another reform aimed at reducing conflicts of interest and at increasing auditor independence is the imposition of an audit partner rotation requirement. Sarbanes-Oxley makes it mandatory for audit firms to change the lead partner and review partner on each audit engagement at least every five years.

Reports to Audit Committees: Auditors are required to provide reports to a company's audit committee with respect to:

- the company's critical accounting policies and practices; and
- alternative treatments of financial information that have been discussed with management, and the treatment preferred by the auditors.

Cooling-off Period: In a further effort to limit conflicts of interest, Sarbanes-Oxley imposes a one-year cooling-off period before accounting firms may provide audit services to companies that employ former accounting firm employees in company positions as CEO, CFO or chief accounting officer.

ACCOUNTABILITY FOR WRONGDOING

Sarbanes-Oxley includes a number of provisions that create additional criminal liability and increase penalties for violations. Among other things, the Act:

- imposes fines and/or up to 20 years' imprisonment for knowingly altering, destroying, mutilating, concealing, covering up, falsifying or making a false entry in any record or document with the intent to impede, obstruct or influence a federal investigation;
- requires auditors to retain their work papers and records for 5 years after the end of an audit period, and imposes fines and/or up to 10 years' imprisonment for knowingly violating the provision;
- prohibits the discharge in bankruptcy of debts in connection with violations of federal securities laws;
- extends the statute of limitations for private rights of actions for securities laws violations to the earlier of 5 years after the occurrence of such a violation or 2 years after the discovery of the facts constituting the violation;
- directs the United States Sentencing Commission to review and amend the Federal Sentencing Guidelines for obstruction of justice, including the destruction or alteration of evidence;
- imposes prison sentences of up to 20 years and/or fines of up to $5 million for any CEO or CFO who wilfully signs a false certification of a periodic report; and
- imposes fines and/or imprisonment for up to 25 years for any person who "knowingly executes, or attempts to execute, a scheme or artifice" to defraud a person in connection with any public company securities.

Whistle-Blower Protection: The Act also extends whistle-blower protection to employees of public companies and accounting firms. Employers are prohibited from retaliating against employees who provide information to assist securities fraud investigations.

Prohibition from Serving as Officers and Directors: The Act gives the SEC authority to prevent an individual who has violated the anti-fraud provisions of federal securities laws from serving as an officer or director of a public company where the individual's conduct "demonstrates unfitness" to serve in these positions.

Authority to Freeze Extraordinary Payments: Sarbanes-Oxley allows the SEC, during the course of an investigation involving possible violations of the federal securities laws by a publicly traded company or any of its directors, officers, partners, controlling persons, agents, or employees, to seek a temporary court order requiring the company to escrow any "extraordinary payments" to those persons in an interest-bearing account for 45 to 90 days or until the conclusion of any legal proceedings.

ANALYST CONFLICTS OF INTEREST/ATTORNEYS' RESPONSIBILITIES

Analysts: Sarbanes-Oxley requires the SEC, either directly or through a national securities exchange or a national securities association, to adopt rules to address potential conflicts of interest by research analysts. The SEC has approved rules proposed by the National Association of Securities Dealers, Inc. (NASD) and the New York Stock Exchange (NYSE), which aim to disclose potential conflicts of interest. The SEC is also in the process of supplementing the NASD and NYSE rules with those of its own.

Attorneys: The Act directs the SEC to establish minimum standards of professional conduct for attorneys who represent public companies before the SEC. Attorneys will have to report to the chief legal officer or CEO of a public company evidence of material violations of securities laws, breaches of fiduciary duty, or similar violations by the company or its agents. If these corporate officers do not respond appropriately to the attorney's report, the attorney must then report the evidence to the company's audit committee or board of directors.