Chapter 12

Appendix A: Sarbanes-Oxley and Other Recent Reforms

12.1 Overview

The Sarbanes-Oxley Act of 2002 imposes significant new disclosure and corporate governance requirements for public companies and also provides for substantially increased liability under the federal securities laws for public companies and their executives and directors. After it was adopted, the NYSE, NASDAQ, and AMEX adopted more comprehensive reporting requirements for listed companies, and the Securities and Exchange Commission (SEC) issued a host of new regulations aimed a strengthening transparency and accountability through more timely and accurate disclosure of information about corporate performance.

The most important changes concern director independence, the composition and responsibilities of the audit, nominating and compensation committees, shareholder approval of equity compensation plans, codes of ethics or conduct, the certification of financial statements by executives, payments to directors and officers of the corporation, the creation of an independent accounting oversight board, and the disclosure of internal controls.

12.2 Director Independence

New stock exchange listing requirements stipulate that the majority of directors of public companies be "independent."An exception is made for "controlled companies"—those for which more than 50% of the voting power is held by an individual, a group, or other company. The rules further state, "No director will qualify as independent unless the board affirmatively determines that the director has no material relationship with the listed company" and require companies to disclose determinations of independence in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

The rationale for increasing independence was that shareholders, by virtue of their inability to directly monitor management behavior, rely on the board of directors to perform critical monitoring activities and that the board's monitoring potential is reduced, or perhaps eliminated, when management itself effectively controls the actions of the board. Additionally, outside directors may lack independence through various affiliations with the company and may be inclined to support management's decisions in hopes of retaining their relationship with the firm. Requiring a board to have a majority of independent directors therefore increases the quality of board oversight and lessens the possibility of damaging conflicts of interest.

12.3 Audit Committees

Rule 10A-3 under the Exchange Act directs the stock exchanges and NASDAQ to require listed companies to have an audit committee composed entirely of independent directors. Subsequent stock exchange and SEC amendments further strengthened this provision by requiring the following, among other things:

- Each member of the audit committee is financially literate, as such qualification is interpreted by the board in its business judgment, or will become financially literate within a reasonable period of time after his or her appointment to the audit committee.
- At least one member of the audit committee is a "financial expert," defined as someone who has
    - an understanding of financial statements and generally accepted accounting principles;
    - an ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
    - experience preparing, auditing, analyzing, or evaluating financial statements;
    - an understanding of internal controls and procedures for financial reporting;
    - an understanding of audit committee functions.
- The audit committee has a charter that addresses the committee's purpose and sets forth the duties and responsibilities of the committee.
- The audit committee obtains and reviews an annual report by the independent auditor regarding the firm's internal quality-control procedures, discusses the audited financial statements with the independent auditor and management, and reports regularly to the board of directors.
- The audit committee is directly responsible for the appointment, compensation, retention, and oversight of the outside auditors. Additionally, the outside auditors must report directly to the audit committee.
- The audit committee has the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.
- The audit committee approves, in advance, any audit or nonaudit services provided by the outside auditors.

The reasons behind these reforms are self-evident. Audit committees are in the best position within the company to identify and act in instances where top management may seek to misrepresent reported financial results. An audit committee composed entirely of outside independent directors can provide independent recommendations to the company's board of directors. The responsibilities of the audit committee include review of the internal audit department, review of the annual audit plan, review of the annual reports and the results of the audit, selection and appointment of external auditors, and review of the internal accounting controls and safeguard of corporate assets.

12.4 Compensation Committees

New NYSE and SEC rules require that

- listed companies have a compensation committee composed entirely of independent directors;
- the compensation committee has a written charter that addresses, among other things, the committee's purpose and sets forth the duties and responsibilities of the committee;
- the compensation committee produces—on an annual basis—a compensation committee report on executive compensation, to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC.

These reforms respond to the unprecedented growth in compensation for top executives and a dramatic increase in the ratio between the compensation of executives and their employees over the last 2 decades. A reasonable and fair compensation system for executives and employees is fundamental to the creation of long-term corporate value. The responsibility of the compensation committee is to evaluate and recommend the compensation of the firm's top executive officers, including the CEO. To fulfill this responsibility objectively, it is necessary that the compensation committee be composed entirely of outside independent directors.

12.5 Nominating Committees

New NYSE and SEC rules stipulate that

- a listed company must have a nominating and corporate governance committee composed entirely of independent directors;
- the nominating and corporate governance committee must have a charter that addresses the committee's purpose and sets forth the goals and responsibilities of the committee.

Nominating new board members is one of the board's most important functions. It is the responsibility of the nominating committee to nominate individuals to serve on the company's board of directors. Placing this responsibility in the hands of an independent nominating committee increases the likelihood that chosen individuals will be more willing to act as advocates for the shareholders and other stakeholders and be less beholden to management.

12.6 Shareholder Approval for Equity-Compensation Plans

An **equity-compensation plan**[1] is a plan or other arrangement that provides for the delivery of equity securities (including options) of the listed company to any service provider as compensation for services. Equity-compensation plans can help align shareholder and management interests, and equity-based awards are often very important components of employee compensation. New NYSE and SEC rules require shareholder approval for stock option plans or other equity compensation plans and any material modification of such plans. These rules are subject to a significant number of exemptions, however. Separately, new accounting rules have changed the accounting of stock options.For more on this subject, see Chapter 8 "CEO Performance Evaluation and Executive Compensation" in this volume.

1. A plan or other arrangement that provides for the delivery of equity securities, including options, of the listed company to any service provider as compensation for services.

12.7 Codes of Ethics and Conduct

New rules also require that public companies must adopt and disclose a code of business conduct and ethics for directors, officers, and employees; include its code of business conduct and ethics on its Web site; and each annual report filed with the SEC must state that the code of business conduct and ethics is available on the Web site. The code of conduct must comply with the definition of a "code of ethics" set forth in section 406 of Sarbanes-Oxley and provide for an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.

12.8 Certification of Financial Statements

Sarbanes-Oxley requires the following:

- The principal executive officers and principal financial officers of public companies should provide a written statement with each periodic report that contains **financial statements**[2] certifying (a) the report complies with the requirements of section 13(a) or 15(d) of the Exchange Act; and (b) the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company
- The above certifications need to be filed separately with the SEC as exhibits to the periodic reports to which they relate.
- The principal executive officer and principal financial officer of the company must certify in each annual and quarterly report that
  - the certifying officers have reviewed the report;
  - to the certifying officers' 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 made, in light of the circumstances under which the statements were made, not misleading;
  - to the certifying officers' 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 the dates of, and for the periods presented in, the reports;
  - the certifying officers (a) are responsible for establishing and maintaining effective internal controls, (b) have designed such internal controls to ensure that material information relating to the company is made known to them, (c) have evaluated the effectiveness of the controls as of a date within 90 days prior to the filing of the report, (d) have presented in the report their conclusions about the effectiveness of the controls, (e) have disclosed to their outside auditors and audit committee any significant deficiencies in the internal controls and any fraud involving management or other employees who have a significant role in the company's internal controls, (f) have identified for the outside auditors any material weaknesses in the internal controls, and (g) have indicated in the report whether or not there were significant changes in the internal controls that could affect those controls, including any corrective actions.

2. The certification of a financial statement through the audit and sign off of an accountant.

Any CEO or CFO who provides the certification knowing that the report does not meet the above-listed standards can be fined up to $1 million, imprisoned for up to 10 years, or both.

12.9 Payments to Directors and Officers

Sarbanes-Oxley and subsequent SEC directives stipulate that

- no public company may make a personal loan to a director or officer, and existing loans may not be materially modified or renewed;
- the CEO and CFO of a public company that restates its financial statements as a result of misconduct will have to forfeit any bonuses, incentives, equity-based compensation, and profits on sales of company stock realized during the 12-month period following the first public issuance of the financial document or report containing the inaccurate financial statements;
- the SEC has the authority to freeze any extraordinary payments by the company to any of its directors or officers while an investigation is ongoing;
- the SEC can bar a person who has violated section 17(a) of the Securities Act of 1933 or section 10(b) of the Exchange Act from serving as a public company director or officer;
- directors, officers, and 10% of stockholders of public companies are required to report changes in beneficial ownership within 2 business days after the relevant transaction;
- directors and executive officers are prohibited from buying or selling equity securities during a blackout period;
- nonmanagement directors are required to meet in regularly scheduled executive sessions without management present.

12.10 Creation of the PCAOB

The **Public Company Accounting Oversight Board (PCAOB)**[3] is a private-sector, nonprofit corporation created by Sarbanes-Oxley to oversee accounting professionals who provide independent audit reports for publicly traded companies. Its responsibilities include

- registering public accounting firms;
- establishing auditing, quality control, ethics, independence, and other standards relating to public company audits;
- conducting inspections, investigations, and disciplinary proceedings of registered accounting firms;
- enforcing compliance with Sarbanes-Oxley.

When Congress created the PCAOB, it gave the SEC the authority to oversee the PCAOB's operations, to appoint or remove members, to approve the PCAOB's budget and rules, and to entertain appeals of PCAOB inspection reports and disciplinary actions.

3. A private-sector, nonprofit corporation created by Sarbanes-Oxley to oversee accounting professionals who provide independent audit reports for publicly traded companies.

12.11 Disclosure of Internal Controls

As directed by section 404 of Sarbanes-Oxley, the SEC adopted a rule requiring registered companies to include in their annual reports a report of management on the company's internal control over financial reporting. The **internal control report**[4] must include

- a statement of management's responsibility for establishing and maintaining adequate internal controls;
- a management assessment of the effectiveness of the company's internal controls including disclosure of any material weaknesses;
- a statement identifying the framework used by management to evaluate the effectiveness of internal controls;
- a statement that the independent auditors have issued an attestation report on management's assessment of the company's internal controls over financial reporting. In addition, companies must provide disclosure about off-balance-sheet transactions in registration statements, annual reports, and proxy statements.

4. A rule within Sarbanes-Oxley that requires registered companies to include in their annual reports a report on the company's internal control over financial reporting.