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Counseling Clients under the Sarbanes-Oxley Act

Lingering skepticism and suspicion toward corporate governance, fueled by the headline-grabbing scandals of the last 18 months, fostered the passage last summer of the Sarbanes-Oxley Act. The act imposes new duties on public companies and their CEOs, board members, and auditors, while expanding the criminal and civil liabilities for securities violations.

While the act currently affects only public companies, some experts predict that its provisions will trickle down to nonpublic companies as well.

As clients struggle to comply, their counsel will need to meet with boards of directors and offer advice on, among other things, establishing and operating audit committees.

Audit Committee Composition

The legislation expands the role of the audit committee but places greater restrictions on who may serve. Every member of the audit committee must be independent of the company. To qualify as "independent," a member may not:

1. accept any compensation from the company other than for service as a member of the board of directors, or
2. be affiliated with the company or any of its subsidiaries.

In addition, proposed rules recently issued by the Securities and Exchange Commission (SEC) under the act would require a company to disclose the number and name of "financial experts" on the committee. It would also require the company to specify that the experts are independent of management or, if not, why they are not.

The SEC has indicated that a financial expert must have experience in the company's industry, or with "comparable issuers" of financial statements.

Audit Committee Operations

Once established, the audit committee has sole responsibility for hiring, compensating, and overseeing auditors. Auditors are prohibited from performing certain nonaudit services while performing audit services for the company.

While some have speculated that this restriction on performing nonaudit services could mark the demise of multidisciplinary practices, it may be too soon to tell. Accountants will still be allowed to market consulting services to their non-SEC clients or to SEC clients of other accounting firms.

The audit committee now has greater latitude in hiring outside consultants to enhance its own performance, including independent counsel, perhaps providing more opportunities for attorneys. The company must provide appropriate funding for these consultants, as determined by the committee.

Finally, audit committees will likely need advice on establishing the required procedures for protecting corporate whistleblowers. The procedures must address:

1. the treatment of complaints received relating to accounting, internal accounting controls, or auditing matters, and
2. the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

The Sarbanes-Oxley Act may have even greater implications if the rules trickle down to private companies.

Lending institutions, for example, may begin to require CEO-certification of financial statements, as is now required quarterly and annually for public companies. And attorneys should be prepared to advise their private company clients on the requirements for auditor independence.