Focus

New Certification Regulations Present Challenges for Issuers

By Terence McCormick

On Aug. 29, 2002, the Securities and Exchange Commission issued final rules implementing the certifications required by Section 302 of the Sarbanes-Oxley Act. These certifications are mandatory for all periodic reports filed under the Exchange Act of 1934.

In response to the accounting scandals at Enron and WorldCom, the commission built into the certification requirement additional disclosure regulations that impose new burdens on public companies. The task facing securities issuers today is to comply with these regulations before the commission announces enforcement proceedings.

The new certification regime began when Congress, eager to respond to the Enron crisis, tried to expand potential Exchange Act liability for the chief executive officer and chief financial officer of each publicly traded company.

Congress reasoned that those responsible for hiding material information from investors in an issuer's Exchange Act report would be deterred from such conduct if they personally were required to certify three things: the truth of such reports, the adequacy of internal controls and the accurate presentation of the issuer's financial condition, results of operations and cash flows.

Consequently, Section 302 requires that the principal executive and financial officers certify that they are responsible for creating and maintaining "internal controls" and that they have evaluated the internal controls within 90 days before the date of the report. It further requires that they include in the report their evaluation of the effectiveness of those controls.

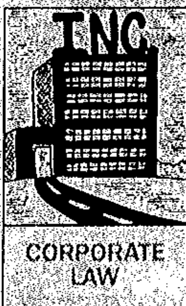
Initially, these certifications may seem unremarkable. The principal financial officer was required to execute the quarterly report on Form 10-Q, filed with the commission under the Exchange Act, and the annual report on Form 10-K, which the principle executive officer also signed.

They also were subject to the anti-fraud provisions of Rule 10b-5, which imposes liability for fraud and material misrepresentations in connection with the purchase or sale of securities as well as liability under Section 20 of the Exchange Act for people who have the power to control the activities of a public company.

Moreover, issuers have internal controls in place to ensure that their transactions are properly authorized, that assets are safeguarded against unauthorized use and that their transactions are properly recorded in conformity with generally accepted accounting principles.

However, the concept of internal controls expanded in the rule-making process, presenting new challenges for public companies.

The Sarbanes-Oxley Act directed the commission to develop rules implementing Section 302. In its proposing release, the commission introduced the notion that the certification should address not only "internal controls" as they have traditionally been understood but also the procedure by which nonfinancial information



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flows through the issuer's personnel up to the signing officers.

In the final rules, the commission introduced a new term, "disclosure controls and procedures." Issuers are to design these procedures to ensure that both financial and nonfinancial information be "recorded, processed, summarized and reported" within the period required by the rules.

The commission dealt with the certification requirement separately from the substantive obligation of the issuer's management to maintain and evaluate disclosure-control procedures. Under Rules 13a-14 and 15d-14, the certification must appear at the end of each quarterly or annual report filed or submitted under either Section 13(a) or 15(d) of the Exchange Act (for domestic issuers, this covers periodic reports, and any subsequent amendments, on Forms 10-Q, 10-QSB, 10-K, 10-KSB, and, for foreign issuers, Forms 20-F and 40-F).

In addition to the certification rules, Rules 13a-15 and 15d-15 require the issuer to conduct an evaluation of the effectiveness of its disclosure controls and procedures within 90 days before the filing of the quarterly or annual report.

The commission did not supply the substance of the required disclosure controls. However, it did "recommend" that issuers create a committee to consider the materiality of information and determine disclosure obligations on a timely basis. It even suggested possible members: the principal accounting officer (or the controller), the general counsel, the risk management officer and chief investor-relations officer. These suggestions immediately became de facto rules.

Companies now are preparing the first 10-K's under the new regime of Sarbanes-Oxley. Although the drafting process used to be less bureaucratic, particularly for the 10-Q and certainly for small issuers, Sarbanes-Oxley regulates the process more directly than ever.

If an issuer wishes to immunize itself from liability under Section 302, it should form the "recommended" committee well before filing the next 10-K. Failure to do so may lead to liability on two fronts. First, if a reporting company is found not to have maintained and evaluated its disclosure controls, then the chief executive officer and chief financial officer face liability for a false certification. Second, in a civil action against the company, the absence of a disclosure committee could become an uncomfortable "bad fact."

Lawyers representing reporting companies should counsel their clients to respond to the new rules proactively. However, zealous advocacy does not require a "one size fits all approach." Practitioners should tailor the procedures to the personnel constraints of the client, lest the client find itself no longer in the business of producing goods and services, but instead of holding "group hugs" over the 10-Q.

The following are some useful ideas to consider:

■ **The disclosure committee.** The number of people on the committee need not be any larger than those employees who are responsible for preparing the issuer's reports. Small issuers, for example, may not have a general counsel or a dedicated internal controls officer. However, it may be useful to include the heads of business units, at least for the relevant portions of the management's discussion and analysis section of the report.

■ **Documenting compliance.** Although formal procedures for the disclosure committee, such as holding regular meetings, may not always be appropriate, the issuer should document that it has gone through whatever disclosure procedures it has adopted, in the form of a checklist, a full-blown "disclosure committee charter" or minutes of the committee's meetings.

One frequently heard proposal, requiring the members of the committee to certify to the chief executive officer and the chief financial officer their own compliance with these procedures, is of doubtful usefulness. Although it may focus those employees on their responsibilities, an internal "certification underlying the certification" will not exonerate the chief executive officer and chief financial officer of their own responsibility under the act. At best, it would generate waste paper and, at worst, sleepless nights for key employees, particularly the controller.

A more useful paper trail would include a confirmation that the work papers underlying the report have been reconciled to the final report before filing.

■ **The disclosure procedures.** A checklist of steps to be followed and responsible employees is a reasonable way to comply with the act. At a minimum, the checklist should identify drafting responsibility for disclosure of related-party transactions, risk factors and the management's discussion and analysis section of the report.

In addition, in light of the recent controversies at Enron, WorldCom and other issuers, the chief executive officer and chief financial officer, as well as the disclosure committee, if one is formed, should scrutinize the issuer's off-balance-sheet transactions and revenue recognition and other accounting issues that have formed the basis for recent pronouncements by the commission.

■ **Awareness of federal reporting regulations.** People responsible for preparing the issuer's Exchange Act reports must be proficient with the instructions to Forms 10-Q and 10-K, including Regulations S-K and S-X. There can be no substitute, however, for review by counsel, including a rules check of the draft report.

■ **Don't procrastinate.** Before Sarbanes-Oxley, reports on Form 10-Q were due within 45 days after the end of the fiscal quarter, and the report on Form 10-K was due to be filed within 90 days after the end of the fiscal year. The commission now is phasing in accelerated filing dates. As a result, issuers should consider preparing their reports and evaluating their disclosure procedures earlier than they traditionally have. Although financial information is not available before the end of the period, significant portions of the management's discussion and analysis section of the report can be prepared in advance.

It remains to be seen whether Section 302 will meaningfully deter fraud. However, the new certification and disclosure regulations promulgated under the authority of Section 302 are a reality. The challenge for practitioners is to adapt to these regulations in ways that enhance the flow of information without imposing undue burdens on the client.

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