

# Accounting Roundup

## Special Edition—Sarbanes-Oxley Update

January 24, 2003

### SEC Adopts Several Rules Implementing Sarbanes-Oxley Act

[Open Meeting—January 15, 2003](#)

- [Conditions for Use of Non-GAAP Financial Information](#)
- [Form 8-K Amendments](#)
- [Disclosure Requirements—Financial Experts, Code of Ethics](#)
- [Rules Restricting Insider Trading During Pension Fund Blackout Periods](#)

[Open Meeting—January 22, 2003](#)

- [Retention of Records Relevant to Audits and Reviews](#)
- [Disclosure of Off-Balance-Sheet Arrangements and Aggregate Contractual Obligations](#)
- [Rules Strengthening Auditor Independence](#)

The purpose of this publication is to briefly describe key regulatory and professional developments that have recently occurred in the field of accounting and to provide links to locations where additional information can be found on each topic. Readers seeking additional information about a topic should review the information referred to in the hyperlinks and not rely solely on the descriptions included in this communication.

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### SEC Adopts Several Rules Implementing Sarbanes-Oxley Act

Signed into law by President George W. Bush on July 30, 2002, the Sarbanes-Oxley Act of 2002 aims to improve corporate responsibility and the quality and transparency of financial reporting. The Act will have a major impact on publicly held companies and their outside professional advisors. Specifically, the Sarbanes-Oxley Act:

- Creates criminal penalties and prison terms for company fraud and illegal document shredding
- Prohibits certain loans from companies to their executives and directors
- Empowers the U.S. Securities and Exchange Commission (SEC) to bar executives convicted of fraud from future service as corporate officers and directors
- Imposes restrictions on the nonaudit services that accounting firms may provide to their publicly held audit clients
- Extends the period of time in which defrauded investors may bring lawsuits against companies
- Establishes an independent oversight board for the accounting profession, which is overseen by the SEC.

Following passage of the Sarbanes-Oxley Act, the SEC undertook a number of initiatives to help ensure compliance with the Act. These initiatives resulted in the issuance of several proposed rules. The comment period has now ended for many of the proposed rules, and the SEC voted to adopt many of them at its open meetings on January 15 and January 22, 2003. With the exception of the rule pertaining to conditions for use of non-GAAP financial information, the final rules are not yet available on the SEC's website; however, the summaries below provide links to press releases describing the respective rules. Much of the information contained in this issue of *Accounting Roundup* is extracted verbatim from the SEC's press releases. The SEC intends to post the final rules as soon as possible to its website, <http://www.sec.gov>.

#### Open Meeting—January 15, 2003

##### **Conditions for Use of Non-GAAP Financial Information**

The SEC's rules under Section 401(b) of the Sarbanes-Oxley Act will apply to the public disclosure or release of material information that includes a "non-GAAP financial measure." For this purpose, a "non-GAAP financial measure" will be defined as a numerical measure of a company's financial performance that (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable measure so calculated and presented. Statistical and operating measures are not covered.

The SEC voted to adopt new Regulation G, which (1) will apply when a company publicly discloses or releases material information that includes a non-GAAP financial measure, (2) will prohibit material misstatements or omissions that would make the presentation of the material non-GAAP financial measure, under the circumstances in which it is made, misleading, and (3) will require a quantitative reconciliation of the differences between the non-GAAP financial measure presented and the comparable financial measure calculated and presented in accordance with GAAP. Regulation G will provide a limited exception for certain foreign private issuers.

Amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B will apply to the same categories of non-GAAP financial measures as those covered by Regulation G, but will contain more detailed requirements. The SEC also decided to adopt the amended Exchange Act Form 20-F to apply these requirements to annual reports filed with the SEC by foreign private issuers.

The final rule is available on the SEC's website at <http://www.sec.gov/rules/final/33-8176.htm>.

## **Form 8-K Amendments**

The SEC voted to adopt amendments to Form 8-K to require public companies to furnish to the SEC releases or announcements disclosing material nonpublic financial information about completed annual or quarterly fiscal periods. These amendments will not require the issuance of earnings releases or similar announcements. However, such releases and announcements will trigger the new requirement. The new Form 8-K requirement will apply regardless of whether the release or announcement included disclosure of a non-GAAP financial measure.

Public disclosure of financial information for a completed fiscal period in a presentation that is made orally, by telephone, by webcast, by broadcast, or by similar means will not be required to be filed if (1) the presentation occurs within 48 hours of a related release or announcement that is filed on Form 8-K, (2) the presentation is broadly accessible to the public, and (3) the information in the webcast is posted on the company's website.

## **Disclosure Requirements—Financial Experts, Code of Ethics**

The SEC voted to adopt rules implementing Sections 406 and 407 of the Sarbanes-Oxley Act that will require public companies to disclose information about corporate audit committee financial experts and codes of ethics.

### **Audit Committee Financial Experts**

The rules will expand the proposed definition of the term *financial expert* and also substitute the designation *audit committee financial expert* for *financial expert* and define *audit committee financial expert* to mean a person who has the following attributes:

- 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 in preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities
- An understanding of internal controls and procedures for financial reporting
- An understanding of audit committee functions.

According to the rules, a person can acquire such attributes through any of the following means:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions that involve the performance of similar functions

- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions, or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements
- Other relevant experience.

An individual will have to possess all of the attributes listed in the above definition to qualify as an audit committee financial expert. Furthermore, the rules will eliminate the proposed requirement that a person's experience applying generally accepted accounting principles in connection with accounting for estimates, accruals, and reserves be "generally comparable" to the estimates, accruals, and reserves used in the registrant's financial statements.

The rules also will provide a safe harbor to make clear that an audit committee financial expert will not be deemed an "expert" for any purpose, including for purposes of Section 11 of the Securities Act of 1933, and that the designation of a person as an audit committee financial expert does not impose any duties, obligations, or liability on the person that are greater than those imposed on such a person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations, or liability of any other member of the audit committee or board of directors.

## **Code of Ethics**

Under the rules, a company will be required to disclose in its annual report whether it has a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions. The rules will define a code of ethics as written standards that are reasonably necessary to deter wrongdoing and to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships
2. Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with or submits to the SEC and in other public communications made by the company
3. Compliance with applicable governmental laws, rules, and regulations
4. The prompt internal reporting of code violations to an appropriate person or persons identified in the code
5. Accountability for adherence to the code.

A company will be required to make available to the public a copy of its code of ethics or the portion of the code that applies to the company's principal executive officer, principal financial officer, principal accounting officer, or controller, or persons performing similar functions.

A company, other than a foreign private issuer or registered investment company, also will be required to disclose any changes to or waivers of the code of ethics within five business days, to the extent that the change or waiver applies to the company's principal executive officer or senior financial officers.

## ***Rules Restricting Insider Trading During Pension Fund Blackout Periods***

The SEC adopted new Regulation Blackout Trading Restriction (BTR) under the Securities Exchange Act of 1934 to clarify the scope and application of Section 306(a) of the Sarbanes-Oxley Act and to prevent evasion of the statutory trading prohibition.

Regulation BTR will incorporate a number of concepts developed under Section 16 of the Exchange Act, which will enable issuers to use the well-established body of rules and interpretations concerning the trading activities of corporate insiders in interpreting how Section 306(a) operates and, with regard to directors and executive officers of domestic issuers, facilitate enforcement of the statutory trading prohibition through the monitoring of the reports publicly filed by directors and officers pursuant to Section 16(a) of the Exchange Act.

Regulation BTR will define the persons, transactions, and types of securities subject to the Regulation, as well as blackout periods and remedies for violation of the rule.

A press release pertaining to the three rules discussed above (Form 8-K Amendments, Disclosure Requirements—Financial Experts and Code of Ethics, and Insider Trading and Pension Fund Blackout Periods) is available on the SEC's website at <http://www.sec.gov/news/press/2003-6.htm>.

## **Open Meeting—January 22, 2003**

### ***Retention of Records Relevant to Audits and Reviews***

The SEC approved the adoption of Rule 2-06 of Regulation S-X to implement Section 802 of the Sarbanes-Oxley Act relating to the retention of audit and review workpapers and records. The rule defines the term *workpapers* and the types of documents to be retained, which include workpapers and other documents that form the basis of the audit or review and memoranda, correspondence, communications, other documents, and records (including electronic records) that are created, sent, or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit or review.

The rule will require that records be retained for seven years after the auditor concludes the audit or review of the financial statements, instead of the proposed period of five years from the end of the fiscal period in which an audit or review was concluded. This change will coordinate the SEC's rule with the forthcoming auditing standards from the Public Company Accounting Oversight Board (PCAOB), which will require the retention of audit documentation for seven years.

The rule addresses "differences of opinion" between the registrant and the auditors. Auditing literature requires that records be retained only if they "support" the auditor's report; Rule 2-06(c), however, will require auditors to keep records that either support the auditor's final conclusions or contain information or data relating to a significant matter that is inconsistent with the final conclusions of the auditor on that matter or on the audit or review.

Rule 2-06(c) will also state that the documents and records to be retained include, but are not limited to, those documenting consultations on or resolutions of differences in professional judgment.

The press release describing this rule is available at <http://www.sec.gov/news/press/2003-11.htm>.

### ***Disclosure of Off-Balance-Sheet Arrangements and Aggregate Contractual Obligations***

The SEC voted to adopt amendments to implement Section 401(a) of the Sarbanes-Oxley Act, which adds Section 13(j) to the Securities Exchange Act of 1934 establishing rules that require each annual and quarterly financial report required to be filed with the SEC to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

The amendments approved by the SEC are generally consistent with the proposed rules and require a registrant to provide an explanation of its off-balance-sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis (MD&A) section in its disclosure documents. The amendments also will require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format.

The amendments will include a definition of *off-balance-sheet arrangements* that has been refined from the proposal to encompass only the following categories of contractual arrangements:

- Certain guarantee contracts as defined in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45)
- Retained or contingent interests in assets transferred to an unconsolidated entity
- Derivative instruments that are classified as equity
- Material variable interests defined by reference to FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, in unconsolidated entities that conduct certain activities.



The amendments will require disclosure of off-balance-sheet arrangements that either have or are *reasonably likely* to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. The *reasonably likely* probability threshold for disclosure in the final rule differs significantly from the proposal, which required disclosure of off-balance-sheet arrangements unless the likelihood of material effect was *remote*. The *reasonably likely* threshold is consistent with the existing standard that governs other disclosures in MD&A.

The amendments will require disclosure of the following specified information to the extent necessary to an understanding of off-balance-sheet arrangements and their material effects:

- The nature and business purpose of the registrant's off-balance-sheet arrangements
- The importance to the registrant for liquidity, capital resources, market risk or credit risk support, or other benefits
- The financial impact and exposure to risk
- Known events, demands, commitments, trends, or uncertainties that affect the registrant's ability to benefit from its off-balance-sheet arrangements.

Consistent with the existing MD&A requirements, the amendments will contain a principles-based requirement that a registrant provide such other information that it believes is necessary for an understanding of its off-balance-sheet arrangements and their specified material effects.

In addition, the amendments will include a requirement for registrants to disclose, in a tabular format, the amounts of payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods. The categories of contractual obligations to be included in the table are defined by reference to the applicable accounting literature.

The proposed rule had included disclosure requirements for contingent liabilities; however, that requirement has been deleted because it is now covered by the recently issued FIN 45.

Registrants will be required to comply with the disclosure requirements for off-balance-sheet arrangements in SEC filings that are required to include financial statements for the fiscal years ending on or after June 15, 2003. Registrants will be required to comply with the disclosure requirements for the table of contractual obligations in SEC filings that are required to include financial statements for the fiscal years ending on or after December 15, 2003. Registrants may voluntarily comply with the new disclosure requirements before the compliance dates.

The press release describing this rule is available at <http://www.sec.gov/news/press/2003-10.htm>.

## **Rules Strengthening Auditor Independence**

The SEC voted to adopt rules to fulfill the mandate of Title II of the Sarbanes-Oxley Act to strengthen auditor independence and require additional disclosures to investors about the services provided to issuers by the independent accountant.

The SEC approved measures that will:

- Revise the rules related to the nonaudit services that, if provided to an audit client, would impair an accounting firm's independence
- Require that certain partners on the audit engagement team rotate after no more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempt from this requirement
- Establish rules that an accounting firm would not be independent if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures

- Establish rules that an accountant would not be independent of an audit client if any "audit partner" received compensation based on the partner procuring engagements with that client for services other than audit, review, and attest services
- Require the auditor to report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer
- Require the issuer's audit committee to preapprove all audit and nonaudit services provided to the issuer by the auditor
- Require disclosures to investors of information related to audit and nonaudit services provided by, and fees paid to, the auditor.

The press release describing this rule is available on the SEC's website at <http://www.sec.gov/news/press/2003-9.htm>.

## Deloitte Accounting Research Tool Available

Deloitte & Touche is making available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called the Deloitte Accounting Research Tool (DART), the library includes material from the FASB, the EITF, the AICPA, and the SEC, in addition to Deloitte & Touche's own accounting manual and other interpretative accounting guidance.

Updated every business day, DART has an intuitive design and navigation system, which, together with its powerful search features, enables users to quickly locate information anytime, from any computer. Additionally, DART subscribers receive periodic e-mails highlighting recent additions to the DART library.

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