

Sarbanes-Oxley Three Years On

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This is the year when the curse of Enron really strikes and companies have to comply with the mass of regulations that was put together in the post-Enron crisis. Its high point is the Sarbanes-Oxley Act. Neither Paul Sarbanes, nor Mike Oxley the two legislators who coproduced the Act could have imagined the outcome of their product. It has spawned a huge industry in their name, that companies are spending \$5 million each to comply with the requirements, the relatively brief legislation has been expanded to hundreds of thousands of words and there is a whole class of auditors and lawyers who are earning millions in interpreting or rather misinterpreting what they have intended. Neither would have imagined that the accounting companies whose powers they wished to clip because of their involvement in corporate history's biggest scandals would profit so hugely from this legislation and double their income from its implementation.

Latest survey by the Corporate Executive Board shows that US audit fees have, on average, doubled. The lowest increase in 2004 was 78 % achieved by Deloitte. The highest was PwC with 134% increase. Sarbanes-Oxley has provided the biggest boost to the Big Four accounting firms, much more than they could ever imagined.

Though Arthur Anderson was the star performer in Enron scandal, Lynn Turner, Chief Accountant of the SEC for 1998-2001, who earlier was a partner of Coopers & Lybrand admitted in a TV interview: "All the Big Five accounting firms helped Wall Street investment banking firms to engineer hypothetical transactions to make companies look better that they actually were". We should in fact be grateful to Enron for throwing open the murky world of corporate finance and providing us the opportunity of getting real with the huge problem of cleansing it. Arthur Levitt, former Chairman of SEC tried for four years to curtail the power of accounting profession. He could not even get the Big Five to meet in the office. Finally, he had to hold it in the office of one of them.

The Sarbanes-Oxley Act of 2002 (also referred to as "SOX" and "Sarbox") requires all public companies doing business in the US to follow a comprehensive accounting framework. SOX means that companies will be required to disclose certain financial information publicly in a standard and transparent manner.

It has been said that the Sarbanes-Oxley Act is the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the US securities laws of the early 1930s.

Sarbanes-Oxley is not merely a US problem, it has relevance for many organisations, particularly for subsidiaries of US corporations. And it is far from being the end of the story; similar legislation is appearing within Europe and it is likely that the principles of Sarbanes-Oxley will be taken up by regulatory authorities outside of the US as guidelines for good corporate governance.

Nor is SOX just an issue for a company's internal accounting professionals and external auditors. Compliance with the new regime which it imposes can have significant implications for its IT systems and IT providers (internal and external) as well.

SOX was enacted in the US in July 2002 as a response to high-profile accounting and document-tampering scandals which cast an unwelcome shadow over the credibility of US company financial information and so became a risk to US company investment. It is named after its two authors Paul Sarbanes (Democratic Senator) and Michael Oxley (Republican Congressman).

The key element of the new SOX regulations is the requirement that companies must establish, and then maintain, accounting procedures that eliminate any possibility of so-called "creative" accounting. Any hint of creative accounting should be eliminated from the financial reports, removing any possibility of interpretation. Additionally, financial reports must be capable of withstanding close scrutiny; they should be auditable and supported by all relevant data. Further, such reports should be tamper-proof. Systems will need to be in place which will identify who has accessed data, and when, such that a full audit stream can be identified.

The Act is intended to address the problems that generated it by instituting various new levels of control and sign-off such that financial reporting provides full and accurate disclosure and corporate governance is completely transparent.

Its major provisions include:

- certification of financial reports by CEOs and CFOs
- ban on personal loans to Executive Officers and Directors
- accelerated reporting of trades by insiders
- prohibition on insider trades during pension fund blackout periods
- civil penalties added to disgorgement funds for the relief of victims
- additional disclosure
- auditor independence, including outright bans on certain types of work and pre-certification by the company's Audit Committee of all other non-audit work
- criminal and civil penalties for securities violations

There are three areas of particular concern to those involved in IT audit and control. Section 302 requires the CEO and CFO to personally sign off on the appropriateness of the firm's financial statements (see also section 1102 regarding tampering with records). Section 404 covers attestation of the adequacy of financial reporting controls. Section 404 means that organisations must not only introduce adequate systems in the first place but must also assess the adequacy of those systems on an annual basis. The third section of direct relevance is section 409 which calls for real-time reporting.

The introduction of SOX is already having a huge impact on hundreds of companies operating in Europe who need to be compliant with the legislation or face heavy penalties. This impact is neatly demonstrated by the increasing instance of job opportunities being advertised for those with experience in SOX (often in combination with experience of International Financial Reporting Standards – the adoption of which next year for European listed companies is another major accounting change).

Provided that the requirements for application highlighted above are met (essentially where a UK or mainland European company is, or securities issued by it are, registered on a US exchange), an organisation will be covered and will need to take action, regardless of that organisation's domicile.

The implementation of SOX leaves much to be desired. Despite its avowed purpose to protect the investors, the investors feel they have been shortchanged. Sarbanes-Oxley Act was legislated to force CEOs to take personal responsibility for financial reporting and building up control systems to ensure its accuracy. The result has created a bureaucratic nightmare and shown that the US approach continues to tick every box and preferably several times over. The legislation is making the US accounting profession a joke. Excessive regard for following the rules to the letter has altered the accounting landscape and the driving purpose of the audit. Essentially audit is supposed to be conducted on behalf of the investor to protect their investment and report on the integrity of financial reporting. Contrarily, the profession is becoming an agent of the regulator. Every clause of the Act is being subjected to hair splitting by auditors to protect themselves from falling foul of their new boss – Public Company Accounting Oversight Board (PCAOB), the new regulator appointed under the Sarbanes-Oxley Act.

Section 404 is a short section that lays down the responsibility of chairman and CEO for disclosure. But the auditor/consultant/lawyer industry spawned by the Act for its implementation has expanded it into thousands of words.

There is a great danger that the burgeoning, bureaucratic and box driven process is negating the very purpose of the Act and its fundamentals are being lost in egregious detail. The traditional exercise of judgement has given place to following the letter of the law as per regulator's rules.

Auditors are supposed to protect investors. Unfortunately, it is they are the ones who are being left out. The Big Four simply cannot cope with the astronomical demand for their audit services created by Sarbox. Investor has been a loser because just four big firms would not provide the degree of competition, security and choice that is needed. Secondly, in order to keep themselves on the right side of the regulation, the big four are dropping clients that they see as risky. These clients go to the third tier accounting firms. But they too have little resources and are working to overcapacity.

Despite all the hoopla and enormous resources and money spent on its implementation there is little change in the attitudes. Auditors have become even more important than they were during Arthur Levitt's days. William Donaldson, the SEC Chairman, has been acutely concerned with the shenanigans of both lawyers and auditors. Speaking to a Washington audience of more than 1000 securities lawyers he said lawyers and auditors are crucial gate keepers for the integrity of the markets.

Lapses over the past few years by outside advisers directly contributed to financial frauds that devastated thousands of investors, he said. "I hope you will not expend significant time, money and energy devising structures aimed at evading requirements and trying to achieve an accounting or disclosure result that . . . artfully dodges the rule's purpose," Donaldson said.

The SEC has lodged 76 cases against lawyers in the past 3 1/2 years, chief litigation counsel David L. Kornblau said in a separate Practising Law Institute session yesterday. Kornblau said 18 cases have been filed already this fiscal year.

"These lawyers did not seem to have in their vocabulary the word 'no,'" Kornblau said.

The conduct of auditors at accounting firms of all sizes also remains on the SEC's radar screen. Agency officials said they will continue to scrutinize auditors' relationships with their clients for possible violations of independence rules. They said they expect more enforcement actions to come in cases where auditors have grown too cozy with their clients to render impartial reviews of financial reports.

Separately, SEC chief accountant Donald T. Nicolaisen laid out several of his priorities for 2005. Donaldson said his office soon would release a report about corporate use of off-balance-sheet entities such as those that hid billions of dollars of Enron Corp. debt.

Nicolaisen also said the agency staff would provide guidance later this year for companies on how to value stock options on their financial statements. Accounting standard-setters are mandating that companies for the first time treat stock options, or chances for employees to buy stock at a set price and time frame, as an expense on their books. The move has proved controversial for technology firms, which used stock options heavily as an employee recruitment and retention tool.

But the issue that appeared to generate the most heat at yesterday's conference involves reviews of corporate financial controls, one of the most expensive and controversial changes mandated in the 2002 Sarbanes-Oxley law. The SEC will host a public roundtable next month to hear suggestions about how to streamline the rules, sometimes referred to as Section 404 of the law. The rules require corporate executives to personally vouch for the effectiveness of their fiscal checks and balances.

SEC Enforcement Division chief Stephen M. Cutler nodded to the controversy when he said the agency was considering its own reality-based TV show, "Corporate Fear Factor," where "big-time executives have to eat worms, jump out of a moving car, and for a final test, they have to sign a Sarbanes-Oxley 404 certification."

The answer of course is not withdrawal of the act or even delisting from US bourses which many European firms are threatening. All said and done the Act provides an excellent self-improvement, risk management opportunity and therefore, is of considerable competitive advantage. This advantage, however, is diminished if the implementation is focused on box ticking. Nonetheless in a survey conducted by PwC of 1300 two thirds of the CEOs interviewed felt that the money spent on its implementation was an investment.

Most CEOs understand that improving corporate governance by strengthening board expertise, board oversight and exercise of better internal controls to manage risks, would improve managerial effectiveness and add significant benefits and savings. The compliance can result in enhanced reputation, increased operational effectiveness, higher employee moral, improved customer loyalty and more transparent engagement with civil society. Transparency is the heart of corporate governance. With the increasing demands on disclosures, companies cannot survive without putting in place internal control architecture that will enable timely disclosures without risking reputation.

The globalisation today offers huge opportunities for proactive businesses. Today's business is dealing with only a fraction of the infinite field of available options. There are enormous opportunities for innovation and creativity. But innovation does require investment. Transparency can work wonders in improving company's credibility and access to global capital.

The real management challenge for global companies lies in creating systems for global governance that comply with stakeholder expectations right across their global operations and help them to build new markets and increase profitability. One of the nagging worries of the businesses after Enron and WorldCom directors accepted to compensate company losses from personal funds is to attract quality independent directors. Companies that have developed robust compliance programme and transparent structures would make them ideal choices for qualified directors.

William Donaldson is currently reviewing the effectiveness of Section 404 of SOX. He has already provided the breathing space for the overseas issuers an additional year to comply with is most complex provisions. Foreign companies with U.S. listings will have until July 15 next year to comply with Section 404. The pressure of delisting is perhaps overdone. Foreign companies realise the advantage that a US listing provides. This gives them access to the world's deepest capital market. Sarbanes-Oxley compliance is a small price for the benefit.

Cynthia Glassman, one of the SEC Commissioners, has publicly questioned whether the Act is achieving its goal and cautioned against auditors turning Section 404 into an expensive "check the box exercise". The question that William Donaldson should be addressing himself in this month's consultation process is why the cost of compliance should be so prohibitive and how he can reduce the wages of sin for these auditing companies and minimise their hegemony so that he can achieve the goal of creating value for investors.

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