US CORNER

Sarbanes–Oxley Act

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In the US, the first criminal charges have been brought under the Sarbanes–Oxley Act. This sweeping legislation was designed to restore public trust in corporate accounting and reporting, and will have implications far beyond the US borders, explains Andrew Durant, a specialist in fraud investigations and partner at BDO Stoy Hayward.

In November 2003, the first chief executive to be charged with breaching the Sarbanes–Oxley Act emerged. Richard Scrushy, the former head of US hospital group HealthSouth, was charged with fraud on 85 counts. If convicted, he faces a prison sentence of up to 650 years and more than $36m in fines.

The allegations include conspiracy to commit fraud, money laundering, securities fraud and – the new charge under Sarbanes–Oxley – falsely certifying the accuracy of the financial statements. In essence, Scrushy is accused of directing staff to inflate earnings by $2.7 billion to help the company meet financial targets. Chris Wray, the assistant attorney general, said, "The magnitude of the alleged fraud is staggering".

Since March 2003, 15 former HealthSouth executives, including five former chief financial officers, have pleaded guilty but Scrushy has maintained his innocence. Under the Sarbanes–Oxley Act, however, chief executives must certify the accuracy of their company's financial statements. Under the penalties imposed by Section 906 of the Act, if Scrushy is found guilty of certifying the statements "knowing that the periodic report does not confer with the requirements of the Act", he could be fined up to $1m, imprisoned for up to 10 years, or both. If the Court determines that he wilfully certified the statements knowing them to be false, he could be fined up to $5m, imprisoned for up to 20 years or both.

This is just one of many changes brought about by Sarbanes–Oxley. Below we examine how the Act came about, take a detailed look at what it says and explore implications for UK companies. In particular, we look at legal protection for whistleblowers and how to make audit committees more effective.

Background to Sarbanes–Oxley

> "We all know what happened to Enron. Moral bankruptcy led to fiscal bankruptcy."
> *– Governor Howard Dean, candidate for the 2004 Democratic nomination for US President*

The Sarbanes–Oxley Act was prompted by a series of high-profile corporate scandals, most notably the collapse of Enron. The Act, passed as law on 30 July 2002, contained sweeping reforms for issuers of publicly traded securities, auditors, executive officers, board members, lawyers and the investment banking community.

Companies directly affected by Sarbanes–Oxley are:

- US publicly traded companies and their worldwide subsidiaries.
- Companies with total assets in excess of $10m and a class of equity securities held by at least 500 US resident shareholders.
- Companies registered with the Securities Exchange Commission (SEC), intending to list on a National Stock Exchange in the US or issue equity or debt securities in the US.

In practice, organisations in all locations and their advisors will feel the effects of Sarbanes–Oxley – especially those interested in best practice and ethical behaviour.

A detailed look at Sarbanes–Oxley

A number of the provisions of the Act were immediately effective. However, many substantial and important provisions of the Act are subject to future regulations and guidance being issued and adopted by the SEC, which has much of the responsibility for policing compliance. In the Appendix, I provide a list of the eleven titles comprising Sarbanes–Oxley and a summary of its main provisions.

Is it the right answer?

Is rule-writing the answer? It seems, looking back over 50 years, that every decade or so there's a rash of new business failures. Then you get new rules and ten years on, another rash of failures. Rule-writing doesn't fix the morals of people in business. Those who want to break the law just need a little time to learn how to work around the newest rules.

Clearly we need to improve corporate behaviour around the world. And we need to improve both the quality of external audits and the involvement of board directors.

The problem with Sarbanes–Oxley is that it's made so many major changes all at once. Just putting in measures to make the relationship between management, the audit committee and auditors more effective could have gone a long way towards fixing the problems.

Some of the current US changes are contradictory and work to the disadvantage of investors. For example, the Act has mandated more procedures, and more disclosures are being required every day. However, the time to file annual and quarterly reports are being reduced. That's at odds with the problems they are trying to resolve. It makes more sense to push through the improvements and disclosures rather than quicker reporting.

Implications for UK companies

The heightened level of reporting, accountability and transparency in US markets will affect companies worldwide. Already in the UK we are seeing companies adopt a 'whiter than white' approach to separating audit and non-audit services. In the future, we can expect the role of the Finance Director in controlling and overseeing the audit to decline as the audit committee assumes more responsibility.

For UK subsidiaries of affected US parent companies, Sarbanes–Oxley presents some practical issues. Firstly, as with certifications, I expect to see additional demands being made of local management (and their auditors) to report to their US parent on their local system of internal controls. Doubtless this will also lead to much activity in drafting appropriate, limiting language to be used by companies and their advisors.

Secondly, all audit and permitted non-audit services provided by external auditors now need to be pre-approved by the audit committee. Within a global group, easy and effective access to the audit committee by local management and their advisers may be problematic. The result is local management may prefer to hire, or are forced to hire, other advisers to perform all non-audit related services – both permitted under the Act or otherwise – as this removes the need to communicate with the audit committee and any time delays that this may cause.

The role of the audit committee, then, is perhaps the most immediate and far-reaching area where UK corporates will feel the impact of Sarbanes–Oxley. Generally, I believe the most important actions for any company to take to improve corporate accountability is to extend the involvement of the audit committee and make its members more responsible for acting as ombudsmen for stakeholders.

Making audit committees more effective

> "If the audit committee is to accomplish nothing else, it should first and foremost strive to establish the right tone at the top. If the appropriate tone at the top is established and communicated, every division, department and individual within the organisation will be pulling in the same direction. Without the appropriate tone at the top you haven't got a chance."
> – *Michael Young, Accounting Irregularities and Financial Fraud, Harcourt Professional Publications*

Even before Sarbanes–Oxley, audit committees at larger companies were starting to be much more involved and ask many more questions. Since early 2003, this has been noticeably increasing, and not just amongst SEC registrants. Audit committee members are starting to think through the implications both of completed and proposed transactions and are meeting with the outside auditors more frequently than ever before. Issues like unadjusted errors are no longer just "the auditors' problem". All indications are that audit committees will get more involved as we go forward, and that's good.

In my view, there are eight attributes that an audit committee should possess. By encouraging these characteristics, companies and their advisers could head off problems before they begin.

1. Create the Right Tone at the Top

The audit committee should ensure that the ethical and compliance commitments of management and employees are understood throughout the company. The message to all personnel, through a written code of conduct and other communications, should be loud and clear: financial misreporting is totally unacceptable. If any misreporting is noted, it must be dealt with quickly and appropriately. An audit committee must also be able and willing to adopt a tough stance with management and ask probing and often difficult questions about the company's affairs. Discretion is needed when the audit committee handles sensitive or controversial matters that could damage either personal or company reputations. Common sense, good legal advice and a clear understanding of the parameters of the committee's role are essential.

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2. Be Independent
While it is not always easy to resist strong management or to tell them what they don't want to hear, audit committee members must be truly objective in guarding against fraudulent financial reporting. The major stock exchanges have set rules identifying situations that would impair independence, and potential conflicts of interest (such as a director who has been an employee of the company during the past five years) are to be avoided.

3. Reflect a Balance of Skills
To be effective, the audit committee must have a sufficient number of members who are 'financially literate'. Other members should be able to read and understand fundamental financial statements well enough to recognise when the numbers don't make business sense. A range of views and expertise is needed, as well as the ability to manage the workload required of audit committee members.

4. Make a Time Commitment
Being an audit committee member is not a full-time job. However, committee members must be informed, diligent and probing. This requires a significant time commitment, usually more than typical board service. On average, this commitment could be around eight to twelve days per year, but it will depend on the complexity of the business, its stage of evolution and the magnitude of its issues. Of paramount concern is the need to set aside enough time for the audit committee to meet so that important matters are given a thorough airing. Meetings that are squeezed into other agendas are usually ineffective and send the wrong message.

5. Develop a Clear Charter
To operate properly, a formal written charter strongly backed by the full board should be adopted and annually reassessed. The primary purpose of the charter is to create a practical roadmap to help the audit committee achieve it goals. After the charter has been drafted and reviewed by the committee's legal advisers, it should be approved by the board and either incorporated into the bylaws or formalised by a board resolution.

6. Develop Specific Committee Duties
Once a charter has been developed, the audit committee needs to decide which specific regular assignments it will undertake and then have them approved by the board. Clearly defined duties are key to an effective audit committee.

7. Plan the Year's Agenda
The complexity of the company's activities, together with the nature of the duties assumed by the audit committee, will determine its agenda. At least four meetings a year should be considered, although this would depend on the company's particular circumstances. Additional meetings may be needed if special matters arise.

8. Document the Committee's Work
Regulators may require audit committees to document and report on a range of issues so the committee's work should be documented. For the committee's own protection, as well as to keep the board informed, the audit committee should keep minutes and issue reports that document its conclusions and recommendations. However, the extent of documentation should be tempered by the understanding that written documentation can have a chilling effect on candour. It may be advisable to take legal advice on sensitive issues (such as questionable payments) covered at executive sessions without outside persons present before documenting them in the audit committee's record.

However, no matter how independent and diligent the audit committee is, it is not 'on the ground'. Therefore, the second area organisations must address is encouraging and supporting employees who report wrongdoing.

Legal protection for whistleblowers: US and UK

Putting out the message that people need to step up and speak up if they are asked to commit fraud or aware of fraud is extremely important. The detection of financial irregularities depends on the cooperation of those in the business, which means employees must be confident that if they blow the whistle they will be supported rather than penalised. Unfortunately, you only need to read the business press to see how often whistleblowers are ostracised, bullied, demoted, overlooked for promotion or treated so poorly their jobs become untenable.

Sarbanes–Oxley has brought in some protection for whistleblowers who "reasonably believe" that their employers have violated the Act and provide information or participate in investigations into wrongdoing. These whistleblowers are protected from being "discharged, demoted, suspended, threatened, harassed, or in any other manner discriminated against". Criminal sanctions may apply to employers who retaliate against whistleblowers, including prison sentences and fines. For whistleblowers who have been discriminated against, remedies include being reinstated to their positions, back pay, interest, compensatory damages and reasonable litigation costs.

In the UK, whistleblowers are protected by the Public Disclosure Act, which came into force on 2 July

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1999. It was designed to encourage individuals to raise any concerns about malpractice in the work environment, encourage entities to investigate the reported concerns and resist the urge to cover up serious matters. The whistleblower benefits from protection if he or she makes a qualifying disclosure in good faith. The disclosure need not even be true, provided that the whistleblower reasonably believed it was true and made the disclosure in good faith. To fall within the category of a qualified disclosure the information should show one or more of the following:

– that a criminal offence has been committed, is being committed or is likely to be committed
– that a person has failed, is failing or is likely to fail to comply with any legal obligation to which he is subject
– that a miscarriage of justice has occurred, is occurring or is likely to occur
– that the health or safety of any individual has been, is being or is likely to be endangered
– that the environment has been, is being or is likely to be damaged
– that information tending to show any matter falling within any one of the preceding paragraphs has been, or is likely to be deliberately concealed.

Employers should encourage whistleblowers to come forward as the quicker a business can spot fraud, the better. Not only does early detection diminish the damage to a firm's reputation, but it wastes less management time and ultimately costs the business less.

This is why having a robust whistleblowing policy in place is good practice. These policies might also discourage potential whistleblowers from approaching the press as a first resort, which could affect the business, especially if the allegations are incorrect. In addition, businesses need to engender a culture in which employees believe their concerns will be taken seriously, and that the protection afforded by the law and policies is real.

In the UK, awards to workers for claims that they have been discriminated against average £100,000, almost twice the maximum unfair dismissal award. Employers can no longer afford to ignore whistleblowing, both for financial and reputational reasons.

Conclusion

The Sarbanes–Oxley Act has its flaws – particularly in its attempt to tackle so much at one time – but it is an important piece of legislation that companies, regardless of location, cannot afford to ignore. There are practical steps that companies can take now to improve their accountability and to reassure investors that their internal controls and reporting is of a sufficient quality to reflect the true state of their financial affairs.

Appendix

TITLE I – PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
Sec. 101. Establishment; administrative provisions.
Sec. 102. Registration with the Board.
Sec. 103. Auditing, quality control, and independence standards and rules.
Sec. 104. Inspections of registered public accounting firms.
Sec. 105. Investigations and disciplinary proceedings.
Sec. 106. Foreign public accounting firms.
Sec. 107. Commission oversight of the Board.
Sec. 108. Accounting standards.
Sec. 109. Funding.

Summary: Creates an independent, non-governmental board to set audit standards and oversee audits. (The profession was previously self-regulated.)

TITLE II – AUDITOR INDEPENDENCE
Sec. 201. Services outside the scope of practice of auditors.
Sec. 202. Preapproval requirements.
Sec. 203. Audit partner rotation.
Sec. 204. Auditor reports to audit committees.
Sec. 205. Conforming amendments.
Sec. 206. Conflicts of interest.
Sec. 207. Study of mandatory rotation of registered public accounting firms.
Sec. 208. Commission authority.
Sec. 209. Considerations by appropriate State regulatory authorities.

Summary: This strictly prohibits auditors from performing certain non-audit services for their audit clients, in areas such as: corporate finance, valuations and fairness opinions, risk management and internal audit, remuneration planning, actuarial services, HR services, forensic services, litigation support and other expert services. It also establishes a number of measures to strengthen auditor independence. (This is intended to stem the growth of non-audit services provided by auditors that could be deemed to impair independence.)

TITLE III – CORPORATE RESPONSIBILITY
Sec. 301. Public company audit committees.
Sec. 302. Corporate responsibility for financial reports.
Sec. 303. Improper influence on conduct of audits.
Sec. 304. Forfeiture of certain bonuses and profits.
Sec. 305. Officer and director bars and penalties.
Sec. 306. Insider trades during pension fund blackout periods.
Sec. 307. Rules of professional responsibility for attorneys.
Sec. 308. Fair funds for investors.

Summary: All public companies are now required to have an independent audit committee, which has defined responsibilities such as appointing auditors, setting fees and overseeing the audit. Audit committees are also responsible for handling complaints relating to the audit and internal controls and approving any non-audit services undertaken by the external auditors, including tax services. (While most companies had audit committees previously, their responsibilities varied and it was often the CFO who effectively selected the auditors.)

CEOs and CFOs are now required to certify the accuracy of quarterly and annual reports to the SEC.

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Section 307 required the SEC to issue rules requiring lawyers to report material violations of securities law. In January 2003, the SEC adopted final rules, which require attorneys to report a material violation to the chief legal counsel or CEO and, if appropriate action is not taken, to the audit committee, the Board or a qualified legal compliance committee. The final rules also revised the definition of material violation to:

> *"an objective, rather than a subjective, standard, involving credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur."*

There are also provisions requiring lawyers to effect a "noisy withdrawal" if the company does not take appropriate action after the violations are reported. Attorneys are now allowed to reveal otherwise confidential information about clients without their consent under certain circumstances.

TITLE IV – ENHANCED FINANCIAL DISCLOSURES
Sec. 401. Disclosures in periodic reports.
Sec. 402. Enhanced conflict of interest provisions.
Sec. 403. Disclosures of transactions involving management and principal stock-holders.
Sec. 404. Management assessment of internal controls.
Sec. 405. Exemption.
Sec. 406. Code of ethics for senior financial officers.
Sec. 407. Disclosure of audit committee financial expert.
Sec. 408. Enhanced review of periodic disclosures by issuers.
Sec. 409. Real time issuer disclosures.

Summary: Management is now required to report publicly on the system of internal controls within their annual report. This title, which has proven controversial, requires that management acknowledge their responsibility for establishing and maintaining these controls. The external auditors must attest to, and report on, management's assessment as part of their audit engagement. Detailed guidance for both companies and auditors is awaited. (This represents a major extension of the scope of both management's and auditors' responsibilities.)

TITLE V – ANALYST CONFLICTS OF INTEREST
Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.

Summary: This title amended the 34 Act (the law) and gave the SEC one year to issue rules to prevent conflicts of interest for securities analysts making share recommendations in research reports and presentations. The SEC and the exchanges have now adopted rules to promote the integrity of reports by analysts.

TITLE VI – COMMISSION RESOURCES AND AUTHORITY
Sec. 601. Authorization of appropriations.
Sec. 602. Appearance and practice before the Commission.
Sec. 603. Federal court authority to impose penny stock bars.
Sec. 604. Qualifications of associated persons of brokers and dealers.

Summary: This gives further funding to the SEC to carry out its additional responsibilities and strengthens the Court's and SEC's ability to censure and bar individuals and organisations.

TITLE VII – STUDIES AND REPORTS
Sec. 701. GAO study and report regarding consolidation of public accounting firms.
Sec. 702. Commission study and report regarding credit rating agencies.
Sec. 703. Study and report on violators and violations
Sec. 704. Study of enforcement actions.
Sec. 705. Study of investment banks.

Summary: This authorises a number of federal regulators to conduct studies into the topics outlined above.

TITLE VIII – CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY
Sec. 801. Short title.
Sec. 802. Criminal penalties for altering documents.
Sec. 803. Debts nondischargeable if incurred in violation of securities fraud laws.
Sec. 804. Statute of limitations for securities fraud.
Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.
Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.
Sec. 807. Criminal penalties for defrauding shareholders of publicly traded companies.

Summary: This title establishes tougher penalties for altering documents, tightens accountability for corporate and criminal fraud and introduces legal protection for 'whistleblowers' who provide evidence of fraud.

TITLE IX – WHITE-COLLAR CRIME PENALTY ENHANCEMENTS
Sec. 901. Short title.
Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.
Sec. 903. Criminal penalties for mail and wire fraud.
Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.
Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.
Sec. 906. Corporate responsibility for financial reports.

Summary: Penalties for white-collar crime have been enhanced, and any person who attempts to commit these types of crimes will now be treated under law as if they had committed the crime.

TITLE X – CORPORATE TAX RETURNS
Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.

TITLE XI – CORPORATE FRAUD AND ACCOUNTABILITY
Sec. 1101. Short title.
Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.
Sec. 1103. Temporary freeze authority for the Securities and Exchange Commission.
Sec. 1104. Amendment to the Federal Sentencing Guidelines.
Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.
Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.
Sec. 1107. Retaliation against informants.

Summary: This title authorises regulators and the courts to impose fines or imprisonment for tampering with records, impeding an official proceeding, retaliating against whistleblowers and other corporate fraud matters.

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