

### New “SOX” for Corporate Management

The series of business failures and corporate scandals that began in 2001 caused a precipitous decline of investor confidence in the capital markets. A handful of companies were caught “cooking the books”—inflating earnings in an attempt to keep their stock prices up. Other charges against companies included sophisticated self-dealing schemes by insiders and lavish personal use of shareholder assets.

In the wake of these well-publicized scandals, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) named after Senators Paul Sarbanes and Paul Oxley. This law ushered in the most sweeping changes in the markets since the Securities Acts of 1933 and 1934. However, a recent survey conducted by Hudson Financial Solutions indicated that investors are largely unaware of the Act or its intended benefits. Hudson found that 80% of U.S. workers and 76% of employed investors have never heard of the Sarbanes-Oxley Act. This is despite massive investments of corporate resources. Companies spent an estimated average of \$3 million in the first year to comply with Sarbanes-Oxley.

### Intended Benefits of Sarbanes-Oxley

The rules mandated by the Sarbanes-Oxley Act cover nearly 100 major provisions, many with several subsets, which significantly expand the rules for corporate governance, disclosure and reporting. Although some provisions of the Act are proving to be onerous for corporations, other provisions have helped investors. We believe Sarbanes-Oxley achieved three important reforms: 1) auditor independence, 2) strengthened Federal securities laws, and 3) emphasis of the critical role of internal control over financial reporting.

### Auditor Independence

When the relationship between Enron and Arthur Andersen was exposed, we learned many lessons about the need for strict rules to maintain independent external auditors. Andersen received over \$54 million in annual fees from Enron, \$25 million in audit fees and an additional \$27 million in “consulting” fees. In addition, Andersen’s permanent Houston office was in Enron’s building, and local Andersen staff apparently attended Enron’s company parties and trips. Unfortunately, it now appears that certain groups within Andersen expressed concern over Enron’s accounting methods as early as 1997, but the local engagement partners in the Houston office repeatedly overruled those groups.

In response to these and other abuses of auditor independence, the Sarbanes-Oxley Act dramatically limits the ability of auditors to provide non-audit services to their audit clients. Sarbanes-Oxley also requires each corporation’s audit committee to be composed of independent members of the board of directors. The audit committee must now appoint, compensate and oversee the external auditor. The auditors report directly to the audit committee and no longer to management.

These efforts to strengthen the rules governing auditor independence are critical to every investor. We all rely on a company’s financial statements for an accurate picture of a company, and the external auditors are the only people with direct access to a company’s accounting records. The auditors are the only parties who have a chance to detect fraud and accounting irregularities. If auditors are not completely objective in their work, public financial statements are useless. We join other institutional investors who are calling for an outright ban on any kind of non-audit services offered in conjunction with audit services.

### Stiffer Penalties For Violators

Another positive outcome of the Sarbanes-Oxley Act is tougher penalties for those who destroy records, commit securities fraud or fail to report fraud. It is now a felony with

penalties of up to ten years in prison to fail to maintain audit work papers willfully for at least five years. This penalty is a direct response to the mysterious disappearance of the audit work papers that Arthur Andersen created for Enron. It is also a felony to destroy any documents in a federal or bankruptcy investigation, and criminal penalties for securities fraud have been increased to 25 years. Sarbanes-Oxley also provides special legal protection for corporate whistleblowers who report a fraud.

One of the most significant aspects of the Sarbanes-Oxley Act is the requirement for top management to certify that each quarterly and annual report fairly presents the financial condition of the company. With this requirement, the “dumb CEO” defense, the defense used by WorldCom’s chief, Bernie Ebbers, is no longer an option. Companies must ensure that their CEO understands the financial statements.

### **Internal Controls (Section 404)**

One of the most notable changes that investors have seen as a result of Sarbanes-Oxley is a new report included in the annual report. It is produced by management and the auditor’s assessing the company’s internal control over financial reporting. An effective internal control process is crucial in preparing accurate financial statements. Sarbanes-Oxley Section 404 requires that management now provides

an assessment of the internal control system. In addition, the external auditors must evaluate management’s assessment, and the auditors must perform their own assessment of the effectiveness of the internal controls. Prior to Sarbanes-Oxley, auditors were required to obtain an “understanding” of the internal control structure sufficient to plan the audit. Now, the internal control structure is the object of an audit.

The goal of Section 404 is to timely identify and correct weaknesses in the internal control structure. Companies should learn from their evaluation process and correct any deficiencies. This will result in more reliable financial reporting and greater investor confidence.

### **The Early Results Are In**

It appears that Sarbanes-Oxley has had a positive impact on the quality of financial reporting in corporate America. A recent study by the Huron Consulting Group found that the number of restated financial reports increased 28% in 2004, the highest number of restatements of any of the last five years. There was a variety of reasons given for the restatements, ranging from misapplication of accounting rules to human error and fraud. In addition to the Huron study, the newsletter *Compliance Week* reported that more than 580 companies announced that they uncovered material weaknesses or deficiencies in their

internal controls in 2004. The increased number of restatements and discoveries of control deficiencies is directly attributed to the Sarbanes-Oxley mandates and to tighter oversight by the SEC. We expect these numbers will begin to decline when companies and their auditors thoroughly review the internal control structure and implement corrective measures.

Restating financial reports frequently results in lower stock prices and shareholder lawsuits, but it rarely affects executive pay. However, the Sarbanes-Oxley Act includes a provision that requires the forfeiture of certain management bonuses and profit sharing when the financial reports are restated. Earlier this year, troubled telecom equipment maker Nortel Networks announced that top executives would return \$8.6 million in bonuses after its restatement. While Sarbanes-Oxley only applies to the bonuses earned by the CEO and CFO, Nortel’s board went further and recovered bonuses from all of the top executives involved. We applaud this action and call on other boards of directors to take similar actions in the face of earnings restatements. Executives should not be rewarded with bonuses and options when their performance is attributed to improper accounting.

### Where Are They Now

The bell has begun to toll for many of the corporate executives who led their companies down the slippery slope of fraud and deception. Former WorldCom CEO, Bernard Ebbers, has just been found guilty of securities fraud and is awaiting sentencing. The trials of Tyco's former CEO, Dennis Kozlowski, and HealthSouth's founder and former chief executive, Richard Scrushy, are now underway. The trial of former Enron CEO, Ken Lay, is expected to begin sometime in the fourth quarter of 2005.

A handful of other trials are also underway, but the most closely watched corporate executive trial is that of HealthSouth's Richard Scrushy. Scrushy is the first chief executive charged under the Sarbanes-Oxley Act. An acquittal would severely undermine the credibility of Sarbanes-Oxley and make it difficult for future prosecutions. Since the Act requires CEOs to certify that their company's financial statements are accurate, it is now difficult to plead ignorance when a significant fraud is uncovered. For his part, Scrushy argues that he was deceived by all of his former chief financial officers. It is difficult to believe that all five of the former CFOs were party to a conspiracy with Scrushy's having no knowledge of the fraud. All of the former CFOs have pleaded guilty to their involvement and have agreed to testify against Scrushy. It is also reported that the

government has audiotapes of Scrushy's incriminating himself. Keep your eyes on the outcome of this case. It is the bellwether for future Sarbanes-Oxley prosecutions.

### Unintended Consequences

As has happened many times in the past when laws and regulations get rushed into effect following a scandal, the Sarbanes-Oxley Act is an example of prescriptive legislation with many unanticipated consequences.

The loudest objections to Sarbanes-Oxley (specifically, Section 404) are coming from small- and mid-sized companies. The criticism surrounds the high cost of conducting an audit of the internal controls. A recent study by Financial Executives International estimates it will cost companies on average \$3 million to comply with Section 404. Small companies with less than \$400 million in revenue are expected to spend around \$500,000. The cost of compliance hits small companies disproportionately harder than large corporations. In many cases, small companies neither require, nor can afford, the same investment in internal controls as large companies. Rising costs have forced a number of small companies to delist their stocks and go private. This includes several overseas firms that are listed on U.S. exchanges. Furthermore, Sarbanes-Oxley may raise the bar on access to the public markets. The cost of compliance with Section

404 effectively raises the cost of capital. This, in turn, makes it prohibitive for some small companies to go public.

The good news is that the SEC has heard the cries for mercy from small companies and recognizes that the implementation of Section 404 may not be progressing in a cost-effective and useful manner. The deadline for compliance with Section 404 has been moved to July 2006 for small companies below \$75 million in market cap, and the SEC has scheduled a public forum in mid-April to consider what is working and to determine if the process can be streamlined.

### Time Will Tell

It is clear that the rules mandated by the Sarbanes-Oxley Act need to be fine-tuned and updated to achieve the intended results. The behavior that led to these new rules was so egregious that action had to be taken. Many aspects of Sarbanes-Oxley will prove to be effective and just; some will turn out to be a waste of time and money. However, we believe the Act is a useful and positive step in protecting investors and improving the reliability of financial statements.