

THE SARBANES-OXLEY ACT OF 2002: WILL IT PREVENT FUTURE “ENRONS?”

by

Robert A. McTamaney

Train wrecks inevitably are followed by investigations of what caused the wreck and how to avoid the next one. Corporate America over the past year has been a virtual cacophony of wrecks, as each day's press awaits the next in the series of Enron to Global Crossings to WorldCom to Adelphia to Qwest, with the consequent destruction of billions in shareholder investment and retirement income, the loss of many thousands of jobs, and the utter elimination of businesses once revered as sound.

Since Enron, responsible boards of directors throughout the country have been undergoing intense self-examinations to ensure that it doesn't happen to their companies. And now, with the support of the President and all but three members of Congress, the Sarbanes-Oxley Act of 2002 has been added to the arsenal to guard against repetitions of these financial atrocities.¹ Whether the new law will work remains to be seen, but it is worthwhile observing what caused the commercial wrecks of the past year, and whether the new legislation is well-designed to protect the next one.

First, it is useful to identify the common accounting thread running through all of the past year's substantial financial disasters. With minor variations, the fair and candid application of traditional generally accepted accounting principles (GAAP) would have disclosed, as it did after the fact, that the earnings reported by these companies were either wholly fictitious, or were premised on foundations of sand. Second, the analysts thought to be expert in detecting weaknesses in their covered companies' financial statements were all quick to point out how apparent the overstatements of reported income were to the seasoned observer. However, they were equally silent on the question of why the fallacies went undetected for so long. Third, with the exception of a handful of high-profile indictments, the individual architects of the disasters seem to have stayed below the radar that was so prominently focused on their corporate employers.

The Sarbanes-Oxley Act of 2002 is a 66-page collection of requirements, many left for real definition by the SEC, designed to highlight and eliminate what its proponents have settled on as the root causes of the financial debacles under study. But broadly, with some frankly disturbing exceptions, the Act simply makes Federal law out of existing financial regulatory regimes and practices, and either creates or increases existing criminal penalties for white collar crimes. The new law does adopt some increasingly-accepted concepts of proper corporate governance, accelerates some existing public company reporting obligations, and, inviting controversy, unexpectedly crafts a new Federal ethics policy for public company lawyers.

Sarbanes-Oxley first creates a new nonprofit corporation, the “Public Company Accounting Oversight Board,” whose five SEC-appointed members (of whom two will be CPAs), financed by new public company fees, will register, inspect and discipline public accounting firms, including foreign firms in certain cases, as

¹In a dramatic extension of the prior “disclosure only” rules, the new law also applies to foreign companies which are Nasdaq-traded or exchange-listed in the U.S.

well as establish and enforce auditing, quality control, and independence standards.² All these functions are subject to broad SEC oversight. The new Board then will fund the Financial Accounting Standards Board (FASB), in its continued authorship and interpretation of GAAP. Viewed alone, these provisions would seem only to create an often redundant level of regulation when perhaps more could have been accomplished by strengthening the existing expert regimes.

The new law then enters but largely continues the long-standing debate over auditors as consultants. After a phase-in period, public companies will be prohibited from using their auditors for designated non-audit services,³ and other services will require audit committee approval and public disclosure. This often-criticized practice thus goes forward with a bit more sunshine.

The audit firm itself must now rotate its lead audit partner every five years, and new conflict rules will prohibit an audit by a firm if the issuer's⁴ chief executive officer, controller, chief financial officer, chief accounting officer, or equivalent person was employed by the auditors and participated in the audit of the issuer in the past year. The merits are fairly debatable of this provision. Some argue that the firm, and not the partner, should rotate, while others point to the increased expense involved in both of these aspects of the new law, and express concern over the elimination from in-house eligibility of perhaps the most qualified outside advisors.

All listed companies will now be required to have audit committees comprised solely of unaffiliated directors who do not accept any consulting, advisory, or other compensatory fee from the company. That committee will appoint, oversee, and compensate the auditors, and resolve financial reporting disagreements. It will also establish whistle-blower procedures ensuring anonymity and confidentiality.⁵ The new law contemplates that one committee member would be a financial expert. Here the problem will be finding qualified individuals for the audit committee who do not also aspire to other relationships with the company beyond their committee and Board meetings. The universe of these persons is limited.

Sarbanes-Oxley then adopts and expands the recent SEC proposal that CEOs and CFOs of public companies be required to certify that the financial information in each of their company's annual and quarterly reports "fairly presents in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report." This follows the outside auditors' familiar certification, and the officers must also review and report on the company's internal controls, an area usually left for comment by the outside auditors, particularly if they find deficiencies. Looking back at this past year's events, it is not at all likely that this requirement would have had any penetrating effect on the circumstances of even the most egregious cases. The senior officers involved were either present at the creation or very soon thereafter, but the new law does subject the CEO and CFO to potential criminal penalties for designated misconduct and to forfeiture of bonuses and stock profits if, through misconduct, the issuer must restate its financials. In this respect, the new law also renders it illegal for directors and officers to exert improper influence on any audit.

The new law next extends the applicability of any blackout period applicable to the company's pension

²Including work paper, second partner review, and internal control requirements.

³"Non-audit services" are broadly (and ambiguously) defined as any professional services other than in connection with an audit or review of financial statements, and specifically include tax services, bookkeeping, systems design and implementation, appraisals, actuarial services, management or human resources services, investment banking, or legal or expert services unrelated to the audit.

⁴"Issuer" means an issuer as defined in Section 3 of the 1934 Act the securities of which are registered under Section 12 or that is required to file reports under Section 15(d) or that files or has filed a registration statement that has not yet become effective and that it has not withdrawn.

⁵Whistleblowers would also be protected against discharge or discipline under the new law.

fund to directors and officers, with respect to any shares received in connection with their employment or service. While it is difficult to argue with this equality of treatment, here again the change would not likely have reversed the awful results for any of the companies involved in the last year's disasters.

Sarbanes-Oxley in addition requires the SEC to promulgate rules of professional responsibility for securities lawyers within 180 days. The rules must require lawyers to report evidence of any material violation of securities law or breach of fiduciary duty to the issuer's chief legal counsel or chief executive officer. If the counsel or CEO does not "appropriately" respond, whatever that means, then the attorney must report the evidence to the audit committee or the board of directors. The organized Bar has opposed these provisions, and if the test for the new law is how it would have tempered or avoided the long line of scandals, there is no evidence that this provision would have or could have, since the lawyers, to the extent involved, seem to have reviewed and in good faith approved the relevant issues. Another concern is that there are already cases where the lawyer certainly must go to the Board or even beyond, but that the breadth and ambiguity of these new provisions imperils the attorney-client privilege and would inhibit the candid discussion of problems which possibly could result in the cure of a potential issue before it fomented into a violation or worse.

The new legislation establishes "FAIR Funds for Investors," which specifies that civil penalties for securities law violations may be added to the disgorgement fund for the benefit of the victims of the violation. The SEC also is directed to improve collection rates, likely as the result of recent criticisms by the General Accounting Office. These are worthwhile, but are simply unrelated to solving Enron-esque situations.

In a provision directed squarely at Enron and Global Crossing, the new law directs the SEC to require public company disclosure of all material off-balance sheet transactions and obligations. Also, in a provision that will affect the "dotcom" world especially, it requires that "pro forma" financial information in any press release or other public disclosure must not include any material misstatement or omission, and must be reconciled with generally accepted accounting principles. Here again, noble attempts, but likely redundant of any fair reading of existing disclosure and GAAP requirements. "Pro forma" used to mean combining or presenting existing financial information to reflect new facts, such as showing the historical combined earnings of two companies now merging. It has come to mean the selective choice of certain income, and the elimination of certain expenses, to show better results than GAAP would reflect. Rather than condoning it, the new law would be better off eliminating it, at least as applied to these earnings-enhancing approaches.

Sarbanes-Oxley will also prohibit public companies from extending new credit to any director or executive officer, other than certain specified margin or other loans made in the ordinary course of business, or from renewing or extending existing loans. This is a debatable provision at best, and compensation prohibited one way likely will surface in another. Here the solution, if one was needed, would seem to be broader and plainer disclosure of executive compensation, an area presently almost over-disclosed (and borderline incomprehensible) as a result of arguable abuses in the past.

The new law accelerates, to the second business day following the trade, insider trade reporting by directors, officers, and 10% stockholders; eventually the reports must be filed electronically and posted on the issuer's and the SEC's web sites. No argument here. The new law also authorizes the SEC to require public companies to disclose on a "rapid and current basis" information concerning changes in the issuer's financial condition or operations. In this case, there simply must be further definition from the SEC. Otherwise the market will be flooded with relatively useless information which could obscure the truly material disclosures from receiving the attention they deserve. The law also in effect mandates that issuers adopt a code of ethics for the CFO and other accounting officers.

Sarbanes-Oxley amends the Securities Exchange Act of 1934, to require the SEC or the market self-regulatory organizations, within one year after enactment, to adopt rules designed to address securities analysts' conflicts of interest. The SEC's new Regulation AC also governs research analysts' research reports and public appearances, and the recent Attorney General proceedings in New York additionally highlight the change in and leveling of the playing field in this area of such importance to investors.

Sarbanes-Oxley provides a limitations period for private securities fraud claims of the earlier of two years after the discovery of the facts constituting the violation or five years after the violation. The statutes do not presently provide an explicit limitations period, but the courts generally apply a period of one year after discovery or three years after the violation.

The new law adds or increases a number of criminal penalties, including a new crime of securities fraud with a maximum penalty of 25 years, and a penalty of up to 20 years for destruction of documents “in contemplation” of an investigation. The crime applies only to frauds in connection with securities of public companies, and the Federal Sentencing Guidelines would be appropriately amended. The Act also provides that securities fraud-related debts are nondischargeable in bankruptcy, and broadens the SEC’s authority to bar persons from serving as a director or officer of a public company.⁶

To finance the new requirements, Sarbanes-Oxley authorizes an appropriation about twice the Administration’s related budget request, but arguably better directed and less money could have a more beneficial result. In contrast, for example, to the antitrust area, if the goal of the new legislation is to avoid the disasters of Enron to Qwest, then the most likely cure is the imposition of reasonably certain criminal penalties and fines on individuals for knowing violations of law resulting in personal benefit, including performance-related compensation. In the Sherman Act context of price-fixing and other *per se* violations, the prospect of criminal liability lifts compliance to another level entirely, and this is a far more effective deterrent than the less dire consequences usually associated with violations of SEC disclosure or other technical accounting requirements.

This is especially so where, as here, the new law seems largely a Federalized amalgam of specific requirements already on the books or part of the professional lore, and where Sarbanes-Oxley goes further, such as the ill-conceived attorney disclosure provisions, it moves into uncharted waters where the cure may be worse than the illness.

Any business, any investment, is worth the current value of the future cash which it will generate for the owner. Nothing more, nothing less. These businesses which collapsed in such spectacular fashion over the last year failed not because they lacked some new regime of government over-regulation, but because they ignored this basic rule of economics, and concentrated on creating “earnings,” often hypothetically or worse, when they should have been working to make *cash*.

Sarbanes-Oxley will certainly result in dramatically increased costs and burdens for the vast majority of companies dedicated to proper conduct; whether the new law will prevent repetition of the last year’s scandals is far less clear, perhaps even doubtful, but hope springs eternal.

⁶The new law also directs a GAO Study into the effects of the consolidation of accounting firms, and SEC Studies of the role and function of credit rating agencies in the operation of the securities markets, of violators and violations of the securities laws, of enforcement actions, and of the role of investment banks in the collapse of Enron and Global Crossing.