

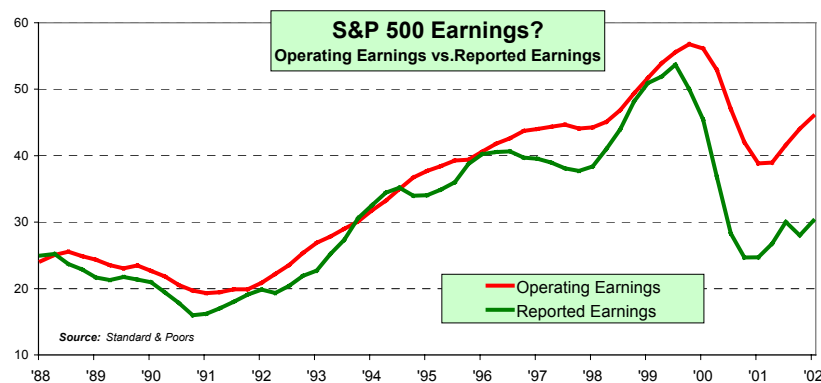


Richard J. Tavis
Investment Analyst

Overview of the Sarbanes-Oxley Act of 2002

In December of 2001 Enron, a company transformed from a sleepy natural gas utility to a darling of growth investors, filed for Chapter 11 in a cloud of accounting irregularities and outright deception. Problems lurking below the murky waters of financial reporting came to the forefront of investor consciousness. Thought at the time to be an “outlier”, subsequent revelations of accounting malfeasance (Worldcom, Tyco, HealthSouth et al.) further reduced investors’ confidence in financial statements, the integrity of corporate managers, and their accountants. The roots of the problem included:

- The lack of independence of auditors providing higher margin consulting services to audit clients.
- Either a lack of understanding or independence by corporate directors (or both).
- The fact that GAAP reporting has not kept pace with increasingly complex financial strategies used by corporations, such as asset securitization or other “off balance sheet” financing arrangements and derivative-oriented risk management techniques. For example, under the current system derivatives with the same economic exposure may be accounted for differently.
- Excessive use of stock options as a form of management compensation. The payoff for option holders and equity holders is **not** the same. Option holders have unlimited upside potential if stock prices rise, but very limited downside risk. Their “free” options simply expire worthless. This rewards unwarranted risk taking and discourages dividend payments. Further, if the options are issued “out of the money” they don’t have to be treated as expenses on the income statement.
- Investor and sell side analyst emphasis on beating *short-term* earnings expectations led to considerable pressure on managers to manipulate earnings, in some cases committing outright fraud. Many firms present investors with pro forma “Operating Earnings” (referred to by cynics as “earnings before bad stuff”). As the chart below indicates, the differences between GAAP earnings and operating earnings have increased significantly since 2000.



Passed by overwhelming margins in both the Senate and House (99-0, 423-3 respectively), the Sarbanes-Oxley Act of 2002 was signed into law by President Bush on July 30, 2002. The Act represents the most sweeping change to securities laws since 1934. Among other things S-O attempts to improve investor confidence in financial statements by:

- Establishing a Public Accounting Oversight Board to oversee auditors and put severe restrictions on the ability of accounting firms to do non-audit work for audit clients;
- Pushing responsibility to the top of the corporate ladder by requiring CEOs and CFOs to “sign off” on financial statements,
- Requiring that corporate boards adopt a more active role in the oversight of financial reporting;
- Attempting to correct some of the asymmetry in the risk/reward equation in the minds of option-incented management. The Act imposes stiffer penalties for white collar crimes and makes provisions for confiscating ill gotten stock option gains;

The following discussion highlights some of the major provisions of the sweeping legislation both with respect to the role of auditors and corporate management.

Role of Auditors

Public Company Accounting Oversight Board

The Act requires accounting firms who audit public companies to register with a newly created Public Company Accounting Oversight Board. Structurally, the Board is an independent not-for-profit corporation, treated as a “self regulatory organization” (similar to the NASD) by the SEC (which has oversight responsibility for the newly created entity). The SEC will choose the Board’s five members with input from the Fed Chairman and the Treasury Secretary. Two (and only two) members must be (or have been) CPAs not currently on the payroll of a public accounting firm.

The Board is charged with the tasks of:

- Establishing auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports;
- Inspecting the auditing operations of accounting firms;
- Investigating potential violations of securities laws, professional accounting standards, and the Board’s own rules, and enforcing compliance.

The Act also calls for a study regarding the potential impact of a transition from a rules-based to a principals-based accounting system (similar to International Accounting Standards).

Auditor Independence

Sarbanes-Oxley prohibits an accounting firm from doing non-audit work for its audit clients including:

- Bookkeeping or other services related to record keeping or the financial statements of an audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution in kind reports;
- Actuarial services;

- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment advisor, or investment banking services;
- Legal services and expert services unrelated to the audit;
- And any other services that the Public Accounting Oversight Board determines (by regulation) is impermissible;
- Services not specifically prohibited require pre-approval from the firm's audit committee (for example tax consulting work is allowed, if the firm's audit committee agrees).

The Act also specifies the lead and reviewing audit partners cannot serve on a client's account for more than five years. In addition, a firm's CEO, Controller, CFO, Chief Accounting officer or person in an equivalent position cannot have been employed by the auditor during the one year prior to an audit. S-O further commissioned the Comptroller General of the United States to conduct a study on the potential impact of requiring companies to rotate auditors.

Corporate Responsibilities

The Audit Committee

The Act requires a firm's board of directors to have an audit committee made up of independent directors. The committee is responsible for the appointment, compensation, and oversight of the firm's auditor. The auditor will report directly to the Audit Committee. The committee is also required to establish procedures for the treatment of:

- Complaints received by the firm regarding accounting, internal accounting controls, and auditing matters;
- Confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

Companies must disclose whether or not they have a "financial expert" as defined by the SEC on its audit committee, and if not, explain why not.

Management Accountability

The Act requires CEOs and CFOs to "sign off" that financial reports are accurate and "fairly present in all material respects the financial condition and results" of the company. The Act specifies "that it is unlawful for any officer or director of an issuer...to take any action to fraudulently influence, coerce, manipulate, or mislead" the auditors. Annual reports also must contain management's evaluation of internal financial reporting controls and procedures.

If a company has to restate earnings due to "material non-compliance" of financial reporting requirements under securities laws, the CEO and CFO will have to "give back" any bonus or incentive based equity compensation or any profits realized by the sale of company stock for the following 12 months.

The law also requires companies to disclose whether (and if not, explain why not) senior financial officers are required to sign a code of ethics.

Prohibition of Insider Trades During Pension Fund Blackout Periods

The Act requires sponsors of defined contribution plans to give 30 days advance notice to plan participants and beneficiaries of blackout periods (with certain exceptions). It also prohibits directors or executive officers from trading company stock during the blackout, *if* they received it in connection with their service or employment to the company, *and if* company stock is an investment option in the plan. In addition the Act:

- Prohibits Personal Loans to executives and directors (with certain exceptions);
- Increases criminal penalties for ERISA violations;
- Accelerates reporting of insider transactions.

Enhanced Financial Disclosures

All annual and quarterly reports will be required to disclose all material off balance sheet transactions, arrangements and obligations. Pro forma information will be required to be presented in a manner that is not misleading and is reconciled with GAAP figures. The Act also commissions a study by the SEC into the extent of off balance sheet transactions and use of Special Purpose Entities; and whether GAAP reflects such transactions to investors in a transparent fashion.

Other Elements of the Act include:

- Enhanced penalties for “white collar” crimes;
- Provisions for corporate and criminal fraud accountability
- Obligation of attorneys to report violations;
- Treatment of securities analysts by registered securities associations.

Comment

In closely reading Sarbanes-Oxley, it is evident that the Act was written as a specific response to the circumstances surrounding Enron. As such, it has both strengths and weaknesses with respect to its impact on the overall corporate governance environment. Some of the Act’s provisions are clearly helpful, while some are overly Enron-specific and could be expected to have only modest impact (like the prohibition of insider trades during pension blackouts). There are also important areas where it is silent, most notably with respect to the expensing of stock options.

In the wake of Arthur Anderson’s public implosion amid the frenzy of paper shredding and finger pointing, explicit oversight of the auditors is a necessary step. Many audit teams were (are?) clearly working for management, with little regard for investors. Restrictions on non-audit work for audit clients are a step in the right direction. However, the fact that tax work for audit clients *is* allowed (if the audit committee agrees) dilutes the full impact of this measure.

Formalizing the role of the audit committee (made up of independent board members) in hiring and overseeing the outside auditors is a critical step. Perhaps even more important is that the audit committee be sufficiently critical and ask the right questions. As NYSE chairman Richard Grasso pointed out in a recent speech “if an independent director of Enron had raised his or her hand and asked the question, ‘Why is it we have 4,000 special purpose entities?’ he or she would have gotten an answer.”

To that end, the notion of a financial expert on the audit committee was well received by most investment managers we've spoken with, despite the difficulty of defining just what a "financial expert" is. Interestingly, a number of managers feel that *more* important than board independence, is the financial commitment directors have to the company. This was not, and probably could not be, addressed by the Act.

Warren Buffet makes the point in Berkshire Hathaway's 2002 Annual Report there is often a "boardroom atmosphere" which makes it difficult for directors to challenge management when management is sitting across the table from them. One solution is simple; outside directors should meet without management, as is often the case with European company boards (an issue not addressed by Sarbanes-Oxley, but which has been by the NYSE).

Enhanced disclosure of off balance sheet items and requirements for companies to present pro-forma "operating" earnings reconciled to GAAP earnings are necessary steps toward eliminating some of the techniques that unscrupulous corporate executives have used to mislead investors. While useful, these provisions are only patching holes in the financial reporting process rather than dealing with any underlying structural issues.

More broadly, the Act commissions the study of the potential impact of a shift from rules-based to principals-based accounting standards. Principals-based accounting is inherently more flexible. The idea is that it would better enable financial reporting to evolve and keep pace with new financial instruments and techniques, instead of acting as a road map to the loopholes. On the other hand, it would require *more* judgment calls by auditors and management. It is important to remember that investors' desire for a more consistent application of accounting principals is what led to the proliferation of transaction-oriented rules to provide implementation guidance to management.

Investment managers we've talked to have had mixed opinions about the requirement that corporate executives "sign off" on financial statements. One camp believes that if management is willing to file fraudulent statements in the first place, they will have little concern about signing them too. This camp concedes that if the penalties for a false attestation are sufficiently severe (more so than penalties for fraud) it could help at the margin. Other investment managers were of the mind that the requirement hangs a much-needed Sword of Damocles over the heads of CEOs and CFOs, making their ultimate liability for financial reporting explicit.

Presently, the HealthSouth case represents the first prosecution under Sarbanes-Oxley. So far eight HealthSouth executives have been convicted, and more are expected. Only seven from Enron are even *facing* criminal charges.

Conclusion

Investors and their portfolio managers are "outsiders" for the most part, and must rely on the good faith and diligent representations of various corporate insiders for insight to the companies they own (or might acquire). To help protect them, the Sarbanes-Oxley Act of 2002 attempts to legislate ethics and integrity back into the public company management/governance/auditing process. As such, a cynic could easily conclude it is bound to fail simply because you can't legislate morality. We see it in a better light, especially the provisions seeking to re-establish auditor independence and audit committee responsibilities. But, it is certainly **not** this generation's version of the '33 Act.

References

Buffet, Warren E., "Chairman's Letter." *Berkshire Hathaway 2002 Annual Report*, (February 21, 2003).

Carrns, Ann, Carrick Mollenkamp, Deborah Solomon, John R. Wilke, "HealthSouth Case Unveils a Shock Strategy." *Wall Street Journal*, (April 4, 2003).

Grasso, Richard A, "Presentation to Securities Traders Association Annual Meeting" (October 11, 2002).

Greenspan, Alan. *Remarks on Corporate Governance at the Stern School of Business*, New York University, (March 26, 2002).

McConnell, Patricia A., "The Current and Future State of Financial Reporting." *AIMR Conference Proceedings: Closing the Gap between Financial Reporting and Reality*, No. 1 (2003).

Schmidt Bies, Susan, "Financial Markets and Corporate Governance in the United States and Other Countries." *Remarks at The American Graduate School of International Management*, Glendale, Arizona, (February 11, 2003).

Report of the NYSE Corporate Accountability and Listing Standards Committee to the NYSE Board of Directors. (June 2002)

H.R. 3763: The Sarbanes-Oxley Act of 2002, www.findlaw.com