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Sarbanes-Oxley & Section 404: Old Dog / New Teeth

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Editor's Note: *As a top executive at IBM during its resurgence in the 1990s, and as a director of State Farm Insurance, Gerry Czarnecki has a keen and long term perspective on trends in corporate governance. In this Viewpoint he argues that much of Sarbanes-Oxley already existed as a federal statute long before anyone heard of Ken Lay, and that the entire business that howls about the new legislative strictures has only itself to blame for ignoring that law.*

Viewpoint

Experience affirms that neglect by management, boards, the SEC, Congress, and accountancies invited federal intervention and the use of enforcement muscle….

Here is a Sarbanes-Oxley quiz:

In what year was the following Federal law passed?

> "Every issuer [of securities]…shall…make and keep books, records, and accounts, which…accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and… devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that…transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements…"

- ❑ 2002
- ❑ 1993
- ❑ 1977
- ❑ 1934

Hint: In that same year, the American President who signed this language into law also accused oil companies of perpetrating "the biggest rip-off in history."

The More Things Change....

Much of Washington's approach to business has changed since the days of Jimmy Carter, but until the accounting scandals that broke in the early days of the new millennium, much stayed the same.

Yet the failures we have seen in the quality and integrity of financial reporting of corporate America's financial reporting, culminating in the loss of tens of billions of dollars, provide clear evidence that something wrong remained wrong.

The law cited above is part of the Foreign Corrupt Practices Act (FCPA). As with that law, many argue that Sarbanes-Oxley went too far. Experience affirms that neglect by management, boards, the SEC, Congress, and accountancies invited federal intervention and the use of enforcement muscle, if for no other reason than to move toward rebuilding public trust. Doubtless Sarbanes-Oxley, and in particular its Section 404[1] , have increased the expense of doing business for public corporations. Yet this mandate is neither new nor useless. All parties to this process ignored the 1977 mandate, and now they all need to accept reality and move past the complaining.

Let's Look at the Record

A little history ... in the wake of the Japanese / Lockheed bribery scandals, the Congress of the United States passed the aforementioned Foreign Corrupt Practices Act. That law is well known for mandating the prohibition of American corporations regulated by the Securities Exchange Commission (SEC) from making any type of corrupt payments to agents of governments or corporations in foreign countries.[2] Facing onerous civil and criminal penalties, most corporations changed their practices in order to comply with the law.

In 1977 the FCPA was often characterized as the most extensive application of federal law to the regulation of business since the passage of the 1933 and 1934 securities acts. Improper payments had been reported by American corporations to government officials in a number of countries. Congress acted decisively to restore the reputation of American business and eliminate improper payments to foreign governments, politicians and political parties.

This law did not stand alone. Were you constructing a case against Andrew Fastow of Enron, for example, you could refer to various pieces of preceding law:

- **The 1934 Securities Exchange Act of 1934:** requiring all publicly traded companies in the United States to disclose any material facts necessary to make financial and management statements "not misleading";
- **The Mail and Wire Fraud Acts:** prohibiting the use of the mails or interstate or international telecommunications for the purpose of executing any scheme to defraud;
- **The False Statements Act:** imposing criminal penalties on persons or corporations that knowingly make false statements to any department or agency of the U.S. government.

…the business world slipped back into its previous lack of focus on controls, and the public accounting firms conveniently acceded to that slippage.

The little remembered aspect of the FCPA was that corporations were mandated to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that ... transactions are recorded as necessary to ... permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and ... to maintain accountability for assets.[3]"

The primary intent was to flush out the warrens where corporations could stash slush funds for bribes. This requirement got a great deal of press when the law was first passed, and many articles were written on how the new law would transform the way corporations managed and the way the public accounting firms audited. And for a short time, that was true, but the business world slipped back into its previous lack of focus on controls, and the public accounting firms conveniently acceded to that slippage. Pressure for firms to maintain cost-effective -- generally meaning "lean" -- operations, and pressure from firms to keep down auditing fees, caused the corporations and the audit firms to whittle compliance with the FCPA mandate.

Toothless Tiger

One further factor: the Act had no teeth. All of the sanctions -- the $2-million fines and the five years in prison -- imposed were focused on punishing illegal payments, not for a failure to comply with the internal controls mandate. For 25 years Congress, the SEC, public companies, and public accounting firms essentially ignored a mandate in large measure because there was essentially no enforcement action for a failure to comply.

For some time the thought leaders in the accounting profession have foreseen a need to strengthen internal control systems. In 1985, the Treadway Commission was asked to identify the causes of fraudulent financial reporting and to make recommendations to reduce its incidence.[4] The Commission's 1987 report included recommendations for management and boards of directors of public companies, the public accounting profession, the SEC and other regulatory and law enforcement bodies, and academics. The Commission made a number of recommendations that directly addressed internal controls.[5]

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COSO: So What?

Importantly, it focused on the control environment, codes of conduct, competent and involved audit committees, and an active and objective internal audit function. It also called for the sponsoring organizations to work together to create a framework for establishing and evaluating systems of internal controls. That caused the creation of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which issued a report that outlined the principles for an effective system of internal controls.

Fast-forward to the current rash of business scandals. We now have another crisis; only this time the fear in Congress was so great that the mandate was restated, and this time sanctions for non-compliance appeared in the legislation. Now 25 years of neglect and sloppiness have caught up to the public and private sectors. Three factors have brought internal controls to the forefront:

- Fear that corporate officers might actually be held accountable with civil and criminal penalties;
- A comprehensive regulatory system (Public Company Accounting Oversight Board) that was imposed on the accounting firms;
- Heightened demands for accountability by the SEC.

The plain fact is, there is nothing new with SOX 404. Quality policy, practice, and procedure documentation systems have always been the basis of sound internal controls and systems audits. The corollary fact is that corporations have generally given lip service to these programs, often calling them unduly bureaucratic and unreasonably expensive. Over these intervening 25 years, we all got sloppy and ignored not just the law, but also sound management practice. Ironically, "cost-effectiveness" provided the requisite excuse.

The Price of Neglect

Every corporation knows that Sarbanes-Oxley has cost business huge amounts of money during this first year. Business may not recognize that this cost is to be expected after 25 years worth of less than enthusiastic attention to a well documented control system. Although subsequent years' relative costs will decrease from today's, higher systems costs are here to stay. Controls cost money. Our own neglect simply meant that corporate boards and managements had to execute a major catch-up program.

Just as with individual behavior, with corporations the only way to get results is to find a way either to reward the results you seek or to punish the results you want to eliminate. As the FCPA's sponsor, Sen. William Proxmire (D-WI), said almost 30 years ago, "Many companies will continue paying bribes if they can get away with it…. Nobody has gone to jail. Only three corporations have fired their chief executive officers. At most there has been some unfortunate publicity. … And so we come to a need for a remedy."

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In government more often than not, the sanction is more effective than the reward. At least it is easier to deploy. Now we have sanctions that threaten all participants engaged in the process of establishing and evaluating the 25-year-old mandate for a system of internal controls. Those sanctions now command the attention of managements and boards alike. SOX has received great focus in every public company board room in America. Indeed, these standards are spreading to all other non-public corporations and even now are becoming a de facto standard for non-profits as well.

With little doubt, as time passes, effectiveness and efficiency will converge on the problem and those costs will fall. Never will they vanish... that is, not as long as the enforcement teeth remain. The sad note is that a mandate of 25 years was ignored. Today we pay the piper.

About the author: Gerald M. Czarnecki, Chairman and Chief Executive Officer of the Deltennium Group (www.deltennium.com), is former Senior Vice President - Human Resources and Administration of IBM and has been a Chairman and Chief Executive Officer of three banks. He has had a diverse career in industries ranging from retail merchandising, consumer banking, operations and technology. He is a director and audit committee chair of the State Farm Insurance Company. He currently teaches seminars on a variety of subjects including leadership, management and marketing. He has a B.S. in Business, an M.A. in Economics and is a CPA. He is the author of *You're In Charge….Now What?*

Footnotes

1. In its entirety, Section 404 of the 2002 Sarbanes-Oxley Act reads as follows:

Section 404 -- Management Assessment of Internal Controls

a. Rules Required. The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 to contain an internal control report, which shall--

1. state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

2. contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

b. Internal Control Evaluation and Reporting. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

2. It is interesting to note that for many years the U.S. has stood alone on the high ground in its legislation against the bribery of foreign government officials. In fact, many have perceived this law to present a competitive disadvantage to doing business in foreign markets. Foreign competitors are not only entitled to bribe foreign government officials, they are also generally allowed to deduct bribes as business expenses on their income tax returns. After many years of U.S. complaints, in early 1996 the International Chamber of Commerce (ICC) adopted new "Rules of Conduct to Combat Extortion and Bribery" and encouraged companies worldwide to adopt the conduct rules and incorporate them into their employee guidelines. Later that year the U.N. General Assembly adopted a "Declaration against Corruption and Bribery in International Commercial Transactions." United Nation member states pledged to: (1) deny the tax deductibility of bribes paid to government officials of another country; (2) criminalize the bribery of foreign government officials in an effective and coordinated manner; and (3) establish jurisdiction over bribery of foreign government officials in a manner consistent with the principles of international law. The next year the Organization for Economic Cooperation and Development (OECD) adopted a resolution that calls on its 29 members to submit legislation to their respective parliaments by April 1998 banning the bribery of foreign government officials.

3. Foreign Corrupt Practices Act (FCPA), 1977

4. The National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, was created in 1985 by the joint sponsorship of the AICPA, American Accounting Association, FEI, IIA and Institute of Management Accountants (IMA).

5. Based on this recommendation, a task force under the auspices of the Committee of Sponsoring Organizations of the Treadway Commission conducted a review of internal control literature.