SARBANES OXLEY
Ushering an Extraordinary Age of Transparency

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Dr. Madhav Mehra is the President of the World Council for Corporate Governance. He was the first elected Chairman of the World Quality Council, a body constituted by 52 national and international quality associations, in Chicago in 1996. He is a corporate visionary and futuristic thinker who is internationally renowned for his innovative ideas in integrating issues of quality, environment and governance to develop a holistic approach to corporate and social transformation.

This is the year when the curse of Enron really strikes and companies all over America and abroad are feeling the pinch of regulations that were put together in the post-Enron crisis. Its high point is the Sarbanes-Oxley Act. Neither Paul Sarbanes nor Mike Oxley the two legislators who coproduced the Act, could have imagined the huge industry spawned in their name that has created a gold rush for lawyers and auditors. Companies are spending an average $5 million each to comply with the requirements. The relatively brief legislation has been expanded to hundreds of thousands of words and there is a whole class of auditors and lawyers who are earning millions in interpreting it. Neither would have imagined that the accounting companies whose powers they both wished to clip because of their involvement in corporate history's biggest scandals would profit so hugely from this legislation and double their income from its implementation.

Latest survey by the Corporate Executive Board shows that US audit fees have, on average, doubled. The lowest increase in 2004 was 78 % achieved by Deloitte. The highest was PwC with 134% increase. Sarbanes-Oxley has provided the biggest boost to the Big Four accounting firms, much more than they could ever imagined.

Though Arthur Anderson was the star performer in Enron scandal, Lynn Turner, Chief Accountant of the SEC for 1998-2001, who earlier was a partner of Coopers & Lybrand admitted in a TV interview: "All the Big Five accounting firms helped Wall Street investment banking firms to engineer hypothetical transactions to make companies look better that they actually were". We should in fact be grateful to Enron for throwing open the murky world of corporate finance and providing us the opportunity of getting real with the hugeg problem of cleansing it. Arthur Levitt, former Chairman of SEC tried for four years to curtail the power of accounting profession. He could not even get the Big Five to meet in his office. Finally, he had

to hold it in the office of one of them.

It has been said that the Sarbanes-Oxley Act is the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the US securities laws of the early 1930s. The Act was enacted in the US in July 2002 as a response to high-profile accounting and document-tampering scandals which cast an unwelcome shadow over the credibility of US company financial information and so became a risk to US company investment. It is named after its two authors Paul Sarbanes (Democratic Senator) and Michael Oxley (Republican Congressman).

The Act, also referred to as "SOX" and "Sarbox", requires all public companies doing business in the US to follow a comprehensive accounting framework. SOX means that companies will be required to disclose huge amount of information publicly in a standard and transparent manner.

Sarbanes-Oxley is not merely a US problem, it has relevance for many overseas organisations, particularly for subsidiaries of US corporations. And it is far from being the end of the story; similar legislation is appearing within Europe and the principles of Sarbanes-Oxley are being taken up by regulatory authorities outside of the US as guidelines for good corporate governance.

Nor is SOX just an issue for a company's internal accounting professionals and external auditors. Compliance with the new regime which it imposes can have significant implications for its competitiveness and access to global capital markets.

The key element of the new SOX regulations is the requirement that companies must establish, and then maintain, accounting procedures that eliminate any possibility of so-called "creative" accounting. Any hint of creative accounting should be eliminated from the financial reports, removing any possibility of interpretation. Additionally, financial reports must be capable of withstanding close scrutiny; they should be auditable and supported by all relevant data. Further, such reports should be tamper-proof. Systems will need to be in place which will identify who has accessed data, and when, such that a full audit stream can be identified.

The Act is intended to address the problems that generated it by instituting various new levels of control and sign-off such that financial reporting provides full and accurate disclosure and corporate governance is completely transparent.

Its major provisions include:

- certification of financial reports by CEOs and CFOs
- ban on personal loans to Executive Officers and Directors
- accelerated reporting of trades by insiders

- prohibition on insider trades during pension fund blackout periods
- civil penalties added to disgorgement funds for the relief of victims
- additional disclosure
- auditor independence, including outright bans on certain types of work and pre-certification by the company's Audit Committee of all other non-audit work
- criminal and civil penalties for securities violations

The most feared is the Section 302 which requires the CEO and CFO to personally sign off on the appropriateness of the firm's financial statements (see also section 1102 regarding tampering with records). Section 404 covers attestation of the adequacy of financial reporting controls. This means that organisations must not only introduce adequate systems in the first place but must also assess the adequacy of those systems on an annual basis. This is a short section that lays down the responsibility of chairman and CEO for disclosure. But the auditor/consultant/lawyer industry spawned by the Act for its implementation has expanded it into thousands of words. This is the most hated section. Section 409 is another highly relevant section that calls for real-time reporting.

The implementation of SOX leaves much to be desired. Despite its avowed purpose of protecting the investors, it is the investors who are being skinned. They are the ones who are bearing the huge costs of $5 million. Sarbanes-Oxley Act was legislated to force CEOs to take personal responsibility for financial reporting and building up control systems to ensure its accuracy. The result has created a bureaucratic nightmare and shown that the US approach continues to tick every box and preferably several times over. The legislation is making the US accounting profession a joke. Excessive regard for following the rules to the letter has altered the accounting landscape and the driving purpose of the audit. Essentially audit is supposed to be conducted on behalf of the investor to protect their investment and report on the integrity of financial reporting. Contrarily, the profession is becoming an agent of the regulator. Every clause of the Act is being subjected to hair splitting by auditors to protect themselves from falling foul of their new boss – Public Company Accounting Oversight Board (PCAOB), the new regulator appointed under the Sarbanes-Oxley Act.

There is a great danger that the burgeoning, bureaucratic and box driven process is negating the very purpose of the Act and its fundamentals are being lost in egregious detail. The traditional exercise of judgement has given place to following the letter of the law as per regulator's rules.

Auditors are supposed to protect investors. Instead they are being squeezed. The Big Four simply cannot cope with the astronomical demand for their audit services created by Sarbox. Investor has been a loser because just four big firms would not provide the degree of competition, security and choice that is needed. Secondly, in order to keep themselves on the right side of the regulation, the big four are

dropping clients that they see as risky. These clients go to the third tier accounting firms. But they too have little resources and are working to overcapacity.

Despite all the hoopla and enormous resources and money spent on its implementation there is little change in the attitudes. Auditors have become even more important than they were during Arthur Levitt's days. William Donaldson, the SEC Chairman, has been acutely concerned with the shenanigans of both lawyers and auditors. Speaking to a Washington audience of more than 1000 securities lawyers he said lawyers and auditors are crucial gate keepers for the integrity of the markets.

Lapses over the past few years by outside advisers directly contributed to financial frauds that devastated thousands of investors, he said. "I hope you will not expend significant time, money and energy devising structures aimed at evading requirements and trying to achieve an accounting or disclosure result that . . . artfully dodges the rule's purpose," Donaldson said.

The SEC has lodged 76 cases against lawyers in the past 3 1/2 years, chief litigation counsel David L. Kornblau said in a separate Practising Law Institute session yesterday. Kornblau said 18 cases have been filed already this fiscal year. "These lawyers did not seem to have in their vocabulary the word 'no,' " Kornblau said.

The conduct of auditors at accounting firms of all sizes also remains on the SEC's radar screen. Agency officials said they will continue to scrutinize auditors' relationships with their clients for possible violations of independence rules. They said they expect more enforcement actions to come in cases where auditors have grown too cozy with their clients to render impartial reviews of financial reports.

Separately, SEC chief accountant Donald T. Nicolaisen laid out several of his priorities for 2005. Donaldson said his office soon would release a report about corporate use of off-balance-sheet entities such as those that hid billions of dollars of Enron Corp. debt.

Nicolaisen also said the agency staff would provide guidance later this year for companies on how to value stock options on their financial statements. Accounting standard-setters are mandating that companies for the first time treat stock options, or chances for employees to buy stock at a set price and time frame, as an expense on their books. The move has proved controversial for technology firms, which used stock options heavily as an employee recruitment and retention tool.

SEC Enforcement Division chief Stephen M. Cutler endorsed the fear psychosis when he said the agency was considering its own reality-based TV show, "Corporate Fear Factor," where "big-time executives have to eat worms, jump out of a moving car, and for a final test, they have to sign a Sarbanes-Oxley 404 certification."

The answer of course is not withdrawal of the act or even delisting from US bourses which many European firms are threatening. All said and done the Act provides an excellent self-improvement, risk management opportunity and therefore, is of considerable competitive advantage. This advantage, however, is diminished if the implementation is focused on box ticking. Nonetheless in a survey conducted by PwC of 1300 two thirds of the CEOs interviewed felt that the money spent on its implementation was an investment.

Most CEOs understand that improving corporate governance by strengthening board expertise, board oversight and exercise of better internal controls to manage risks, would improve managerial effectiveness and add significant benefits and savings. The compliance can result in enhanced reputation, increased operational effectiveness, higher employee moral, improved customer loyalty and more transparent engagement with civil society. Transparency is the heart of corporate governance. With the increasing demands on disclosures, companies cannot survive without putting in place internal control architecture that will enable timely disclosures without risking reputation.

The globalisation today offers huge opportunities for proactive businesses. Today's business is dealing with only a fraction of the infinite field of available options. There are enormous opportunities for innovation and creativity. But innovation does require investment. Transparency can work wonders in improving company's credibility and access to global capital.

The real management challenge for global companies lies in creating systems for global governance that comply with stakeholder expectations right across their global operations and help them to build new markets and increase profitability. One of the nagging worries of the businesses after Enron and WorldCom directors accepted to compensate company losses from personal funds is to attract quality independent directors. Companies that have developed robust compliance programme and transparent structures would make them ideal choices for qualified directors.

Laws such as Sarbanes Oxley, reforms in NYSE and NASDAQ and a raft of regulators such as IFRS, OFR, BASL II that are crowding the corporate firmament are reminders that we are entering an extra ordinary world of transparency. We have no alternative but to disclose all. Transparency is the key survival. As Don Tapscott & David Ticoll say in the book "The Naked Corporation", "Strive like glare of public scrutiny through the nasty web has melted the veil of secrecy and made the corporation Naked". Investors will forgive errors but punish omission specially when they turn out to be deliberate. Only the firms who can harness the power of transparency will survive.