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Exclusively for Management

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Ethics: A call to action in 2003

Sarbanes-Oxley Act calls for increased accountability by public organizations, auditors

The previous year has been one characterized by moral bankruptcy. Corporate giants toppled, leaving a wake of betrayed employees forced to watch their retirement savings and financial security evaporate. Allegations of insider trading stained prominent public figures, and misuse of company funds to support executives' exorbitant lifestyles further shook the confidence of American investors, contributing to the economic upheaval that continues to plague the nation.

These highly publicized crimes, committed by a few rogue organizations, cast the rest of corporate America in an unfairly negative light. To combat this image, the business community must unite, demonstrating to the world that such companies are indeed exceptions—and not the rule—in the United States of America.

The Sarbanes-Oxley Act became law in 2002 to bolster the accountability of public companies and their auditing firms. This issue of The Lipman Report *examines some of the act's provisions designed to promote sound corporate governance and to help ensure ethical conduct in business transactions. Even though the legislation does not affect private companies, experts predict that those firms would do well to adhere to its provisions, as the American public expects the same level of responsibility—regardless of an organization's ownership structure.*

Ethics and economic success

Historically, a key ingredient in the success of corporate America has been a fundamental trust shared by employees, investors and the nation's business leaders. Ethics authorities have noted that productivity runs high and stress runs low when workers trust their supervisors. Likewise, investors are more likely to provide capital and fuel the economic machine when they have faith in the men and women who run major corporations.

Such trust is becoming increasingly scarce. A benchmark study on loyalty in the workplace reports that only 24 percent of U.S. employees are committed to their employers and plan to stay for the next two years. Thirty-four percent are not committed and plan to leave their positions within the next two years, while 37 percent feel trapped: they are not committed to the organization, but plan to stay because they have no better options.

Much of this employee discontent appears to stem from mistrust of corporate leadership; less than half of all employees surveyed believe their senior leaders possess high integrity. The recession has exacerbated the situation. Economic crunches may tempt many supervisors and managers to take shortcuts or to deal dishonestly with workers concerned about layoffs. Such behavior erodes employee trust and morale, producing a decrease in overall productivity.

At the same time, several cases demonstrate a positive correlation between sound ethics and business success. One ethics publication compiles an annual list that ranks firms according to quantitative measures of corporate service to various stakeholder groups, including stockholders, employees, customers and the community, then compares the financial performance of their best-rated companies with the Standard & Poor's 500. The most recent research shows that the outstanding corporate citizens named in 2002 significantly outperformed other organizations in the S&P 500. In another example, one privately held company with a public track record of putting principle before profit has enjoyed double-digit, organic growth on a compound annual basis for more than 20 years—a trend that coincides closely with the formal adoption of its first code of ethics in 1980.

Consequences of misconduct

Similarly, examples abound of the consequences of ethical misconduct.

The business community continues to recoil from media reports of corporate wrongdoing. Headlines have named members of corporate America that have been taken to task for various ethical infractions—employers deceiving workers and investors about company stock, auditors obstructing justice by shredding potentially incriminating evidence, companies inflating earnings reports—and the sins have carried hefty penalties, ranging from multi-million-dollar fines to plummeting stock prices

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and ultimately, bankruptcy. Stories have also emerged of financially struggling firms that loan significant sums of money to their top executives—often with no expectation of repayment.

Such conduct speaks poorly for the United States in the international community. As one of the primary forces behind this successful democratic society, U.S. businesses represent the country as a whole to the rest of the world. Their failings can be perceived as weaknesses in the national fabric.

The Sarbanes-Oxley Act

In an attempt to prevent future incidents of this nature, both Houses of Congress passed the Sarbanes-Oxley Act by an overwhelming margin. Enacted into law on July 30, 2002, the legislation has a far-reaching impact on public companies and their related entities, as well as on the auditors and attorneys responsible for financial oversight. Key provisions include the following:

Greater CEO/CFO Accountability. Both the Chief Executive Officer and the Chief Financial Officer must certify financial statements and earnings reports on an ongoing basis. The CEO and CFO will also be accountable for incentive-based remuneration if a company restates earnings because of noncompliance due to misconduct. Additionally, the act disallows new corporate loans to executive officers and directors.

Increased Disclosure. The legislation requires the U.S. Securities and Exchange Commission (SEC) to adopt regulations mandating real-time disclosure by public companies and new disclosures of off-balance sheet transactions and internal controls.

Oversight of Accountants and Attorneys. The act also establishes a Public Company Accounting and Oversight Board, regulated by the SEC, to monitor external auditors. New requirements are designed to ensure the independence of public auditors and prescribe the actions of attorneys who encounter evidence of misconduct.

Audit Committees. The responsibilities placed on audit committees of boards of directors increase, including mandatory establishment of procedures for handling complaints about corporate accounting practices.

Enforcement. Stockholders now have a significantly longer time period during which they can file suit for securities violations—among other protections. The legislation also stiffens criminal penalties, imposing hefty fines and prison sentences, and it expands the number of criminal prohibitions under securities law.

Several of the law's requirements are effective now, including the provisions on new loans, CEO/CFO certifications and compensation forfeiture for earnings restatements due to noncompliance. The provisions regarding off-balance sheet transactions, professional responsibility of attorneys and the retention of audit records went into effect last month, with the adoption of SEC rules. Other requirements will take effect during the first half of 2003, with compliance expected in financial reports pertaining to the fiscal year ending in 2003.

Corporate governance

The provision on audit committees addresses the need for greater independence of boards of directors to facilitate objective review of company operations. "This is really a recognition of the fact that there has been too cozy a relationship between directors and management," said a New York attorney who serves as senior advisor to Fortune 500 companies. "The message that the board of directors is a fiduciary of the public and not management is really the most important component of Sarbanes-Oxley."

The New York Stock Exchange (NYSE) has proposed additional provisions to ensure board independence. These rules would require that a majority of directors be independent—defined as an individual who is not (or has not been):

- an employee for the preceding five years;

- an immediate family member of a person employed by the firm in the prior five years;
- a former employee of the organization's auditor, again within five years; or
- a person who has a "material" relationship with the company, with board members affirmatively determining non-materiality.

In addition, the NYSE guidelines would mandate that non-management directors participate in regularly scheduled executive sessions without management.

Experts agree that stronger measures are needed to ensure that directors maintain the necessary independence to make objective decisions. According to the president of a leading ethics organizations, boards must take an active role in shaping the ethical culture of the organizations they oversee, while examining themselves to reduce potential conflicts of interest. He recommends that each board regularly undergo an independent review of its major actions and decisions, concentrating on the group's oversight of executive management and its own freedom from conflicts of interest.

Codes of ethics

In implementing the Sarbanes-Oxley Act, SEC rules require public companies to disclose in their annual report whether they have adopted a written code of ethics that applies to the executive officers of the organization. Companies with a code must include it in the report as an exhibit. Although the rules do not require firms without a code to adopt one, these companies must explain their reasons for not having a code. The new regulations do not require organizations with existing codes to amend these documents, even though changes may be necessary to comply fully with the rules governing ethics codes. Companies that choose not to amend their codes accordingly will have to disclose their reasons for failing to do so.

The SEC allows each company to determine specific provisions and compliance procedures for its ethics program, including disciplinary measures for breaches. At the same time, the regulations establish a standard protocol for ethics codes, requiring that such documents include reasonable provisions to discourage misconduct and to promote:

- Honest and ethical behavior, including resolution of any real or perceived conflicts of interest between personal and professional relationships;
- Prompt, internal reporting of ethical violations to a party identified in the code, with established enforcement measures to ensure accountability;
- Compliance with applicable laws and regulations; and
- Full, timely disclosure in public communications.

The SEC rules require that public companies disclose any changes to, or exemptions from, the organization's code of ethics within two business days. Exemptions include both stated waivers and "de facto" waivers caused by failure to enforce the code. A company may choose to disclose such information on its website, provided that the website address was published in the last annual report, accompanied by a notice that the organization intended to publish this information on that medium. Any electronic disclosure would also need to appear on the website within two business days of the event, with the information remaining on the website for at least 12 months. The issuing company would need to maintain a record of the disclosure for a minimum of five years.

To encourage enforcement of the ethics code, the SEC rules recommend that each organization appoint an individual who would serve as the primary contact to receive communication concerning the code, including violations and potential conflicts of interest. The commission does not specify which person in the company should occupy this role, such as the treasurer or the general counsel. However, the SEC does recommend

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appointing a person of sufficient rank to foster respect for the code and to carry the appropriate authority to deal with the individuals subject to the code, regardless of their position within the organization. The Sarbanes-Oxley Act requires that certain examples of misconduct be reported directly to the company's general counsel.

The provisions of the Sarbanes-Oxley Act only affect those organizations that are publicly traded in the U.S. stock markets. Even so, the American people expect ethical conduct from all companies, regardless of whether they are privately or publicly held. The attorney cited above believes the legislation "reflects an official, political view as to what is right and what is wrong, and it will seep down even though private companies are not legally required to do it." The act offers a "psychological incentive" for private companies to reassure employees, customers and business partners that they are upholding the same standards now legally required of public companies. The legislation will serve as a model of corporate governance, and those organizations not subject to regulation—including philanthropic endeavors—will send a positive message by following the spirit of the Sarbanes-Oxley Act, where applicable, in their operations.

'Unintended consequences'

While experts applaud the principles behind the act's provisions, many have expressed concern about the legislation's efficacy in practice. For instance, the act requires that a company's audit committee include at least one "financial expert." This stipulation ensures that at least one member of the committee possesses the necessary expertise to verify the information disclosed in financial reports. Unfortunately, the legislation's current definition of a "financial expert" may be too narrow. The president of a Washington, D.C., based think tank points out that a former chairman of the SEC would not qualify under the proposed definition by virtue of the fact that he never served in the capacity of CFO, although the individual's professional experience attests to his financial competency. "What you need is not just expertise, but experience," he said. "If you come up with an overly formulaic, regulatory definition, you'll end up doing more harm than good. Under the guise of trying to fix something, you'd actually make it worse." The organization is currently developing a forum to discuss whether the legislation contains other "unintended consequences" that may present problems in practice.

Only two years into the new millennium, Americans live in a vastly different world—one haunted by the omnipresent threat of global terrorism and clouded by economic uncertainty. High-profile cases of corporate misconduct undermine investor and consumer confidence in the business community.

Corporate America occupies a prime position to help elevate this great democracy both in the eyes of its own citizens and the international community. No other combined entity wields as much influence in the lives of the estimated 288 million men, women and children of this country. The U.S. business community serves as the primary transmitter of the nation's values and thus bears a social and global responsibility to operate in an ethical manner.

Each organization—in the public and private sectors alike—must uphold this responsibility by conducting its operations in a manner that places principle first. Companies that fail to do so will find the penalties of the Sarbanes-Oxley Act insignificant compared to the response of the investment community and the public at large.

The Lipman Report Editors

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