

Sarbanes-Oxley Act

White lies and legal risk

The SEC's interpretation of the Sarbanes-Oxley Act requires criteria be used when judging the effectiveness of a firm's controls – which is good news for lawyers, says *Tim Leech*.

There's likely to be more work for lawyers as the Sarbanes-Oxley Act, the US law that sets some of the stiffest corporate governance rules in the world, generates fraud and negligence actions against companies whose internal controls prove to be less effective than they claimed.

US listed companies and others caught by Sarbanes-Oxley should already be preparing for the massive change in legal exposure that will come with the advent of criteria-based control effectiveness representations by chief executive officers and chief financial officers. Firms in other jurisdictions that still allow internal control representations from senior executives without disclosed criteria can rest a little easier – at least for the time being.

At least, that's a conclusion that can be drawn from the answers to two simple questions I posed at a recent presentation to a Florida conference on enterprise risk management.

The questions were:

How many participants were from companies whose CEOs and CFOs had already stated they had an effective system of control over financial disclosures, as required by section 302 of Sarbanes-Oxley, in quarterly reports to the US Securities and Exchange Commission (SEC)?

How many of those that said yes to question #1 felt they were ready for their external auditor's review of the adequacy of these statements, as required by section 404 of Sarbanes-Oxley?

Answers to the first question showed that a large percentage of the attendees came from companies where the CEO and CFO were already making control effectiveness representations each quarter in their 10Q filings, the quarterly reports required of all companies with shares listed on stock exchanges supervised by the SEC.

Answers to the second question showed that not one of the companies represented in the room felt they were ready yet to

withstand the scrutiny of an external audit of the support for those representations.

What this apparent anomaly indicated to me, as a risk and control specialist and forensic accountant, is that the standards are shifting and shifting significantly. What has been OK to date will apparently not be OK soon, when the clarity of the criteria to define an "effective system" and burden of proof increases.

It is important to note that this situation is not restricted to U.S. listed companies. Senior executives and, in some cases, members of boards of directors of public companies in countries such as the UK, Canada and elsewhere have made control effectiveness representations to investors with only limited technical support for the claim for many years.

Given the U.S. is widely regarded as the most litigious country in the world, why are so many senior executives making weakly supported, or even false, control representations?

The white-lie defence

There are several possible explanations.

One is that it is a common human trait is to tell "white lies" or "fibs". These are non-truths, but the person telling them doesn't consider them to be serious enough to cause much harm. Senior executives and internal and external auditors all over the world have been claiming companies have good or effective systems of internal control to audit committees and regulators for many decades. Frequently, investors, regulators and even audit committees haven't really cared much whether there was strong evidence to support the claim. Hence the notion of these representations being only white lies. Since there was rarely a request for a rigorous technical defence of these internal control status assertions, falsehoods and half-truths grew to be acceptable in many companies.

Executives around the world have been making different forms of control effective-

ness representations to a range of different constituents for decades. Seldom has there been any personal consequence when subsequent events proved the control effectiveness representations to have been grossly inaccurate, at least with respect to the propriety of the control representation itself. Directors of internal audit assured the audit committee that things were/are fine. External auditors issued management letters with lists of petty issues when companies had hugely flawed and inadequate control systems. CEOs and CFOs have filed a range of declarations claiming good control systems. In no case that I am aware of has an individual or individuals making the control status representation been called to task for a false, misleading, or inadequately supported statement on internal control effectiveness. They may have been fined or jailed for other transgressions, but the inaccuracy of internal control representations has not been questioned. If any reader is aware of specific prosecutions or civil actions for fraudulent internal control statement, I'd like to hear from you.

A career-limiting move?

Another explanation is that telling important outsiders that your boss or client is not telling the whole truth and nothing but the truth is a CLM – a career-limiting move.

In many companies the head of internal audit formally reports to the CFO or finance director. Even in cases where the formal reporting lines indicate otherwise, the head of internal audit's career path is heavily influenced by the view of the CFO. This common situation makes reporting the truth about seriously flawed internal controls by heads of internal audit a possible CLM. Meanwhile, the tenure of the external auditor is still today largely at the pleasure of the senior executives of a company. To suggest that your client

Sarbanes-Oxley Act

maintains a deficient internal control environment requires a fortitude few external auditors have had the stomach for to date.

Nobody knows anyway

Most representations on internal control made to date by internal and external auditors and senior executives have been “criterialess”; that is, made without a formal set of criteria as to what constitutes an adequate or effective internal control system. This is somewhat akin to my asking my teenage daughters after they have been out for the night if they’ve have been good girls. “Of course I was a good girl, dad” is the general response. The fact that my definition of what constitutes being a good girl may differ greatly from theirs doesn’t mean their representation is false. In fact I like hearing they have been good girls. Only in rare instances have I added details as to what my definition of being a good girl consists of. Unfortunately, adding a lot of detailed criteria as to what constitutes good can cause the representation to alter. Sometimes it is better not to know.

Hearing what you want to hear

Over my many years as a control and assurance specialist I have seen instances where internal audit departments have issued numerous, even scores, of individual audit reports indicating serious control problems. However, when asked by an audit committee member – and this was rare – whether the overall system of control in the entire company over financial disclosures was effective, the answer was inevitably “Yes”. That is the answer that senior management, audit committees and regulators wanted to hear.

To answer otherwise is akin to telling a customs inspector when entering a country that you have goods to declare, have recently visited a UK farm or had a fever and cough. Those answers cause delays and hassles. You will likely be directed to another inspector. Your bags may be inspected. You will be questioned at greater length and you may be billed. Many feel it is easier to simply say “Nothing to declare”.

I have even been told that some senior

executives and board members, particularly in US companies, have been advised by legal counsel not to ask for an overall opinion on control, especially internal controls over external accounting disclosures. If the answer they get isn’t what they want to hear they would then be burdened with a whole new set of legal expectations and problems.

Given this vague world of control representations has been around for a long time with few challenges to its limitations what’s different now?

But the world is changing

It is virtually certain that starting in 2004 U.S. listed companies will have to disclose that their system of internal control over external financial disclosures is effective in accordance with criteria in a disclosed control model or framework.

In most cases, companies will use either the 1992 version of the COSO (Committee of Sponsoring Organisations) control framework or the new version scheduled for final release in early 2004. (NOTE: The exposure draft was issued in July 2003) Some Canadian companies listed on a U.S. exchange may elect to use the shorter, 20 criteria CoCo model issued by the Criteria of Control Board sponsored by the Canadian Institute of Chartered Accountants. UK-based companies listed in the U.S. may decide to use criteria in the December 1994 Cadbury report. This legal change will immediately reduce or eliminate the current defence of claiming that a control representation was not fraudulent because the issuer was using their own definition of what constitutes an effective control system. Although these models are still not what most would consider clear and unambiguous criteria, they are certainly clearer than Fred’s, Beverly’s, John’s or Martha’s view of what constitutes an effective system of control over external disclosures.

The biggest change by far for US listed companies is that the opinion of the CEO and CFO that they have an effective control system will have to be signed off by the company’s external auditor. This will mean that the CEO and CFO must both indicate they have a system of control over financial disclosures that manifests, at least in a

material way, the criteria of a specific control framework such as the COSO framework issued in July 2003, CoCo issued in 1995, Cadbury issued in December 1994 or the old COSO framework issued in 1992. The company’s external auditor will then examine and test the evidence that supports this assertion and put their reputation on the line with an opinion. It is this change that played such a large role in the extension of the Sarbanes-Oxley implementation date from 2003 to 2004 for large US companies, and to 2005 for foreign companies and small US firms. It is this change that will also create significantly heightened litigation risk for senior executives and their external auditors. It will also create new remedies for those harmed by major breakdowns of control systems and attorneys working on contingency fees.

Regulators in Canada have indicated so far that they are still satisfied with control effectiveness representations without disclosed criteria. The UK would appear to be somewhere in the middle, with disclosure against general governance criteria but not a control effectiveness representation against a specific set of control model criteria with an external audit opinion. This is somewhat akin to indicating that financial statements are fairly stated in accordance with criteria the CEO and CFO made up last month.

A new growth industry

Once these new criteria-based control effectiveness assertions begin to be made, it is safe to assume that there will be many instances where the representations from CEOs and CFOs will subsequently be proved wrong. That will create the opportunity for actions by the SEC and plaintiff attorneys alleging the control effectiveness representations were fraudulent, or made negligently without adequate care for their accuracy and completeness.

Future articles will examine how to prepare due diligence defences against this kind of legal action as well as potential strategies plaintiffs may use in the future to advance them.

Tim Leech is Managing Director and CEO of CARD@decisions Inc, an Ontario, Canada-based risk and assurance management software and consulting firm.

Email: Tim.Leech@carddecisions.com.