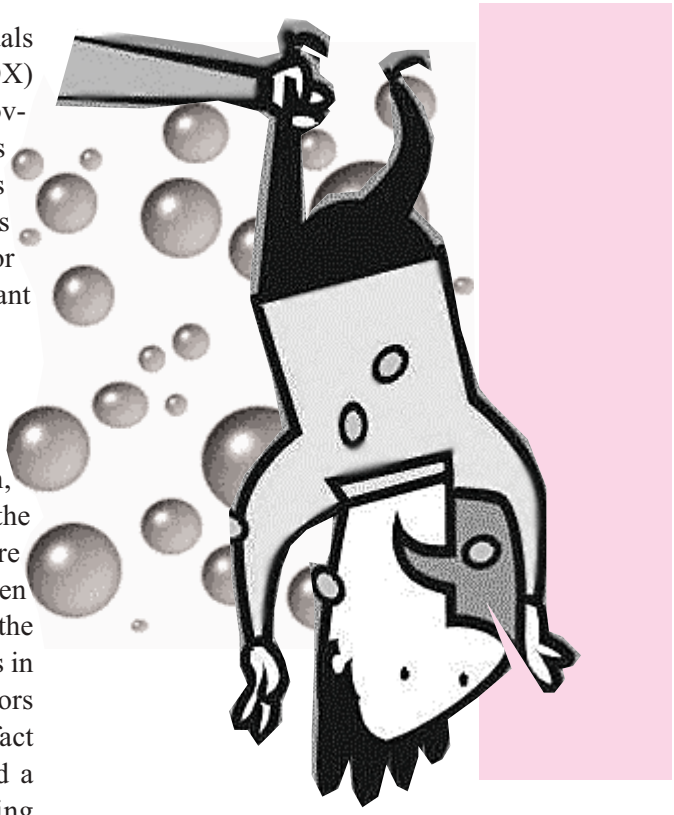
Sarbanes Oxley Act & Corporate Governance

Sarbanes Oxley Act, 2002 has created ripples in Corporate Governance arena following the recent corporate scandals hitting America

-- Pradeep Godbole

Enacted as a result of the recent corporate scandals in the USA, Sarbanes Oxley Act, 2002 (SOX) addresses the shortcomings noticed in corporate governance practices prevailing at that time, redefines the roles and responsibilities of various participants in the corporate governance chain and prescribes severe penalties for any wrongdoing - intentional or otherwise. This article elaborates on the significant provisions of the Act.



Backdrop of SOX

The string of corporate scandals in USA-Enron, WorldCom, Global Crossing etc. created havoc in the financial sector and heralded losses to the tune of more than $35 billion in the stock markets. There have been cases of organization failures or financial frauds in the past, but the sheer size and number of such scandals in such a short span overwhelmed and shocked investors around the world. And this happened despite the fact that defined corporate governance standards and a well-developed regulatory and financial reporting framework already existed in the US at that time.

All about SOX- 2002

Sarbanes-Oxley Act was enacted in the backdrop of the aforementioned corporate failures in the year 2002. SOX - named for its originators - Republican Senator Paul Sarbanes and Democratic Senator Michael Oxley, was a drastic measure to improve corporate governance and regain investor trust and confidence. This act has more than 300 sections divided into 11 titles.

Let us examine the significant provision of SOX,

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2002, in greater depth:

(a) Public Company Accounting Oversight Board

This title attempts to strengthen the regulatory supervisory mechanism and ensures that adequate resources and funding is available to meet supervisory responsibilities.

Section 101 of the Act envisages creation of a new independent corporate body, the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies. The Act specifically states that PCAOB should be a non-profit-making corporation and not an agency or establishment of the United States Government. It also lays down the principles for the composition, qualification and independence requirements of the PCAOB membership.

PCAOB holds the following responsibilities:

- Enforce compliance with SOX, PCAOB rules and securities laws relating to preparation and issuance of audit report
- Mandatory registration of public accounting firms (Section 102)
- Establish standards for auditing, quality control, ethics and independence (Section 103)
- Conduct inspections of public accounting firms (Section 104)
- Conduct investigations, disciplinary proceedings (Sec. 105)

Section 102 requires the mandatory registration of public accounting firms by PCAOB. This is also, applicable to foreign public accounting firms (Section 106). Only the firms registered

With its cutting-edge penalties, SOX acts as a blessing in disguise and fosters interest in corporate governance. Efforts are already underway in Europe and rest of the world to develop laws similar to SOX- 2002.

(b) The Auditor Independence under SOX

This title articulates a mechanism to avoid auditor conflict of interest situations.

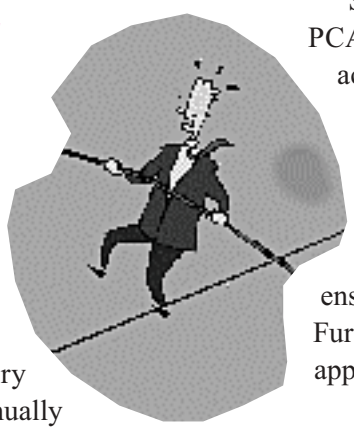
Section 201 prohibits public accounting firms to provide certain non-audit services to their audit clients. If the aggregate amount of non-audit service is more than 5% of the amount paid to public accounting firm or independent auditor, it requires a pre-approval by the Audit Committee, or by one or more members of the Audit Committee delegated with authority, and who are independent directors of the Board of Directors (Section 202). Similarly, audit services also require a pre-approval by Audit Committee. Amount paid for non-audit services also need disclosure in periodic reports.

Section 203 requires mandatory rotation of lead audit partner and review partner every five years while Section 207 requires a mandatory rotation of audit firms.

Section 204 requires public accounting firm to report to Audit committee of Board of Directors. Auditor has to report to the Committee about critical accounting policies and practices used, and if alternative accounting treatment is possible, discuss the impact of such treatments and recommend preferred treatment.

Section 206 prohibits appointing any employee of a public accounting firm as CEO or CFO during one year prior to initiation of audit.

As per the Sarbanes Oxley Act-2002, if any significant deficiencies are noticed in the design and operations of internal controls, or if any frauds are detected, it requires disclosure to the Audit Committee and auditors.



with PCAOB can carry out audit and reporting assignments.

Section 104 mandates a supervisory review of audit firms by PCAOB. It will annually inspect registered public accounting firms issuing more than 100 reports, while other firms will be reviewed once in three years. Section 105 empowers PCAOB to investigate and take on disciplinary proceedings against registered public accounting firms. Any deliberate violation or negligent conduct can be penalized with a temporary or permanent revocation of registration, or suspension, or a permanent limitation on activities and a civil fine. (Section 105)

Section 103 endorses PCAOB to issue auditing, quality control and independence standards. It aims to improve audit quality assurance either through mandatory concurring or a second-partner review. It also mandates that audit papers and related material be documented for a period of seven years after the audit.

Section 108 of the Act empowers PCAOB to recognize the generally accepted accounting principles/standards for financial reporting purposes.

Securities and Exchange Commission (SEC) is responsible for dictating rules under SOX and ensuring its enforcement (Section 107). Further, PCAOB regulations require SEC approval.

PCAOB and the Accounting standard-setting body will be funded under Section 109 of SOX.

(c) Corporate Responsibility

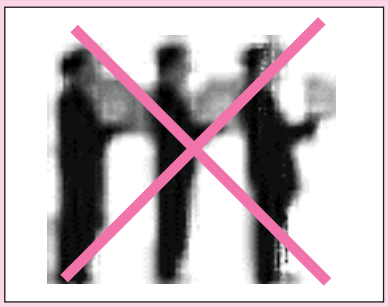
This title reinforces audit committee mechanisms and also places responsibilities on various stakeholders.

Section 301 requires the corporate to form an Audit

Corporate and Criminal Fraud

The Corporate and Criminal Fraud Accountability falls under title (h) of the Sarbanes Oxley Act-2002. Some of the provisions of SOX are similar to previous laws but the key differentiators are the stiff penalty structures that SOX imposes.

Section 802 requires maintenance of the documentation of the audit or review work for five years. Any knowing and willful violations will attract imprisonment for 10 years or more. Cases of deliberate destruction, alteration or falsification of records in federal probe attract an imprisonment of 10 years, or more.



Section 806 protects any employee providing proof of fraud from threats, harassment, discharge, demotion or suspension. Those who retaliate against these informants are liable to be imprisoned for 10 years or/and pay heavy fines.

Fraudulent activities against share holders can lead to a 25-year imprisonment under Section 807. This action can be initiated within 2 years of the discovery of these activities or 5 years after such a violation.

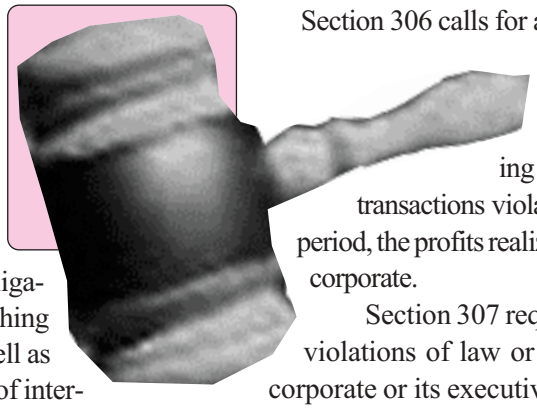
White collar crime penalty enhancement

The 'White collar crime penalty enhancement' provisions fall under Title (i) of the Sarbanes Oxley Act-2002.

As per Section 902, any attempt to commit criminal fraud is equivalent to a fraud actually being committed and can be penalized. Section 903 and 904 lays down criminal penalties for mail and wire fraud and violation of the Employee Retirement Security Act, 1954.

Section 906 stipulates that the CEO and CFO provide a statement along with periodic audit reports about compliance with Securities Exchange Act, 1934. Any unintentional wrong certification attracts penalty of USD 1 million or an imprisonment of 10 years, or both, while the penalties for deliberate acts are even higher - at USD 5 million or an imprisonment of 20 years, or both.

Committee of the Board of Directors. The members of this Audit Committee should not receive any compensation for any consulting or advisory services, other than as members of the Board Committee or Board of Directors. These members should not be affiliated to the corporate or its subsidiaries. The Audit Committee will be responsible for the appointment, compensation and oversight of the public accounting firm and can engage any advisors if necessary. The committee should be sufficiently funded and follow a mechanism for receiving any confidential or anonymous submission of information concerning any questionable accounting or auditing matters.



Section 302, a significantly important section in SOX, casts an obligation on the CEO and CFO for establishing and maintaining internal controls as well as testing the existence and effectiveness of internal controls 90 days prior to the date of the report. Every quarterly and annual report filed with SEC requires CEO and CFO to provide certification, in the prescribed format, about the accuracy and completeness of financial statements as well as the existence and effectiveness of internal controls. If any significant deficiencies are noticed in the design and operations of internal controls, or if any frauds detected, it requires disclosure to the Audit Committee and auditors.

Section 303 lays down penalties for any fraudulent activities including that of coercion, manipulation or misrepresentation. If financial statements require a re-statement as a result of material non-compliance, Section 304 requires that organizations recover any profit made from sale of securities, within 12 months or any bonus, incentives or equity-based compensations paid to CEO or CFO.

Section 306 calls for a corporate to issue a notice to directors and executive officers about the blackout period for purchasing, selling, acquiring or transferring equity. If any transactions violate the section during blackout period, the profits realized have to be recovered by the corporate.

Section 307 requires Attorneys to report any violations of law or breach of fiduciary duty by corporate or its executives, to the chief legal counsel or the CEO. If the chief legal counsel or CEO does not take any suitable remedial measures, the Attorney has to report it to Audit Committee.

(d) Enhanced Financial Disclosures

Significant thrust of SOX has been on improving internal controls, financial disclosure and transparency.

Section 303 of SOX lays down penalties for any fraudulent activities, including that of coercion, manipulation or misrepresentation.

Section 406 requires that organizations establish a code of ethics for Senior Management/Financial Officers. The institution of code of ethics including any changes to code of ethics has to be disclosed in SEC reports.

This title has drawn most of the flak.

Section 401 requires that periodic financial statements, including proforma financial statements filed with SEC, to be reconciled with GAAP and contain material-correcting adjustments. All material facts regarding off balance sheet transactions, arrangements, obligations and relationships with unconsolidated entities need to be disclosed.

Section 402 lays down enhanced restrictions on the arrangement or extension of credit/loans to directors or executives and requires such facilities to be on same terms and conditions and market rates as is available to the general public in ordinary course of business.

Section 403 requires the revelation of stock holdings of director or executive or principal stakeholders (i.e. persons directly or indirectly holding more than 10% of beneficial ownership of the company) in statements filed with SEC and National Securities Exchange, as well as on the corporate website. For purchases, sales or any changes in the ownership holdings, disclosure within two days is an imperative.

Section 406 requires that organizations establish a code of ethics for Senior Management/Financial Officers. The institution of code of ethics, including any changes to code of ethics, has to be disclosed in SEC reports. If there is no code of ethics instituted, the reasons have to be disclosed.

Section 404 (Management Assessment of Internal Controls) has caused significant implementation challenges for the organizations. The section requires the CEO and CFO to provide an annual certification, in a prescribed format, about internal controls. The onus is on the management team to design, establish and maintain sufficient internal control structures to avoid any material financial mis-statements or omissions/inclusions of material facts.

Further, it mandates that a mechanism for evaluating the existence and effectiveness of internal controls, within 90 days prior to filing the report, be established.

Management assertion about the existence and effectiveness of internal controls also requires an attestation from an Independent Auditor. Consequently, this section casts onerous responsibility on the management and auditors to ensure accuracy and reliability of financial statements.

Section 404 is applicable to all listed corporates filing annual report with SEC under section 13(a) or section 15(d) of Securities Exchange Act, 1934.

In short, Section 404 spreads its wings far and wide -- even those organizations outside the USA find themselves affected by its tenets. Investment companies registered under section 8 of the Investment Company Act, 1940 are, however, out of purview of section 404. (Section 405)

Section 407 requires that an Audit Committee has at least one financial expert with the requisite education, understanding and application of GAAP, or experience in the preparation of financial statements, internal controls, or in the functioning of a public accountant, auditor or CFO.

Reports filed with the SEC should disclose the appointment of such an expert. If this section is not complied, reasons for not hiring a financial expert need to be provided too.

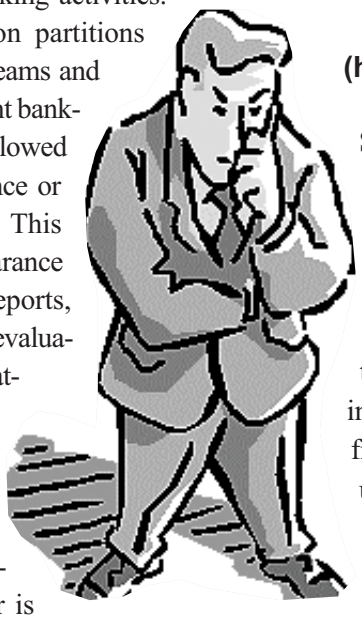
Section 409 requires disclosure of material changes in financial conditions or operations on a real time basis.

Section 408 requires SEC to review financial statements, and periodic reports with the SEC, at least once in three years.

(e) Analyst Conflict of Interest

This section attempts to segregate investment research and investment banking activities. Further, any conflict of interests is to be disclosed by the analysts or the organization.

Section 501 entails the segregation of investment research and investment banking activities. There should be information partitions between the two business streams and persons involved in investment banking activities should not be allowed to exert any pressure, influence or oversight over the analysts. This includes pre-publication clearance or approval of research reports, supervision or compensation evaluation of analysts, and any threatening measures to elicit favorable reports. A one-year ceiling restriction is prescribed for publishing of any research report in case the organization had participated, or is going to participate, as a dealer or underwriter. Public appearances or research reports require disclosure of any conflict of interest by the analyst or the organization.



(f) Commission Resources and Authority

Section 601 authorizes appropriations to SEC for additional compensation and resources and infrastructure.

(g) Studies and Reports

This title directs multiple agencies to study and report on public accounting firms, credit rating agencies and investment banks; any violations or enforcements and related information.

Section 404 (Management Assessment of Internal Controls) has caused significant implementation challenges for the cororate world. The section requires the CEO and CFO to provide an annual certification, in a prescribed format, about the internal controls.

(h) Corporate Tax Returns

Section 1001 decrees that the Chief Executive Officer sign off the Corporate Tax Returns.

(i) Corporate fraud and accountability

Section 1102 prescribes imprisonment of 20 years for tampering with records or impeding official proceedings. Section 1105 authorizes SEC to prohibit people from serving as officers or directors, conditionally or unconditionally, temporarily or permanently. Section 1106 lays down criminal penalties under Securities Act, 1934 of USD 1 million or imprisonment of 10 years, or both, or USD 5 million or imprisonment of 20 years, or both.

Conclusion

SOX has received criticism and described as a knee-jerk reaction to corporate scandals in the US rather than a proper, well-thought out plan to propagate good corporate governance. This may impede its effect to a certain extent, but the fact remains that with its cutting-edge penalties, SOX acts as a blessing in disguise and fosters interest in corporate governance. Efforts are already underway in Europe and rest of the world to develop laws similar to SOX, 2002.