

## Sarbanes-Oxley Myth

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Corporations are failing, employees are being laid off, pension funds are evaporating, and executives are heading to jail. In the wake of this new round of corporate scandals, the government again vainly attempts to prevent individuals from wrongdoing by passing more stringent legislation. While dollar-hungry managers suck the life out of our corporations, the government reaches for that representative wooden stake to kill the vampires taking refuge within these entities. The latest weapon is the Sarbanes-Oxley Act of 2002. Some of the more important changes incorporated within the act and related Securities and Exchange Commission (SEC) regulations include:

- Audit committees must now consist solely of independent directors and at least one financial expert.
- Chief executive officers (CEOs) and chief financial officers (CFOs) must certify that their financial statements fairly present the financial condition and results of their company.
- CEOs and CFOs must certify that they have an operational system of internal controls over financial reporting.
- A public company must disclose whether it has adopted a code of ethics for the principal executive officer and senior financial officers.
- Outside auditors must attest to and report on management's evaluation of the strength of its company's system of internal control.
- Public companies may no longer make loans to executive officers or directors.
- CEOs and CFOs may be required to give back compensation if financial statements are restated due to "material noncompliance" with reporting requirements.

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- Officers, directors, and other insiders are prohibited from trading company stock during pension-fund blackout periods.
- The SEC has explicit power to establish the new Public Company Accounting Oversight Board.
- New professional responsibility rules for attorneys are required.
- New conflict-of-interest rules for financial analysts are required.
- New protections for whistle-blowers are created.

So will this new legislation slay the beast? Hardly. Just like the television soap opera *Dark Shadows*, the same story will run again in syndication. (For those of you too young to remember, *Dark Shadows* ran from 1966 to 1971. The main character of the program was Barnabas Collins, a hard-to-kill vampire operating in a human world in a manner similar to some of our unsavory corporate managers.) Where managers, employees, accountants, or attorneys intend to do wrong, no amount of legislation will stop them. The penalties may be more stringent and the chances of getting caught greater, but it is safe to say that neither Congress nor the SEC can legislate individuals into doing the right thing. History has shown that, regardless of the good intentions, such measures provide little deterrent.

Let's examine the managers, the employees, the accountants, and the lawyers to show why this is true. We will then be ready to discuss what we can do to meet the control-related goals of Sarbanes-Oxley and drive a stake through the heart of our vampires.

### LEGISLATING EVIL OUT OF OUR CORPORATIONS

*A good name, like good will, is got by many actions and lost by one.*

—Lord Jeffery

There is no arguing that the stakes have been raised for board members, executives, and employees. The consequences of illegal and unethical business practices are now front and center in the nation's conscience. Government is taking a lead role by interrogating, prosecuting, and stiffening fines for those managers associated with a company scandal. Prosecutors are publicly parading to jail, with handcuffs prominently displayed, some of the wealthiest businesspeople in our country. Consider the following lengthy

list of those caught in the current financial crisis: Dennis Kozlowski, former Tyco CEO; Mark Swartz, former Tyco CFO; Mark Belnick, former Tyco Chief Counsel; Frank E. Walsh, former independent Tyco Director; Jerry Boggess, former Tyco Fire & Security Services President; Paul Allaire, former Xerox CEO; G. Richard Thoman, former Xerox CEO; Barry D. Romeril, former Xerox CFO; Philip D. Fishbach, former Xerox Controller; Daniel S. Marchibroda, former Xerox Assistant Controller; Gregory B. Taylor, current Xerox Treasurer; Gary Winnick, Global Crossing Chairman; Jim Gorton, former Global Crossing Chief Counsel; Greg Casey, former Global Crossing Sales Executive; Jackie Armstrong, Global Crossing Counsel; Philip F. Anschutz, former Qwest Communications Chairman; Joseph P. Nacchio, former Qwest Communications CEO; Robin Szeliga, former Qwest Communications CFO; Grant P. Graham, former Qwest Global Business Unit CFO; Thomas W. Hall, former Qwest Global Business Unit Senior Vice President; John M. Walker, Qwest Global Business Unit Senior Vice President; Bryan K. Treadway, Qwest Global Business Unit Assistant Controller; Albert J. Dunlap, former Sunbeam CEO; Russell A. Kersh, former Sunbeam CFO; Bernard Ebbers, former WorldCom CEO; Scott Sullivan, former WorldCom CFO; David Myers, former WorldCom Controller; Buford Yates Jr., former WorldCom Accounting Director; Michael H. Salisbury, WorldCom General Counsel; Susan Mayer, WorldCom Treasurer; Betty L. Vinson, former WorldCom Accountant; Troy M. Normand, former WorldCom Accountant; John Rigas, Adelphia Communications Founder; Timothy Rigas, former Adelphia Communications CFO; James Brown, former Adelphia Vice President for Finance; Michael Mulcahey, former Adelphia Director for Internal Reporting; Kenneth Lay, former Enron Corporation Chairman; Jeffrey Skilling, former Enron Corporation President; Andrew Fastow, former Enron CFO; Richard A. Causey, former Enron CAO; Michael J. Kopper, former Enron Executive; Kenneth Rice, former Enron Broadband Division Chief Executive; Ben F. Glisan Jr., former Enron Broadband Division Treasurer; Dan Boyle, former Enron Broadband Division Finance Executive; Kevin Hannon, former Enron Broadband Division Executive; Scott Yeager, former Enron Broadband Division Executive; Joe Hirko, former Enron Broadband Division Chief Executive; Kevin Howard, former Enron Broadband Division Executive; Rex Shelby, former Enron Broadband Division Executive; Michael Krautz, former Enron Broadband Division Executive; John Giesecke, former Homestore

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COO; Joseph Shew, former Homestore CFO; Eric Keller, former AOL-Time Warner Executive; Sam Waksal, former Imclone Systems CEO; Richard M. Scrushy, HealthSouth Chairman; Michael Martin, HealthSouth CFO; Clark E. McLeod, former McLeod USA CEO; Stephen A Garofalo, Metromedia Fiber Networks Founder and Chairman; Jack Grubman, former Salomon Smith Barney Analyst; Schuyler Tilney, former Merrill Lynch Executive; Thomas Davis, former Merrill Lynch Executive; Phua Young, Merrill Lynch Analyst; David Duncan, Arthur Andersen Partner; Robert Asti, former Symbol Technologies Vice President; Enio Montini, Kmart Vice President; Joseph Hofmeister, Kmart Vice President; Frank Quattrone, Credit Suisse First Boston Investment Bank Executive; Charles W. McCall, former McKesson Chairman; Helen C. Sharkey, former Dynegy Risk Control & Deal Structure Executive; Gene S. Foster, former Dynegy Vice President of Taxation; Jaime Olis, former Dynegy Senior Director of Tax Planning; and Martha Stewart, Martha Stewart Living Omnimedia Chairman.

If it was not obvious prior to the swift demise of Enron, it is obvious now. The managers and employees on this list have one thing in common: their professional careers and personal lives have been negatively and severely affected by events at their companies and firms. They have been subpoenaed, investigated, interrogated, indicted, fired, or otherwise lost their jobs due to the accounting, financial reporting, and disclosure practices at their companies. In certain cases, these managers were directly involved in the destruction of their companies. Many even face jail time. The SEC and the Department of Justice are aggressively pursuing wayward managers. President George W. Bush established the Corporate Fraud Task Force on July 9, 2002, and by May of the following year, more than 250 corporate fraud convictions or guilty pleas were obtained; 25 of these were former chief executive officers. Criminal penalties for securities fraud now carry jail sentences of up to 25 years and fines of up to \$2 million.

Some of the biggest losers, however, are the employees: 85,000 at Arthur Andersen, 4,000 at Enron, and the thousands laid off at Global Crossing, Qwest, Tyco, Adelphia, and other companies affected by these frauds. They are the innocents who pay the greatest price.

And while the list is stunning, it documents merely the most well-known cases of late. The SEC, Congress, and prosecutors are far from done. They are now turning their attention to the various boards of directors, whose members are charged with oversight, to their outside advisors, and

to managers who were enriched by trading investment banking business for access to “hot” initial public offerings (IPOs).

The fallout from these financial scandals is massive. It involves some of the world’s largest companies and accounting firms and touches many different industries. The landscape is changing, and managers at all levels, from the boardroom to the shop floor, need to take action to improve controls throughout their organizations and protect themselves in the process. According to governance expert Ira Millstein, “Today, every action or inaction is potentially cause for, at least, public discussion, and maybe even legal liability.”<sup>1</sup> Managers may not be the cause of the problem or want to get involved, but they owe it to their families and employees to remain vigilant and do all they can to prevent and detect fraud. Only through quick action can a company save itself from a few bad managers. Greater transparency in how companies report their earnings is no longer optional, but a requirement.

Even companies with a longstanding tradition of being “shareholder-friendly” have failed to install the necessary checks and balances required to ensure that the financial position of the company is properly disclosed. Boards of directors and managers must make this happen. If ever there was a reason to take the initiative, the list of names given here should provide that wake-up call. Even if innocent, the experience of being investigated, indicted, or suddenly unemployed is not pleasant and can take a terrible toll on a person’s health and on the well-being of his or her family. And that experience pales in comparison to losing one’s job and being cheated out of one’s pension, as were the employees of Enron.

Despite new laws, greater vigilance, and oversight, fraud still haunts us. The government has stepped in before to exorcise these demons. After the stock market crash of 1929, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 to address corporate abuse. The savings and loan crises of the 1980s led to even more regulation. Shareholder activists waged battles with corporations throughout the 1990s against so-called poison pills (corporate actions that prevent an unsolicited takeover) and secret executive compensation. These actions resulted in many boards and regulators requiring more transparency. Nevertheless, we still had an epidemic of frauds surface in 2002. It should be clear that while legislation can help strengthen the system, it cannot stop bad people from doing bad things. Just like the threat of life in prison will not deter a single-minded killer, strong penalties will not discourage a manager determined

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to play by his or her own rules. The evidence to support both of these facts is served to us with breakfast by way of our daily newspapers.

While I hope it will be different this time, history suggests that the importance of implementing and monitoring a robust control structure may be forgotten and subsequently doom many companies to fall victim again. Star managers will test boundaries just because they believe they can without penalty. Auditors will provide clean opinions on failing companies. Lawyers will set up legal entities that enable financial shenanigans. The government will respond with even more regulation. How senior management responds to these issues will determine the future of their organization. Ira Millstein speaks to our corporate governance responsibilities by urging that “Everyone helping to guide the corporate enterprise—directors, officers, accountants, bankers and lawyers alike—needs to ‘get it.’”<sup>2</sup> If we don’t “get it”, we will continue to undermine the very engine that drives the nation’s wealth creation.

### EMPLOYEES, FRAUD, AND LESSONS FORGOTTEN

It was late 1996, less than two years after Nick Leeson left his famous note at work and disappeared, leaving Barings Bank \$1.2 billion poorer and headed for bankruptcy. ING, a giant financial services company, eventually bought Barings out of bankruptcy and attempted to turn the business around. Paul Gyra was the man in charge of addressing Barings’ control issues worldwide. He hired me to address what he perceived to be a clear and present threat to the business. ING Barings continued to aggressively strengthen controls worldwide, and Paul was satisfied with progress made in Asia and Europe, but was still concerned with the Americas. Hence, he asked me to take on the challenge. Paul was correct to be concerned, not only because the control environment in the Americas required improvement, but because the culture of the industry made it difficult to identify and correct control deficiencies. In good times, financial services executives seemed willing to sacrifice controls to keep a star performer happy. They would turn a blind eye to the secrecy and control these stars exerted over their empires and avoid asking the hard questions that would have surfaced fraud. It seemed that lessons of the past were just swept under the carpet.

Examples of this behavior run deep. The SEC found in 1994 that Joseph Jett committed “record-keeping violations” and ordered him to repay Kidder

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Peabody more than \$8 million in bonuses paid to him. Lack of supervision and an unwillingness to challenge the huge margins earned by Jett contributed to, and even enabled, the “record-keeping violations.” Kidder claimed more than \$350 million in fake profits had been booked and the firm was eventually dismantled and sold.

Then along came Nick Leeson and Barings. Leeson was able to set up accounts to hide his losses from a declining Nikkei, resulting from the Kobe earthquake. Improper supervision and segregation of duties delayed detection of the losses. Management continued to fund these losses until Leeson went missing, but by then the damage was done. The resulting \$1.2 billion loss brought down one of the largest and most fabled financial institutions in the world. (Barings, formed in 1762, purchased the Louisiana territories from France on behalf of the United States and funded the Napoleonic Wars. It was sold out of bankruptcy for 1 pound.) Leeson was found in Germany and returned to a Singapore prison.

On the heels of Leeson came Toshihide Iguchi of Daiwa Bank’s New York branch, who executed in excess of \$1.1 billion in unauthorized trades, including the sale of more than \$375 million in *customer* securities. Imagine if the securities he sold were yours! The fraud was perpetrated over several years and discovery was complicated by management attempts to conceal the losses.

This was followed in 1996 by the acts of Sumitomo’s Yasuo Hamanaka who, for over a decade, maintained two sets of books for his huge copper positions, concealing what eventually became \$1.8 billion in losses. Also in 1996, it was discovered that NatWest’s Kyriacos Papoulis was able to conceal well over \$100 million in losses by overvaluing option positions held on the books. You know things are getting bad when this awesome amount seems like a pittance when compared to those losses experienced before it.

As recently as February 2002, John Rusak, a U.S.-based trader for Allfirst, a subsidiary of Allied Irish Bank, lost more than \$750 million. He was able to keep losses unrecognized by booking phony options contracts to offset real losses. Even though the phony options would expire with a profit, no controls were in place to ensure that “in the money” or profitable options were exercised and money received. Instead, Rusak would simply replace the expired options with more phony trades. Allied publicly admitted the loss was directly related to a failure of internal controls and eventually entered into an agreement to sell Allfirst. Rusak was sentenced to over seven years in prison.

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It is hard to explain how individuals, mostly acting alone, can cause such huge losses. In every instance, there was a strong, apparently successful personality, exerting complete control over key operations. There was also a lack of strong internal controls to prevent or alert senior management of the staggering losses that were eventually realized. Where there were clues, no one was willing to risk challenging these powerful icons. Many of these rogues had perfected the art of misdirecting or intimidating subordinates, peers, and even supervisors. Sumitomo's Hamanaka was so revered that anything he said could move the copper market. Externally, regulators were slow to challenge him; internally, auditors were powerless to force him to divulge financial information. Baring's Leeson would brag about his \$2 million annual bonus and unlimited travel expenses. His authority over both management and trading operations, his physical presence, and his aggressiveness overpowered diminutive, respectful Asian traders. Kidder's Jett was physically intimidating and able to end any conversation abruptly just by asking, "Are you questioning me?"<sup>3</sup>

While these examples relate to companies with trading operations, arguably among the most risky business models utilized in legitimate industry, recent events at Enron, WorldCom, Global Crossing, and Adelphia Communications have proven that control breaks can occur at companies competing in a wide range of industries. One common thread among these recent failures is a company culture that rewards immediate results without regard to ethical considerations or long-term consequences. In the end, the biggest losers are the employees and those who invest in these organizations. The executives of these companies damage the public trust in the markets and the image of corporate managers everywhere. But executives are not the only ones to damage the public trust. Our view of the trusty accountant has also changed.

### WHY YOU SHOULD NOT RELY ON AUDITORS

In the latest congressional Enron hearings, those senior managers who did testify complained that they did not know what was occurring on their watch and that the auditors never brought the material issues to their attention. Whether the auditors did or did not identify and report the irregularities at Enron, it is management that has final responsibility for the financial statements filed with the SEC. What they did not know, they should have prevented or discovered by way of strong controls.

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Every independent auditor's report states clearly that the financial statements are the responsibility of the company's management. The auditors only provide an opinion on the financial statements based on their audits. This sounds like doublespeak, but the distinction is important. The auditors will normally have management represent their responsibility in a signed letter that explicitly states the company maintains a system of internal controls designed to provide reasonable assurance that accounting records are reliable for the preparation of financial statements and safeguarding assets.

External auditors are unlikely to identify a lapse in the control structure of a company. Their focus is to provide an opinion that the financial statements are fairly presented in accordance with Generally Accepted Accounting Principals (GAAP). If competent, it is likely that they will detect an irregularity only after it has a significant, negative effect on the reported results of the company. If not competent, they will not see it that the financial statements fairly reflect the results and standing of the company, nor will they recognize that the entire enterprise may be at risk of collapse. However, internal auditors are charged with ensuring that preventive and detective controls are in place. But commonly an audit team may review each auditable entity once a year or even less often. In the period between audits, the controls that were in place may have been changed or otherwise compromised. Once again, it is management that bears the risk of a control break. To put a career and a company at risk by solely relying on auditors to oversee a business is shortsighted at best.

David Allocco, a life-long operations and control expert at Goldman Sachs, as well as a personal friend and mentor, has a keen eye for helping managers spot their risks. Dave is fond of saying, "The problem with the current process is that while the internal auditors are chasing garbage trucks to determine if unshredded sensitive information is leaving the firm, a trader is sending a firm's trading positions to a competitor via e-mail when his [or her] supervisor isn't looking." This statement implies that yesterday's audit procedures are not effective in today's electronic world. Sensitive information can leave a firm in a number of ways, both physical (in the trash) and electronic (e-mail). Simply put, auditors have a hard time keeping up with the ingenuity and initiative of those who would break our rules and laws.

These are not new concepts. The General Accounting Office (GAO), in its investigation of the savings and loan (S&L) crises of the 1980s, found that the accounting profession had failed to keep abreast of the fundamental changes sweeping through the thrift industry. The profession continued to

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apply decades-old procedures to transactions new to the industry. The industry had shifted from making home loans to investing in real estate, land development, and junk bonds. The result was that many S&Ls went belly-up only weeks or months after the auditors provided clean audit opinions. When the bill came due, it cost taxpayers more than \$200 billion.

Most recently, Arthur Andersen was effectively put out of business for its involvement in the accounting shell game at Enron. The fact that one of the world's largest corporations could just dissolve within months of receiving a clean opinion from one of the prestigious Big 5 accounting firms shook the nation. Through the Sarbanes-Oxley Act of 2002, Congress and the SEC have created a new regulatory oversight board for the accounting profession; it has been charged with the awesome responsibility of setting ethics and conflict-of-interest standards, disciplining accountants, and conducting annual reviews of the largest accounting firms. Called the Public Company Accounting Oversight Board, it has taken over many functions that were previously self-regulated. Prior to this legislation, the profession monitored itself through peer reviews and self-imposed standards with oversight from the Securities and Exchange Commission. It is important that the new board quickly exercise its new power, establish credibility with investors, and return integrity to the profession.

Unfortunately, the board is off to a poor start. The first person selected to head the board was forced to resign after it was learned that a company for which he was a director was under investigation. The revelation that Harvey Pitt knew of the investigation but did not disclose it contributed to his decision to resign his position as chairman of the SEC. The oversight board subsequently met without a chair, and as a first order of business, voted themselves a salary in excess of \$400,000—each. Call me crazy, but it seems that the first order of business for a new body empowered to change the country's professional landscape should be something other than setting its members' own compensation, particularly at a level few laypeople would understand.

The SEC finally took a step in the right direction by appointing William J. McDonough, the respected former president of the Federal Reserve Bank of New York. Because of the prior missteps, however, I am keeping my expectations for this new board low in the hope that they exceed them by a wide margin. The board has already opened itself up to criticism and I rather fully expect that those resisting change will benefit. Only time will tell.

## YOU CAN'T TRUST THE LAWYERS EITHER

When one considers the various investment vehicles set up by Enron to shift assets and debts behind an opaque financial curtain, a question regarding their creation must be raised. Generally, a lawyer, or more likely, several of them, will diligently work to set up the legal vessels that enable the transactions. In the clear light of day, many of these transactions were so dubious it is hard to imagine a lawyer, or for that matter, an entire firm, not questioning them.

Just as egregious, there seems to be nothing that will disqualify a law firm from being retained to investigate accusations against management. The law firm investigating Sharon Watkin's memo (the Enron whistleblower) was rife with conflicts of interest. The firm of Vinson & Elkins was a long-term advisor to the company and, predictably, its investigation was ineffective. Good investigators leave no stone unturned. This investigation left every stone undisturbed.

A law firm investigating the whistle-blower memo regarding Global Crossing's accounting had similar conflicts of interest. Some of the attorneys reportedly owned their client's stock. Are we surprised that this investigation also did not unearth any issues?

This is a good time to point out that while the accounting profession is regulated, lawyers continue to be relatively unpoliced. In fact, the American Bar Association (ABA) is still debating whether a lawyer's first duty is to a client or to prevent a crime. If the ABA is not sure, how can we expect our nation's attorneys to make the distinction? The answer is, we can't. Society can no more put its faith in the legal profession to do the right thing than to expect a criminal to self-report his or her crime. Until the ABA sees that the client is truly the shareholder of a company, rather than one or two company executives, and that they must do what is ethically right on his or her behalf, there will be no progress on this point.

Sarbanes-Oxley allows the SEC to establish professional standards of conduct for the nation's attorneys. These standards include "up the ladder" reporting obligations that would be triggered when an attorney "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer." The lawyer would then have to report the matter to the chief legal counsel of the company. If the attorney does not receive an adequate response from the company's chief legal counsel and the CEO, the lawyer must report the violation to the board

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of directors. That is where the lawyer's duties currently end. These actions protect the lawyer from disciplinary action and civil liability. The SEC initially proposed language that required the attorney to make a "noisy withdrawal" if the board does not take appropriate action. A noisy withdrawal consists of resigning the engagement, slamming the door on the way out, and notifying the SEC. Unfortunately, the SEC yielded to intense lobbying from the legal community and withdrew this language from the final rule. The fact is that lawyers are the most potent lobbying force in the United States. This is why it is so hard for states to pass tort reform despite widespread support. The SEC has twice tried to regulate the profession, but both times the legal lobby prevailed. It appears increasingly likely that Sarbanes-Oxley could fall prey to this formidable special-interest group and have little real impact on the conduct of the nation's lawyers.

This point may be irrelevant, however, as SEC guidance on what is material and reportable is sufficiently vague as to question whether any attorney can ever be held accountable.

## SUPPORTING THE FRAUD CULTURE

*We've seen a bit of a crisis of morals at all levels of society. We've see it in politics, the business world and the church. I think a very big thing is 20 or 30 years ago when a player did something wrong, he knew it was wrong. There's been a shift in values.<sup>4</sup>*

—U.S. Congressman Tom Osborne,  
former head football coach of the University of Nebraska

Social scientists describe culture as a way of life. It is one of those "soft" subjects that many companies and managers do not believe warrants significant daily attention. These managers unwittingly allow the potential of fraud to find a home and take root in their organization. They will launch their statement of values with great fanfare, never to refer to them again. Culture can be a powerful control tool, or ensure the destruction of a company.

A strong culture, positive or negative, will directly impact a control environment. Ignoring culture is like ignoring a cancer threat. Failure to take responsibility for the health of the corporate culture by way of periodic checkups and the constant exercise of values can lead to apathy and a diet deficient of reinforcing procedures. It allows a malignancy to take hold

and grow undetected. While a manager may not be directly responsible for the cancer, inaction will allow it to spread.

Most companies today use buzzwords to describe how nice they are. Little time is spent developing a credible statement of shared values. Enron's set of corporate values lists communication, respect, integrity, and excellence. They sound like something to which we should all aspire. But a simple list of words does not mean much if it is not clear how to apply their meaning to our daily work lives. Even more important, it must be clear that the company leaders actually believe in their stated values. Not too many people would use the word "integrity" to describe the company's management. It is clear to all that Enron's managers either could not, or did not, care to enforce this value. They became the gold standard for poor corporate governance and culture.

A fuzzy or vacant set of values is not just neutral, but destructive. Employees can spot insincerity in the executive ranks all the way from the mailroom, and will make a company pay for it. In an excellent article in the *Harvard Business Review*, Patrick M. Lencioni discusses his 10 years working with companies to improve their corporate culture. "Most value statements are bland, toothless, or just plain dishonest. And far from being harmless, as most executives assume, they're often highly destructive."<sup>5</sup>

The culture of aggressive accounting at Enron made "gaming the system" an acceptable practice. According to former Enron executives, the company struck a sham energy deal with Merrill Lynch, to help it meet 1999 profit targets, that unleashed millions in bonus money and restricted stock to top executives. The \$60 million in profits evaporated when the transaction was later canceled; however, the bonuses that accrued to managers were paid nevertheless.

Growth and pressure to meet Wall Street expectations can put tremendous pressure on a management team. If a strong culture of honesty and forthrightness is not cultivated and rewarded, a cancer of shady behavior can spread until it kills the company. Consider CUC International, which was acquired in 1997 by the company that would become Cendant. Cendant's due diligence failed to uncover more than \$500 million of fake, pretax profits. Even more shocking is that it required employees and managers in more than 22 businesses to falsify records to this extent. The managers that booked the fictitious profits told investigators that they felt pressured by their bosses to meet Wall Street expectations. This goal took hold of the organization and triumphed over all other moral and ethical considerations.

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It is hard to judge in financial terms what a strong, positive culture means to companies. Simply stated, in their promotion of shared values through business principles or a credo, companies that communicate and live by a strong culture of ethics will have a better control environment. Two companies that exemplify what it means to communicate and live by good corporate values are Johnson & Johnson and Goldman Sachs.

Johnson & Johnson is a company synonymous with compassionate health care. When people think of Tylenol, they think of safe and effective pain relief. This view remains despite the fact that, in 1982, seven people were poisoned when a murderer introduced cyanide into Tylenol bottles in the Chicago area. A number of years after that incident, I remember sitting in a classroom at the Harvard Business School listening to J&J CEO James Burke lecture. Predictably, a student asked him how he went about making tough decisions. To many of us, his answer was remarkable. He related that the decisions were relatively easy to make, as Johnson & Johnson had a culture and a credo that put people first. It may at first be difficult to imagine a sophisticated CEO looking to a credo to manage his business, but not when you realize that J&J takes its values seriously. When you open the J&J Web page, the credo is prominently displayed, and you can review it easily in 63 different countries in the local language. By analyzing the credo, I believe I understand the J&J culture and the decisions that emanate from it.

The statement begins by announcing the responsibility of the company: “The first responsibility is to the doctors, nurses, and patients, to mothers and fathers and to all others who use our products and services.” Note that it does not start with management, employees, shareholders, profits, or corporate accounts that buy the product. Rather, the focus is on the people who use its products. If this is the first priority, that then frees a manager from having to consider short-term profits when faced with a moral dilemma. The type of question a manager will ask shifts from “How can we address this problem at the lowest cost?” to “What steps must we take to protect our consumers?” CEO Burke did not have to think twice about quickly removing Tylenol product from all shelves, regardless of cost. It was in the best interests of those who used its products; and, in the long run, it was also the best decision for the long-term reputation and financial health of the company.

At Goldman Sachs I experienced firsthand the power of culture. When I was interviewing for a position at this investment banking giant, I had many discussions with human resources staff and with hiring managers

regarding the “culture” of the company. Goldman looks to its 14 business principles for corporate identity, and these managers wanted me to understand what was expected of me. In a relationship business, trust is everything. There is no room at Goldman for anything but honesty. A scenario similar to what happened at CUC would have difficulty taking hold at Goldman. The cancer that spread there would have been “surgically” removed before it had a chance to take root in their culture.

Goldman Sach’s human resources department makes it clear that if you lie on your application, in even the smallest detail, you will be terminated. Every so often, a new hire would ignore this preemptive warning, but he or she would disappear after a few weeks of working there. Evidently, the wheels of justice within the HR department finally caught up with these applicants. Goldman’s principles were not only applied to newcomers; star performers were also regularly let go by the firm during my tenure there for failing to abide by them. These rainmakers were generally considered to have put themselves above the firm or their clients. I was impressed by this at the time, and even more so later when I observed other firms that were loath to take such action. Compare this to Bausch & Lomb’s handling of its CEO, Ronald L. Zarrella. The eye-care giant’s CEO padded his resume by improperly claiming he had graduated from New York University’s Stern School of Business. Rather than terminating the company’s relationship with Zarrella, the board withheld \$1.1 million in bonus. Seems like a steep price to be paid, for sure, but the larger question of integrity remains. How can shareholders trust their leader to do the right thing for them when he admits to misrepresenting himself?

Goldman Sachs is able to aggressively insist on honesty because of its team culture and its significant investment in developing its “bench talent,” another ingrained cultural trait. There was always a qualified replacement ready if need be to keep the business running at any level. Furthermore, it was understood that the best way to get ahead was to be a team player and make your boss and the team look good. This cultural trait has served many of the firm’s leaders well, as there is a worn path directly to Washington for firm graduates. In a town where hardball politics is the norm, honest, confidential, and deferential service is highly prized. Not surprisingly, former Goldman chairmen and CEOs have been very successful in Washington. John Whitehead served as the deputy secretary of state for the Reagan administration; Bob Rubin served as the chief economic advisor and, later, treasury secretary for President Clinton; Steve Friedman is now serving as

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the chief economic advisor to the Bush administration; Henry Paulson served in the Nixon White House; and Jon Corzine represents New Jersey in the Senate.

The culture is so strong that, recently, the current chairman, Henry Paulson, was forced to make a public apology to the firm's employees for implying that there are "15 or 20 percent of the people that really add 80 percent of the value." This upset many employees who were raised on the Goldman ethic that there is no star system, rather, that it is all about teamwork. Troubled by this interpretation, Paulson issued a blanket apology stating, "I am profoundly embarrassed about my choice of words." Such a response is certainly not usual in American business.

Contacts still working at Goldman tell me that the firm has changed somewhat since reshaping the corporate structure from that of a partnership to a corporation. Though I'm certain it is not the same paternalistic place of my memory, there is evidence that the firm still values and acts on its business principles. These principles are presented in the firm's annual report, and are prominent on its Web site. While not immune, it seems that the firm has experienced fewer investigations and fines than those levied against its competitors relating to the latest corporate meltdown (although the firm has participated with many competitors in settlements involving industrywide practices). Chairman Paulson took a courageous public stand recently by condemning the aggressive corporate accounting that led to the high-profile bankruptcies of late. The cynics were quick to point out that it is pressure from Wall Street to hit or exceed profit estimates that drives aggressive behavior. However, Paulson's position is consistent with the firm's business principles and the public stance of Goldman's legendary leaders before him.

The degree to which the firm has changed will become apparent quickly. Of interest is the ongoing investigation into the relationship between the firm's investment bankers and research analysts. Regulators in Utah are conducting a review of unprecedented scope by searching more than 100,000 e-mails dating back several years for evidence that the firm breached the regulatory wall between its investment banking and research units. If evidence is found, the reward for Utah will be a fine levied similar to the \$100 million Merrill Lynch had to pay the State of New York to settle a similar case. How well Goldman fares in this detailed investigation will tell outsiders a lot about the firm. The point will turn on whether there were breaches of firm policy by individuals or that the firm as a whole ignored

regulatory requirements to manage these businesses separately. The outcome and how the firm responds will determine whether the culture is alive and well.

As a manager, it is important to communicate and monitor your “culture.” Your staff will look to you to see how seriously to take a company’s statement of shared values. Much like Johnson & Johnson’s Burke, managers need to reinforce how they have relied on these values in making tough decisions. If your company does not have a statement of shared values, credo, or business principles, then you have the opportunity to create one. I did this for the audit department I built at ING Barings. I knew there were high expectations for the department and that there would be a lot of pressure on new hires as the team addressed the many control issues faced by the firm. I wanted there to be no doubt that I would always support my staff to do the right thing. There was no need to be intimidated by bad news in a star’s business; conversely, the staff was required to treat their counterparts in an honest, professional manner. I prepared the first draft of the statement of shared values, refined them with my managers, and then presented them to the department. Whenever confronted with a public decision, I would often refer to how our team values applied.

The audit department definitely developed a culture and, in the process, a clear view of how its members contributed to the firm. No longer a dumping ground for incompetents or fodder for lashings of a star performer, our department gained the respect of the organization. Even the National Partner for Investment Banking at KPMG went on record with ING management stating that if we did not have the best audit team on the “Street,” it was one of the top two. Not a small achievement in only two years. I place the credit for this success squarely on the team, for the way they perceived themselves (values) and what they aspired to (mission). Values played a crucial role.

If you need to create a statement of values, Johnson & Johnson’s credo and Goldman Sach’s business principles are provided in Appendix A for you to contemplate as a starting point. Another excellent resource for help in creating a statement of shared values can be found in the Criteria for Performance Excellence of the Malcolm Baldrige National Quality Award. The information there can guide a manager through the design and implementation of a value statement. The statement of shared values will be different for every organization, and each one needs to make it its own, infusing it into every aspect of the organization. J&J periodically revisits its

## 18 CHAPTER ONE SARBANES-OXLEY MYTH

credo to ensure it still matches the objectives of the organization. Like any great document, it “lives.” It cannot be easily changed, but it has the ability to grow with proper nurturing.

To demonstrate that you take your value system seriously, you need to clearly articulate behavioral attributes that are rewarded and those actions that are off-limits. One barrier to openness can be the resistance to bad news. Those who express candid criticisms are often accused of not being a part of the team, and managers may withhold rewards from such employees. Employees at all levels learn *not* to speak up. They avoid being the one to alert management to real problems. The best and the brightest with any character will find a more rewarding place to work. The result will be an organization infested with sycophants and cowards who remain silent even as the company collapses around them. Employees must understand that they need to embrace positive corporate values if they are to be successful. The best way to do this is to reward open communication, even if the news is painful.

Naturally, a supervisor will repel the initiatives of subordinates to fix control issues if he or she is the one perpetuating the fraud. For those who wish to report troubling behavior, taking the problem to their supervisor may not be an option. Therefore, alternative methods of communication need to be provided for these employees. A corporate ethics hotline to *independent* outside legal counsel that reports solely to the board of directors can be particularly effective. Truly independent outside counsel can confidentially capture and relay issues back to the company’s board.

Here, too, WorldCom provides an example of what can occur if no alternative method of communication is made available to employees. A congressional committee released copies of e-mail messages between the controller and a London-based vice president for international finance and control. It seems that the vice president for finance objected to the company’s unilateral reduction of \$33 million in expenses without explanation. Since this would increase publicly reported profits, he tried to bring in outside accountants from Arthur Andersen to support the position. The controller, David Meyers, ordered the vice president to not have any more meetings with the team from Andersen. He wrote, “I do not want to hear an excuse; just stop,” and concluded with “Don’t make me ask you again.”<sup>6</sup>

If the vice president had had a credible alternative means of alerting the board of directors to this fraud, corrective action may have been taken much sooner. Had it been uncovered, the board would then have been

presented with an opportunity to reward in some fashion the London vice president and set an example for others in the organization.

The Sarbanes-Oxley Act addresses the ethics of top executives by requiring that a public company “disclose whether they have adopted a code of ethics for the company’s principal executive officer and senior financial officers, or if it has not, why it has not and to disclose on a current basis amendments to and waivers from the code of ethics relating to any of those officers.” The code will be a “codification of standards that is reasonably necessary to deter wrongdoing and to promote:

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or that reasonably could be expected to give rise to such a conflict;
3. full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
4. compliance with applicable governmental laws, rules and regulations;
5. the prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
6. accountability for adherence to the code.”

Additionally, a public company must disclose in its annual report whether it has a code of ethics.

Frankly, it is sad that we are at a point at which the behaviors of our most senior executives have to be spelled out. Why would an experienced executive need to be told to be honest and ethical? The fact is that most don’t. It is a very small group of executives who do not have the best interests of shareholders and the company at heart, and these executives will not be dissuaded from bad behavior by mere words. The words must be backed up by board action that directly ties the success of the executive to these words.

## WHAT REALLY WORKS

So we know that a positive culture is vital to good governance and control and that the government cannot effectively legislate it. We also recognize that we can't fully trust our fellow executives and long-tenured employees, the accountants, or the lawyers to do the right thing. The wake-up call has been received, and our eyes are wide open. But where do we start? Each of us individually has the power to lead by example and set the proper tone within his or her area of influence. We can implement tools to alert us to potential problems and have the courage to act on the alarms. To do so, we need and require a control approach that will help us to identify and take action on any breaches of acceptable behavior. Furthermore, to be effective, this tool must be ingrained in our operations. A good control structure starts with a positive culture, will contain elements to help monitor the health of the enterprise, and alert management when a boundary of expected behavior is compromised. More important, it will also provide feedback regarding what is going right in the organization.

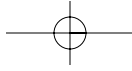
Internal control is not a separate discipline; rather, it is an important component of the overall management process guiding the enterprise. Management tools such as value chains, which help management understand their cost drivers; Balanced Scorecards, which help align activities to corporate objectives; Six Sigma procedures, which ensure product quality; benchmarking, which provides feedback regarding overall performance; and employee performance evaluations all contribute to the control framework, and vice versa.

Unlike other control manuals and processes, the Control Smart approach speaks to the health of the enterprise and its employees as a whole by infusing these management tools. Enlightened management dictates that controls do not focus on what employees *can't do*, but rather *what is expected* of them. Under this framework, managers and employees should remain free to perform their tasks with creativity and be encouraged to make improvements to processes within boundaries.

As good employees, managers, and directors, we recognize that it is no longer acceptable to allow a star manager to run roughshod over our organizations. We need to actively encourage and guide them. We can also do a better job of identifying those who would destroy our companies by means of communicating false information to the public. But even with increased vigilance, opaque financial reporting by a rogue CFO or star

employees taking advantage of the system are not the only practices that can put a company, its managers, and its employees at risk. The crimes of tomorrow will be different from the ones today. To focus on a single risk is like overstuffing a suitcase. The more pressure applied to one area will either result in contents proportionately protruding from another area, or if successfully stuffed, may result in complete baggage failure in transit. Pushing on a single control point may only place pressure on another point of vulnerability in your company. It is better to evaluate the entire enterprise and select a vessel that can properly contain and protect all that is important. The Control Smart approach is that evaluation tool; it will help you establish boundaries appropriate for your operations.

While Congress has passed more legislation to dissuade damaging corporate practices, I am quite certain that we have not heard the last of such behavior. If solid internal controls are not in place, someone within an organization will find a way to take advantage of the oversight. It is up to owners, partners, and senior managers to ensure that their business is properly controlled and that no safe harbor exists for those intent on fraudulently utilizing its assets. Do not trust others to play by the rules; make certain that they do. You can be sure that employees will notice how seriously the company takes its cultural and procedural boundaries and how it responds to the visible failures. This is your wake-up call. Use this framework to learn from the mistakes of other managers. It is important that well-meaning managers do not find themselves in front of the House Committee on Oversight and Investigation trying to defend their actions. Protect yourself, your employees, and your company.



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