

# The Implications of SOX Enforcements for the Board

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By Glenn C. Davis

The September 2008 collapse of the nation's financial markets sent a ripple effect across corporate America. Company helmsmen are once again being painted with broad strokes as leaders of questionable competency who are motivated by greed and fueled by unscrupulous business practices. Along with the bailout came angry cries for more government oversight and more regulation. And while it is still too early to determine, it is probably safe to assume that government reform will be on a large scale, along the lines of the Sarbanes-Oxley Act (SOX), which was enacted as a result of the corporate scandals that shook America in the early part of this decade.

With numerous companies now under federal investigation and civil and criminal charges likely to follow, board members and senior executives alike are understandably anxious about their personal liability and accountability. For board members especially, it has been frustratingly difficult to gain a clear understanding of what is expected of them from a legal and regulatory standpoint. There is renewed concern about the processes they need to follow and the questions they need to ask in order to effectively exercise their "duty of care," which is defined as maintaining good oversight and control of the company.

In its 2008 fiscal year, the SEC reportedly brought more than 670 enforcement actions, the second highest in the agency's history. But in the last few months of 2008, the agency also came under fire for not being more aggressive

in its oversight. As some debate what the role of the SEC should be—proactive regulator or after-the-fact forensic detective—others speculate what the SEC's priorities will be in the months ahead; all would agree that the SEC has its work cut out for it and will be very busy indeed.

When the dust finally settles, what will be the ramifications for corporate board members? What adjustments will they need to make to ensure that the company's compliance efforts remain current and consistent with best practices? An examination of how SOX is currently being enforced may shed some light on how future reform/ enforcement will be applied.

J.H. Cohn LLP recently conducted research on trends in SOX certification enforcement and implications for board members and senior corporate executives. The research was prompted by the many questions surrounding SOX Sections 302 and 906, which require CEOs and CFOs to certify that public financial filings are materially accurate. Chief among them is the question of how serious the government is in enforcing these provisions, given the absence of any news regarding investigations or prosecutions stemming from false certifications.

## SOX Certification Enforcement—Perception vs. Reality

When SOX was first enacted, many in the financial industry wondered whether restatements would trigger investigations into false certification liability, since restating prior financial statements means that the prior statements were erroneous or false. Despite the increasing prevalence of restatements, however, it has not triggered any widely publicized SEC or Department of Justice certification enforcement actions, contrary to the initial expectations of the industry watchers. This has led many industry observers and insiders to question the government's seriousness in enforcing Sections 302 and 906. Some CFOs and board members have lately noticed a "relaxing" or "more lax" attitude in colleagues regarding the possibility of govern-

**Director Summary:** The Sarbanes-Oxley Act of 2002 requires CFOs and CEOs to certify company financial statements filed with the SEC. Now that the Act has been in place for a number of years, the government is getting serious about enforcement. Boards must take a proactive stance to ensure their organizations are filing accurate accounts.

ment prosecutions for certification violations.

This increasingly relaxed attitude toward the possible risk of liability for false certifications, coupled by the high volume of filings that executives are required to sign under SOX, has led to a tendency for some senior executives to go on “autopilot” when signing certifications. Moreover, when inaccuracies are discovered after the filing, many executives have simply filed restatements to signal to the SEC that they did not actually know that the previously filed statements were incorrect.

For board members, the lack of any prominent news regarding certification violation enforcements has led to a “business-as-usual” approach. In fact, some experts believe that the increased risk of personal liability for senior executives has led some boards to conclude that there is less need for board oversight of the internal and financial operations of the company. The SOX penalty provisions, they argue, provide more reason to trust that executives will do everything to ensure the accuracy of public filings.

### Government Pursuit of Certification Violations

Contrary to the assumption that the government is not pursuing certification violations, it actually appears that government officials are pursuing certification violations with increasing vigor. According to defense attorneys specializing in corporate securities law, false certifications have already played a significant part in the prosecutions of securities fraud and other corporate wrongdoings. Because of the substantial financial and prison terms associated with Sections 302 and 906, false certifications provide a great leverage point for the government. Yet, many times, even though false certifications are used frequently as the underpinning for criminal or civil actions, certification violations are not listed in the formal charges because 302/906 discussions are so effective in forcing companies to take corrective compliance actions and/or to settle the matter. Further, enforcement of the 1977 Foreign Corrupt Practices Act (FCPA), (which includes Section 13(b), an internal accounting control provision), reached record highs in 2006 and 2007. Our research found that the government may be opting to bring Section 302 and 404(a) certification enforcement actions under the more time-tested FCPA.

The fact that false certifications play an important role in plea negotiations and agreements, even in actions that are not based on those certifications, is demonstrated by the fact that there are many prosecution-related documents that reference the 302/906 certification requirements. Legal experts have concluded that these types of references signify that the government used the certification provisions as a leverage point against the senior executives

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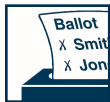
in negotiating the terms of the consent decree.

Although using false certifications as leverage points in non-certification cases appears to be the most common usage of the SOX certification provisions at this time, the government has shown a willingness to file false certification charges as well, even in cases lacking evidence of actual knowing, material misrepresentations.

### The Scrushy Case

In one of the most notable cases to date, the government brought a federal criminal case against Richard Scrushy, former CEO and chairman of HealthSouth Corporation. The government alleged that Scrushy filed a false certification of fraudulent financial statements with \$2.5 billion in accounting “errors.” Significantly, however, the government did not even allege that Scrushy filed these certifications with actual knowledge that the financial reports were false. Ultimately, the judge dismissed the Section 906 charge precisely on this ground—i.e., that the government failed to allege actual knowledge of willfulness.

Legal experts warn, however, that the mere fact that the government can credibly file these charges (and can possibly continue to do so, especially in other districts and circuits) should provide a powerful deterrent effect. Moreover, the fact that the government was willing to indict a CEO for filing a certification that he should have known was false, underscores the fact that even negligently—or recklessly—filed false certifications should continue to be important to the government as leverage points for the prosecution of other criminal conduct.



## Top executives and board members must take an active role in ensuring a culture of accountability and a company-wide system of internal controls.

Securities lawyers also agree that the government tends to “dangle” false certification claims as bases for deferred- or non-prosecution agreements.

As time passes, more and more investigations for post-SOX conduct will be made public, and we will likely see an increasing number of false certification claims. Moreover, some experts believe that the government has been more forgiving of companies and executives during this ramp-up, learning-curve time, but that we are now entering an environment in which enforcements will kick in, starting in the very near future.

### Proactive Boards

The government’s practice of leveraging false certifications in pursuing corporate wrongdoings, coupled with the increasing vigor with which the government is expected to enforce certification claims in the future, make clear that board members and senior management must step out of the current state of apathy, and proactively take steps to ensure the accuracy of SEC filings and certifications. As a general matter, top executives and board members must take an active role in ensuring a culture of accountability and a company-wide system of internal controls. Board members and executives who take their responsibilities under the Act seriously have focused, first and foremost, on hiring and cultivating employees who embrace their responsibilities. Companies should also conduct reviews of HR policies and training processes at the board level, emphasizing the importance of its people in complying not only with the technical requirements, but also with the spirit of corporate governance laws and regulations. Setting a strong culture of controls and responsibility at the very top—i.e., with the board members—will filter down throughout the organization.

In addition to focusing on people and the culture, board members should also ensure the utilization of specific methods and processes to guard against even “honest mistakes” leading to false certifications. For example, to the extent

that internal controls are systematized and automated as much as possible, human error leading to mistakes affecting financial reports will be reduced considerably. In addition, many boards have implemented a system of sub-certifications throughout the organization. Just as CEOs and CFOs are required to sign certifications regarding the accuracy of the financial reports as a whole, division heads, department vice presidents, and even managers should sign certifications to verify that the portions of the financial reports for which they are responsible are materially accurate.

At the board level, the audit and/or governance committees could conduct regularly scheduled reviews of the internal controls to demonstrate a culture of responsibility at the top. At the end of this review process, board members, especially those on the audit committee, could also sign a symbolic certification to guard against the reputational risk that the possibility of false certifications would carry.

### Conclusion

Given the fact that the early “honeymoon period” in the life of SOX is over, and that the government is leveraging false certification claims with increasing vigor (in both active investigations, as well as in behind-the-scenes negotiations for plea agreements), it appears likely that restatements will no longer serve as an “easy fix” for false certifications. Board members must take an active role in this new era of SOX enforcements by setting a culture of accountability at the top and overseeing the establishment of internal controls and strong hiring and training practices. Only by taking proactive measures can the board and senior management lead companies away from the increasingly frequent practice of “fixing the mistakes later,” and instead refocus the corporate culture on preventing even “honest mistakes” at the outset. ■

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Visit <http://www.sarbanes-oxleyactof2002.com> to request a complimentary hard or soft copy of “Trends in Sarbanes-Oxley Certification Enforcements and Implications for Board Members and Senior Corporate Executives.”