

BEYOND THE OXLEY-SARBANES BILL: ADDITIONAL MEASURES TO INCREASE CORPORATE ACCOUNTABILITY AND TRANSPARENCY

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Recent disclosures of gross accounting misstatements and omissions by companies such as Enron, Global Crossing, Adelphia and WorldCom have inspired the current call for accounting and corporate governance reform. These transgressions and wholesale breaches of investor trust have led to a wide range of reform proposals from a variety of different sources, including Congress, the Securities and Exchange Commission ("SEC"), the New York Stock Exchange ("NYSE"), the NASDAQ, and numerous organizations representing or purporting to represent investors' interests. Each of the foregoing sources has proposed measures designed to increase the accountability of publicly traded companies and their auditors for reported financial results, while at the same time increasing transparency of financial reporting by providing investors with the information necessary to make fully informed investment decisions.

The most notable reform initiative arising from the wave of corporate accounting scandals is the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "Act"), which derives from the "Public Company Accountability and Investor Protection Act of 2002," S. 2673, championed by Senator Paul S. Sarbanes (D. Md.) (the "Sarbanes Bill"), and the "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002," H.R. 3763, introduced and promoted by Representative Michael G. Oxley (R. Ohio). On July 24, 2002, a Conference Committee, consisting of members of the House Financial Services Committee and the Senate Committee on Banking, Housing and Urban Affairs, approved the Act, which utilized the Sarbanes Bill as the base text. On July 25, 2002, the House and Senate approved the Act, which has been submitted to President Bush for final approval.

The Sarbanes-Oxley Act imposes broad measures designed to increase corporate accountability and transparency and to provide corporate shareholders with enhanced litigation avenues and remedies for corporate securities fraud. Most notably for purposes of this article, the Sarbanes-Oxley Act requires senior officers of a company to file statements certifying the accuracy of financial reports, creates a new criminal securities fraud provision that carries a maximum of 25 years in prison, and increases penalties for other financial crimes. With respect to financial reporting, the Act requires companies to furnish contemporaneously to the SEC any information that has an impact on financial statements. The SEC will establish rules defining the specific information to be covered by this provision. While we applaud the bi-partisan efforts in approving the Sarbanes-Oxley Act and recognize that many of the Act's provisions provide healthy safeguards which will undoubtedly advance corporate accountability, we believe that the fundamentals of periodic financial disclosure have yet to undergo a vastly needed overhaul.

"Show Me the Math": Providing Investors With Access to a Second Tier of Financial Information

The Sarbanes-Oxley Act seeks to increase the level of financial disclosures by requiring the SEC to issue final rules providing that periodic filings disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer that may have a material effect on the issuer's financial condition. The Act would also require the SEC to issue final rules providing that pro forma financial information included in public filings or press releases be presented in a truthful and accurate manner. Finally, the Act would require the SEC to prescribe rules requiring issuers' annual reports to contain a description of internal accounting controls. While each of these proposals is aimed at increasing the overall level of disclosure, they do not materially alter the traditional forms of periodic reporting which have permitted serious accounting frauds such as in Enron, Global Crossing, Adelphia and WorldCom to pass by the scrutiny of investment professionals.

At least one solution to assist investors and advance the overall level of transparency of financial statements would be to require public companies to provide shareholders with access to a second tier of financial information in the form of additional documentation which supports the basis and structure of traditional financial statements. Consistent with this approach, the Financial Accounting Standards Board ("FASB") has recently promulgated accounting standards that would require substantial additional disclosures. Specifically, FASB's recent initiatives include changes in the accounting treatment applicable to special purpose entities ("SPES"), which were at the center of Enron's massive accounting fraud. Although the foregoing proposal represents only one instance of increased accounting disclosure, such a measure will likely prevent future corporate accounting frauds that utilize SPES. We commend these and other measures designed to prevent public companies from concealing investment structures that are deliberately designed to deflate debt levels while artificially inflating both revenues and profits. In light of public companies' proven potential for fraudulent behavior, such additional disclosure would place a justifiable burden on public companies.

On February 13, 2002, SEC Chairman Harvey Pitt asked the NYSE to review its corporate governance listing standards. In conjunction with that request, the NYSE appointed the Corporate Accountability and Listing Standards Committee (the "Committee") to review the NYSE's current listing standards, along with recent proposals for reform, with the goal of enhancing the accountability, integrity and transparency of the Exchange's listed companies. Statements submitted to the Committee by Fidelity Investments, Financial Executives International and the Association for Investment Management and Research echo the need for improving corporate disclosure and cures for areas where reporting standards are highly deficient. Proposals from these and other groups included: (i) adoption of the SEC's proposal to shorten deadlines for the filing of periodic reports; (ii) modernization of financial reporting by developing new practices for MD&A disclosure, disclosure of business performance metrics and ratios; (iii) reporting

of financial assets of fair value rather than historic cost; and (iv) disclosure of sensitivity analyses to allow investors to appreciate risk in changing environments.

What has been made quite clear from the recent accounting scandals is that the routine financial reports and narrative disclosures that are required under today's reporting requirements, have become inadequate to report sufficiently on sophisticated corporate structures, financial devices, capitalizations and accounting nuances. The frauds at Enron, WorldCom, Adelphia and others served to fool the most experienced of investment professionals thus demonstrating a clear need for enhanced disclosure and availability to investors of underlying financial books and records of the issuer. While we are cognizant of the burdens which would be imposed on corporate departments to respond to more stringent and exhaustive disclosure requirements, the integrity of our securities markets demands added transparency.

Learning from State Legislation

In addition to the enhanced corporate transparency provisions set forth in the Oxley-Sarbanes Act, Congress should explore proposals which provide corporate shareholders with a federal right to obtain copies of corporate books and records. Providing shareholders with access to more detailed corporate documents to shed added light on reported financial results is not a new tool. Many states, including Delaware, New York, Alabama, Missouri, and South Carolina have already recognized the importance of transparency in corporate bookkeeping and financial reporting by enacting statutes that provide investors with access to a company's books and records under certain circumstances.

In particular, the Delaware statute, which enables corporate shareholders to obtain access to certain corporate books and records, provides a framework for increasing transparency in corporate financial reporting. Under Delaware corporate law, stockholders have the right to inspect "for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom." 8 Del. C. § 220.

This provision of the Delaware law, modeled after the common law, was enacted early in the twentieth century to afford stockholders the "absolute right" to inspect the books and records of a corporation in which they owned stock. See *State ex. rel. De Julvecourt v. Pan-American Co.*, 61 A. 398 (Del. Super. Ct. 1904), *aff'd*, 63 A. 1118 (1906). Early cases had permitted more expanded inspections, especially where public information concerning the public affairs of the company were fraudulent or unreliable. See *State ex. rel. Waldman v. Miller-Wohl Co.*, 28 A.2d 148 (Del. Super. Ct. 1942); *State ex. rel. Cochran v. Penn-Bauer Oil Co.*, 143 A. 257 (Del. 1926). The early wisdom of this absolute right of inspection should provide guidance for meeting today's challenges for meaningful reporting and disclosure.

To obtain access to such corporate information, a stockholder must serve a written demand under oath setting forth the purpose for which the stockholder seeks the desired

information. The Delaware statute defines a "proper purpose" as any "purpose reasonably related to such person's interest as stockholder." *Id.* The stockholder seeking to inspect corporate books bears the burden of proving a proper purpose. See *Helmsman Mgt. Servs., Inc. v. A & S Consultants, Inc.*, 525 A.2d 160, 164 (Del Ch. 1987). In this regard, a stockholder who seeks inspection under §220 must prove by a preponderance of the evidence: (a) its compliance with the form and manner of making a demand specified in the statute; and (b) the propriety of its purpose for seeking inspection, i.e., that the purpose is reasonably related to its interest as a stockholder. See *Kortum v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 119-20 (Del. Ch. 2000). Once the stockholder demonstrates its entitlement to inspection, it must also show that the scope of the requested inspection is proper. See *id.* Thus, the Delaware statute provides a framework for enabling stockholders to review corporate documents under circumstances that do not disrupt regular corporate operations.

In addition to the measures set forth in the Sarbanes-Oxley Act, Congress should enact an expanded analog to the Delaware statute which would offer shareholders access to more in-depth levels of corporate records which "show the math." Any federal legislation here should contain an "ownership threshold," which would limit the relief afforded by the statute to stockholders who own a benchmark level of the subject company's securities. Including such a threshold requirement would minimize the potential for shareholder abuse of this proposed statutory right and would help ensure that it is properly utilized to protect significant investment interests.

The Certification Requirement Should Be Extended To Other Members of Management and The Audit Committee

In its present form, the Act would also require the chief executive officer and chief financial officer (and persons performing similar functions) of an issuer to provide a written statement with each periodic financial report filed with the SEC. The written statement would certify, among other things, that the company's financial statements fairly present in all material respects the issuer's financial condition and results of operations. Officers who violate this provision would be subject to criminal penalties, including a maximum fine of \$5,000,000, a maximum prison sentence of 20 years, or a combination of both. While the certification requirement is certainly a well-intentioned structure to advance accountability, it does not extend beyond the senior officers of the company. Surprisingly, the Conference Committee relieved the chairman of the board from signing the certification, apparently concluding that only those with actual responsibility for the financial statements should be required to sign the document.

Financial accounting and the reliability of financial statements may only be enhanced with an expansion of the certification requirement to include the chairman and audit committee members of the board of directors, as well as the outside auditors. Let us not forget that the recent wave of scandals have eliminated trillions of dollars of domestic and global market capitalization, warranting a larger scope of certifications from persons who can be held accountable for reported financial information. In this regard, corporate

officers and board members who issue certifications should be strictly liable when the reported financials do not accurately reflect the financial condition of the company.

Conclusion

Under the new corporate responsibility legislation, which by the date of publication of this article will have been signed into law by the President, the government will be afforded new powers to police corporate executives and the accounting profession. While we do believe that requiring senior corporate officers to certify financial reports and other concepts of the Act will have a chilling effect upon corporate wrongdoing, the current legislation falls well short of providing the true owners of our public companies access to underlying, more detailed financial information. Indeed, granting investors a federal expanded books and records entitlement is one positive leap towards greater transparency and comfort in corporate financial health.