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CorporateGovernor

Providing vision and advice for management, boards of directors and audit committees

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Tone from the top: Focus on key risk areas

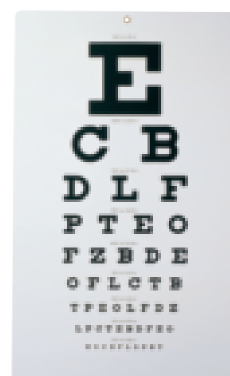
Virtually every public company is struggling with the same basic questions regarding Sarbanes-Oxley and internal controls: "Where should we focus our controls evaluation?" This article will give you some food for thought.

In October 2002, the General Accounting Office (GAO) published a study of public company financial statement restatements that resulted from material errors or fraud. From January 1997 through June 2002, the GAO studied 919 restatements by 845 public companies. That study highlighted some interesting trends that should translate into red flags for us today.

The first noteworthy fact was the nature of the errors that caused the restatements. Fully 38 percent of those restatements corrected material errors related to revenue recognition. An additional 16 percent included errors related to expense capitalization.

Those two items alone accounted for nearly 60 percent of the restatements studied. The remaining restatement causes included an assortment of items such as restructuring, and asset impairment charges and acquisition accounting.

The second noteworthy fact in the GAO's study was the impact that restatements had on the market values of the restating companies. The GAO calculated that the 919 restatements caused a reduction of approximately $100 billion in the market value of the related companies. Of that, approximately 56 percent was attributed to restatements that included revenue recognition errors, 19 percent to errors involving acquisition accounting, and 5 percent to errors involving expense capitalization.



So what does this tell us? First, getting revenue recognition right the first time is critical. It has the highest likelihood to cause a restatement, and when it does, the consequences are extreme. Second, reporting expenses at the right amount, in the right period, is also an important area of financial statement risk. Third, when you have complex accounting issues, such as those related to acquisitions, impairments or restructurings, you should go the extra mile to make sure you have the right people on staff with the right training and authority to get the job done.

None of this is easy, but if you step back and draw circles around your critical accounting risks, you can make sure your Sarbanes-Oxley project is properly focused.

Sincerely,

National director of corporate governance advisory services

For the complete text of this abridged article, visit www.GrantThornton.com/sarbanesoxley.

U.K. companies wrestle with corporate governance best practice

Great Britain's largest public companies have made significant strides in the last six months to comply with corporate governance best practice, according to an annual study produced by Grant Thornton United Kingdom (U.K.).

However, Simon Lowe, head of Grant Thornton U.K.'s risk management services warns, "Companies cannot afford to be complacent. With the introduction of the Revised Code on Corporate Governance, the goal posts continue to move and companies have even more to do to comply."

In the U.K., public companies must follow the Combined Code on Corporate Governance, which forms part of the U.K. Listing Rules.

In its study, Grant Thornton analyzed how far Britain's FTSE 350 comply with the principles of the country's Combined Code and, in particular, with the hot topic of risk management. Grant Thornton's report found that 54 percent of FTSE 100 and 42 percent of FTSE 250 consider themselves to be fully compliant compared to 41 percent and 32 percent, respectively, last year.

Investors use the FTSE indices worldwide for investment analysis, performance measurement, asset allocation, portfolio hedging and for creating a wide range of index tracking funds.

The Grant Thornton study also revealed significant progress with regard to risk management reporting. In last year's survey, 47 percent of the companies did not make any mention of the processes that they have in place for embedding risk management in their organization. This year, the figure dropped to 10 percent.

There is still a great deal of progress to be made, however. Lowe comments, "While there has been improvement, our survey found that more than half of FTSE 350 companies still do not comply fully with the Combined Code. And, when it comes to explaining why they are not compliant, two-thirds provide only a brief explanation as to why they are not compliant."

Simon Lowe is the managing partner of Grant Thornton UK's risk management services.

Lowe continues, "If the U.K. is to continue to promote a principles-based approach as opposed to the U.S.-favored prescriptive approach, then our top companies must demonstrate that they are able to support this in practice. It's no good advocating guidance over regulation and then opting to give the barest minimum of information."

"To do that undermines the whole argument that a principles-based approach is the preferable solution to creating a strong, corporate governance environment."

The study identifies the two most prevalent areas of non-compliance relating to non-disclosure of information with respect to risk management and internal control, and issues pertaining to the role of non-executive directors.

One-third of companies gave no summary of the risk management process that boards and audit committees presumably had applied in reviewing the effectiveness of their internal control systems. A similar number of companies failed to acknowledge the full range of risks that are covered by their review, often mistakenly only referring to financial controls.

Although most boards meet the Combined Code's requirement that one-third of the directors be non-executive, there are still significant issues surrounding their independence. More than one in seven of the FTSE 350 still include on their remuneration (compensation) committees non-executive directors who are either not identified as or not deemed to be independent.

"It is encouraging to see that the FTSE 350, and particularly the FTSE 250, have made good progress over the past 12 months, however, they must not become complacent," Lowe says.

Similar to the United States, Lowe adds that "public awareness of this topic is at an all time high and, as a result, there is intense pressure on audit committees of our top companies to ensure that they and their management address these issues." ■

For more information about corporate governance issues in the U.K., visit www.GTUK.com.

OCEG: A new approach to compliance and ethics

Historically, the thorny issue of compliance and ethics in the business world has been handled haphazardly and on a case-by-case basis. The results were difficult to benchmark, reducing effectiveness. This approach, if it ever did indeed work, is not working anymore.

To be successful in today's environment, organizations must strive for performance beyond the basics, implementing a comprehensive approach to the practice of entity-wide compliance and ethics.

"The global marketplace has raised compliance and ethics expectations for private and public companies," says Carole Stern Switzer, Open Compliance and Ethics Group (OCEG) general counsel. "The new Securities and Exchange Commission (SEC) regulations demand that audit committees and senior officers of U.S.-registered organizations be responsible not only for compliance, but also for ensuring that organizations have the capability to keep employees fully aware of compliance processes and requirements. These regulations move compliance and ethics issues to the top of the list of business priorities."

Until recently, there has been no common, enterprise-wide, multi-industry, multi-disciplinary guidance for developing effective compliance and ethics programs. The OCEG was created by a broad ranging group of business thought leaders to fill that void by developing compliance standards and guidelines.

The OCEG Framework for Effective Compliance and Ethics Management was drafted by experts who have developed ethics and compliance programs, leading law firms and major consulting groups. It has been reviewed by more than 150 individuals representing more than 200 companies interested in improving ethics and compliance management to address internal concerns and to assist insurance underwriters and investors in evaluating a program's effectiveness. For the first time, OCEG defines a comprehensive approach for building and improving an ethical culture, managing regulatory compliance and reducing business risk.

"The OCEG Framework provides organizations with a reference model and evaluation method to develop and improve compliance and ethics programs," Switzer says. "By improving these programs, an organization greatly improves its relative risk profile."

Specifically, the OCEG Framework consists of:

- Foundation guidelines — 38 high-level and 140 detailed practices that form the backbone of an effective compliance and ethics program.
- Domain guidelines — Customized supplements for areas including governance, employment, competitive practices, environmental, financial assurance and sales.

It is important to note, Switzer says, that the OCEG Framework ensures that its users adhere to both the "letter of the law," as well as the "spirit of the law."

"The OCEG Framework points out applicable laws, rules and regulations that an organization must address to reduce legal and regulatory risks. At the same time, it analyzes the values and ideas and translates them into tangible actions that organizations should take to reduce both short-term and long-term integrity, ethics and reputational risks."

Some of the benefits organizations may receive by adopting the OCEG Framework include:

- A common integrated framework for compliance and ethics management.
- Best practices for management of compliance and ethics programs.
- The ability to benchmark against peers.
- A method for mapping programs to risk management tools.
- Enhanced protection of its reputation and brand.
- Reduction of the financial and business risk associated with ethics, legal and regulatory compliance.

"Perhaps most importantly, the adoption of the OCEG Framework will help to dramatically reduce the incidents of ethics and compliance mishaps in the marketplace," Switzer explains. ■

OCEG's founding beliefs

Leadership: While the government has enacted legislation aimed at establishing greater regulative oversight and control, it is up to the business and organizational communities to take the lead in structuring confidence restoring solutions.

Core ethics and conduct: Without a strong core of ethics, values and codes of conduct, imposed laws, rules and regulations mean less to an organization.

Effective governance and compliance: Workforce compliance education and supporting processes are a critical basis for overall effective corporate governance.

Shared responsibility: The organization, its leadership and its employees all share one philosophy.

Prevention and education: Prevention is the goal. Dealing with issues "after the fact" damages an organization's reputation, productivity and finances. Education, which should be administered as part of the hiring process, needs to be refreshed and updated at specified intervals.

Grant Thornton is an OCEG founding member. For more information about OCEG's mission and how to join, visit www.oceg.org.

Sarbanes-Oxley and not-for-profits: A mixed bag

A recent national survey of not-for-profit business leaders and executives by Grant Thornton finds that Sarbanes-Oxley has had little effect on not-for-profit organizations throughout the United States.

"It is now more than 18 months since Sarbanes-Oxley was enacted and still most not-for-profit organizations, including larger ones, have not made any changes to their board governance policies," says Bob Leavy, Grant Thornton's national partner in charge of the not-for-profit industry practice.

"While Sarbanes-Oxley is not a mandate for not-for-profit organizations, many believe that the requirements and guidelines stated in the Sarbanes-Oxley Act set a standard or benchmark that not-for-profit organizations should consider emulating. Those organizations that adopt these governance standards may be seen more favorably by donors and funders."

Overall, 57 percent of the respondents to the Grant Thornton *National Board Governance Survey for Not-for-Profit Organizations* indicated that they are "somewhat familiar" or "very familiar" with the Sarbanes-Oxley Act. And, surprisingly, only 20 percent said that they have made some changes to their board governance policies as a result of the Sarbanes-Oxley Act.

In addition, only 38 percent of respondents have had discussions with their board members about the implications of the Sarbanes-Oxley Act.

Leavy says, "This is a clear indication that communication between boards and executive staff is insufficient. The issues that Sarbanes-Oxley addresses are the critical issues that boards and management must be discussing in light of their own governance policies."

The complete report is available online at www.GrantThornton.com/nfpsoxsurvey. ■

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