Commentary

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BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Sarbanes-Oxley and the Path to Reform

The new SEC corporate governance rules are now in effect under the Sarbanes-Oxley Act and companies are undertaking corporate governance reviews to ensure compliance with the new standards. The new rules require CEOs to personally certify that their company's financial reports do not contain any material misrepresentation or omission and that the information in the company's financial statements fairly represents the financial condition, results of operations and cash flows of the company. The rules also require CEOs to certify that they have designed disclosure controls and procedures to ensure that material information about the company is made known to them in a timely fashion by others within the company and that they have evaluated the effectiveness of the disclosure controls and procedures. CEOs are also required to certify that they have disclosed to the auditors and the audit committee all significant deficiencies in the design or operation of internal controls that could adversely affect the company's ability to record, process, summarize and report financial information, as well as any fraud that involves management or other employees who have a significant role in the company's internal controls. These reviews will typically examine, from a corporate governance perspective, the interaction, functions and processes of management, the board of directors and the audit committee, as well as the mandates of the board and the audit and other board committees, with a particular focus on member composition, independence and expertise.

The Sarbanes-Oxley Act has created a new regulatory oversight board for the accounting profession. This new agency, the Public Company Accounting Oversight Board, has a broad mandate to set ethics and conflict-of-interest standards, discipline accountants and conduct annual reviews of accounting firms. The urgent need for the accounting profession to raise its standards, regain public confidence and overcome its tarnished reputation from the Arthur Andersen saga and other accounting scandals, is of paramount importance from Wall Street to Main Street. The composition of the five-member oversight board is a very important matter that will determine how effective the board will be in achieving the needed reforms. Two candidates that we felt were exactly right for the oversight board, are Paul Volcker and John Biggs. Paul Volcker, former Federal Reserve Chairman, and head of the London-based International Accounting Standards Board, would have been an excellent choice to head the oversight board, but regrettably has declined the offer of the post. John Biggs, actuary and chief executive of TIAA-CREF has been a strong proponent of accounting reform and has been a powerful influence through testimony to Congress in advocating appropriate accounting standards to expense stock option awards, the independence of auditors to avoid conflict-of-interest as consultants, and strong oversight of the accounting profession. He was offered the post to head the oversight board in September, but is now facing the prospect that he may not be appointed due to political pressure and lobbying efforts to halt his appointment. The appointment of the members of the oversight board will be a litmus test for the independence of the Securities and Exchange Commission. Failure to appoint John Biggs as chairman of the oversight board will be a sure sign that Harvey Pitt, SEC Chairman, has succumbed to political pressure and the lobbying efforts of the accounting profession to weaken the effectiveness of the oversight board. We hope that he has the courage and strength of character to stand up against these powerful interests and do the right thing to earn the public's respect and trust.

Arthur Levitt, former SEC Chairman, has written a fine new book "Take on the Street." While we generally abhor the practice of noun-verb reversal as a jarring misuse of the English language, we compliment the author's subtle double meaning in the title as both an appeal to challenge the wrongdoing on Wall Street and as a scathing criticism of the self-enriching practices of corporate executives and investment bankers. Levitt has for a long time criticized the accounting profession for the inherent conflicts-of-interest in the dual roles as auditors and consultants. As SEC Commissioner, he was unable to overcome the powerful forces arrayed against the reforms he sought to correct, such as the widespread abuses in corporate earnings management, merger accounting, re-structuring charges and executive stock option awards. If any of the perpetrators of these accounting gimmicks and frauds have any sense of remorse or shame, we earnestly hope they will think long and hard about the extent of the harm caused to individual investors and 401(k) participants who naively believed that corporate America and the accounting profession were sufficiently honest and trustworthy to dedicate their lifetime savings to the "cult of the equity" that partly emanated from these practices and burgeoned over the last two decades until the bubble burst.

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