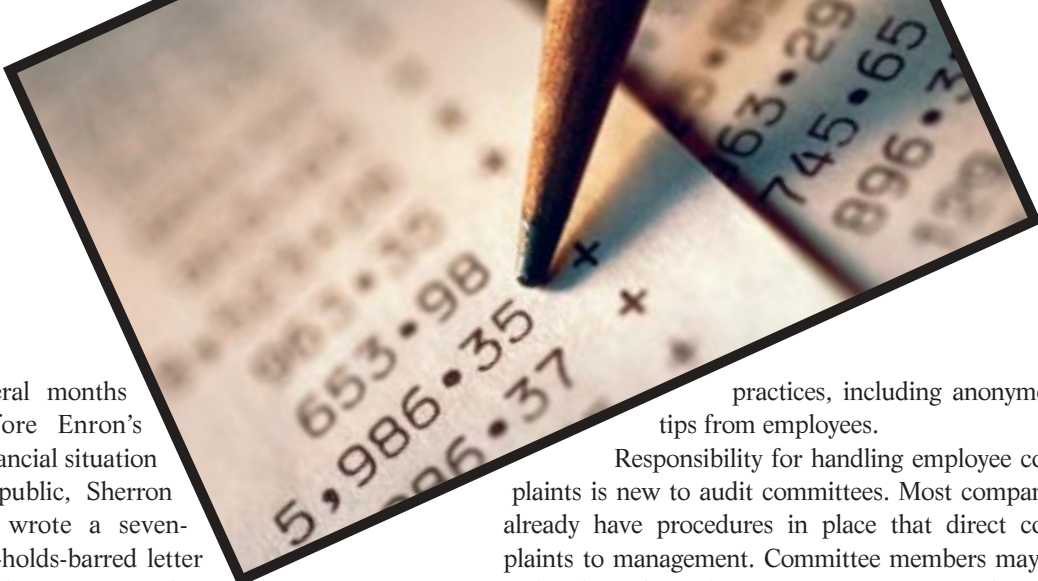


Audit Committees Under the Sarbanes-Oxley Act

Establishing the New Complaint Procedures



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Several months before Enron's financial situation became public, Sherron Watkins wrote a seven-page, no-holds-barred letter detailing her concerns about Enron's accounting practices. She addressed it to her boss, CEO Ken Lay. According to press reports, he brushed it off. Apparently, no member of the Enron board of directors saw the letter, and her concerns did not generate any changes in Enron's financial or accounting practices. The terrible price paid by Enron shareholders and employees is well known.

Congress enacted the Sarbanes-Oxley Act of 2002¹ partly in response to the Enron situation. Among other things, the Sarbanes-Oxley Act attempts to create new lines of communication between public companies and their employees so that people like Sherron Watkins can express concerns that will be heard by a wider audience in the company. In § 301 of the Sarbanes-Oxley Act, Congress has now charged independent audit committees—not company management—with establishing procedures for the receipt and treatment of complaints regarding questionable accounting

practices, including anonymous tips from employees.

Responsibility for handling employee complaints is new to audit committees. Most companies already have procedures in place that direct complaints to management. Committee members may be inclined to rely on these existing structures and merely require that management funnel complaints dealing with accounting and auditing matters to the committee. You should review these existing structures carefully to make sure that they comply with both the intent and the spirit of Sarbanes-Oxley Act § 301. In some cases, management may not have the appropriate incentive to follow up on all complaints made, particularly those that relate to alleged wrongdoing by management itself. In addition, employees may be reluctant to report concerns directly to management for fear of reprisal. In-house counsel's assistance in creating credible and effective procedures will be critical to the audit committee's performance of its increased role under Sarbanes-Oxley Act § 301 in identifying potential problems before they become major financial scandals.

This article explains what you need to know and do now about Sarbanes-Oxley Act § 301 in order possibly to avert a compliance crisis before it develops rather than merely respond to one later. Use the list of steps in the sidebar on page 104 to develop and implement a compliant complaint procedure for your company.





**Audit
Committees**
under the Sarbanes-Oxley Act

**Establishing the New
Complaint Procedures**

By Marian Exall and John D. "Jack" Capers Jr.

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THE LAW

The relevant portion of Sarbanes-Oxley Act § 301 provides as follows:

Complaints.—Each audit committee shall establish procedures for—

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.²

Congress directed the U.S. Securities and Exchange Commission ("SEC") to flesh out the sparse language of Sarbanes-Oxley Act § 301 in a rule implementing the provision. In the final rule, the SEC chose not to specify any required features for a complaint procedure that complies with Sarbanes-Oxley Act § 301. Citing a desire to maintain maximum flexibility for public companies, the final rule issued on April 9, 2003, does no more than add a deadline for compliance. Audit committees must have their complaint procedures in place by the first annual shareholders' meeting after January 15, 2004, and no later than October 31, 2004.

Comments submitted to the SEC on the proposed rule on Sarbanes-Oxley Act § 301 were

STEPS FOR IMPLEMENTING A SARBANES-OXLEY ACT § 301 COMPLAINT PROCEDURE

1 Conduct an audit of the company's existing complaint procedure to determine whether it complies with Sarbanes-Oxley Act § 301. For example, does it cover accounting and auditing concerns? Does it guarantee anonymity? Are reports routed to the audit committee?

2 Define the company's special requirements, such as the ability of foreign-based employees or non-English-speakers to access the system, compliance with federal contractor requirements, compliance with laws in non-U.S. locations relating to employee grievances, confidentiality of personnel data, and the investigation of employee misconduct.

3 Determine who will receive reports, who will investigate them, information management requirements, including how long records should be kept and what kinds of summary reports are needed, and a communication strategy.

4 Solicit and review proposals. Although the audit committee may rely on management to screen proposals, the chance to participate in interviewing finalists will give committee members a comfort level about the procedure finally chosen. An audit trail of committee involvement in all important aspects of the complaint procedure selection and implementation process will be helpful if compliance is ever challenged.

5 Have the audit committee select a provider and approve the implementation plan.

6 Implement the complaint procedure plan. This step may take from a few weeks to several months, depending on the company's individual requirements. During this phase, design, produce, and distribute training and awareness materials, announce the program to employees and train them on the procedures, and train management.

7 Roll out the complaint procedure and let it go live.

about equally divided between those who wanted more specific guidance and those who felt that the complaint procedures already in place were working adequately, arguing that there was no need to overreact to what they believed would be a rare and extraordinary circumstance.

In-house counsel charged with the responsibility of advising a company as to whether an existing complaint procedure complies with Sarbanes-Oxley Act § 301 would be wise to review the requirements of Sarbanes-Oxley Act § 301 carefully and to keep in mind the consequences for noncompliance. If a public company does not have a complaint procedure that complies with Sarbanes-Oxley Act § 301 in place by the deadline, the company will be subject to being delisted from the national stock exchange and securities association on which its stock is traded.

ELEMENTS OF A COMPLIANT COMPLAINT PROCEDURE

What constitutes a complaint procedure that will satisfy the requirements of Sarbanes-Oxley Act § 301? The best practices are likely to evolve over time as companies develop complaint procedures in response to the Sarbanes-Oxley Act. Nevertheless, given the need for companies to act now to comply with Sarbanes-Oxley Act § 301, we believe that in-house counsel should consider the following key factors as they evaluate existing complaint procedures or create new procedures:

- Audit committee access to all complaints.
- Outsourcing to increase credibility.
- Coding of complaints.
- Reporting mechanisms.
- Building employee awareness through training.
- Safeguarding against retaliation.
- Disclosure regarding internal controls.
- Investigating complaints.

Audit Committee Access to All Complaints

Sarbanes-Oxley Act § 301 clearly states that the audit committee is responsible for establishing a procedure that creates an effective mechanism for employees and others to make complaints to the company. This requirement means that the audit committee should have access to the information

generated by the complaint procedure so that the committee can make the ultimate judgment about whether the company should take action with respect to a reported matter. The issue then is how to give the audit committee access to the complaint information and what role management should have in the process.

A COMPANY SHOULD NOT DESIGN A COMPLAINT PROCEDURE THAT FUNNELS COMPLAINTS EXCLUSIVELY THROUGH MANAGEMENT TO THE AUDIT COMMITTEE BECAUSE MANAGEMENT WOULD DECIDE WHAT INFORMATION SHOULD BE FORWARDED TO THE AUDIT COMMITTEE.

A company should not design a complaint procedure that funnels complaints exclusively through management to the audit committee because management would decide what information should be forwarded to the audit committee. The concern is that the potential is too great for management to ignore or divert complaints, even if acting on a good faith judgment that the complaint is not “serious” enough to warrant audit committee involvement, lies outside the scope of accounting and auditing matters, or simply lacks a factual foundation. In addition, in cases in which the complaint relates to management, an employee may be dissuaded from coming forward because of fear of retaliation, even in the face of management’s assurances of confidentiality. Although these concerns may not be totally eliminated, they are lessened when complaints are made to a person who is not a member of management, whether that person is a member of the audit committee, an officer of the company specifically charged with the job of managing the complaint procedure, or an outside party.

Outsourcing to Increase Credibility

For many companies, outsourcing the complaint procedure is a better alternative than managing the procedure with internal resources. As discussed above, credibility is the key to an effective

procedure. If a company does not have an internal structure that can handle effectively the high-stakes, sensitive subject matter of Sarbanes-Oxley Act § 301 complaints, the company should consider using the services of an outside service provider to manage the procedure.

IN EVERY CASE, YOU SHOULD MAINTAIN A COMPLETE RECORD OF ALL COMPLAINTS RECEIVED, THE TREATMENT OF THE COMPLAINTS UNDER THE PROCEDURE, AND THE ULTIMATE DISPOSITION OF THE COMPLAINTS.

A variety of service providers have jumped into this field, offering telephone hotlines, messaging services, and email and web-based systems tailored to Sarbanes-Oxley Act § 301 compliance. In sorting through these vendors, you should ask the following questions:

- How long has the provider been in business?
- What experience does the provider have with handling business ethics complaints?
- How does the provider guarantee complainant anonymity?
- Is a hotline call always answered by a trained interviewer?
- Are complaints received around the clock?
- Does the provider offer a case management system?

Coding of Complaints

Audit committee members will naturally be concerned about being deluged with complaints that have little to do with the serious accounting frauds and audit failures that are the target of the Sarbanes-Oxley Act. Here, the company must walk a thin line in establishing the parameters for its complaint procedure: reject complaints because they are not obviously and directly related to financial reporting requirements, risking the consequence that something that has serious financial consequence goes uninvestigated, or take a more comprehensive approach, encouraging reports of anything that seems questionable about the company's practices,

and then identify the complaints that have some Sarbanes-Oxley Act § 301 substance to them.

We believe that a company should include in its complaint procedure some process that involves coding or classification of complaints received so that the procedure identifies the complaints that require more investigation and attention from the audit committee. We are not suggesting, however, that audit committee members perform the triage themselves. You, another person in the company charged with managing the complaint procedure, or your properly qualified service provider could use the coding procedure. In setting up the coding procedure, you can establish a set of codes for complaints received and the appropriate recipient for a report of a complaint based on its code. If a complaint receives a code that indicates that it may involve a Sarbanes-Oxley Act § 301 matter, the complaint will result in a report to the audit committee. You can have other complaints routed to human resources, loss prevention, or some other internal department, as appropriate. In every case, you should maintain a complete record of all complaints received, the treatment of the complaints under the procedure, and the ultimate disposition of the complaints. You should periodically review the entire record with the audit committee.

Bear in mind that Sarbanes-Oxley Act § 301 does not limit the scope of the procedure to employee complaints, although the mandate of confidentiality applies only to submissions from employees. In defining the scope of complaints to handle in a Sarbanes-Oxley Act § 301 complaint procedure, you should anticipate that complaints may come from vendors, clients, customers, and other stakeholders.

Reporting Mechanisms

The systems that companies use to permit employees and others to make complaints range from low-tech to high-tech and formal to informal. Your company may already use a variety of these systems. An open-door policy, an ombudsman office, and a suggestion box are some of the most frequently used systems. The telephone hotline has been a classic reporting method for more than 20 years. A hotline system may be a 24/7 service with trained interviewers to elicit information, create and transmit incident reports, and follow up as requested by the company to gather

more information from complaining parties, or it may be merely a voicemail box checked sporadically. Don't assume that they're all alike. The quality of information received in the initial contact will influence your ability to conduct an effective investigation later.

New technology has spawned new reporting systems. Email reporting has the disadvantages of not providing complete anonymity and of not being as interactive as other systems are. Although attempts are being made to overcome these drawbacks, many employees still do not have computer access to use a web-based system. Email, therefore, does not offer a comprehensive solution, although it may form part of an overall compliance strategy.

An effective complaint procedure should not depend on any single reporting mechanism, but should incorporate a number of different channels for employees to voice concerns. Some channels will provide anonymity, some interactivity, and some both. For Sarbanes-Oxley Act § 301 complaints, a telephone hotline might be the centerpiece of the system, but it could and probably should be supplemented by other procedures, such as a simple post office box for snail mail reports and an email reporting system. Old faithfuls, such as an "open door" process, if still credible with employees, continue to be useful channels in surfacing accounting and auditing concerns.

Building Employee Awareness through Training

Even a well-designed complaint procedure will fail without adequate training for employees. You must train employees as to the reasons for the procedure, the types of complaints sought, how to use the procedure, and its confidentiality. Without this type of training, the system will crumble.

You should view employee training as an ongoing effort. After the initial announcement of the complaint procedure, a company should use staff meetings, employee newsletters, websites, posters, wallet cards, and brochures to maintain awareness. If the company uses a third-party service provider for its complaint procedure, employee communications should be part of the implementation plan established with the service provider. The messages conveyed should be fresh and relevant and cover the "what's in it for me?" aspect. Ultimately, creating a climate of compliance depends on everyone from

the board down internalizing the new standards of corporate accountability and disclosure reflected in the Sarbanes-Oxley Act. Constant and consistent communications and training play an important part in achieving this objective.

EVEN A WELL-DESIGNED COMPLAINT PROCEDURE WILL FAIL WITHOUT ADEQUATE TRAINING FOR EMPLOYEES. YOU MUST TRAIN EMPLOYEES AS TO THE REASONS FOR THE PROCEDURE, THE TYPES OF COMPLAINTS SOUGHT, HOW TO USE THE PROCEDURE, AND ITS CONFIDENTIALITY.

Safeguarding against Retaliation

If employees fear retaliation for making complaints under the procedure, they will not make complaints. The system will fail if employees have no confidence in the confidentiality of the procedure. You must design procedures that ensure that management cannot identify a person who filed an anonymous complaint by handwriting or voice recognition, phone records, or internet email accounts.

Safeguarding against retaliation is also necessary to protect companies from the possibility of incurring civil and criminal penalties under the Sarbanes-Oxley Act. Sarbanes-Oxley Act § 806 creates a new private cause of action for whistleblowers who claim that they have been retaliated against for reporting accounting fraud. An aggrieved employee's remedy is to file a charge with the Department of Labor ("DOL"), exhaust their administrative remedies, and then seek damages in court. The other Sarbanes-Oxley Act whistleblower protection provision is § 1107, which imposes criminal penalties of imprisonment for up to 10 years for retaliation against an employee who reports accounting fraud. These two provisions together clearly reflect a heightened standard for handling employee complaints about accounting and auditing misconduct, even if such complaints are rare and unusual occurrences.

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Disclosure of Internal Controls

Section 301 is only part of the focus on internal controls in the Sarbanes-Oxley Act. Internal controls are generally considered to be those systems and procedures used by a company to achieve core business objectives, to provide reliable financial reporting, and to comply with applicable laws and regulations. A complaint procedure is one aspect of the internal controls of a company.

The Sarbanes-Oxley Act requires extensive disclosure regarding internal controls. Sarbanes-Oxley Act § 404 requires that a company state in each annual report the responsibility of management to establish and maintain effective internal controls and an assessment by the company of the effectiveness of its internal controls. Sarbanes-Oxley Act § 404 also requires that a company’s auditor attest to and assess the effectiveness of a company’s internal controls as part of the annual audit of the financial statements of the company. Sarbanes-Oxley Act § 404 requires an auditor to disclose any “material weakness” or “significant deficiency” in the company’s internal controls. Under applicable accounting standards, the

existence of a material weakness in a company’s internal controls is likely to prevent the auditor from giving an “unqualified” opinion on the company’s internal controls. Therefore, in reviewing an existing complaint procedure or establishing a new one, you need to view the procedure as an integrated part of the company’s internal controls and be aware that both management and the external auditor will need to refer to it in making their required disclosures regarding internal controls.

Investigating Complaints

There is no one best way to investigate a complaint made by a whistleblower. The procedure for conducting the investigation will be influenced significantly by whether the audit committee chooses to conduct an internal investigation managed by company officials or to conduct an independent investigation managed by outside counsel or another independent party. For a thorough discussion of the whistleblower provisions under the Sarbanes-Oxley Act, see Le Hammer, Nick Linn, Laurence E. Stuart, and Susanne K. Sullivan, “Navigating the Civil and Criminal Whistleblower

Provisions of the Sarbanes-Oxley Act,” *ACCA Docket* 21, no. 3 (March 2003): 22–41, available on ACCA OnlineSM at www.acca.com/protected/pubs/docket/ma03/whistle1.php.

Regardless of the type of investigation conducted, some steps are important in every effective investigation. First, make sure that the investigators have adequate resources, expertise, and time to complete the investigation. The quality of the investigation will depend on these factors. Second, make sure that the investigators gain control of all documents, emails, and other written materials that might be involved in the allegations in the complaint. Third, have the investigators interview all employees and anyone else that may have information that relates to the subject of the investigation. Fourth, coordinate the timing of the investigation with other priorities or responsibilities of the company, such as responding to a government subpoena, making filings with the SEC, and complying with local laws or internal policies relating to investigations of possible employee misconduct. Finally, make sure that there are no conflicts of interest among the investigators that might affect the independence of the investigation or the credibility of the conclusions reached in the investigation.

To make sure that investigators gain control of all relevant documents at the beginning of an investigation, you should immediately suspend all ordinary course document destruction practices of the company as soon as the investigation begins. Sarbanes-Oxley Act § 802 creates new criminal penalties for any knowing destruction or concealment of documents to obstruct or influence a government investigation or in contemplation of a government investigation. Because an internal investigation or an independent investigation may be conducted “in contemplation” of a government investigation, destruction of documents during the course of an internal or an independent investigation may violate Sarbanes-Oxley Act § 802.

Although you cannot anticipate the shape of any particular investigation when you are establishing your Sarbanes-Oxley Act § 301 complaint procedure, you need to help the audit committee understand the range of options that it will have if it receives a complaint of accounting fraud. When setting up the procedure, help the audit committee think through the issues of who might

do the investigation, what steps will be taken to ensure investigator access to all relevant information, and how the investigation will be managed in coordination with external disclosure obligations. Taking these steps will enable the audit committee to act more effectively if the procedure is ever triggered.

CONCLUSION

The Sarbanes-Oxley Act is a monumental piece of legislation. Having worked hard to address the immediate requirements of the Sarbanes-Oxley Act, public companies are now turning to other provisions with longer deadlines, such as the Sarbanes-Oxley Act § 301 requirement that audit committees establish procedures for receiving and handling complaints regarding accounting and auditing issues. In-house counsel have to determine what Sarbanes-Oxley Act § 301 intends in this provision, a task made more difficult by the lack of guidance in the subsequent regulation, and then help the audit committee assess whether existing complaint procedures measure up or what new procedures need to be implemented to bring the company into compliance.

In developing a Sarbanes-Oxley Act § 301 complaint procedure, in-house counsel should take a step back and look at the Sarbanes-Oxley Act as a whole and the scandals that gave rise to it. Companies that embrace new standards of disclosure and accountability by going beyond the letter of the law to adopt complaint procedures that are transparent, objectively administered, consistently monitored, and openly communicated will gain an advantage in today’s business environment. Over time, the courts will flesh out the legal standards for compliance in whistleblower lawsuits and securities class actions. More immediately, investor opinion will decide whether a public company has honored the spirit of Sarbanes-Oxley Act § 301 by encouraging employees and others to speak up about questionable accounting practices and listening to them when they do. ■

NOTES

1. Pub. L. No. 107-204.
2. 15 U.S.C. § 78f (2002).

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