Back to Our Future: Challenging New Compliance and Leadership Accountabilities for Human Resources, Courtesy of Sarbanes-Oxley

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The Sarbanes-Oxley Act of 2002 (SOX) has created big new challenges for publicly traded organizations, most often with little to no involvement by the HR function. The burden of compliance has fallen primarily on Finance, as SOX has tangible implications that result in severe penalties and reduced shareholder value. Nevertheless, HR has a key role in the development and implementation of systemic and sustaining policies, procedures, and programs that ensure the organization fully complies with SOX. HR leaders need to step up to these accountabilities, for the benefit of their companies and their functions. The authors detail five critical opportunities for HR leaders to assist in the implementation of successful SOX-related initiatives and establish their leadership roles with boards of directors and senior management. Ironically, compliance, once a reason to criticize HR, now becomes a way to elevate the function and its leaders.

The Field Shifts, Again

Federal legislation once again has shifted the playing field for Human Resources. This time, the Sarbanes-Oxley Act (SOX) of 2002 requires HR leaders to rise up to new accountabilities for building an ethical culture, as well as partnering with other leaders, especially in Finance, to insure statutory compliance with the legislation. SOX legislation was designed to restore public trust in corporate accountability and external auditor independence following the revelation of concealed financial transactions and significant abuses by Enron, HealthSouth, Worldcom, Global Crossing, and others (PriceWaterhouseCoopers, 2004). Overall, the legislation imposes:

- Higher standards for financial reporting by public companies
- Greater accountability from boards of directors for corporate governance
- More stringent standards for insuring external audit independence
- Stiffer civil penalties to corporations for SOX violations
- Criminal penalties against CEOs or CFOs for significant noncompliance or "bad faith" financial filings

Implementation and monitoring of SOX has thus far been the primary responsibility of Finance, or newly created Compliance Officers operating at the top levels of US corporations, but full compliance and effective monitoring requires strategic leadership and operational attention from HR leaders (Deloitte & Touche, 2003). First, HR leaders oversee a significant portion of company expenses through payroll and benefits. Yet HR leaders generally have little experience in financial and internal controls. Instead they have relied on company processes, without enough direct knowledge of proper controls and accounting. Second, the legislation falls short in recognizing that people make decisions daily about adhering to laws, policies, and company guidelines. SOX does not go far enough with preventive solutions that address the root of the problem: unethical and illegal behaviors performed by employees in the company as well as company agents and outsourced partners.

Compliance, of all things, once again becomes a primary focal point for HR leaders. For all the times HR has been criticized in the past as the policy police, now compliance is vital to ensure ethical behavior, proper compensation practices, and the financial future of the company. To achieve this level of compliance—much further-reaching than before—HR leaders must engage in these five behaviors:

1. Build ethical and transparent cultures
2. Strengthen HR's role in corporate governance
3. Bring executive compensation practices into compliance
4. Adopt robust vendor management processes
5. Partner with Finance to implement safeguards and ensure compliance

Build Ethical and Transparent Cultures

The SOX legislation was founded on the belief that ethical behavior and an atmosphere characterized by "transparent" financial transactions are essential elements in restoring shareholder confidence. Transparency was a matter of significant concern by law enforcement arms of the SEC while investigating Enron and other violators of SEC and federal legislation. Top management in these corrupt companies effectively obfuscated the facts and the true picture of their business dealings and financial conditions, while enriching themselves beyond the imaginations of most people.

Where was HR leadership at Enron? Enron had a Code of Ethics. It was a 65-page handbook issued to employees by CEO Ken Lay; however, senior Enron leadership winked at its own code while creating a culture that encouraged employees to "push the envelope," including cooking the numbers. Enron rewarded employees who produced bottom-line profits, even while they manipulated the figures to conceal operating losses. Rewards went to those who played the game, while the few people who raised objections were persecuted. HR leaders were silent and complicit, as were most of their colleagues.

Wong (2002) described this an "ethical deficit," created by toxic executives. In his view, an organization must have strengths in four areas to be healthy and productive: financial capital, technological capital, human capital, and social-spiritual capital. Enron failed in most of these areas, particularly the last one, the most difficult to manage and to quantify. Enron's executives, and its board, were lacking in ethical leadership and personal integrity.

Now, SOX legislation clearly places the creation of an ethical and transparent culture as an essential, yet still subjective, goal for corporations. The expectation extends beyond attention to purely financial transactions. The new reality acknowledges that senior leaders play the most critical role in successful, ethical companies. They need to be openly supportive and strongly committed to the ethical values of the company. Leaders must promote and uphold this commitment in speeches, directives, company publications, employee meetings, and personal actions. Leaders set the tone for the company's ethics; when they do not, the "grapevine" is quick to spread the story of expedience over ethics.

The HR leader has a clear responsibility to grow this ethical culture. No other position, aside from the CEO, has the scope and reach to external stakeholders and internal employees to build a culture of integrity and honesty. Progressive policy development, employee training, and controlled monitoring all help create this. Encouraging the reporting of unethical and illegal situations and appropriately addressing unethical and illegal behaviors enables HR to oversee dealing with these issues. Compliance with ethical behavior is necessary daily, in an affirmative manner, not just by exception when things break down (PriceWaterhouseCoopers, 2003).

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Here are three things HR can and should do immediately to build transparency and ethical behavior:

1. Upgrade the code of conduct policy. Creation of a code of conduct is among the first tangible steps a company should use to communicate company requirements and employee obligations for business and financial conduct, ethical behaviors, and reporting suspected "code of conduct" violations. An improved policy should address the company's support of fair treatment of employees and the standards of ethical and legal behavior expected of all employees (Hammer, et al., 2003).

- Require all associates to comply with the code of conduct policy and applicable statutes.
- Delineate specific behaviors and practices that are prohibited by the company.
- Adopt procedures of confidential, anonymous reporting of alleged corporate fraud and code violations.
- Include specific duties and responsibilities in job descriptions for managers and supervisors about training employees on these matters and upholding code of conduct responsibilities.
- Establish procedures for investigating and documenting alleged abuses of the code or violations of SOX.
- Operate a compliance hotline.
- Obligate any employee or stakeholder to report suspected fraud or misconduct to a designated company officer.

2. Protect whistleblowers. SOX defines the protections afforded employees reporting suspected company violations, so-called "whistleblowers." The employee need only "reasonably believe" the company to be in a violation of the Act and does not have to be accurate. Companies must put in processes to offer safe harbor to these people.

The legislation makes it unlawful for an employer to "discharge" or in any other manner discriminate against any employee because the employee has filed a complaint or instituted or caused to be instituted any proceeding under this or related Act or has testified or is about to testify in any proceeding. SOX holds individual executives and supervisors personally liable for unlawful retaliation and makes retaliation a felony offense. Executives can be sued personally and held liable for termination and face criminal penalties.

3. Champion ethical behavior. Written policies can never cover everything. HR leaders must reduce the gray areas in policy statements and practice that may confuse ethical behavior or obscure transparent dealings. By supplementing policy statements with training, communications, performance management programs, key promotions, and compliance, HR goes a long way toward transparency and ethical behavior. As Vickers (2005) noted, HR's job is to cultivate an ethics-friendly environment, in word and deed.

Strengthen HR's role in Corporate Governance

In the wake of the scandals, Congress was alarmed especially at the lack of oversight provided by boards of directors. Board members were criticized loudly for not providing necessary accountable leadership to their chief executives and companies for whom they had fiduciary responsibility. Congress and the SEC concluded that too many boards operated in the "hip pockets" of corporate executives, had little impact upon good governance, and failed to be the check and balance upon CEOs they were supposed to be.

Independent scrutiny by external financial audit firms also was ineffective. Investigations documented that audit firms shielded themselves from the real transactions of the corporation or, more egregiously, were complicit in obscuring financial matters that violated GAAP guidelines and SEC statutes. As a consequence, financial reporting was lax, and offending companies and their crooked leaders avoided revealing their true business transactions and financial conditions.

HR can help address this, with a broadened charter to establish access to all board members. Access and dialogue with boards and audit committees will help ensure the company is complying with all aspects of SOX. HR leaders should report on the policies, procedures, and controls for areas that have material impact on the company, including executive and director compensation, employee compensation, payroll, health and welfare, pension, and equity plans. HR should enlist board member support and involvement in various committees that provide direction and oversight in corporate plans such as health and welfare, pension, and equity plans.

Many of the steps to strengthen corporate governance are the direct responsibility of the chief human resource officer.

1. Clarify directors' roles and committee responsibilities. HR leaders need to assume visible and active roles with boards of directors. They should develop and outline the specific responsibilities of directors in areas of HR compliance, especially in all compensation and benefits matters that have material impact. HR leaders also should assist CEOs to outline the types of specific experiences that would be beneficial for compensation committee membership. Finally, HR executives should detail the involvement required by board members throughout the year for accessibility, decision-making, time requirements, and meeting dates.

2. Educate directors on compliance processes and HR's role. HR leaders must document all relevant compliance processes for each material aspect of the company's compensation and benefits programs. Each phase of the process (i.e., annual/periodic review, changes, additions; delivery of compensation and benefits; vendor management; and financial accounting) should be provided to board members and reviewed on a frequent basis. As a part of implementing a control process, company audit committees may develop action plans for overseeing the quarterly review of controls and assessing the adequacy of remedial actions to satisfy SOX. Action plans can help a company communicate risk targets and policy, organize the ongoing audit, monitor process, and act to document or fix problems. Recently, *HR Magazine* (2005) outlined several areas HR can play in board member orientation and education. With access to the board on compensation, benefits, director selection, and succession, HR leaders have great opportunities to expand their roles to implement compliance with SOX.

3. Facilitate effective meetings. HR leaders should lead in organizing efficient and effective meetings for directors in compensation and benefit topics. This is an enormous opportunity for HR executives to display leadership. Critical topics include compensation, benefits, key executive additions, new hire terms and conditions, SOX controls, status of employee allegations of wrongful actions, cultural audit results, and updates of employee training in the promulgation of ethical and transparent cultures.

Bring Executive Compensation Practices into Statutory Compliance

In the span of just 20 years, the gap between the compensation for a typical company's senior executive and its entry-level employee has widened dramatically. What at one time was a ratio of 20:1 has

grown, in many cases, to a gap of 400-500:1. The average range of total compensation for chief executives of US public companies is now $3 to $5 million. These pay levels have been challenged for their legitimacy, as have the types of performance (or in some cases, nonperformance) incentives that executives can earn. Some shareholders have pointed out the errors of executive compensation when their interests have diverged from those of enriched executives, and some of the abuses have placed a spotlight on executive compensation. Legislators have installed statutory restrictions and protections for shareholders, though pay levels have not changed much.

These new restrictions void many of the special compensation arrangements that have been practiced within the executive suite (Bokert & Hahn, 2002). SOX includes specific restrictions in executive compensation practices that discourage extreme personal financial gain and wealth accumulation to the detriment of shareholders and employees. Severe civil and criminal penalties have been put into place to punish executives who violate these new statutes.

Actually, the definition of an executive is of importance. An executive is more broadly defined in SOX than in SEC documents. According to SOX, an executive includes a president, certain vice presidents, and any other officers who perform a policy-making function. Executive officers of subsidiaries are not deemed to be executive officers of the primary corporate body unless they are involved in policy-making decision for the primary corporate entity.

A company's board of directors also are included in the SOX legislation.

Here is how to bring compensation practices in line with SOX:

1. Discontinue illegal practices. It is illegal to provide personal loans, guarantees, credit, or direct or indirect involvement in credit arrangements to executives and officers and directors. Also, trading in company stock during retirement plan blackout periods is prohibited, if the individual acquired the stock in connection with employment as a director or executive officer.

2. Re-shape the company's compensation philosophy. Realign senior leadership pay with the financial outcomes of the business and the interests of shareholders and employees. Insure there is balance in executive pay plans to support the shareholder's long-term interests. Plans that rely heavily on stock options are being further scrutinized as "out of balance" with long-term interests.

Beyond the specific restrictions and cautionary areas discussed, HR executives should steer compensation philosophy and practices in directions that acknowledge a culture of transparency. Compensation and wealth programs that create extreme motivation for personal gain at the apparent disadvantage of shareholders and employees will increasingly be viewed as counter to the spirit and the law of SOX. Cash compensation in contrast to equity-based compensation seems on the rise, with executive compensation levels showing early signs of moderating just a little bit.

3. Monitor compensation issues and trends. As the SOX legislation is further interpreted and shaped by case law, several areas of compensation may be problematic. The areas that need monitoring to insure companies remain compliant include:

- The inclusion of emeritus, advisory, or honorary directors in these restrictions
- Company contributions to split-dollar life insurance policies
- Loans for margin calls, and/or cashless option redemption
- Relocation loans
- Routine cash advances for reimbursable travel and business purposes
- Personal use of company credit cards
- Company funds for executives' payroll tax obligations for nonqualified deferred compensation benefits
- Signing bonuses subject to repayment upon early termination
- Loans from 401(K) plans
- Failure to repay loans

4. Outline HR's roles and responsibilities. HR leaders should establish and document their roles in executive compensation and benefits with respect to CEOs, CFOs, other officers and board members. HR plays a key role in setting up the criteria for eligibility, conducting periodic reviews of compensation and benefits, recording changes and communicating these in an accurate and timely basis to Finance, approving specific pay packages and changes in conjunction with the board, periodically monitoring compliance to plans, as well as recordkeeping and data integrity. Finally, centralize the monitoring of executive employment contracts in the HR department.

Managerial accountability and liability now extend into the business decisions and operations of agents and suppliers. Increased use of outsourcing and partnering have elevated the exposure companies may have with SOX statutes as well as code-of-conduct requirements.

Adopt a Robust Vendor Management Process

Historically, the business values and operating practices of suppliers, vendors, and other service providers were not scrutinized. The prevailing notion was that companies purchased "products and services" from these providers, and the means and methods used by the suppliers were not particularly relevant. These long-standing assumptions are no longer valid. Companies now are ethically and legally bound to insure that practices and compliance levels operating within contractor and vendor companies fall within the policy guidelines and statutory requirements of SOX and other federal and state legislation.

Managerial accountability and liability now extend into the business decisions and operations of agents and suppliers. Increased use of outsourcing and partnering have elevated the exposure companies may have with SOX statutes as well as code-of-conduct requirements. Other legal entities—contractors and their employees, consultants, joint ventures, partners, suppliers, downstream resellers—acting as

company agents come within the scope of accountability for SOX compliance.

For HR leaders, this becomes a major area of attention, with so many people-related services now outsourced to third-party vendors. The era of outsourcing to a trusted vendor under an "assumed" compliance to standard approaches is over. HR leaders must have documented internal control procedures and accountability reviews with all vendors that handle employee services. Areas of particular scrutiny include matters that require financial estimation and future projections resulting in establishment or adjustment to reserve accounts or income statement or balance sheet calculations.

Here's what to do:

1. Limit service offerings provided by external audit firms. Companies are limiting service from audit firms to either audit or the firm's other consulting services—not both—as a step toward improved internal controls and transparency. Services now restricted from being provided by external audit firms include bookkeeping or other services related to accounting records or financial statement of the audit, creation, or management of financial information systems design and implementation, valuation and actuarial services, internal audit outsourcing services, HR functions, investment banking or broker services, and legal services or any expert services unrelated to audit.

2. Hold vendors providing contingent workers to company standards. Temporary agency workers, contract employees, consultants, and outsourced workers who conduct their business on company property or through company networks raise concerns over the issue of co-employment and SOX-related statutes. The recruitment, background checks, tax payments made by their actual employers, and even the legal working status of these contingent workers fall into areas with a possible impact on compliance issues. HR leaders should create policies and conduct audits to insure full compliance.

3. Establish required contractor and vendor policies and procedures. Starting with the RFP process and continuing through the provision of services, HR needs to establish, monitor, and take corrective actions for all vendors that handle compensation and benefits, payroll, health and welfare, retirement plans, nonqualified plans, and other pay arrangements. HR leaders cannot assume that a reputable vendor is delivering the intended benefits, compliance, record keeping, and reporting without taking an active role in this compliance.

HR leaders should insure that department heads have a documented vendor management process and that vendor audits are performed routinely. An audit checklist will contain responsibilities for the vendor based on the legal, service agreement, and company plan requirements. For example, sections of the defined benefits vendor audit would include administrative provisions (e.g., Is vendor accurately and in a timely manner calculating participant vesting levels?), management and disbursement of benefits (e.g., Is vendor consistently complying with depository responsibilities regarding the plan assets in accordance with the trustee agreement?), problem resolution (e.g., Does vendor have a documented problem-resolution procedure in place with guaranteed response times and escalation procedures?), employee communications (e.g., Is vendor preparing SPDs for all eligible employees?), compliance (e.g., Is vendor consistently preparing an annual SAS 70 Report?), management reporting (e.g., Is vendor providing management reports to company?), actuarial (e.g., Is vendor following accepted FAS standards?), and security and disaster recovery (e.g., What are vendor's formal back-up procedures and disaster recovery plan?).

Partner with Finance to Insure Compliance

A new dynamic is emerging in every public company. Finance and Audit are providing much greater levels of internal controls and scrutiny (Ernst & Young, 2004).

Although Finance and Audit have been in the lead, HR activities have a significant impact upon the financial condition, legal compliance, and ethical reputation of the company. Priority areas include the previously mentioned areas of executive compensation, defined benefits programs, health and welfare programs, payroll operations, and recruitment activities—areas where financial forecasts and significant monetary transactions occur.

In this world, management by exception is obsolete. A major emphasis in Section 404 of the legislation is the upgrading of internal control processes that insure compliance and "flag" transactions or situations that deviate from established policy or procedures. SOX places significant importance on internal control procedures, as well as formal documentation and record keeping of compliance. Unfortunately, HR does not have the internal controls or financial reporting as core competencies; therefore, it is imperative that effective communications and collaboration be established among HR, Finance, Legal, and Treasury departments to implement the required controls.

Sarbanes-Oxley elevates the accountabilities and responsibilities of HR leaders toward increasing levels of business focus and requires a strong and informed partnership with Finance, as well as with other corporate leaders.

Here are three ways to partner with Finance.

1. Adopt a standard approach for managing internal control procedures. An effective "internal control" discipline is the key to managing these SOX accountabilities. Most HR functions do have documentation of many internal processes, but most have not completed the comprehensive documentation and process evaluation that independent auditors will begin to request. Do not mistake process for controls. Exhibit 1 shows these levels of internal controls. The most commonly used framework for evaluating internal controls is that contained in the report of The Committee of Sponsoring Organizations of the Treadway Commission (COSO). This report identifies categories of controls: effectiveness and efficiency in operations, reliability of (financial) reporting, and compliance with laws and regulations.

EXHIBIT 1

Internal Control Rigor

LEVEL 1 Unreliable	LEVEL 2 Informal	LEVEL 3 Operational	LEVEL 4 Monitored	LEVEL 5 Optimized
Controls are . . . ■ Not in place	Controls are . . . ■ Designed but inadequately documented ■ Mostly people-driven ■ Not communicated through formal policy or training programs.	Controls are . . . ■ Documented and communicated to employees ■ Deviations or exceptions may not be reported and corrective action haphazard ■ Sporadic monitoring may occur	Controls are . . . ■ Operational with periodic testing of effectiveness ■ Automation or tools may be used to spot check compliance ■ Procedures are in place to take immediate corrective after violations or policy deviations occur.	Controls are . . . ■ Automation or tools continuously track compliance ■ Procedures are in place to block policy deviations from occurring ■ Formal risk management procedures are operational.

Source: Adapted from Ernst & Young, 2004.

The relevant questions are:

- Do you have policies?
- Are you in control of your policies and procedures?
- Are you able to provide documentation of compliance?

2. Institute a regular audit review of key human resources processes. Working with your Finance organization, prepare an audit protocol of those HR processes that may have significant SOX compliance value. Regularly conduct HR audits to uncover deficiencies in processes and outcomes. Finally, invest in remediation of those processes that are assessed to be noncompliant and regularly disclose these to audit.

3. Develop feedback channels in performance reviews and attitude surveys for reinforcing and monitoring compliance issues. Examine your current performance management and reward systems to insure that these promote and reinforce an ethical and transparent culture. They should evaluate both results and the behaviors that are used to get results. Insure that anyone evaluated below standard on any of the values or ethical standards is flagged and reviewed for appropriate actions. HR leaders play significant roles in promotion decisions and should insure that role models for the company's values and ethics get ahead. Periodic employee survey and feedback processes to monitor adherence to company ethics should be used. This type of monitoring is essential in compliance efforts.

Conclusion

Compliance with SOX is not optional, and is no longer the sole accountability of Finance or the compliance officer. Sarbanes-Oxley elevates the accountabilities and responsibilities of HR leaders toward increasing levels of business focus and requires a strong and informed partnership with Finance, as well as with other corporate leaders. HR accountabilities span policy creation, stakeholder communication and training, completion of regular and proactive compliance audits, and, finally, full documentation and storage of audit results and remedial activities. Refer to Exhibit 2 (on the next page) for some checklist examples to assist in the audit of SOX compliance. Human Resources leaders who are willing to step up to these heightened compliance accountabilities will have bigger and louder voices at the executive committees and boards. Ironically, stepping back to the future of compliance helps HR in its modern business partner role.

BIOGRAPHICAL SKETCHES

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EXHIBIT 2

SOX IMPACT AREAS	WHAT CAN GO WRONG
Build Ethical Culture.	Executives do not comply with stated values. Executives engage in illegal behavior. Employees discouraged or punished for speaking up. HR does not have adequate sensing tools in place to detect problems. HR not viewed as credible or confidential by employees. Code of Conduct not documented, disseminated, and lack of training. Lack of board oversight in this area.
Strengthen HR's Role in Corporate Governance.	HR leader not part of board meetings. CEO shields insiders from attending meetings. Board members not educated on their roles and responsibilities. Board members not actively involved in the business beyond the meetings. HR leader lacks credibility with the executive team. HR leader not providing effective leadership to HR team for SOX compliance.
Bring Executive Compensation Practices into Compliance.	Incorrect earning per share calculations could result in earnings misstatement. Executive loans made or not repaid. Executive stock trading during 401K blackout could trigger SEC inquiry. Stock grants not properly treated for taxation. Improper stock option execution can trigger supplemental taxation. Stock option expense recorded in wrong period. Stock option valuation assumptions are incorrectly determined. Windfall compensation awards out of step with the overall performance of company can trigger investor litigation. FAS 123 footnotes could be based upon inaccurate assumptions.
Adopt Vendor Management Processes.	HR leader does not implement controls. HR department heads (e.g., Benefits) do not have a documented process. Vendor audit checklist not documented. Board does not meet with key vendors on periodic basis. Appropriate vendor certifications are not required. Vendor calculations are not monitored for accuracy. Periodic vendor audits not performed.
Partner with Finance to Implement Safeguards.	Benefits, pension, and post-employment benefits costs not properly recorded for P&L document. Impact of census data and benefits claims data miscalculated by actuary affecting accruals. Pension and benefits reserves are incorrectly calculated and stated because of incorrect assumptions. Miscalculation of service credit for employees of acquired operations. Job eliminations not legally executed according to statutes and accounting standards in various countries. Co-employment violations could result in pension and benefit miscalculations. Payroll expenses could be recorded in incorrect periods and or fictitious payments made. Sales incentive compensation paid against revenue that was incorrectly recognized.