AccountingMalpractice.com
Advanced Prevention Resources for Accountants

September 26, 2002

Executive Compensation, Prohibition on Personal Loans to Executives and Other New Challenges to the External Auditor, Internal Auditor and Board Committee Member

Of all the accounting and auditing failures that have been reported in the last year, the one that could have the biggest impact on the daily audit planning regimen of practitioners is Tyco International. Taken together with the new prohibitions of loans to executives under the Sarbanes-Oxley Act, practitioners may now need to spend more time evaluating the legitimacy, veracity and propriety of executive compensation. This is an area that both internal and external auditors traditionally have avoided like the proverbial plague. The thought of challenging the propriety of the compensation being paid to the executive who may have hired you is daunting at best. Consider, however, what has happened at Tyco International.

Tyco International

Over the past six months, Tyco International has lost more than 75% of its market value. All of its directors have resigned and its top three executives are subject to indictment. It is a company in disarray, with numerous investigations ongoing. Tyco has been sued by federal agents, class actions groups, the SEC and others. The Company has itself sued its former executives for "egregious, self-serving and clandestine" conduct. And what has prompted all of this negative attention? The answer is simple, questions about the propriety of executive compensation. The following are excerpts from two of the complaints.

The case brought by the SEC against three of the executives of Tyco begins as follows:

> "This is a looting case. It involves egregious, self-serving and clandestine misconduct by the three most senior executives at Tyco International Ltd. ("Tyco"). From at least 1996 until June 2002….took hundreds of millions of

> dollars in secret, unauthorized and improper low interest loans and compensation from Tyco…."

The case brought by Tyco itself may be the most instructive in that it provides details about what exactly is being claimed:

> "….Despite that substantial compensation, Kozlowski, beginning at least as early as 1995, contrived a scheme to abuse the trust that had been placed in him by Tyco's Board of Directors by misappropriating money and assets from the Company, and engaging in a concerted pattern of conduct to conceal his larcenous acts from the Board."….Specifically, Kozlowski concealed from the Board and its relevant committees the following: a. Kozlowski transformed and approved 1995 relocation program that complied with IRS regulations and was available to all employees into a special program for senior executives that permitted them to use millions of dollars of Company funds to purchase and speculate in New York real estate….b. Kozlowski abused the Company's Key Employee Loan ("KEL") program which had been established for the purpose of facilitating the continued ownership of Tyco stock, from at least 1997 onward, by using it as his personal line of credit to fund a myriad of personal expenditures….Kozlowski misappropriated the Compensation Committee's approval of the 1995 relocation program…Kozlowski awarded unauthorized "special bonuses" to himself and over 40 other Tyco employees in September 2000…"

From these two complaints, one thing should be obvious to both external and internal auditors, as well as audit committee and compensation committee members: executive compensation must be reviewed carefully to evaluate whether it has been properly authorized. To date, no action has been taken against PWC or the internal auditors in this matter, however, that may just be a matter of time. All of the audit committee members, however, have been sued. As a consequence of the adverse publicity and the changes in law, auditors and board committees should expect that many more stakeholders will be asking about the veracity of their company's or client's executive compensation.

Prohibition on personal loans to executives

Deriving in part from revelations at Enron, Tyco and others, that senior executives at a number of major corporations were utilizing loop holes in compensation, stock trading and blackout rules to enrich themselves, several new sections of the Sarbanes Oxley Act were added that otherwise might not have passed. One of these new rules governs the granting of loans to executives by corporations. It significantly eliminates what had become a growing perk for executives. Section 402 of The Act amends Section 13 of the Securities Exchange Act of 1934 to make it unlawful for any issuer, directly or indirectly (including through any subsidiary), "to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a

personal loan to or for any director or executive officer (or equivalent thereof) of that issuer."[1]

One commentator believes that, "due to its broad nature, the provision would appear to prohibit standard officer relocation loans as well as loans to officers to enable them to purchase company equity. It may therefore tend to encourage greater use of stock option grants as opposed to direct stock sales. Certain traditional compensation arrangements that have become commonplace (for example, split dollar insurance policies) also will need to be evaluated to determine whether they could be deemed a loan for the purposes of the Act."[2]

From an auditor's perspective, the prohibition on loans creates several problems. The first is that no one knows for sure what constitutes a loan under the act. The second is that such forms of compensation can be perfectly legitimate and should be allowed in some form. Finally, until the rules are made clear, corporate counsel may need to be engaged to give guidance. With respect to what constitutes a loan, loans can manifest themselves as quasi-derivative transactions such as options, forward contracts and straddle schemes, as well as advances, prepayments and credit enhancements. Each of these forms has it's own issues that will need to be addressed. In short, auditors and compensation, finance and /or audit committee members must engage themselves in the process reviewing all aspects of these transactions.

---

[1] The Act grandfathers extensions of credit maintained by the issuer on the date of the Act, as long as there is no material modification to any term of such extension of credit or any renewal of the credit after the date of the Act.

[2] "To Our Friends and Clients," August 2, 2002, Fried Frank Harris Shriver & Jacabson, pg. 10.