# Raising the bar on corporate governance

## What Sarbanes-Oxley means to the tourism, hospitality and leisure industry

The 2002 Sarbanes-Oxley Act came on to the statute books as an attempt to rebuild public confidence in the way corporate America governs its business activities. The Act has far-reaching implications for the tourism, hospitality and leisure industry, as well as for its corporate customers and supply chain.

The 1990s were some of the most prosperous and exciting times American business has ever seen. This period of prosperity came to an abrupt end in early 2000, when the infamous 'Internet bubble' burst, heralding economic turmoil in the USA. The disorder was only compounded when corporate giants such as Enron and WorldCom came crashing down amidst deceptive and corrupt business practices. Change was inevitably in the air.

The Sarbanes-Oxley Act was the answer to concerns about ethical and legal issues in corporate America. This new law, passed by Congress in 2002, sets a new precedent for the way in which public companies function and insists that they comply with rigorous corporate governance requirements.

Although Sarbanes-Oxley is long and complex, most of the attention has focused on a few key areas. Section 302 imposes much greater responsibility on top executives at public companies. Meanwhile, Section 404 requires companies to gain an intimate understanding of their internal controls and their effectiveness. Lastly, companies are required to disclose publicly all significant deficiencies and material weaknesses relating to their internal controls in their periodic financial reports.

### Responsibility at the top

Section 302 has the most profound impact for upper levels of management of public companies. CEOs and CFOs are now required to certify the financial statements as well as the internal controls of their company not just annually, but quarterly. This means they must take much greater responsibility than before to ensure that the company's annual and interim financial statements are fairly represented.

The main change relates to the certification of internal controls. By doing this, management is demonstrating that they are responsible for establishing, maintaining and evaluating the effectiveness of the internal control environment. Although on the surface this change may not seem particularly significant, the reality is that Section 302 is causing quite a stir in the highest ranks of corporate America. It is even more severe because if CEOs or CFOs misrepresent financial statements or the internal control environment, their personal assets are at risk, and they may face fines and/or imprisonment.

### Internal controls: documented, tested, approved

As well as increasing management accountability, Sarbanes-Oxley requires companies to define, document, and test their internal control structure. This means that Section 404 is perhaps the most significant aspect of the Sarbanes-Oxley Act.

Under this Section, not only do companies have to document their internal controls more rigorously, including financial reporting systems, but their auditors have to confirm that these controls are effective. This involves fully evaluating the process by which management makes its assessment about the effectiveness of internal control. If the auditors find what they consider to be any 'significant deficiencies' or 'material weaknesses', the company must report these publicly.

Having a significant deficiency or a material weakness can prevent a company from producing reliable financial statements. If a particular internal control process does not allow managers or employees to detect or prevent financial misstatements whether because of poor design or operational practices, or because it never existed in the first place then it is deemed to be deficient. The most serious instances of this are known as 'material weaknesses' under the Sarbanes-Oxley regulations. This is a deficiency in controls that results in a relatively high probability that a material misstatement of the financial statements will not be prevented or detected.

Because the formal assessment and the independent auditor's report relates to the company's year-end, there is generally time to correct potential control deficiencies, even those that involve significant lead times. But companies should not risk leaving these actions to the last minute.

### New frameworks, new oversight

Complying with Sections 302 and 404 of Sarbanes Oxley and publicly disclosing any internal control issues enables far more accurate depiction of public companies. But at the same time it has created new challenges for corporations and the accounting firms they work with.

Managers and auditors alike soon realised that they needed a suitable framework for assessing internal controls. The Committee of Sponsoring Organizations (COSO) of the Treadway Commission provide the solution. As far back as 1995, COSO published its 'Internal Control Integrated Framework', known as the COSO Report. This provides a generally-accepted universal framework which management can use to assess internal controls.

The COSO framework identifies five components of control, which when integrated and operating within an organization, will help achieve internal control objectives:

- Monitoring.
- Information and communication.
- Control activities.
- Risk assessment.
- The control environment.

It also categorises internal control objectives into:

- Efficiency and effectiveness of operations.
- Financial reporting.
- Compliance with laws and regulations.

To further protect the interests of investors, audit firms in the USA are also now being subjected to much stricter inspection and regulation, with the creation of the independent, non-profit Public Company Accounting Oversight Board (PCAOB) to oversee the profession.

### Challenges for THL companies and customers

Sarbanes-Oxley raises a number of specific issues for THL enterprises, both in terms of their own internal controls and the way they interact with their customers and supply chain. A key requirement of the Act is to improve the way information is stored, tracked and made available to auditors or other independent inspectors.

When it comes to the customers of THL companies, the requirements to control and accurately report expenditures will clearly have an impact in areas such as corporate travel and hospitality. Executives will have to be able to demonstrate the 'business purpose' behind travel, meetings and even meals in restaurants, as a result much tighter documentation will be needed. This could be seen as a threat by the industry, but we believe it is also a potential opportunity. Those travel and hospitality companies who can provide slick, e-delivery of key information such as bookings, confirmations and receipts could win significant competitive advantage by doing so. Even more so if that information can be tailored to the precise reporting needs of each customer.

Although much of Sarbanes-Oxley remains open to interpretation, the impact on the travel industry will be substantial. Purchasing departments will face much tighter controls on how they procure meeting space, hotel rooms, airline tickets, food and drink, and other THL-related services.

With these greater controls over corporate procurement, hotel and transport companies should also be working hard to attain 'approved vendor' status, in order to streamline their sales process with large account customers. Being able to provide documentary evidence of all the due diligence checks needed to satisfy rules on the safety of meeting attendees, for example, could also help astute hospitality companies win in a competitive world.

### Improving transparency

Due to their unique owner/manager split, many hotel companies will have significant work to do on the transparency of their own internal controls, with many having to review their management contracts in the light of Sarbanes-Oxley.

Hotels and leisure businesses have a particular challenge when it comes to the treatment of fixed assets under the new Act. More closely managing and documenting a complex and constantly-changing inventory ranging from real estate to beds, linen and crockery creates additional cost. And the rules for writing-off demand that companies keep more detailed and precise records.

In terms of operational practices, those hotel companies who have implemented a 'shared service centre' model to manage activities such as accounts payable and receivable, and cash management are already starting to reap the rewards, not simply in terms of cost savings, but also in their ability to demonstrate Sarbanes-Oxley compliance. The Act may well prove a catalyst for significant growth in shared service centres across the THL industry.

The restaurant sector is likely to be less widely affected than other parts of the industry, but even here we may see a short-term fall in corporate bookings, as companies hold back on hospitality as their new policies and controls become established.

### Time is running out

So how long do companies have before they must comply with Sarbanes-Oxley? So-called 'Accelerated Filers' under the Act (generally companies with an aggregate market value of US$75 million or more) are required to comply with the internal control reporting and disclosure requirements for fiscal years ending on or after 15 November 2004. Other companies have until fiscal years ending on or after 15 July 2005. That means many companies have their work cut out for them.

The Sarbanes-Oxley Act, with its definitive guidelines for implementation is primarily aimed at restoring the public's trust in business. That trust is the essential cornerstone in re-building confidence in 'America Inc.'. But what will the future hold for corporate governance policies in the THL industry and more widely? And at what cost? We shall see in the upcoming months, as theory meets practice.

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