Governance lessons learned from SEC v. Con-way, Inc.

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Summary

On August 27, 2008 the SEC entered a Cease and Desist Order ("Order") against Con-way, Inc. ("Con-way") (Securities Exchange Act of 1934 Release No. 58433). Con-way consented to the entry of the Order without admitting or denying the findings, except as to the SEC's jurisdiction over it and the subject matter of the proceedings. The findings, although not admitted and rather sparse on detail, nevertheless provide insight, lessons and missed opportunities. This discussion is organized in the following order: Summary; Comments, Lessons Learned and Missed Opportunities; and Details of the Cease and Desist Order.

In pertinent part, the Order alleges that Con-way is a public company, listed on the New York Stock Exchange. Menlo Worldwide Forwarding, Inc. was a wholly-owned U.S-based subsidiary of Con-way that Con-way purchased in 1989. During the relevant period, Menlo Forwarding had a 55% voting interest in Emery Transnational ("Emery"). As alleged by the SEC, "this matter involves Con-way's violations of the books and records, and internal controls provisions of the Foreign Corrupt Practices Act ("FCPA") through a Philippine-based firm, Emery Transnational. From 2000 to 2003, Emery Transnational made hundreds of small payments totaling at least $417,000 to Philippine customs officials and to officials of numerous majority foreign state-owned airlines. These payments were made with the purpose and effect of improperly influencing these foreign officials to assist Emery Transnational to obtain or retain business. In connection with these improper payments, Con-way failed to accurately record these payments on the company's books and records, and knowingly failed to implement or maintain a system of effective internal accounting controls."

Comments, Lessons Learned and Missed Opportunities

1. As alleged, the payments in question, although numerous, appear individually not to be material in amount. From the information provided it is not possible to determine whether the amounts would be material in total. Of course, materiality can be quantitative and qualitative in nature. An unlawful act can be material qualitatively, even if it is not material quantitatively. Quantitative materiality also may depend on whether it is viewed from the perspective of Con-way or from the perspective of Emery. In light of the disparity in size between Con-way and Emery, the transactional occurrences at Emery may have simply fallen under the radar screen.

2. Nevertheless, illegal payments are unlawful, and internal controls are required, even at subsidiaries. Thus, the SEC alleges that Con-way knowingly failed to implement or maintain a system of effective internal accounting controls. Without additional background information, such a conclusion appears harsh. "Knowing" failure to implement effective controls may imply intentional wrongdoing. The factual allegations do not support an inference of intentional wrongdoing. However, companies, officers, internal auditors, boards and audit committees should

take note that lack of attention to internal controls may prompt an allegation of "knowing" failure to implement.

3. The outside auditor was required to evaluate internal controls for the purpose of performing its annual audit of Con-way's consolidated financial statements. Additionally, Statement on Auditing Standards (SAS) 99 required the auditor to consider the risks of fraud and related programs and controls, and Statement on Auditing Standards 54 required the communication of information pertaining to unlawful acts. Although new Auditing Standards 109, 112, and 114 had not yet been enacted during the relevant period in question, SAS 60 (communicating internal control related matters) and SAS 61 (auditor's communications) were applicable. Additionally, Sarbanes-Oxley §404 (management's assessment of internal controls) and §302 (chief executive and chief financial officer financial statement certification) were applicable during part of the period in question. The SEC missed an opportunity to evaluate and comment on how this situation did not come to the attention of the outside auditor. Alternatively, if the situation did come to the attention of the outside auditor, the SEC missed an opportunity to comment about how it could or should have been handled differently. The Order does not provide information from the outside auditor perspective. Even if the Order is limited to a cease and desist against Con-way, more detailed discussion about the other participants, as dicta, would help other companies, officers, outside auditors, inside auditors, boards and audit committees learn from the situation.

4. The Order does not discuss or provide information from the Con-way audit committee perspective. Such a discussion might have been helpful for other audit committees, especially with respect to governance. The audit committee is required to oversee internal controls. See, e.g., NYSE Listed Company Manual §303A.07 (audit committee composition, and additional audit committee requirements), Sarbanes-Oxley §301 (public company audit committee requirements), and Sarbanes-Oxley §407 (disclosure of audit committee financial expert). Management and the audit committee, and the outside auditor and the audit committee are also required to communicate regarding internal controls.

5. The Order also does not discuss or provide information from the internal audit perspective. New York Stock Exchange Listed Company Manual §303A.07 requires each listed company to have an internal audit function. Curiously, NASDAQ does not have such a requirement. Working with the audit committee, and with management, it may have been possible to use internal audit to evaluate and report on subsidiary internal controls and payments. A discussion in the Order about how internal audit was or was not used might have been helpful from a governance learning perspective.

These are my initial thoughts that readily come to mind. I am sure that other people will have other thoughts. What are your opinions about the events and circumstances leading to the Cease and Desist Order, and the Order itself? Please feel free to drop me an email. See below for additional detail about the Cease and Desist Order.

Regards,
Dave Tate

Details of the Cease and Desist Order

The Cease and Desist Order in part alleges:

"During the relevant period, Con-way and Menlo Forwarding engaged in little supervision or oversight over Emery Transnational. Neither Con-way nor Menlo Forwarding took steps to devise or maintain internal accounting controls concerning Emery Transnational, to ensure that it acted in accordance with Con-way's FCPA [Foreign Corrupt Practices Act] policies, or to make certain that its books and records were detailed or accurate.

During the relevant period, Con-way and Menlo Forwarding required only that Emery Transnational periodically report back to Menlo Forwarding its net profits, from which Emery Transnational then paid Menlo Forwarding a yearly 55% dividend. Menlo Forwarding incorporated the yearly 55% dividend into its financial results, which were then consolidated in Con-way's financial statements. Neither Con-way nor Menlo Forwarding asked for or received any other financial information from Emery Transnational. Accordingly, neither Con-way nor Menlo Forwarding maintained or reviewed any of the books and records of Emery Transnational – including the records of operating expenses, which should have reflected the illicit payments made to foreign officials.

Emery Transnational made hundreds of small payments to foreign officials at the Philippines Bureau of Customs and the Philippine Economic Zone Area between 2000 and 2003 in order to obtain or retain business. These payments were made to influence the acts and decisions of these foreign officials and to secure a business advantage or economic benefit. By these payments, foreign officials were induced to: (i) violate customs regulations by allowing Emery Transnational to store shipments longer than otherwise permitted, thus saving the company transportation costs related to its inbound shipments; and (ii) improperly settle Emery Transnational's disputes with the Philippines Bureau of Customs, or to reduce or not enforce otherwise legitimate fines for administrative violations.

To generate funding for these payments, Emery Transnational employees submitted a Shipment Processing and Clearance Expense Report ("SPACER") to Emery Transnational's finance department. These SPACER reports requested cash advances to complete customs processing. The cash advances were then issued via checks made payable to Emery Transnational employees, who cashed the checks and paid the money to designated foreign officials. Unlike legitimate customs payments, the payments at issue were not supported by receipts from the Philippines Bureau of Customs and the Philippine Economic Zone Area. Emery Transnational did not identify the true nature of these payments in its books and records. During the period 2000 to 2003, these payments total at least $244,000.

Emery Transnational, in order to obtain or retain business, also made numerous payments to foreign officials at fourteen state-owned airlines that did business in the Philippines between 2000 and 2003. (Footnote omitted). These payments were made with the intent of improperly influencing the acts and decisions of these foreign officials and to secure a business advantage or economic benefit. Emery Transnational made two types of payments. The first type were known

as "weight shipped" payments, which were made to induce airline officials to improperly reserve space for Emery Transnational on the airplanes. These payments were valued based on the volume of the shipments the airlines carried for Emery Transnational. The second type were known as "gain shares" payments, which were paid to induce airline officials to falsely under-weigh shipments and to consolidate multiple shipments into a single shipment, resulting in lower shipping charges. Emery Transnational paid the foreign officials 90% of the reduced shipping costs.

Both types of payments to foreign airline officials were paid in cash by members of Emery Transnational's management team. Checks reflecting the amount of the "weight shipped" and "gain shares" payments were issued to these managers, who cashed the checks and personally distributed the cash payments to the foreign airline officials. Emery Transnational did not characterize these payments in its books and records as bribes. During the period 2000 to 2003, these payments totaled at least $173,000. Neither Con-way nor Menlo Forwarding requested or received any records of these payments, or any of Emery Transnational's expenses, during this period."

The Cease and Desist Order further in part alleges:

1. Con-way's books, records, and accounts did not properly reflect the illicit payments made by Emery Transnational to Philippine customs officials and to officials of majority state-owned airlines, and that as a result, Con-way violated Exchange Act Section 13(b)(2)(A). The FCPA, enacted in 1977, added Exchange Act Section 13(b)(2)(A) to require public companies to make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and added Exchange Act Section 13 (b)(2)(B) to require such companies to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's general or specific authorization; and (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for assets. 15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B).

2. Con-way also failed to devise or maintain sufficient internal controls to ensure that Emery Transnational complied with the FCPA and to ensure that the payments it made to foreign officials were accurately reflected on its books and records. As a result, Con-way violated Exchange Act Section 13(b)(2)(B).

3. Exchange Act Section 13(b)(5), 15 U.S.C. § 78m(b)(5), prohibits any person or company from knowingly circumventing or knowingly failing to implement a system of internal accounting controls as described in Section 13(b)(2)(B), or knowingly falsifying any book, record, or account as described in Section 13(b)(2)(A). By knowingly failing to implement a system of internal accounting controls concerning Emery Transnational, Con-way also violated Exchange Act Section 13(b)(5).

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