

## **Sarbanes- Oxley Act 2002 (SOX) - 10 years later**

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### **ABSTRACT**

The Sarbanes-Oxley Act of 2002 is one of the most prominent and controversial pieces of securities legislation in American history. Although no one can doubt the act's intentions, it is subject to debate on the effectiveness of its implementation over the years. This paper will review the corporate corruption and legislative environment leading up to Sarbanes-Oxley, as well as describe the act's intentions. Furthermore, it will explore how its implementation has affected corporations and investors, and describe the modifications enacted over the years. Lastly, we will evaluate both support and criticism of Sarbanes-Oxley, as well as attend to the recent events surrounding it almost 10 years since its inception.

Keywords: Securities, SEC, Sarbanes-Oxley Act, PCAOB, Accounting, Fraud



## I. SECURITIES LEGISLATION PRIOR TO 2002

Prior to the Great Depression, regulation around the sale of securities was predominately determined by state laws and audits were voluntary. Kansas was the first state to create a comprehensive securities law in 1911 as a result of a rash of flighty salesmen selling interests that had no financial backing other than the ‘blue skies of Kansas’, coining the term blue-sky laws in the state for years to come.<sup>1</sup> Understandably so, as result of the 1929 market crash, the need for more precautionary business practices on a federal level could not be ignored.

As a result, the Securities Act of 1933 was passed with the purpose of providing investors with comprehensive financial information and explicitly prohibiting dishonest dealings of securities, including but not limited to fraud, misrepresentation, and omitting relevant financial information.<sup>2</sup> Under the ’33 act, corporations were required to register their stock and securities available to the public, in addition to providing transparent and extensive financial documentation. Soon after, the Securities and Exchange Commission (SEC) was created through the Securities Exchange Act of 1934. The ’34 act gave the SEC power over the entire securities industry; explicitly “the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation’s securities self-regulatory organizations (SROs)”.<sup>3</sup> Consequentially, businesses were required to register through the SEC, providing the following information: a description of the company’s properties and business, a description of the security to be offered for sale, information about the management of the company, and financial statements certified by independent accountants. Once this information was provided to the SEC it was made available to the public. However with the purpose of lowering the costs of offering public securities for smaller companies, there were exclusions to the registration requirement including private offerings to a limited number of persons/institutions, offerings of a limited size, intrastate offerings, and securities of municipal, state, and federal governments.<sup>4</sup>

Collectively these two pieces of legislation offered the public additional and more transparent disclosure from businesses. Yet, the responsibility of investigating securities and deeming them reliable or not, fell solely on the investors themselves.

The case of *Otis & Co. v. Pennsylvania R. Co.*<sup>5</sup> (1944) concerned a stockholder (Otis & Co.) accusing the Pennsylvania Railroad Company of negligence for only using a single investment house, arguing that if the company would have searched for comparable alternatives; they could have avoided a loss of almost a half a million dollars.<sup>6</sup> This gave birth to the legal principle of the Business Judgment Rule, which the American Law Institute (ALI) defines as:

A director or officer who makes a business judgment in good faith fulfills the [duty of care] if the director or officer:

(1) is not interested in the subject of his business judgment;

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1 Jonathan R. Macey & Geoffrey Miller, *Texas law Review*, Volume 70, Number2, December 1991.

2 *A Brief History of Securities Regulation.*/ State of Wisconsin Department of Financial Institutions. Retrieved from <http://www.wdfi.org/fi/securities/regexemp/history.htm>

3 Law Library - American Law and Legal Information. *Business Judgment Rule - Further Readings*. Retrieved from <http://law.jrank.org/pages/495>

4 Id. 1945)

5 *Otis & Co. v. Pennsylvania R. Co.*, 61 F. Supp. 905 (D.C. Pa.

6 Law Library - American Law and Legal Information. *Business Judgment Rule - Further Readings*. Retrieved from <http://law.jrank.org>

- (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
- (3) rationally believes that the business judgment is in the best interests of the corporation.<sup>7</sup>

Essentially, the rule states that action cannot be taken against directors or officers if they act in good faith, independently (without a conflict of interest) of the decision, unless evidence can be provided to the contrary. It does not protect managers from acts of fraud, illegality, conflict of interest, overreaching, lack of good faith, or oppressive conduct, but merely holds them personally liable from breaching their fiduciary duties. Although various amendments and minimal securities laws were passed after these, this was the basic securities business environment extending into the 21<sup>st</sup> century.

## II. AMERICAN INVESTOR'S LOSS OF CONFIDENCE

Historically, legislation around improving securities regulation has been sparked by public outcry; specifically, when citizens lose their faith in just and honest business practices. While the SEC and '33 Act set a higher standard, in 2001 the public again suffered a loss of confidence in the industry with the discovery of a domino effect of corruption, beginning with the Enron scandal.

Founded in 1985 in Omaha, Nebraska, the Houston-based energy company Enron became the face of corruption for the nation. Through fraudulent financial reports the company had its investors convinced they were turning a profit almost up until they declared bankruptcy. In less than a year stock prices plummeted from nearly \$90 USD per share to less than a dollar.<sup>8</sup> Under the impression that the company was thriving, Enron's investors collectively lost \$25 billion dollars with the overall destruction of shareholder wealth totaling upwards of \$60 billion dollars.<sup>9</sup> The fraudulent activity was confirmed when the SEC conducted an audit of Enron,<sup>10</sup> which then turned the attention to Arthur Andersen, the accounting firm previously responsible for Enron's audits. In the fallout of Enron, Arthur Andersen LLP was convicted for obstruction of justice for shredding potentially incriminating documents. Although convicted in 2002, the Supreme Court overturned the verdict in 2005.<sup>11</sup> However this was too little too late, as the reputation of Arthur Andersen had been so severely tarnished, that it was impossible to compete with the remaining "Big Four" accounting firms: Deloitte & Touche, Pricewaterhouse, Ernst & Young, and KPMG. It was also speculated that Arthur Anderson consulted WorldCom, an American telecommunications company who faced a similar fate as Enron when they filed for

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7 Branson, D. M. (2002). The Rule That Isn't A Rule - The Business Judgement Rule. (A. P, Ed.) *Valparaiso University Law Review*, 36(3), pp. 631-634

8 Gutman, H. (2002, July 14). *Dishonesty, Greed and Hypocrisy in Corporate America*. Common Dreams. Retrieved from <http://www.commondreams.org/views02/0712-02.htm>

9 Canabou, C., Germer, E., & Row, H. (2002, August 31). *Speedometer: Going Fast. Going Slow. Going Nowhere*. Fast Company. Retrieved from <http://www.fastcompany.com/magazine/62/speedometer.html>

10 2002/Law/02/02/enron.report/powers.report.pdf

11 *Arthur Andersen LLP v. United States*, 544 U.S. 696 ( May 31, 2005).

bankruptcy in 2002. The SEC's report of investigation<sup>12</sup> stated that "WorldCom's improper accounting took two principal forms: reduction of reported line costs, WorldCom's largest category of expenses; and exaggeration of reported revenues".<sup>13</sup> The report concluded further that WorldCom's board members and committees had minimal involvement and were essentially puppets for the company's CEO, Bernard Ebbers, stating that "He created, and the Board permitted, a corporate environment in which the pressure to meet the numbers was high, the departments that served as controls were weak, and the word of senior management was final and not to be challenged".<sup>14</sup> The total destruction of shareholder wealth during the WorldCom scandal was estimated at around \$175 billion dollars.<sup>15</sup> These two were only a sample of many accounting scandals that went public between 2001 and 2002. Forbes cited a total of 22 accounting scandals, a few of which listed were Tyco, Halliburton, and of course Enron, WorldCom, and Arthur Andersen.<sup>16</sup>

The true outrage of the American people can be attributed to the fact that not only were corporate entities misleading their investors, but they were doing so right under the nose of accounting firms that were supposed to be regulating practices. Furthermore, investigations began regarding auditing firm's conflict of interest, in that they were providing both auditing and consulting services to the same businesses. Often, the consulting was significantly more lucrative which begs the question of unethical motivations within accounting firms.

This avalanche of corruption put the nation's focus on 'white collar crime' which the 1983 Annual Report of the Attorney General defined as:

...illegal acts that use deceit and concealment – rather than the application or threat of physical force or violence – to obtain money, property, or service; to avoid the payment or loss of money; or to secure a business or professional advantage. White collar criminals occupy positions of responsibility and trust in government, industry, the professions and civic organizations.<sup>17</sup>

Understandably so, the pressure was put on Congress to respond accordingly, which resulted in the creation of the Sarbanes-Oxley Act of 2002, which would represent the most dramatic change to federal securities law since the 1930's.

### III. LEGISLATIVE SOLUTION – SARBANES – OXLEY ACT OF 2002

The act's namesakes were Senator Paul Sarbanes and Congressman Michael G. Oxley. Sarbanes, a Democrat, served 30 years representing the state of Maryland in the Senate, prior to which he served in the House from 1970 to 1976 during which he served on the Judiciary and Merchant Marine and Fisheries Committee, in addition to the Select Committee on House

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12 See complete report at <http://www.sec.gov/Archives/edgar/data/723527/000093176303001862/dex991.htm>

13 Beresford, D. R., Katzenback, N. d., & Rogers, C. J. (2003). *Report of Investigation*. Special Investigative Committee of the Board of Directors of WorldCom, Inc

14 Id. (page 30)

15 Ca nabou, C., Germer, E., & Row, H. (2002, August 31). *Speedometer: Going Fast. Going Slow. Going Nowhere*. Fast Company. Retrieved from <http://www.fastcompany.com/magazine/62/speedometer.html>

16 Patsuris, P. (2002, August 26). *The Corporate Scandal Sheet*. Forbes.com. Retrieved from <http://www.forbes.com/2002/07/25/accountingtracker.html>

17 Podgor and Israel's White Collar Crime in a Nutshell, 3D Edition (Nutshell Series) (West Publishing Company) (2004)

Reorganization.<sup>18</sup> Sarbanes proposed his Public Company Accounting Reform and Investor Protection Act to the Senate in 2002.<sup>19</sup> Simultaneously, Congressman Oxley, a Republican representing Ohio, introduced his Corporate and Auditing Accountability and Responsibility Act to the House of Representatives. Oxley's resume included four years with the Federal Bureau of Investigation preceding his 10 years in the House of Representatives where he served as Chairman of the Committee on Financial Services.<sup>20</sup>

Due to the overwhelming public demand for reform, both acts passed seamlessly through their respective houses with a 423-3 vote in the House and a 99-0 vote in the Senate and were merged together.<sup>21</sup> On July 30, 2002 President George W. Bush signed the Sarbanes-Oxley Act, later to be referred to as Sarbanes-Oxley or just SOX, into law stating that "The Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders".<sup>22</sup> Critics argue that the act's effortless passing into law to appease the public caused more harm than good, as aspects of the law were not fully thought through. However this will be discussed later in the paper.

#### IV. PURPOSE

The act itself stated that its purpose was "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes".<sup>23</sup> More specifically, the intention was to ensure the board of directors of publicly held companies took responsibility for both receiving accurate information about the company's finances and reporting accurately on those finances to the public. Not only did Sarbanes-Oxley introduce new criterions for corporate responsibility, but it also established explicit penalties for breaching those standards.<sup>24</sup>

#### V. HOW IT EFFECTS BUSINESSES

Some specific responsibilities that came with Sarbanes-Oxley were that the chief financial officer (CFO) and chief executive office (CEO) were now required to provide a letter stating the financial data they provided auditors was indeed accurate. Beyond that, the aforementioned letter, must be given to the auditing firm, as well as incorporated in the published audit. Sarbanes-Oxley extended § 1350 "Failure of Corporate Officers to Certify Financial Reports" of the 1934 Act to include the following penalty for non-compliance of the above guidelines by saying whomever:

- (1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that they periodic report accompanying the statement does not comport

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<sup>18</sup> *Sarbanes-Oxley Essential Information*. (G. Thomas, Editor) Retrieved November 26, 2011, from SOX-online: The Vendor-Neutral Sarbanes-Oxley Site: <http://www.sox-online.com/basics.html>

<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> Id.

<sup>22</sup> Bush, George W. (2002, July, 30). Statement on Signing the Sarbanes-Oxley Act of 2002. Online by Gerhard Peters and John T. Woolley, The American Presidency Project. Retrieved from <http://www.presidency.ucsb.edu/ws/?pid=64514>

<sup>23</sup> H.R.3763 -- Sarbanes-Oxley Act of 2002 <http://thomas.loc.gov/cgi-bin/query/D?c107:6:./temp/~c107AnGacD::>

<sup>24</sup> *Sarbanes-Oxley Essential Information*. (G. Thomas, Editor) Retrieved November 26, 2011, from SOX-online: The Vendor-Neutral Sarbanes-Oxley Site: <http://www.sox-online.com/basics.html>

with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both.

Furthermore, company executives and staff were restricted from withholding financial information from auditors, or attempting to influence audit findings in any way. Section 802, entitled “Criminal Penalties for Altering Documents, Destruction, Alteration, or Falsification of Records in Federal Investigations and Bankruptcy”, states that:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impeded, obstruct, or influence the investigation or proper administration of an matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

So how do these guidelines translate to businesses? Firstly, as per Section 404, companies were now required to adopt and adequately document a Code of Business Conduct and Ethics, in addition to Corporate Policies and Procedures. Secondly, companies had to implement Entity-Wide Controls tests in order to measure overall internal compliance with company policies and procedures. Results were to be confirmed by the company’s independent auditing firm to ensure accuracy of reporting. The responsibility of the auditing firm is to understand the company’s entity-wide control tests through assessing the five components of internal control as defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which are control environment, risk assessment, control activities, information and communication, and monitoring through understanding the six elements of control documentation.<sup>25</sup>

Other applicable controls are the Revenue Cycle which accounts for a company’s process from customer order to payment, the Inventory Cycle which addresses the shipping, receiving, and inventory safeguarding, the Procurement Cycle which follows vendor creation through purchase order, and finally the General Ledger, Fixed Assets, and Accounts Payable Cycles which collectively cover finance procedures.

The trickle down effect of these internal controls was that employees were now responsible for knowing their company’s Code of Conduct, Ethics, employment policies, performance review process, company finance manual, record retention policy, resources for accounting questions, and complaint (whistleblowing) procedures.<sup>26</sup>

## VI. HOW IT EFFECTS ACCOUNTING FIRMS

Title I of SOX established the Public Company Accounting Oversight Board (PCAOB) of which SEC Commissioner Paul S. Atkins stated “was created because of deep failings in the U.S. accounting ability to regulate itself”.<sup>27</sup> The act itself defines the PCAOB’s purpose as:

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25 University of California. (2010). *Understanding Internal Controls: A Reference Guide for Managing*. Oakland: University of California - Office of the President

26 Newman; Sevey. Protection for Whistleblowers Under Sarbanes-Oxley. 51 Prac Law 39, April 2005

27 Atkins, P. S. (2003, February 5). *Speech by SEC Commissioner: The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation*. U.S. Securities and Exchange Commission. Retrieved from <http://www.sec.gov/news/speech/spch020503psa.htm>

...to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.<sup>28</sup>

The board was established as a nonprofit corporation regulated by the SEC with expressed duties including but not limited to: registering public accounting firms, conducting inspections, and overseeing quality control.<sup>29</sup>

The board itself is composed of five members who have “a demonstrated commitment to the interests of investors and the public” in addition to a proven ability to review and comprehend financial documents.<sup>30</sup> Two of said board members must currently be, or have previously served as a certified public accountant (CPA), however in order to serve as the chairperson, he or she must not have been an active CPA for at least five years prior to their appointment. Each member is required to carry out a single five-year term, during which they will serve the board exclusively on a full-time basis. Board members may not receive any form of payment from public accounting corporations, other than reoccurring retirement payments, subject to Commission approval.

Sarbanes-Oxley Section 102: Registration with the Board, lays out the new responsibilities of certified public accounting firms who wish to work with public companies. The first of which is a mandatory registration with the PCAOB. The application for registration requires reporting of both past and present issuers, the annual fees received from said issuers, internal quality control procedures, current financial information as well as a list of accountants and their certifications.<sup>31</sup> Additionally, firms must update this information annually, along with paying a registration fee that covers the costs of their application review by the Board. Firms auditing more than 100 issues must submit to an annual inspection, however those firms auditing less than 100, are only inspected every three years.

Companies were also required to keep detailed paperwork of audit reports for no less than seven years, subject to inspection by the Board. One of the most significant changes that Sarbanes-Oxley instituted was a list of prohibited activities specifically:<sup>32</sup>

- (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
- (2) financial information systems design and implementation;
- (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (4) actuarial services;
- (5) internal audit outsourcing services;
- (6) management functions or human resources;
- (7) broker or dealer, investment advisor, or investment banking services;
- (8) legal services and expert services unrelated to the audit; and
- (9) any other service that the Board determines, by regulation, is impermissible.

Additionally, Sarbanes-Oxley added the following amendment to the Securities Exchange Act of 1934:

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28 Public Law 107-204 July 30, 2002

<http://www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf>

29 Id.

30 Id.

31 Id.

32 H.R.3763 -- Sarbanes-Oxley Act of 2002 <http://thomas.loc.gov/cgi-bin/query/D?c107:6:./temp/~c107AnGacD::>

(l) Conflicts of Interest-It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.<sup>33</sup>

## VII. IMPLEMENTATION PROBLEMS

As previously mentioned, concerns were raised in regards to the swift passage of Sarbanes-Oxley into law. Consolidation of the two acts proved difficult initially, as party lines were split between reconciling the overall tougher Senate bill with its House counterpart, which proposed significantly firmer penalties for executive non-compliance. However after substantial pressure was put on Congress to finalize the process, only minor changes were implemented.<sup>34</sup> Representative Richard Baker summarized the pressure by commenting “We have our instructions: Get this done”.<sup>35</sup>

In the transition from rulemaking to actual implementation of Sarbanes-Oxley several problems were brought to light, specifically in business compliance with the infamous Section 404. A.R.C Morgan (2005) conducted a cost-benefit analysis of business initial compliance with § 404, compiling data from SEC filings representative of approximately 280 companies. The results concluded that on average, smaller companies incurred a significantly higher cost of implementation than their larger competitors, projecting approximately \$1 million in compliance costs to every \$1 billion in sales.<sup>36</sup> This disparity can largely be contributed to the fixed assessment fee required for registration. When addressing these concerns, Deputy Chief Accountant of the SEC, Andrew Bailey stated “We are all incurring the costs of lost public trust, a trust that cost nothing to lose, but requires significant expenditures of time, talent and money to reclaim”.<sup>37</sup> Beyond initial complications for smaller companies, continued compliance with § 404 proved extremely difficult and often outweighed potential benefits. Chairman and CEO of the American Stock Exchange, Neal Wolkoff (2005) petitioned on behalf of small businesses that amendments be made to the universal guidelines stating that “the current system now threatens to stifle entrepreneurship and deter companies, domestically and overseas, from accessing the U.S. capital markets”.<sup>38</sup> Similarly, Section 404 did not account for the variety of existing organizational structures. And thus, companies with more complex, non-centralized business structures had a significantly more difficult, and costly experience creating and auditing internal controls.

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33 Id.

34 Murray, S. (2002, July 18). Leading the News: House GOP Moves On Oversight Bill, With Few Changes. *Wall Street Journal*, A.3.

35 Murray, S. (2002, July 24). Lawmakers Near Completion Of Accounting-Regulation Bill. *Wall Street Journal (Eastern Edition)*, A. 10

36 A.R.C. Morgan. (2005). *Sarbanes-Oxley Implementation Costs: What companies are reporting in their SEC Filings*. A.R.C. Morgan.

[http://www.auditnet.org/articles/Sarbanes-Oxley\\_Implementation\\_Costs.pdf](http://www.auditnet.org/articles/Sarbanes-Oxley_Implementation_Costs.pdf)

37 Id.

38 Wolkoff, Neal L. (2005, August 15). Sarbanes-Oxley is a Curse for Small-Cap Companies. *Wall Street Journal (Eastern Edition)*, p. A.13.

doi: 882031971



With the new mandate for auditing services, coupled with the conflict of interest restrictions on auditing firms, the price of auditing services spiked to meet the demand.

As a result, companies were reconsidering going public, as the system was not a friendly climate for budding corporations. As for those existing public corporations, finding the balance between external business and internal controls proved difficult and more and more executives were passing on taking reasonable risks to advance business. Chief accounting officer at General Motors Corp. said “The real cost isn’t the incremental dollars, it is having people that should be focused on the business instead of focused on complying with the details of the rules”.<sup>39</sup>

The impact of Sarbanes-Oxley on a global level was also significant as foreign companies had problems adhering to the universal compliance guidelines as well as their own country’s standards. In his address to the House (2005) to repeal Section 404, Congressman Ron Paul stated “These regulations are damaging American capital markets by providing an incentive for small US firms and foreign firms to deregister from US stock exchanges”. Paul referenced a study done by Wharton Business School stating that “the number of American companies deregistering from public stock exchanges nearly tripled during the year after Sarbanes-Oxley law, while the deregistering New York Stock Exchange had only 10 new foreign listings in all of 2004”.<sup>40</sup>

## VIII. MODIFICATIONS TO SARBANES-OXLEY

The ramifications that became of Sarbanes-Oxley on small businesses were evident across the board. In its first attempt to remediate the situation, the SEC released a public statement in early April of 2007 endorsing a collaborative effort with the PCAOB aimed at revising Section 404. Shortly thereafter, the SEC released the following public statement on May 23, 2007:<sup>41</sup>

The Securities and Exchange Commission today unanimously approved interpretive guidance to help public companies strengthen their internal control over financial reporting while reducing unnecessary costs, particularly at smaller companies. The new guidance will enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing company management on the internal controls that best protect against the risk of a material financial misstatement.

SEC Chairman, Christopher Cox stated, “Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of Section 404 is to provide meaningful disclosure to investors about the effectiveness of a company’s internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources”.<sup>42</sup> The statement explained that the SEC was committed to providing interpretive guidance for small businesses to better navigate Section 404 compliance, and “reduce uncertainty about what constitutes a reasonable approach to management’s evaluation while maintaining flexibility for companies that have already developed their own assessment and tools that serve the company

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39 (Solomon and Bryan-Low, 2004 Companies/ Complain About Cost Of Corporate-Governance Rules.

<http://online.wsj.com/ad/article/ironmountain/SB107636732884524922.html>

40 See the complete report at <http://knowledge.wharton.upenn.edu/papers/1285.pdf>.

41 See full Interpretative Release at <http://sec.gov/rules/interp/2007/33-8810.pdf>.

42 Securities And Exchange Commission. (2007, April 4). *SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'*. Retrieved December 11, 2011, from Securities And Exchange Commission: <http://www.sec.gov/news/press/2007/2007-62.htm>

and its investors well”.<sup>43</sup> This new approach would allow companies with preexisting internal procedures to keep them as long as they met Section 404 standards.

On July 25, 2007, the SEC approved the PCAOB’s new Auditing Standard No. 5 (AS5) which provided a scaling of the external control audit for smaller companies and a simplification of the requirements. The PCAOB acknowledged, “...that smaller companies often present different financial reporting risks than larger and more complex ones, and that their internal control systems often appropriately address those risks in different ways”.<sup>44</sup> AS5 added more variability than its predecessor AS2, by incorporating an auditing standard dependent on where the company lands in the “size and complexity continuum”.

On October 17, 2007, the PCAOB published its staff guidance<sup>45</sup> on auditing internal control in smaller public companies stating that “The guidance will assist auditors of smaller, less complex public companies in implementing AS No. 5”.<sup>46</sup> The guidance included suggested auditing approaches and covered the following topics: entity-level controls, risk of management override, segregation of duties and alternative controls, information technology controls, financial reporting competencies, and testing controls with less formal documentation.<sup>47</sup> Furthermore, there were a series of extensions made for compliance in response to smaller businesses inability to meet requirements by the original timeline.

## IX. WHERE ARE WE TODAY?

The overall impact of Sarbanes-Oxley on the securities industry is difficult to gauge due to the impact of similar litigation as well as market trends in research findings. However, qualitative surveying of businesses paints a fairly accurate picture of the sentiment around the act. Financial Executives International (FEI) annual survey of Sarbanes-Oxley compliance polled 185 companies in search of trends in company perception of the act’s impact and effectiveness over the four years. When surveying the overall value of section 404 the results were as follows:<sup>48</sup>

- 50.3% agreed that financial reports are more accurate; up from 46% in 2006.
- 56.0% agreed that financial reports are more reliable, up from 48% in 2006.
- 43.6% agreed that compliance with Section 404 has helped prevent or detect fraud; up from 34% in 2006.
- 69.1% agreed that compliance with Section 404 has resulted in more investor confidence in their financial reports, up from 60% in 2006.

The same survey showed an overall decline in cost of compliance in the last four years. FEI President and CEO, Michael P. Cangemi concluded "As companies continue to find efficiencies in complying with Section 404 and make compliance part of a routine practice, we have seen a continued decline in costs".<sup>49</sup> However, Cangemi also acknowledged the flipside to this decline, “While 404 auditor costs also declined 5.4% as the auditor scope of work narrowed, these costs

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43 Id.

44 Harrer, J. (2008). *Internal Control Strategies: A Mid to Small Business Guide*. Hoboken, NJ: John Wiley & Sons, Inc.

45 See full release at <http://pcaobus.org/Standards/Auditing/Documents/AS5/Guidance.pdf>.

46 Auditing Standard No. 5/[http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_5.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx)

47 Id.

48 Financial Executives International. (2008, April 30). *FEI Survey: Average 2007 SOX Compliance Cost \$1.7 Million*. Retrieved from [http://www.financialexecutives.org/KenticoCMS/News---Publications/Press-Room/2008-press-releases/FEI-Survey--Average-2007-SOX-Compliance-Cost-\\$1-7-.as](http://www.financialexecutives.org/KenticoCMS/News---Publications/Press-Room/2008-press-releases/FEI-Survey--Average-2007-SOX-Compliance-Cost-$1-7-.as)

49 Id.

were offset by a reported five percent increase in the average hourly audit rate charged by auditors".<sup>50</sup>

In 2009, the SEC's Office of Economic Analysis published the results of a survey of thousands of public companies conducted the previous year. Contrastingly, the results showed that over the long haul the overall costs (relative to assets) of Section 404 on smaller companies were seven times more than that of larger ones.<sup>51</sup> Furthermore, a substantial 70% of smaller companies surveyed said that Section 404 encouraged them to consider going private. Similarly, upon panning out to global scale, survey results showed that 77% of smaller foreign companies were motivated to consider delisting due to Section 404.<sup>52</sup>

Regardless of any particular survey or study, some effects of Sarbanes-Oxley are evident. The first of these effects is the decline in overall risk-taking. Early on, previous SEC Chairman William Donaldson alluded to the possibility that the legislation could lead to "a loss of risk-taking zeal" as result of what he described as a "huge preoccupation with the dangers and risks of making the slightest mistake" weighing on the shoulders of company executives.<sup>53</sup> Another notable result is the increased tendency for both American and foreign companies to delist themselves from the American markets. On a similar note, a study conducted by the University of Southern California found that after Sarbanes-Oxley the likelihood of American small public firms being sold to private-equity buyers was substantially higher than those companies abroad.<sup>54</sup>

One of the positive effects of Sarbanes-Oxley touches on the act's original intention of reducing fraud and misrepresentation. A study that researched 230 alleged corporate frauds spanning from 1996-2004 found the following results:

...pre-SOX, only one-third of big corporate frauds were uncovered by those with a responsibility to find them, such as auditors, industry regulators, or the SEC. Employees were more likely than anyone to report corporate wrongdoing. After SOX, however, the proportion of serious frauds discovered by those professionally responsible for doing so rose to 50%.<sup>55</sup>

Beyond that, it is evident that upper management of public companies is now invested more than ever in the procedures and processes that impact their financial reporting.

Over the years, dissenting opinions seem to outweigh supporting ones with calls for the repeal<sup>56</sup> of Sarbanes-Oxley and more recent legal action taken against act's established PCAOB. In 2010, the Supreme Court ruled that the establishment of the PCAOB was beyond Congress' constitutional authority.<sup>57</sup> Chief Justice John Roberts stated the board was a "government-created entity with expansive powers to govern an entire industry".<sup>58</sup> The ruling did not declare the entire act unconstitutional, which would have resulted in its complete invalidation. However the Supreme Court did acknowledge that the act's establishment of the PCAOB as an independent board allows for no accountability nor presidential oversight.

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50 Id.

51 Freeman, J. (2009, December 7). The Supreme Case Against Sarbanes-Oxley. *Wall Street Journal (Eastern Edition)*, A. 23.

52 Id.

53 The Economist. (2007, July 26). Five Years Under the Thumb: Corporate America is learning how to live with the tough regulations introduced after the collapse of Enron. *The Economist*. New York, NY, USA.

54 Kamar, E., Karaca-Mandic, P., & Talley, E. (2009). *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*. University of Southern California, Gould School of Law.

55 The Economist. (2007, July 26). Five Years Under the Thumb: Corporate America is learning how to live with the tough regulations introduced after the collapse of Enron. *The Economist*. New York, NY, USA

56 Representative Ron Paul's Repeal Sarbanes-Oxley! At [http://paul.house.gov/index.php?option=com\\_content&task=view&id=209&Itemid=60](http://paul.house.gov/index.php?option=com_content&task=view&id=209&Itemid=60).

57 Free Enterprise Fund v. PCAOB/ <http://www.supremecourt.gov/opinions/09pdf/08-861.pdf>

58 Factor, M. (2010, June 30). The Lessons and Limits of Sarbox. *Wall Street Journal (Eastern Edition)*, A. 19.

The most recent event of Sarbanes-Oxley is the proposed Startup Expansion Investment Act introduced by Congressman Ben Quayle of Arizona. The bill's purpose is to ease the process of business expansion. Quayle's press release states, "Specifically, the bill allows new companies with a market capitalization under \$1 billion to opt-out of regulations within section 404 of the Sarbanes-Oxley Act for the first ten years after going public".<sup>59</sup>

One cannot say for sure that this controversial piece of legislation is all good or all bad, and the debate is sure to continue. The proposal and passing of Sarbanes-Oxley in 2002 gave the investing public exactly what it wanted, but is it what the securities industry really needed?

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