

## SARBANES OXLEY ACT OF 2002: IMPLICATIONS FOR COMPLYING CORPORATIONS

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### Abstract

The purpose of this paper is to examine whether or not the Sarbanes-Oxley Act of 2002 has benefited corporations for the better. This paper will explore the historical background of Sarbanes-Oxley as well as its purpose and discuss divulge current implications that this legislation imposes on the public corporations that are required to comply.

**Keywords:** corporate governance, legislation, corporate scandals

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### Introduction

The American economy has experienced a number of corporate scandals throughout the past decade. With the backdrop of Enron, Financial compliance issues have caused a shift in the way public corporations are viewed by its investors. Government legislation has been passed to attempt to help remedy the situation. The corporate scandals of Enron, WorldCom and Tyco International, for example, are a continuum of events that have resulted from previous historical corporate crises; for instance, the stock market crash of 1929 and the implosion of equity funding, McKesson & Robbins, Inc. of the 1930's (Bealing & Baker, 2006). These were two events that historically began the issues of compliance or more specifically, fraud.

Compliance has always been an expected, as well as an important part of doing business throughout corporations. The only difference today is the degree of severity and seriousness it now imposes on corporations/organizations if found non-compliant. One of the most well known examples today of non-compliance is Enron. The downfall of this once rising and profitable supplier of energy and energy products is now marked down in history as the largest corporate scandal of all. Enron's participation in accounting fraud and corporate deception sent a message of distrust and disbelief on behalf of the investing public.

Enron was one of the top fortune 500 companies. As stated in the article, "The Good, The Bad, and their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior", "the collapse of Enron powerfully demonstrated that a corporate code of behavior is only as good as the directors and officers responsible for

implementing it" (pp. 2124). To put it simply, they did not practice what they preached. There was no internal control implemented into this corporate structure and that is why it failed; Enron did not comply.

The purpose of compliance is to provide order and order is what is necessary for a corporation/organization to function effectively (Atkinson & Leandri, 2005, pp. 37). The non-compliance of Enron resulted in accounting fraud as well as breaking the code of ethics and ethical behavior. Enron needed to foster a compliant culture and that can only be successful if the entire organization is involved and committed (Paonita, 2004, pp. 1). Needless to say, this scandal was responsible for legislation inducted by Congress. This legislation became known as the Sarbanes-Oxley Act of 2002.

### Sarbanes-Oxley Act of 2002

There is much confusion as to what exactly Sarbanes-Oxley, commonly referred to as "SOX", really is. Paul Sharman stated, Congress intended this act to result in "more reliable auditor certified financial disclosures" (pp. 8). The overall affect of Sarbanes-Oxley deals with corporate governance and the lack of it within today's corporations. The lack of this control by corporations, evident with the exposure of the countless financial fraud that included earnings restatements and deception, shows not only the government but the investing public that integrity is far from being taken seriously (Cohen, Krishnamoorthy & Wright, 2005, pp. 127). The scandals of Enron as well as those of Tyco and WorldCom were not the sole contributors of SOX but in actuality the "tipping point" of their scandalous

predecessors before it; SOX was the government's answer to solving this problem. It became the combative component in Congress' response to a series of scandals both past and present with the intention of demanding corporations/organizations to be effective; in areas of operations, the reliability of the financial reports being submitted and reported to the SEC, and the compliance of all appropriate laws and regulations (Garbinski, 2006, pp. 28).

SOX currently has two oversight boards monitoring its implementation, the Securities Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB). The SEC is charged with having to provide "clear" compliance guidance for SOX while the PCAOB is primarily focused on the internal control auditing standards. Both oversight boards work jointly to try and revise/refine the requirements of this act to ultimately help corporations achieve the goal of compliance with SOX (Swartz, 2006, pp. 14). Internal control is what the objective for section 404 pertains to as part of the Sarbanes-Oxley Act. As noted by Newman & Oliverio (2006):

With respect to the internal control assessment required by subsection (a) each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer (pp. 6).

Corporations must comply with the standards of Sarbanes-Oxley Act and if found non-compliant will face consequences that include imprisonment and/or fines.

### **Sarbanes-Oxley Flawed?**

SOX has been anything but simple for Corporate America these past few years. There has been this overall distaste for the act by corporations because it requires ALL companies to be compliant within a short amount of time; from large corporations to small. Some question if this is realistic. For many, SOX is exemplifying a one-size-fits-all mentality where they, the government, are requiring a diverse population of corporations to comply with one set of standards that was a result of one, not many, corporations' misconduct (Crawford, Klamm & Watson, 2007, pp.47). Corporations are literally put through the ringer and subjected to a lengthy process of auditor opinion. (See Exhibit 1 to illustrate this auditor opinion process). The problem is that companies are diverse and do not operate the same on a daily basis. What may take one company a few weeks to months in order to be in compliance with SOX may take another company a few months to a year to comply. Each company is set up to run its organization according to processes and procedures that "fit" their goals and objectives; who better to say what works best but those who live it everyday.

Also questionable, is the "clear" guidance that is to be provided by the SEC. Corporations still do not

understand fully how they need to be compliant without causing alarms. This vagueness especially applies to section 404. Section 404 deals with the ever important component of internal control and the redundancy of auditor opinions as well as the oversight by two governing bodies, SEC and PCAOB (Newman & Oliverio, pp.7). With these requirements comes the need to produce audit trails and documentation for every financially related transaction as required within the SOX provisions. The need to implement processes and procedures that have to follow these guidelines in order to comply, have become excessive. Corporations are now operating on a needs-specific basis versus understanding the big picture and why SOX is beneficial in regaining the investing public's confidence. Is SOX imposing more harm than good? To help better understand the answer, this paper will look into the implications of cost concerning SOX.

### **Cost of implementation**

What corporations are facing now due to this redundancy and vagueness are high costs; costs that are stemming from the implementation process of SOX into their corporate culture. In addition, what is also necessary to note are the costs that are associated with earnings restatements and litigation cases that have also come forth in response to this new act.

Corporations with \$75 million or more in market capitalization were required to comply with section 404 requirements when it phased into the US in 2003 (Hartman & Lardner, 2006, pp. 1). For the majority of these companies, the final cost of implementing SOX has risen from the original guesstimate of \$91k per company to an astounding \$40 million per company (Sharman, 2007, pp. 8). This cost includes but is not limited to, corporate governance reform, auditor fees, financial planning, updating IT processes, training for managers, staffing, etc. These are a result of companies having to utilize a top-down, risk-based approach that is required by SOX. Using this approach allows auditors to examine all levels of control throughout the organization; starting at the entity level.

The issue posed with this approach is that the focus is mainly on the high-risk balance sheet accounts for financial statements. With the focus mainly on these types of accounts, which was the cause of previous scandals leading to the development of SOX, other areas that may pose risk but are unknown to the auditors, are overlooked (Basilo, 2007, pp.6). Due to this oversight, companies have to update documentation for these less relevant accounts in order to be compliant with SOX, after the fact. In essence, this approach has seemingly cost corporations more money and less compliance. The expense, time investment and extra audits is costing companies too much of their resources.

## Financial Restatements

Another factor that resulted from SOX is companies having to restate their earnings. According to Business and Management Practices, a survey conducted by Huron Consulting Group, found 414 companies, including members of the fortune 100, have restated their financials by 16.4% due to Sarbanes-Oxley and has increased by 28% in comparison to previous data collected in 2003 when SOX was just introduced (2005, pp. 15). In the midst of implementing provisions of SOX like section 404, companies are finding themselves in non-compliance with their financial statements. Therefore, companies have to re-evaluate and restate according to the standard auditing guidelines created. Another part of these restatements is due to auditors taking their roles in SOX more seriously. The auditing portion is a major part of the proper compliance for Sarbanes-Oxley; this act was set up to be auditor focused and though this may not have been the intention, it naturally focused on finances and the need to gain more control of it. As mentioned earlier, companies currently are required to undergo an audit process that subjects them to three audit opinions in order for them to be deemed compliant under SOX. These opinions cover the auditor's report on management's assessment of internal control as well as the effectiveness of internal control and also the company's financial statements (Crawford et al., 2007). After this process is concluded, companies re-evaluate and decide whether restatements are necessary. This unfortunately has been the case for some organizations. A prime example of this is Fannie Mae. Fannie Mae is one of the largest buyers of American mortgages and listed within the fortune 100 who unfortunately has had to restate earnings due to several years of accounting problems (Dash, 2006). Although unfortunate, this incident has also proved beneficial for other organizations in what not to do. The sum of dollars overstated that year was estimated to be 6.3 billion. This sweltering sum of dollars is what led to the lawsuit the company is now facing.

## Litigation of SOX

One of the downsides, of many, for restating earnings is the trigger of class-action suits that are yet to follow. With that said, according to Business Management and Practices, 212 shareholder lawsuits were filed alone in 2004 in comparison to the 181 filed in 2003 (2005, pp.16). The result of this increase was not solely due to SOX. However, SOX did play a role in adding class action suits that involved corporate governance reforms into settlements. The total settlement in dollars for 2004 alone doubled what it was in 1996 reaching a history high of \$3.3 billion (Anderson, 2005). This amount reflects the changes that major corporations were undergoing due to SOX. Some of the settlement dollars include the settlements on corporate giants

such as WorldCom, Raytheon and Bristol-Myers Squibb. All of which settled in the year of 2004. Though it is seemingly shocking to see these major contributors to the US economy non-compliant, it is definitely a wake up call that no one is safe; every corporation is subject to class-action lawsuits.

As mentioned, SOX added the subject of corporate governance reform to settlements and since then, settlements have been skyrocketing. (See exhibit 2 for Top Ten List posted by Stanford Securities Class Action Clearinghouse). Nine out of the top ten settlements have included governance reforms which are very telling to the public of how organizations are operating (Anderson, 2005). Companies are being challenged to own up to what they are 'preaching' within their organization. A huge reason as to why these settlements are so high is that they deal with the failure of some corporations doing what's right. When companies have to reissue earnings statements they ultimately are affecting their reputation within the US economy. With this flawed reputation comes the less attractive result of becoming a liability to its investors. Very few want to invest in a company that is blaringly unstructured and therefore less productive in generating ROI. A return on your investment is not only desirable for investors but also for newly developed companies who would like to take part in America's market. Another intriguing topic is of IPO's, initial public offerings and how the cost of SOX has impacted it.

## Future Prospective Corporations?

It's understandable that non-US companies want to be a part of the largest capital market in the world however, after the implementation of stricter financial regulations in America, like Sarbanes-Oxley, this may not continue to be the case. Ever since the impact of scandals such as Enron on the US economy, shares of global IPO's have decreased. As listed in the London Times, Bawden (2006) stated, "London has a 26.4 per cent share of global IPOs in which \$1 billion or more was raised this year. New York has only 6.5 percent. In 2001, the year before the Sarbanes-Oxley Act was passed, London had 8.7 per cent to New York's 59.1 per cent, according to Thomson Financial". This is not a good sign to the US economy's future. These new international companies are realizing that entering the market and having to comply with these new US regulations, may prove to be more risky.

Most complaints stem from that fact that complying with these newly strict rules requires extra time and money and then maybe the company will be compliant, until the rules change again. These class action suits over the last few years have cost multi-million's whether settled in or out of the courts and this message alone is frightening to prospective corporations. For one, this cost would directly impact the way these company's view their current processes and procedures and two, after review it could be determined that these guidelines are too extreme to

where this company may ultimately not even survive the initial implementation of SOX.

The move to greener pastures, choosing to operate within the London market versus the US, could prove to be more profitable for those new corporations but horrific for the US economy and its history of ever-changing and growing ability. How will the economy maintain its competitive advantage if companies take their business elsewhere? As with all new compliance regulations, only time will tell.

## Discussion

With all that's been discovered, the ultimate resolution is that Sarbanes-Oxley needed to be revised and refined and this is exactly what corporations are demanding. Fortunately, the government is hearing the outcry for the revision of SOX and has made steps, however not strides to correct what they, the very corporations who follow it, are saying. The positive thing about this experience for corporations is that, they get it. They understand why the act was developed and inducted into the US. They understand the importance of internal control to prevent catastrophes such as Enron from re-occurring and how the government will not tolerate misconduct. They also understand the consequences that follow misconduct and most importantly they understand how gaining investor's confidence back, is a main priority if not a must. Initially, the implementations of the specific provisions are what caused concern. However, delving deeper into the process of SOX compliance, corporations found that the excessiveness of documentation as well as the cost of being compliant, proved to be extremely high. What companies need are better, clearer guidelines of what certain standards mean for certain corporations. Every organization runs its processes differently to better suit their structure. SOX needs to be structured in the same way. The SEC as well as Congress needs to work more diligently to ensure that this happens. Until corporations within the US can get "a hold" of this new compliance regulation, the future new corporations will not be inclined to join this market. There must be a middle ground so that companies and the SEC can work to make this process more effective and less costly. The result of not being able to refine SOX and make it more aligned with these organizations, can fearfully lead to a less innovated US economy. What every market wants is to make profit and also survive. Secondly, without innovation how can these corporations be competitive? SOX can be an excellent competitive tool over competitors. The government has to make it more 'user friendly' for these corporations.

Sarbanes-Oxley has great potential to overcome the unexpected consequences and issues it has caused Corporate America. With a little more due diligence on its creators part, the act could set a precedence for this economy of doing things right, the first time. Ultimately, what the government as well as Corporate

America should be striving for, is uniformity and the understanding of how this will help build a more profitable and sustainable future for the American economy.

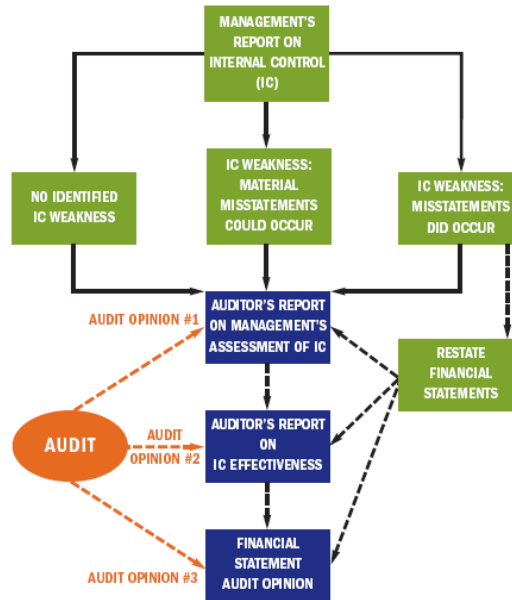
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**Exhibit 1. SOX Audit Opinions**

Figure 1: SOX Audit Opinions



(Source: Surviving Three SOX Opinions (2005, May)).

**Exhibit 2. Top Ten Settlement's List  
Post-Reform Act Securities Case Settlements  
SECURITIES FRAUD "TOP TEN MEGA-SETTLEMENTS" LIST [1]**

**Top 10 Mega Settlements: Settlements of Post-Reform Act Securities Class Action Lawsuits in Excess of \$100 million (As of February 13, 2006)**

Rank	Issuer	Maximum Asserted Valuation [1]	Percentage of Total "Mega-Settlements"
1	Enron	\$7,160.5 Million	21.12%
2	WorldCom	\$6,156.3 Million	18.16%
3	Cendant [2]	\$3,528.0 Million	10.41%
4	AOL Time Warner	\$2,500.0 Million	7.37%
5	Nortel Networks	\$2,473.6 Million	7.30%
6	Royal Ahold	\$1,091.0 Million	3.22%
7	IPO Allocation Litigation	\$1,000.0 Million	2.95%
8	McKesson HBOC	\$960.0 Million	2.83%
9	Lucent Technologies	\$673.4 Million	2.19%
10	Bristol-Myers Squibb [3]	\$574.0 Million	1.69%
	All Other Mega Settlements	\$7,786.5 Million	22.97%

[1] Settlement values may include securities as well as cash. Securities are valued as of the highest value asserted by any party in a court filing. Settlements include proceeds from all sources. Not all settlements have received final court approval. Settlement values in some cases may still increase as additional defendants settle individual claims.

[2] Includes settlements in the PRIDES and common stock litigation.

[3] Includes the pending \$185 million settlement of the 2000 lawsuit against Bristol Myers, the \$300 million settlement of the 2002 lawsuit against Bristol Myers, and the \$89 million settlement of four lawsuits filed by shareholders who decided to opt out of the \$300 million settlement.

(Source: <http://securities.stanford.edu/news.html#settles>)