

Sarbanes-Oxley: An Overview

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How It Came About

When World Com collapsed taking Arthur Anderson along with it, there seemed to be a panic among stockholders everywhere wondering if they were going to be the next victim. Their reactions called for government action to be taken. In 2002, an attempt was made by the U.S. Congress along with President Bush to restore investor confidence (Goodman). They signed into action a monumental piece of legislation for the accounting industry. The Sarbanes-Oxley Act of 2002 set forth standards that were aimed at identifying fraud currently being committed in corporate America and warding off future fraud by early detection. This act hoped to keep people from worrying about another scandal the size of Enron or WorldCom. While the reasons for writing Sarbanes-Oxley were justified, the short-term effects may prove to outweigh the long-term benefits.

Contents of Legislation and Intentions

The most tangible entity that came out of SOX was the Public Company Accounting Oversight Board or PCAOB. It was set up to oversee the accounting industry and their practices. The SEC is responsible for appointing the five-member board. Of these five professionals, only two members are CPAs. This was a huge blow to an industry that had always prided itself on being self-regulated (McDermott). The PCAOB is in charge of writing standards that interpret SOX at the auditor level. They are also in charge of inspecting and monitoring all accounting firms that audit public companies. The PCAOB has already made their presence and power known as demonstrated in the firm quality control reviews, which were much more detailed and rigorous than the "peer

reviews” performed prior to SOX. However, this is only one of the changes that CPA firms find themselves faced with.

There are a few major sections of SOX that have caused a stir when it comes to how these firms audit companies and how the companies do business. One of the first to go into effect was Section 302, which states that the CEO and CFO must sign a letter saying that the quarterly and annual financial statements are an accurate picture of the financial status of the company (Summary of Sarbanes-Oxley). Any violation of this is punishable under SEC regulations and the CEO and CFO can be imprisoned or fined up to \$1 million. This is a major change, making two people in the company directly liable for material misstatements. Before, the intrinsic legal formation of a corporation meant that employees in the company could not be held personally liable for the faults of the company. Now stockholders have two people whom they can hold responsible for fraud. It also puts a very high price on being the CEO or CFO of a company. It is very possible that there will be a large rise in the compensation of both positions in the future.

The issue causing the largest upset is Section 404. This section requires that management of a company be responsible for internal controls and report on them at the end of the fiscal year. This also requires auditors in their report to attest to and report on management’s report (Summary of Sarbanes-Oxley). The main discussion over this section has pertained to the cost that companies are incurring and the perceived benefits that they are reaping from it. Financial Executives International conducted a survey in July 2004 where the average costs had been reported at approximately \$ 3,143,685 per company in year one alone. But when they asked internal auditors if the costs exceed benefits, at least 72% said yes (Controller’s). Before Section 404, many companies had

spent little to no time on internal controls, at least not much attention in the way of capital. But approximately 15-20% of larger companies will be facing qualified or adverse opinions if they do not comply in time. The date for compliance for companies with public floats greater than \$75 million is April 30th. The date for smaller companies has been pushed back several times due to the difficulty these companies are encountering (Reosti). It seems that they expect more of the smaller companies to get an adverse or qualified opinion. Many have not used a system in the past that required the strict observance of internal controls. Some had controls in place, but did not have the documentation of it fleshed out.

In the AICPA summary of SOX, other small issues are discussed such as the rotation of partners every five years, prohibition of personal loans to executives, and disclosing financial information in real time. It has yet to be seen whether rotating the lead partner every five years will benefit the companies by having a fresh pair of eyes on the audit or if more fraud will be able to be committed that year because of the lack of company-specific knowledge. Also there some concern about the availability of partners with expertise in the fields in which they audit and enough in the same city to be able to rotate. Along with these changes there have been some provisions set up for whistleblowers, issuing them much more protection. Before SOX, states differed in their statutes as to whether or not employees had to prove that unlawful practices were going on. Now, SOX allows employees to report alleged unlawful practices with recourse if the employer retaliates in an adverse manner (Goodman). This legislation was put into place with the intentions of more whistleblowers coming forward. It seems though, that not as many whistleblowers have come forward as the SEC would have liked.

On a more positive note, however, SOX has done one small thing that has not cost companies as much as it has benefited them. SOX states that the external auditor must report to the audit committee only and not to management of the company being audited (Sarbanes-Oxley). While this seems like a small change to outsiders, it really changes the environment for auditors and realigns the relationship to what it should have been from the start. Auditors will still find that they will still work with management, but they are not reporting to them (Sarbanes-Oxley). This gives the auditor more freedom to report issues that they feel are noteworthy to the audit committee. It also places more responsibility on the audit committee than before. Many companies are finding their audit committees meeting more frequently in 2003 and 2004 than before. Many feel that this change will benefit shareholders the most in the near future.

Corporate Effects

In previous years there was much incentive for companies to go public. Having publicly traded debt or stock meant an easy way to compensate employees when a corporation was growing. It provided a cheaper access to capital than taking on debt. It seems though that the cost to go public has become much more than was previously thought. Companies must now pay much higher audit fees. Companies such as ASB Financial Corp are conducting a reverse stock split in order to go private and not have to file with the SEC (Reosti). For ASB, becoming private will save them at least \$150,000 per year. It seems that from now on, firms will have to analyze more closely whether going public will really benefit them as much as it once did. Compliance now costs them more because of 404 and for some, because they have to hire more than one accounting firm to help them. Accounting firms are no longer able to provide advice on the proper

way to record transactions, but must keep a much higher level of independence. In speaking with practicing auditors, they feel that this is creating more work than before for them because they are not able to tell companies the correct way to record them, creating more work for the company employee to have to solicit a different source for the answer.

Effect on Accounting Industry

Already, whistleblowers are being upheld for their observance of SEC regulation (Boston case). While the volume has not been as much as expected, it is clear that now employers have to take employees who threaten to expose them seriously and if they plan on firing or changing the working conditions of the employee, they are more than likely going to have litigation enacted against them. Auditors must be able to use impartial judgment on all issues included in the engagement (McDermott). Lead partners on audits must rotate every five years. Mainly though, SOX has created a large volume of work. This has helped the industry on the revenue side, but they are hurting on the employment side, especially with experienced hires. SOX will also affect their structure of employment in that their audit team members that provided more than 10 hours of work to a specific company's audit will not be able to work for that company in a financial oversight role for at least one year (Sarbanes-Oxley). In the past, many Big Four employees would be hired by the companies that they audited and not be required to have a "cooling off" period. This will hurt companies looking for employees with 2-4 years of experience in accounting and auditing. They will have to look to different places to hire individuals. There is also discussion as to whether the accounting industry should benefit on the revenue side from a piece of legislation that was meant to reform the way they do business. It is apparent that there is no perfect solution to who will pay for this ultimately.

However, the accounting industry seems to have shouldered the lesser part of the burden in this case.

Shareholder Effects/Impact on Economy

For small businesses, Sarbanes-Oxley seems to send a negative message in their direction. It sets the bar so high to go public, that many companies are being deterred from moving in that direction at all. They are looking for alternative ways to grow their business and other ways of raising capital. Some people are pleased by the change in legislation; they feel that there have been some companies that never should have been a part of capital markets in the first place. Though this may be true, SOX still seems to be a backfire reaction to the corporate scandals. While it seems that Congress had honorable intentions in drafting such a piece of legislation, the pendulum seems to have swung too far in the opposite direction in terms of cost. Some might argue that no cost is too high in protecting stakeholders, but it seems that certain parts of SOX may be going a bit too far. When running a business, there is an inherent risk that fraud will be committed. While this does need to be minimized as much as possible, there needs to be a balance between auditing and examining companies so much that it becomes dictating how they do business and keeping people who have a stake in the company assured that their capital is not at risk of collapsing. There is no easy answer here.

Suggestions for Improvement

It seems that SOX needs not to go away completely, but rather to be trimmed down a bit. While several businesses are in need of upgrading their technology systems so that they can conduct business better and have better security and records of transactions and business, they do not need to spend valuable capital on systems that are

not proven to decrease the chance of fraud significantly. Also it needs to be examined how useful all the information that auditors are gathering actually is. It seems that there is no evidence that the extra tests on controls will actually decrease fraud as much as Congress hopes it will. It can be expected that it will boost audit fees and provide lots of work for the accounting industry. It seems in the best interest of our economy to scale back or slow down the compliance process so that small public companies are able to meet the requirements. This will prevent an even larger number of companies facing an adverse or qualified opinion than are now. It would still provide for investor confidence to be boosted, as efforts would still be underway, but would also give firms more time to space out the costs of this project.

It seems that the intentions that Congress and President Bush set out to accomplish were honorable. It also seems that drastic action did need to take place in the public company sector. But now that companies are finding the cost to comply so high, there will probably be a smaller percentage of companies go public in the next few years. While the next generation of people in the marketplace and auditing industry will look at SOX as just another part of doing business, it will still remain one of the most extensive and comprehensive pieces of securities legislation in the turn of the 21st century.

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