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Unraveling the Sarbanes-Oxley Act: An Examination of the Requirements and Implications

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I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

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Unraveling the Sarbanes-Oxley Act: An Examination of the Requirements and Implications

Senior Honors Project
The University of Tennessee, Knoxville
Spring 2003

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Unraveling the Sarbanes-Oxley Act: an Examination of the Requirements and Implications

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Abstract:

Sarbanes-Oxley was passed into law on July 30, 2002. The law has huge implications for the accounting industry, investment firms, and especially public corporations. Its goal is to improve the confidence of investors in order to improve the economy.

This project focuses on developing an explanation of the requirements of Sarbanes-Oxley. Additionally, it provides a hypothesis of what the overall outcome and effect of the Sarbanes-Oxley Act will be.

An examination of numerous articles relative to the Sarbanes-Oxley Act was used to complete this project. First, several articles were analyzed to develop an understanding of what requirements were entailed in the law. Second, articles were selected to get a grasp on what changes were already occurring in reaction to the Sarbanes-Oxley Act. Next, articles were reviewed to determine what current events could affect the outcome of Sarbanes-Oxley. Finally, a study of articles pertaining to recent additions and changes in the law was completed.

The project concludes that the success of the Sarbanes-Oxley Act will depend upon the implementation of the Public Company Accounting Oversight Board. This board is responsible for enforcing the standards included in the Sarbanes-Oxley Act. Additionally, they are required to mandate new standards for auditors. If the board earns the respect of investors, it will be reflected in the economy and the Act will be successful.
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I. Sarbanes-Oxley Act – A Brief History

Beginning in the early 21st Century, circumstances arose that cast a shadow on corporate responsibility and on the accounting profession. Numerous companies attributed to the prevalence of corporate accountability issues within the news, including Enron, WorldCom, Tyco, Adelphia Communications, Global Crossing, and Qwest. Various situations caused each of these companies to allegedly participate in financial reporting fraud, and, when this fraud was discovered, their stocks took hard hits. Unable to recover these losses, investors began to doubt the responsibility and ethics of company executives. Thus, the stock market and American economy suffered.

Signed into law by President George W. Bush on July 30, 2002, the Sarbanes-Oxley Act is intended to resolve these issues related to corporate accounting fraud and to give a boost to investors’ confidence in the stock market.1 Sponsored by Senator Paul S. Sarbanes (Democrat – Maryland) and Congressman Michael G. Oxley (Republican – Ohio), the Sarbanes-Oxley Act received resounding support in both the U.S. House of Representatives and the U.S. Senate. The bill received only three “no” votes in the House, and was passed unanimously in the Senate.2

II. Purpose of Project

This project’s purpose is two-fold. The first objective is to clarify the law itself, with an explanation that is comprehensible to the ordinary individual. It is difficult to understand what is entailed within the Sarbanes-Oxley Act; however, use of this

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explanation should allow someone to get a grasp on the intent and requirements of the law itself. The second goal is to achieve a reasonable theory of what the result of the Sarbanes-Oxley Act will be. Changes within the accounting industry and the framework of public companies are assured with this new law. Additionally, it is probable that other economic sectors will see changes with the act’s implementation.

Sarbanes-Oxley applies to all companies registered with the Securities and Exchange Commission (SEC) as well as their auditors; thus, the number of entities that are affected is quite large. Also, the law marks the first time that the accounting industry will fall under the governance of the United States. In fact, Sarbanes-Oxley has been deemed “the most far-reaching legislation affecting the accounting profession since the securities laws of the 1930s.” Therefore, it is important to determine what changes are likely to occur and what their impact will be.

III. A Summary of the Enacted Law

There are eleven different concepts that are covered by the Sarbanes-Oxley Act. These are:

Title I: Public Company Accounting Oversight Board
Title II: Auditor Independence
Title III: Corporate Responsibility
Title IV: Enhanced Financial Disclosures
Title V: Analyst Conflicts of Interest
Title VI: Commission Resources and Authority

3 Williams and Carcello 1.
Title VII: Studies and Reports
Title VIII: Corporate and Criminal Fraud Accountability
Title IX: White-Collar Crime Penalty Enhancements
Title X: Corporate Tax Returns
Title XI: Corporate Fraud and Accountability

Each of these areas will be addressed individually.

**Title I: Public Company Accounting Oversight Board**

Of all the sanctions included in Sarbanes-Oxley, this provision has the potential to provide the most change. It provides for the creation of the Public Company Accounting Oversight Board (PCAOB), which will take responsibility for overseeing, monitoring, and disciplining accounting firms that participate in audits of SEC companies. Much of the self-regulatory power that has existed within the accounting industry will dissipate, as the PCAOB will now take charge of this regulation.\(^4\) Although the PCAOB will be established as a non-profit, non-governmental entity, it will fall under the oversight of the SEC.\(^5\) An annual “accounting support fee” that is assessed to public companies based on their market capitalization will fund the board.\(^6\)

The PCAOB will be made up of five members. These members must serve full-time; therefore, members cannot pursue any other professional position or participate in other business activities during their term. Exactly two of these members must be

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\(^4\) Williams and Carcello 2.
\(^6\) Williams and Carcello 3.
certified public accountants (CPAs).\textsuperscript{7} If either of these individuals serves as the Chair, he or she cannot have practiced as a CPA within the past five years.\textsuperscript{8} There is a two-term limit for members, and each term consists of five years.\textsuperscript{9} Members will be appointed by the SEC “after consulting with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of Treasury.”\textsuperscript{10}

After the selection of the board members, the board will work to hire staff, set its budget, adopt audit standards, and propose procedures to be followed by the board. The SEC must determine if the PCAOB is prepared and capable of performing its responsibilities. If so, the PCAOB will then become the officiating body for all auditing related to SEC-registered companies.

The PCAOB will require registration by public accounting firms. All firms that participate in audits of public corporations are required to register no later than 180 days following the enactment of PCAOB’s enactment.\textsuperscript{11} These firms will pay a registration fee designed to cover the costs involved with processing registrations. They will also be required to pay annual fees that will be used to process the annual reports that each firm must file.

Auditing standards will be drafted by the PCAOB. There are several provisions that must be enforced under Sarbanes-Oxley. These are: (1) sufficient documentation must be kept to support the audit report for no less than seven years, (2) audit reports must have the approval of an additional partner, (3) a detailed analysis of internal

\textsuperscript{7} Hardison 30.
\textsuperscript{8} Harry S. Davis and Megan Elizabeth Murray, “Corporate Responsibility and Accounting Reform,” 
\textsuperscript{9} Hardison 30.
\textsuperscript{10} Hardison 30.
\textsuperscript{11} Williams and Carcello 2.
controls and how they were tested must be maintained, and (4) standards for quality control that are in effect for consultations within the firm must be disclosed.

Registered firms will be inspected by the PCAOB. Firms that audit over 100 public issuers must be inspected every year, while other firms must be inspected every three years. Inspections will ascertain that firms are properly following guidelines and standards that have been established by the PCAOB.\textsuperscript{12}

The PCAOB will be responsible for investigating possible violations of standards or laws by firms and their associates. They can report any pending violations of standards to the SEC, and are mandated to inform the SEC of any pending investigation related to securities violations.\textsuperscript{13} Firms must cooperate with investigations by the PCAOB. Individuals and firms face suspension and disbarment from lack of cooperation. The PCAOB can request a subpoena from the SEC if a company fails to provide desired documentation. Firms can be fined $15 million, and individuals can be fined $750,000 as the result of investigations.\textsuperscript{14}

It is important to note two issues relevant to the power of PCAOB. First, Sarbanes-Oxley did not give PCAOB the authority to make changes in accounting principles. This power will remain with the SEC and the Financial Accounting Standards Board (FASB), which will also be monetarily funded by the annual “accounting support fee.” Second, the PCAOB will not be responsible for monitoring the public corporations themselves, although they can request information from the companies in regards to investigations of accounting firms.\textsuperscript{15}

\textsuperscript{12} Williams and Carcello 2-3.
\textsuperscript{13} Hardison 30.
\textsuperscript{14} Williams and Carcello 2-3.
\textsuperscript{15} Hardison 30.
Title II: Auditor Independence

The Auditor Independence section is intended to prevent accounting firms from giving companies preferential treatment as a result of their relationship with the company. This biased treatment could result in the lack of stringency in auditing the company’s financial statements, which could thus lead to false or fraudulent statements.

By limiting the types of services that can be performed by a public accounting firm for a company that it is auditing, the likelihood that auditors will give preferential consideration to clients in order to obtain business in other areas is lessened. Sarbanes-Oxley prohibits firms from providing these services to their audit clients: “(1) bookkeeping services, (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 or human resources functions, (7) broker or dealer, investment adviser, or investment banking services, and (8) legal services and expert services unrelated to the audit.” Other audit services as well as non-audit services are allowable only if the audit committee has approved them in advance.

There are additional stipulations to this section. First, audit partners cannot be responsible for a specific company more than five years without rotation. Second, reporting is to be provided to the audit committee of the company in a timely manner. This reporting must convey any significant communication with management that occurred as part of the audit, as well as critical issues related to accounting principles.

16 Williams and Carcello 3.
Lastly, if the audit firm previously employed an executive of the company within the last year of the start of the current audit, then the firm cannot perform the company’s audit.

**Title III: Corporate Responsibility**

Under this section, public companies are required to form an audit committee that is independent. This committee is “to establish procedures for handling complaints related to accounting, internal controls, and auditing matters, including complaints that may be submitted anonymously.”[^17]

If necessary, the audit committee has the right to choose an independent counsel or to seek the advice of others.

This section further requires that the external auditor must be appointed, compensated, and overseen by the audit committee. The committee must be given enough funding to pay for the services of the accounting form chosen to perform the audit.

Several other provisions in this section apply to the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). First, these officers must certify in each quarterly and annual report that they have reviewed it, that it contains no material misstatements or omissions, that it presents the financial condition of the company fairly, that an evaluation on internal controls occurred within ninety days of the report and are commented upon in the report, that all fraud and internal control deficiencies have been reported to the auditors and audit committee, and that any material changes to internal controls since their evaluation is disclosed. Second, it is now illegal for CEOs, CFOs, other officers, or their employees “to fraudulently influence, coerce, manipulate, or

[^17]: Williams and Carcello 3.
mislead the external auditor." 18 Third, executives and company insiders are prohibited from trading stock during blackout periods, and plan participants should be notified of the blackout period in advance. 19 Finally, if a financial statement must be re-issued due to noncompliance with GAAP, then the CEO and CFO must return bonuses and incentives that are received within the one year period following the restatement, as well as profits from securities sales.

Title IV: Enhanced Financial Disclosures

Within this section, new requirements are set for public disclosures related to various areas.

First, management is to assess the internal controls, their design, and their effectiveness within each annual report. The external auditor must concur with the management on the assessment of the internal controls.

Second, it must be disclosed if there is at least one financial expert serving on the audit committee. If there are no financial experts, it should be stated why there are none in this position.

Third, it must be disclosed if a code of ethics exists for executive financial officers within the company. If there is no code of ethics, the reason for this omission should also be disclosed. Additionally, the company must disclose any changes to this code.

Next, any material adjustment determined by the external auditor must be contained within the financial statements. The SEC must make rules that require issuers

18 Williams and Carcello 3-4.
19 Davis and Murray 1.
to disclose any off-balance sheet transactions, obligations, or arrangements if they are material to the financial condition of the company. Also, pro forma information is not to be included with or in the statement if it is misleading. All pro forma information is to be reconciled to GAAP requirements.

In addition, personal loans from the company to executives are now prohibited. The period of time in which stock transactions involving executives and significant stockholders are to be disclosed has been reduced to the second business day following the transaction. Companies must also disclose “on a rapid and current basis any material changes in the issuers’ financial condition and results of operations.”

Finally, the SEC will be required to review each issuer’s filings no less than every three years.

**Title V: Analysts Conflicts of Interest**

Title V works to improve neutrality and independence of those in the securities analyst profession. Rules are to be established in this area by either the SEC, an industry association, a national securities exchange, or any combination of these entities within a year of Sarbanes-Oxley. These rules must ensure that investment bankers are no longer allowed to perform clearance on research reports by analysts, that investment bankers will have limited ability to give performance evaluations of analysts, that investment bankers cannot retaliate for negative or harmful reports, and that safeguards are in effect that will protect analysts from pressures that will influence their decisions. Additionally, one of these entities must establish rules that require analysts to disclose any conflicts of interested in any public appearance or report. The analyst must provide information on

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20 Williams and Carcello 4.
the amount of securities he or she owns in companies under analysis. Additionally, if the company being reported upon has compensated the analyst’s firm in any way, this must be disclosed. When recommending securities, an analyst is required to disclose if the issuer has been a client of his or her employer within the past year. He or she is also to disclose if investment-banking revenues are used to determine his or her compensation.

**Title VI: Commission Resources and Authority**

Two hundred professionals are to be hired by the SEC to monitor the accounting profession, according to this section. This section provides the SEC with increased funding to hire these employees and for other functions.

The SEC is also allowed to restrict the practice of individuals if they lack qualification, lack character, lack integrity, participate in unethical or unprofessional conduct, or violate or assist others in violating securities laws. An individual can also be punished for negligent conduct.

**Title VII: Studies and Reports**

Five studies should be performed under the jurisdiction of this section. These studies are to be performed by a combination of the SEC and the General Accounting Office (GAO).

The first study will analyze the effects of consolidation within the public accounting industry on the securities market. This study is to be conducted by the GAO and should review approximately the past fifteen years. Several topics must be included in this study. First, it must determine what factors led the industry towards consolidation.
Second, it must include what impact consolidation has had on the securities market and the formation of capital. Finally, it must suggest possible solutions to improving upon any problems revealed in the study. This study should provide information on how the business community has been affected by the accounting industry’s consolidation. The report is to be given to the U.S. Legislature by August 2003.

The second study is the responsibility of the SEC. They are to examine what effects credit rating agencies have upon the securities markets, how accurately those agencies have assessed risk, and what the industry’s barriers to entry are. Additionally, the study should suggest ways to decrease the barriers. This report must be presented to the U.S. Legislature and the President.

The third study will analyze securities law violations that occurred between 1998 and 2001. It, too, will be performed by the SEC. Basically, this study will estimate how many people have been found in violation of securities laws, but were not disciplined or sanctioned. It should also determine the number of these individuals that were "primary violators." Securities laws violations and sanctions are to be categorized as well. These results must be presented to the U.S Legislature.

The fourth study is intended to reveal which areas of financial reporting are most conducive to manipulation, fraud, and earnings management. This will occur through an analysis of SEC enforcement releases, and restatements of financial statements. The study should include these elements for the five years before Sarbanes-Oxley was adopted. The SEC is to conduct this study and must provide the results to the U.S. Legislature.
The fifth and final study will be the responsibility of the GAO, and concentrates on the role of investment banks in misleading financial information. Specifically, it is “to determine whether investment banks helped companies to manipulate their earnings and to obfuscate their true financial condition.” The interaction of investment banks with both Enron and Global Crossing is to be investigated. This report should be released to the U.S. Legislature.

**Title VIII: Corporate and Criminal Fraud Accountability**

This section sets forth several new statutes related to punishment and penalties for violations. For example, the section enacts a twenty-year maximum imprisonment for those that alter, falsify, or destroy records that are under federal investigation or bankruptcy procedures. Additionally, the section requires external auditors to maintain workpapers and other materials relative to their audits for 5 years. The auditor can be imprisoned for ten years if they do not maintain proper documentation. Individuals can be imprisoned for up to twenty-five years for successful or failed attempts to defraud someone under securities law.

Other parts of this section are relative to changes in court procedures. For instance, the law increases the period to file a civil lawsuit related to a violation of securities law. The period was increased to two years following the discovery of the violation and five years following the occurrence itself. In addition, the section prohibits debts relative to security law violations from being discharged under bankruptcy.

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21 Williams and Carcello 4-6.
Another significant part of this section is the protection of whistleblowers. This section sets a maximum imprisonment time of ten years for individuals that intentionally retaliate against a whistleblower.

**Title IX: White-Collar Crime Penalty Enhancements**

Crime penalties are also dramatically increased under this section. First, the section changes the maximum prison time from five to twenty years for wire and mail fraud. It also enacts punishment upon CEOs and/or CFOs for certifying financial reports that do not meet Sarbanes-Oxley. Punishment is not to exceed $1 million and 10 years of incarceration unless the executive was knowledgeable that the financial statement being certified was misrepresentative, in which case the punishment is not to exceed $5 million and 20 years of imprisonment.

**Title X: Corporate Tax Returns**

This section simply suggests that the corporate tax return be signed by the CEO.

**Title XI: Corporate Fraud and Accountability**

This section deals with guidelines to be followed when a company is under examination for violations. It allows the SEC to prohibit public companies from making unusual payments to executives while the company is being investigated. Any extraordinary payments would instead be put into an escrow account for forty-five days. This period can be extended by forty-five additional days. If charged, the payments will remain in the escrow account until resolution of the case.
Also included in this section are specific punishments or suspensions that can be made under certain circumstances. For instance, a person that tampers with evidence or impedes an investigation can be subject to a maximum of twenty years in prison as well as fines. Penalties for violations of the Securities and Exchange Act of 1934 are increased. In addition, the section makes it less complicated for an individual to be barred or suspended by the SEC from an executive position within a public company.22

IV. The Effects

Undoubtedly, the Sarbanes-Oxley Act has had profound effects on many groups. These include public accounting firms, public companies, executive officers, employees, investors, stock markets, governmental agencies, other nations, etc. A separate analysis should be performed on each of these groups in order to better understand the implications that have resulted from passage of Sarbanes-Oxley.

Public Accounting Firms

Due to the law’s intent to improve the competency and independence of the accounting industry, it is logical that public accounting firms are one of the groups that has been most significantly impacted by its provisions.

First, public accounting firms have been mandated to enhance their retention of workpapers and all documentation relative to the audit. This includes voicemails, emails, and other forms of electronic documentation. Firms that do not have these record management capabilities must work to develop them and to create internal controls that

22 Williams and Carcello 6-7.
ensure the effectiveness of the system. They must also work to emphasize the retention of documentation in employee training, so that required documentation is not accidentally disposed of. With these safeguards in place, firms will be protected from unintentionally destroying parts of the audit trail.23

Second, the professional standards of public accounting firms will now be subject to monitoring. The creation of the PCAOB ensures that firms will be inspected. Their actions will now be closely observed. This requires firms to pursue additional training, technicality, and preciseness in their work to meet the newly set standards. In addition, “firms registering with the board must provide detailed information regarding clients, fees, client disagreements, and pending disciplinary proceedings. Firms should ensure that their systems are capable of generating that information.”24

Next, accounting firms may be required to alter their internal structures. One of the biggest factors that attribute to this necessity is the requirement that partners rotate from client to client. The structure must be designed to suit this rotation, as well as to allow partners to easily understand the operations of newly inherited clients.

Additionally, the external auditor is no longer allowed to perform various non-audit services for their client. The most significant of these disallowed services is consulting, which accounts for a large percentage of the income of public accounting firms.25

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24 Hardison 30.
25 Davis and Murray 1.
Finally, there are tremendous costs associated with implementation of Sarbanes-Oxley. As a result, firms that have few public clients may choose to pursue only private clients in order to avoid these costs.\textsuperscript{26}

**Public Companies**

Sarbanes-Oxley focuses on increasing the transparency of public companies, holding them more accountable for accurately releasing information to the public. Therefore, these public companies are subject to significant new requirements that will affect their operations and management. According to a study conducted by PricewaterhouseCoopers, approximately 85\% of large U.S. multinational companies have experienced changes in compliance practices and controls since the enactment of Sarbanes-Oxley.\textsuperscript{27}

Like accounting firms, public companies should work to improve their retention of documentation. Companies may be called upon to provide proof of their financial statements or to provide evidence in an investigation about a public accounting firm. Therefore, companies should work to build document retention systems as well, so that they will not be accused of tampering or destroying evidence.\textsuperscript{28}

Corporations are affected by the new requirements related to audit committees. For instance, the companies must now work to find independent members to serve on their audit committees. They must also attempt to have at least one financial expert on their committee. Since companies cannot pay audit committee members for serving on

\textsuperscript{26} Hardison 30.
\textsuperscript{28} Gable 19.
the committee, these are difficult tasks. It is hard to find qualified individuals willing to serve on these committees without compensation. Especially since the views and decisions of these audit committees can be called into question if there are inaccuracies in published financial statements or if a corporation fails. Because of this enhanced accountability, it is not uncommon to find audit committees sitting in on board meetings. Additionally, under Sarbanes-Oxley, some of the power of companies over their audit committee is removed. This is because the law delegates authority to the audit committee. Therefore, the company must trust and remove itself from the decisions made by the audit committee. 29

Companies are also affected by the high costs associated with compliance to Sarbanes-Oxley. These costs arise from new requirements such as the development of independent audit committees, the requirement of more detailed financial disclosures, the responsibility of executives to certify financial reports and internal controls, the removal of the ability to maintain the same public accounting firm for both audits and consulting, and the inability to hire auditors as executives. Of the various situations that result from these costs, one possibility is that small and mid-size companies may choose to go private to avoid these expenditures. 30

Executive Officers

Executive officers of public companies are also affected by passage of the Sarbanes-Oxley Act. The law stipulates many new obligations and responsibilities for these executives, holding them personally liable for non-compliance.

29 Del Franco 3.
Although lying should never be acceptable in business practices, Sarbanes-Oxley puts this moral into law. It does so by making it illegal for an executive or someone representing him to intentionally mislead, coerce, or influence the external auditor. This could play a big effect on executives that attempt to hide or misrepresent information that is requested by the audit firm.31

Executives are required to certify financial statements under the new law, which puts them at increased risk. This risk comes in the way of a hefty fine and period of imprisonment for those that certify inappropriate statements.32 A study by PricewaterhouseCoopers estimates that approximately 18.6 executives will be required to sub-certify financial documents at each company, excluding the CEO and CFO. This means numerous executives are being put at risk.33 Additionally, if a company is forced to restate financial statements because of noncompliance, the CEO and CFO must give up any bonuses and incentives they have received during the past year. Because of these threats, executives must be more diligent in their supervisory roles.34

One other important result of Sarbanes-Oxley is that executives are no longer allowed to take loans from their companies. This affects some of the financing methods that executives have access to, as well as eliminating one of the methods in which officers have used to delay financial disclosures.

32 Davis and Murray 1.
33 "Sarbanes-Oxley Act Requires Changes in Corporate Control, Compliance, According to PricewaterhouseCoopers Survey of Senior Executives."
**Employees**

Protection for whistleblowers is established for employees under Sarbanes-Oxley. Therefore, employees are encouraged to speak out against inappropriate business practices that may result in an inaccurate financial statement or in a decline of the internal control environment. In fact, it is required for lawyers employed by the company to inform the CEO of any possible violation of security law under the whistleblower provision. If the CEO does not react accordingly, the issue is to then be directed towards the audit committee for resolution.\(^{35}\) This requirement is interesting because it could cause attorneys to breach their professional obligation of maintaining the confidentiality of information about their client.\(^{36}\)

Securities analysts and brokers are also affected by Sarbanes-Oxley. These employees are required to disclose any areas of bias that may affect their professional judgment. In addition, analysts are alleviated from some of the pressures imposed by investment bankers. Therefore, the resulting securities research reports should be more independent and objective.\(^{37}\)

**Investors**

Sarbanes-Oxley is intended to restore trust in corporate accounting and U.S. business. However, according to a study conducted by PricewaterhouseCoopers, only 31% of executives believe the law will restore confidence in the economy and capital market. According to Frank Brown of PricewaterhouseCoopers, "But, rules, standards

\(^{35}\) Davis and Murray 1.
\(^{37}\) Davis and Murray 1.
and frameworks can only do so much. It will take demonstrated commitment to transparency, accountability and integrity to regain public trust.”\(^{38}\) Sarbanes-Oxley is a first step towards regaining this confidence.

Another important effect for investors is that the period of time in which they can bring securities fraud claims is increased. This could improve the investors’ confidence in the market because it will give them increased potential for being compensated for losses due to fraud.\(^{39}\)

**Stock Markets**

Stock markets such as the New York Stock Exchange (NYSE) and Nasdaq must change their rules for issuers, with specific goals and requirements to be met in accordance with Sarbanes-Oxley. If issuers do not meet these new standards, they will not be allowed to be listed with the market.\(^{40}\)

**Governmental Agencies**

The governmental agency that is most affected by Sarbanes-Oxley is the SEC. “To handle the law’s new enforcement duties, the Sarbanes-Oxley Act authorizes a 77 percent increase in SEC funding to $776 million.”\(^{41}\) This money will be used to increase staff. Additionally, the law places the responsibility for conducting investigations and initiating law proceedings upon the PCAOB. Thus, the SEC will be able to free itself

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\(^{38}\) “Sarbanes-Oxley Act Requires Changes in Corporate Control, Compliance, According to PricewaterhouseCoopers Survey of Senior Executives.”

\(^{39}\) Davis and Murray 1.


from some of these duties and focus their efforts elsewhere, taking on cases as they are requested by the PCAOB.\textsuperscript{42}

**Other Nations**

One must realize that the effects of U.S. legislation are not limited to the U.S. alone. Instead, virtually every other nation is affected by U.S. law. The same is true of Sarbanes-Oxley.

In October 2002, Canada introduced its own version of Sarbanes-Oxley as Bill 198. Although the legislation sets forth far fewer requirements and will give the Ontario Securities Commission (OSC) the power to set these rules, it demonstrates the effect that U.S. policy can have on other nations.\textsuperscript{43}

An example of this is the treatment of foreign auditors and companies. Currently, all SEC registrants and their auditors are subject to Sarbanes-Oxley. This is somewhat problematic because these groups are vulnerable to oversight by multiple jurisdictions. In fact, laws within a particular nation may contradict with those put in place with Sarbanes-Oxley. Auditors and companies would have to determine which rules to follow. Therefore, it is not surprising that there are various groups working to either alter or abolish the application of Sarbanes-Oxley to foreign auditors and companies.\textsuperscript{44}

Until a decision on the application of Sarbanes-Oxley is reached, foreign companies are left in a state of uncertainty. They are unsure of what changes in business practices will result from Sarbanes-Oxley, as well as the costs associated with these changes. Although it is possible that these companies will remove some of their business

\textsuperscript{42} Hardison 30.
\textsuperscript{43} Melnitzer 33.
\textsuperscript{44} Hardison 30.
from the U.S., it is unlikely: “it’s a pain in the neck, but given the size of the economy, you can’t afford not to do business there, just because it’s a regulatory hassle.”45

However, it is possible that some companies will move their stock issuance to the London Stock Exchange. Therefore, it is even more important that the U.S. resolve the issue of foreign company compliance to avoid losing this valuable business.46

V. Recent Developments

Since the adoption of Sarbanes-Oxley, there have been several related recent developments that should be discussed.

The first development involves a bill that is under debate in legislature. This bill, Bill H.R. 658, would remove some of the SEC’s requirements relative to job posting, job publication, and job interviews for new employees, specifically economists, accountants, and compliance examiners. Currently, the requirements can create a delay of at least six months in the hiring process. Since the SEC needs to hire over 800 people to fulfill these positions as a result of Sarbanes-Oxley, the bill would increase the speed at which the SEC can improve public company oversight.47

Another important development is the resignation of Harvey Pitt from his office as SEC Chairman. He was replaced by William Donaldson, who had previously been in charge of the NYSE. Pitt’s resignation as Chair was likely the result of several
controversies over his leadership. William Donaldson's effectiveness as Chair will be crucial in the success of Sarbanes-Oxley.48

In January 2003, the SEC submitted its interpretation of Sarbanes-Oxley, setting the rules that are expected to be required by the PCAOB. Of the introduced rules, several should be emphasized because of their importance. First, public accounting firms will be allowed to perform both audit and tax services for the same client. Second, the rotation requirements for audit partners were changed. Now, only the two head partners will be required to rotate every five years; other partners that have played a significant role with the client will rotate every seven years. Third, CPA’s will be allowed to begin working immediately for a former audit client provided that the individual is not responsible for overseeing the preparation of financial disclosures. Finally, the new SEC rules require for all documentation relative to the audit be kept for a minimum of seven years. This is important because it clarifies Sarbanes-Oxley, which required retention for five years in one section while requiring seven years in another. Additionally, it should be noted that twenty states intend to announce laws interpreting Sarbanes-Oxley during 2003.49

The first arrest under Sarbanes-Oxley occurred in March 2003. The accused individual was Weston Smith, CFO of HealthSouth Corporation. Smith plead guilty to filing a false certification with the SEC and securities fraud charges. This is a strong indication that the rules of Sarbanes-Oxley will be enforced.50

VI. The Future Impact of Sarbanes-Oxley

What is the likely outcome of Sarbanes-Oxley? Will the law help to improve the economy and serve its purpose of improving the transparency of public companies? Will the act reassure investors’ confidence in the accounting industry and in the stock market? The answers to these questions remain to be seen. However, reasonable predictions about the success of Sarbanes-Oxley can be made.

First, two key decisions will help determine the future of Sarbanes-Oxley. First, a decision must be reached on the application of the law to foreign companies and firms. Second, the debate on whether public companies should be required to rotate audit firms needs to be resolved. These decisions will indicate both the breadth of society being affected as well as the amount of independence that is sought.

It is probable that the relationship between the SEC, public accounting firms, and the PCAOB will be stressful in the initial period of enactment. However, this relationship should improve as accounting firms begin to recognize the authority of the PCAOB and become accustomed to their oversight. Additionally, it is unlikely that the SEC will “cast aspersions on a profession that it specifically oversees.”

The accounting profession will work to regain control of its own industry. Although the profession will be under the oversight of the PCAOB, this is still an achievable goal. To do this, the industry must show willingness to regulate themselves in areas of independence. It should impose stricter restrictions upon itself than those set by Sarbanes-Oxley.

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51 Hardison 30.
standards that are set by the accounting profession as their own: “on a long-term basis, the board may continue to look to external bodies such as the AICPA’s Auditing Standards Board as a primary source--particularly if the new board and the SEC conclude that such organizations have taken the initiative, or responded to recommendations, in developing enhanced standards in areas such as fraud detection and internal controls.”

Overall, the success of Sarbanes-Oxley depends upon the PCAOB. This agency is responsible for developing new rule and enforcing them. If the public has confidence that the board is adequately performing its duties, the public will be assured that public accounting firms are acting independently and public companies are being honest in their disclosures. Additionally the arrests of individuals for violations of Sarbanes-Oxley will both curb the behavior of individuals subject to similar risk and ensure investors that their interests are being protected.

In the words of Paul Sarbanes, one of the sponsors of the Sarbanes-Oxley Act, “you...need to try to get a system in place that will screen out, monitor, or prevent the bad apples from happening in the first instance.” The law is intended to discourage individuals from portraying a false image to the public. While this intention may take a while to achieve, it is certainly obtainable using what is set forth in Sarbanes-Oxley.

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53 Hardison 30.
VII. Works Cited


Del Franco, Mark. “Complying with the Sarbanes-Oxley Act.” Catalog Age (Mar. 2003), p. 3.


