Sarbanes-Oxley and Its Impact on Management

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INTRODUCTION

Enron. WorldCom. Global Crossing. Tyco. Qwest. These are but a few of the more than two dozen companies to share the dubious distinction of significant accounting scandals brought to light in 2002.[1] This time period was already a difficult era for the U.S. economy because the 9/11 terrorist attacks had taken their awful toll and the dot.com bubble was in the process of bursting. Stock exchanges around the world left millions of investors awash in red ink. These corporate scandals, to varying degrees, exacerbated the market's plunge. As the financial performance of these tainted firms began to decline, upper management imposed draconian measures on operations and employees in an apparent attempt to signal to investors, employees, and the public that action was being taken to turn around performance. Meanwhile, those same top executives enjoyed luxurious lifestyles, with many even receiving lavish bonuses and stock grants. When the full picture emerged, employees, investors, and consumers understandably felt betrayed. Honest competitors began to understand why performance in their industries had seemed so lopsided in favor of these scandalous companies. In addition, investors with huge losses were predictably outraged. Investors losing money through "irrational exuberance"[2] is an unfortunate risk of investing, but to lose money through accounting chicanery is just plain wrong. Scandals in the business world, unfortunately, are not unique to our generation, but the stunning number and magnitude of these scandals sent shock waves through the business community and reverberated in legislative chambers.

For perspective, here is a summary of corporate fraud cases brought by prosecutors and regulators since July 2002:[3]

Criminal Convictions and Plea Deals	
Chief Executive Officers	82
Corporate Presidents	85
Corporate Vice Presidents	102
Chief Financial Officers	36
Chief Operating Officers	14

Whenever business leaders demonstrate that greed trumps self-policing and ethical behavior, government has a history of stepping in to introduce legislation and demand compliance. For example, price fixing, bid rigging, and other monopoly-producing behavior led to the Sherman Antitrust Act of 1890 and the Clayton Antitrust Act of 1914. Securities scandals in the early 1930s led to the Securities Act of 1934, establishing the U.S. Securities and Exchange Commission (SEC). Exploitation of labor led to the passage of the Wagner Act of 1935. Each of these Acts represents a watershed piece of legislation in its own right that dramatically and forever changed the landscape of business. The Sarbanes-Oxley Act of 2002 seems likely to join these landmark acts as yet another turning point in American business.

Senator Paul Sarbanes (D-Md.) and Representative Michael G. Oxley (R-Oh.) were the politicians who introduced a bill designed to make financial statements more transparent and to curb unethical behavior by top executives, in part, by requiring a number of new accounting reports to be submitted in a standardized format. The resulting Sarbanes-Oxley Act was approved in the U.S. House of Representatives by a vote of 423-3 and in the U.S. Senate by a 97-0 margin. It was signed into law on July 24, 2002, by President George W. Bush.[4]

UNETHICAL BEHAVIOR PRECIPITATES SARBANES-OXLEY

So, specifically, what were some of the details of the scandals that motivated introduction and passage of the Sarbanes-Oxley Act of 2002? The following sections highlight the more infamous of these companies.

Enron

Of all the accounting scandals that occurred in 2002, the Enron debacle is likely the most notorious. Enron became the poster-child company that demonstrated the need for legislation. The Enron scandal was significant in that it was the seventh largest firm in the United States and the largest at that time to ever have declared bankruptcy in the history of the United States. Complicit in Enron's demise was Arthur Andersen, a century-old accounting firm that had enjoyed a sterling reputation until news of the scandal broke. Arthur Andersen was convicted of destroying evidence. Although the conviction was later overturned on May 31, 2005, irreversible damage had been done. The firm ceased performing audits as long-standing clients walked away to avoid being tainted.[5]

Among the accounting sleight-of-hand tricks employed by Enron was the creation of offshore entities that concealed currency movement, hid financial losses, and found loopholes to avoid paying taxes. These entities made Enron appear much more profitable than it actually was. Certain employees of Arthur Andersen, Enron's auditing firm, apparently were tempted to look the other way over these improper entries and other significant accounting malpractices. Arthur Andersen representatives endorsed Enron by declaring it financially healthy. Eventually, financial performance began to slide, the accounting house-of-cards rapidly imploded, and Enron abruptly declared bankruptcy. Many Enron employees were heavily invested in the company's employee stock ownership plan at the time but were prohibited from selling their own stock, a condition known as "pension blackout." Meanwhile, top management surreptitiously dumped most of their own Enron stock as quickly as they could. Enron stock plunged precipitously once the SEC began investing accounting irregularities, and reports hit the news of Arthur Andersen employees feverishly shredding documents. Many employees lost their entire retirement savings along with their jobs. Consumers had to scramble to find new suppliers. Some competitors said it all finally made sense—they now understood how Enron had been able to report unbelievable financial numbers.

In May 2006, Kenneth Lay, former Chairman and CEO of Enron Corporation, was convicted on six counts of conspiracy and fraud and faced a maximum of a 5–10 year prison sentence on each count. Jeffrey Skilling, former CEO of Enron Corporation, convicted on 19 of 28 counts of conspiracy, fraud, and insider trading, is looking at a maximum of 5–10 years on each count.[6]

MCI WorldCom

MCI WorldCom, another major company, was also accused of using fraudulent accounting methods to mask poor financial performance and misleading investors about the terms of their financial growth. In false accounting entries, the company capitalized current expenses and inflated revenues. Interestingly, Arthur Andersen was also the auditing firm for MCI WorldCom. When KPMG took over the auditing task, $3.8 billion in fraud was uncovered. After an SEC investigation, it was determined that the company's total assets had been inflated by some $11 billion. Bernard Ebbers, the co-founder and former CEO of WorldCom, was convicted of fraud and conspiracy in 2005 and sentenced to 25 years in federal prison.

Global Crossing

This firm declared bankruptcy in January 2002, making it the fourth largest insolvency in U.S. history. The company chairman, Gary Winnick, along with former CEOs Leo Hindrey and Thomas Casey, were all accused of taking personal fortunes out of the company, subsequently costing shareholders billions of dollars.[7] Similar to the other companies profiled, accounting information was manipulated to make the company appear financially healthier than it actually was. Winnick, in particular, sold stock at prices that were artificially inflated for a total of more than $700 million. He was criticized for spending lavishly, including the purchase of a $60 million Bel Air Estate. Global Crossing settled with the SEC in 2005, admitting to accounting irregularities.

Tyco

Tyco's former chairman and CEO Dennis Kozlowski and former chief financial officer Mark H. Swartz were accused of stealing $600 million from the company. During their trial, they argued that the board of directors authorized this amount as compensation. In June 2005, a jury convicted Kozlowski and Swartz on 22 of 23 counts each, including grand larceny, conspiracy, and securities fraud in connection with looting millions of dollars from Tyco. They were each acquitted of one charge of falsifying documents. In August 2005, Kozlowski and Swartz were sentenced to prison terms and ordered to pay $240 million in fines and restitution. With good behavior and other factors, the earliest the two men could be eligible for parole is August 2012. Incredibly, Kozlowski is now demanding his insurance company pay for court defense costs of $17.8 million![8]

Qwest

Qwest was involved in accounting scandals and fined $250 million by the SEC. One of the accusations centered on a series of deals with Enron's broadband division. It was alleged that this activity may have helped Enron hide their losses.[9]

MAJOR PROVISIONS/REQUIREMENTS OF SARBANES-OXLEY

The Sarbanes-Oxley Act of 2002 (Pubic Law No. 107-204, 116 Stat. 745), is also known as the Public Company Accounting Reform and Investor Protection Act of 2002. More commonly, it is referred to as SarbOx or SOX.[10]

The Act establishes new or enhanced standards for all U.S. public company boards, management, and public accounting firms. (In the United States, a company is called "public" if it sells stock to the general public and "private" if it does not.) It contains 11 sections addressing issues as diverse as corporate board responsibilities, enhanced financial disclosure, auditor independence, and criminal penalties. SOX requires the SEC to implement rulings on requirements to comply with the new law.[11]

The major provisions of SOX include:[12]

- Certification of financial reports by chief executive officers (CEOs) and chief financial officers (CFOs)

- Bans on personal loans to any Executive Officer and Director
- Accelerated reporting of stock trades by insiders
- Prohibition on insider trades during pension fund blackout periods
- Public reporting of CEO and CFO compensation and profits
- Auditor independence, including outright bans on certain types of work and precertification by the company's Audit Committee of all nonaudit work
- Criminal and civil penalties for violations of securities law
- Significantly longer jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements
- Prohibition on audit firms providing extra "value-added" services to their clients including actuarial services, legal, and additional services unrelated to their audit work
- A requirement that publicly traded companies furnish independent annual audit reports on the existence and condition of internal controls as they relate to financial reporting

Auditing standards of SOX require (1) disclosure of how various significant transactions are initiated, authorized, processed, and reported, (2) details about the flow of transactions in order to identify where error or fraud could occur, and (3) controls to prevent and detect fraud and safeguard assets.[13]

SOX dictates that upper management must be cognizant of all financial activities in the organization and that an internal control report must be generated as part of each annual Exchange Act report. The framework for such reporting presents significant challenges for many businesses, especially documentation of control procedures related to information technology.[14]

IMPACT ON BUSINESS AND MANAGEMENT

Without a doubt, SOX adds layers of complexity to doing business as a publicly traded firm. Complying with all of the provisions requires top management to be aware of all financial dealings of the organization and to be involved actively with establishing and overseeing monitoring systems. These activities usually require the specialized expertise of consultants and auditors in establishing and maintaining systems. Many areas of business and our economy are affected by SOX, often in unexpected ways.

SOX Stimulates Best Practices

There is a strong argument that SOX equalizes the playing field by making all firms adopt the same accounting rules and documentation methods. The rules are more stringent than the vast majority of firms would have adopted on their own. In certain ways, these rules can lead to a "best practices" approach in industry, resulting in overall better quality and productivity due to attention to detail. In a recent survey of CEOs managing fast-growing privately held businesses who have adopted at least some SOX standards, 27 percent said they have adopted SOX "best practices." The same survey revealed that 37 percent believed SOX has done a good to fair job of improving governance and transparency for public companies.[15]

Cost of Sarbanes-Oxley Compliance

The total cost to U.S. industry for complying with SOX is staggering. Experts disagree about the actual cost. Some project the cost to be about $6 billion for 2006,[16] while others say the cost for 2005 was upwards of $25 billion.[17] For firms with revenue greater than $5 billion, the average cost of compliance is $4.36 million.[18] Of course, noncompliance costs can be even more painful, including stiff penalties and jail sentences. For example, maximum white-collar crimes tied to wire-fraud in violation of SOX have been increased from 5 to 10 years[19] and up to 20 years for destroying, concealing, or falsifying records.

The cost of compliance has become especially disproportionate and burdensome for many small firms.[20] For instance, auditing and related expenses at Fairchild Corp., a firm that sells aircraft parts and motorcycle gear, have exploded to $2.9 million this year, up from $800,000 last year. So far, attempts to modify SOX to exclude small firms from certain compliance issues have been resisted. A Government Accounting Office[21] publication maintains that it is inconclusive whether there is long-term disproportionate impact on smaller companies, and there is concern that offering SOX relief for smaller firms would create a "second-class" tier of businesses.

Interestingly, some small, private firms have elected to adopt all reporting requirements articulated by SOX, even though they are under no mandate to do so. The stated reason for voluntarily adopting SOX is that compliance offers flexibility that can help those private firms in the future if they decide to go public or acquire a public company.[22] Another motivation to become SOX compliant is that if an owner of a firm wants to sell and the buyer is a public firm, it makes the firm up for sale more attractive. Thus, the asking price for a mid-size SOX-compliant firm would likely be higher than that of a noncompliant firm.[23] An even more compelling reason to get in line with SOX compliance is that 30 state legislatures are considering SOX-like legislation for private companies in their states.[24]

Turnover of Upper Managers

SOX has been blamed for increased pressure on CEOs, resulting in significantly higher turnover. For example, in January 2006, there were 291 CEO changes and 19 CMO (Chief Marketing Officer) changes at publicly traded North American companies. In contrast, there were only 172 CEO and 5 CMO changes in January 2005. A partial explanation for the turnover may be found in the types of skills needed. A number of firms are seeking CMOs with more analytical skills, a strong track record in strategy, and the ability to articulate the marketing vision to top executives.[25] The rate of turnover may also be a situation of perceived declining cost/benefit ratio. Top executives may find that the liability exposure and increased worries related to compliance are not commensurate with their current level of compensation.

Required Information Technology Skills Are Changing

Operationally, problems have occurred in the technology departments of businesses. Chief information officers (CIOs) are experiencing difficulty finding information technology (IT) professionals with business skills. These skills are deemed necessary to help organizations comply with SOX.[26] IT departments are frequently enlisted to help develop control systems, and it helps if these individuals understand the legal and strategic objectives of the control systems.

International Issues

SOX also impacts the international business arena. First, non-U.S. firms auditing U.S. companies must register with the SEC, raising the standards for these firms. If these firms must become SOX compliant, the attractiveness of doing business in the United States may be diminished.

There is also a question about international competitiveness of U.S. firms if substantial resources are spent on compliance with SOX while international firms based in other countries do not have the same restrictions. Some are arguing for global banking reform. Foreign companies have expressed distaste for the requirements set forth by SOX because it would present an obstacle to foreign companies listing in the United States.[27] Additionally, SOX has affected the way foreign companies raise capital. In the year 2000, nine out of every ten dollars raised by foreign companies through new stock offerings was done in New York City. Today, nine out of every ten dollars is raised in London or Luxembourg.[28] It appears that foreign companies may find SOX compliance too onerous; thus, they are pursuing the path of least resistance to acquire investment capital. Loss of investing opportunities for U.S. investors is a hidden cost that may be attributed to SOX.

Effect on Mergers

Mergers can be appealing because of economies of scale, diversified risk, and the enhanced ability to raise capital. But SOX complicates consolidation. An acquiring firm must vouch for the controls of the company it acquires. It is likely that SOX could have a dampening effect on mergers unless some provisions are made to mitigate the liability facing an acquiring firm.[29]

Impact on Accounting and Compliance Cottage Industries

Surprisingly, some larger firms report that actual payments to auditing firms have declined.[30] This is because firms are paying only for auditing, in accordance with SOX rules. Auditing firms must maintain independence, meaning they cannot provide a "package" of services including legal advice, consulting, or other activities. If public companies want consulting, process evaluation, and the like, they must contract with different firms to provide these services. Ironically, this provision has brought a sense of relief to a number of auditing firms because it has allowed them to return to, and focus on, their core competence of auditing. Others argue that SOX has also proven to be a boon to the accounting industry since auditing firms must also audit financial controls in addition to the books.[31]

While payments to firms conducting audits have declined since they are not offering packaged services, there has been a huge opportunity for firms to capitalize on helping other firms become SOX compliant. Smaller companies that are more adaptive and can mobilize quickly have benefited most. For example, Sanjay Anand, who previously ran his own financial and technology consulting business, has created the Sarbanes-Oxley Institute of Clifton, New Jersey, that offers Sarbanes-Oxley certification. Diane Wolff of Canton, Massachusetts, introduced a SOX-compliance software package for small and medium-size businesses, while Shai Stern founded Vintage Filings in New York to help public firms format and file financial statements quickly and economically.[32]

Managers' Perceptions of Sarbanes-Oxley

Managers give SOX mixed reviews. While there is some debate over the specific requirements of SOX, as it is currently written, John Thain, CEO of the New York Stock Exchange, is among those who argue the necessity of SOX. Mr. Thain contends that business leaders did indeed spin out of control and needed reigning in. Conversely, Mallory Factor, chairman of the Free Enterprise Fund, believes that SOX is an expensive overreaction. He maintains that there is no problem with transparency, but instead a problem with professional bureaucrats that want a larger bureaucracy—one that is expensive and inhibits innovation.[33]

Some sound the alarm that SOX is really an attempt to legislate ethics. This is problematic "if ethics becomes just a matter of following rules and of understanding systems," because "there is a danger that the intuitive bases of ethical conduct will become clouded and ignored."[34]

Many CEOs of smaller firms dislike the imposition of SOX and claim the bad behavior of a few individuals at very large corporations spoils business for the vast majority of honest business people. These business owners say SOX has not changed underlying human behavior, but instead has simply increased costs. "If you want to be a bad guy and cheat, you can still find a way to do it," laments Dan Piro, President and CEO of Aspen Healthcare Metrics, a Denver-based consulting firm. "We are a relatively small firm, but we have several people working full-time just to handle Sarbanes-Oxley compliance. It is essentially a tax on all businesses because of a few that have spoiled it for the rest. But it hasn't made the management of companies any more ethical."[35]

GOING PRIVATE—A WAY TO CIRCUMVENT SOX?

One might consider the SOX focus on publicly traded organizations and surmise that a way around the stringent compliance requirements would be to take a firm private. Indeed, some leveraged buyouts currently underway have as one of their objectives *to reduce financial reporting requirements.* Under SEC rules, a company with fewer than 300 shareholders may voluntarily terminate registration of its securities. So, why don't all firms consider going private? Well, in addition to the reduced ability to obtain equity capital, some believe there is increasingly little advantage to going private. However, others, such as Charles Koch, CEO of Koch Industries, believe that SOX will cause a re-emergence of private corporate structures.[36] Koch claims that the success of his company is based on the fact that it has remained private, thus limiting compliance costs.

One Indiana holding company, Home Financial Bancorp, elected to de-register its stock in order to "save reporting time and resources required to achieve the level of transparency required by SOX."[37] It was determined that it was more advantageous to continue as a private company than a public one, allowing management to focus more on its core business. Fairchild Corp., the firm referenced earlier, has also followed this strategy.[38]

CONCLUSION

While not all are happy with the outcomes of SOX, there continue to be compelling reasons for the passage of SOX in order to protect investors, employees, suppliers, and customers. On the downside, SOX has increased barriers for firms wanting to go public and increased costs for public businesses. This has taken a toll on upper management, causing higher levels of turnover. Also, there may be some appeal for wanting to take a public company private to avoid costs associated with compliance. Meanwhile, some enterprising individuals have found opportunity in helping firms comply with SOX rules. There are a number of unresolved issues concerning the disproportionate impact on small business and the potential impact SOX will have on firms operating internationally.

For those who must be SOX compliant, or voluntarily choose to be so, here are some pitfalls to avoid:[39]

1. Do not adopt a project mindset relative to implementation—there is no discrete ending point for SOX.
2. Budget adequately to deal with compliance.

3. Clearly define roles within the organization relative to reporting.
4. Avoid an improvisational approach to reporting.
5. Do not underestimate the impact of technology.
6. Do not ignore risks of failure to comply with any part of SOX.

QUESTIONS FOR DISCUSSION AND REVIEW

1. Can ethical behavior be legislated? Explain. What are the risks of attempting to legislate morality?
2. Do you think the convictions of Kenneth Lay and Jeffrey Skilling are deterrent enough to prevent future unethical behavior, or are additional laws such as Sarbanes-Oxley truly needed to ensure ethical behavior? Explain.
3. Will the Sarbanes-Oxley Act of 2002 stand the test of time? What are the various arguments for and against continuing enforcement of this legislation? Should small firms be given special consideration, or should they be required to comply with all requirements of the Act as large firms are?
4. Do you think that in the long run the Sarbanes-Oxley Act of 2002 will make U.S. firms more or less internationally competitive? Explain.
5. Do you believe it is more costly for society to suffer the costs associated with the scandals or to incur the expenses tied to Sarbanes-Oxley compliance since these costs are ultimately passed on to consumers? Explain. What do you think the visible and hidden costs are for each approach?
6. One of the intended outcomes of Sarbanes-Oxley is to restore public confidence in U.S. business. Do you think SOX has been effective in achieving this objective? Explain.
7. In your opinion, is it better to remain a publicly traded firm in spite of the costs of compliance with Sarbanes-Oxley, or should a publicly traded firm go private? Explain. What are the advantages and disadvantages to each approach?

NOTES

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