

Sarbanes – Oxley Act Of 2002: Is It Worth The Price?

RamMohan R. Yallapragada, (E-mail: ryallapragada@gmail.com), Fayetteville State University

ABSTRACT

Sarbanes – Oxley Act (SOX) was hastily passed in July, 2002. The Act requires public companies to establish internal control systems sound enough to prevent fraud. Senior officers have to sign-off on the financial statements. Section 404, dealing with internal controls, resulted in misery to US business firms. Auditor fees have doubled. Some small-cap companies and foreign corporations are delisting from US stock exchanges. The provisions of the Act, its impact on US firms, and some of the complaints against the Act are presented in this paper.

BACKGROUND

Accounting scandals of biblical proportions involving Enron, Global Crossing, Arthur Anderson etc., hit the United States (US) in late 2001 and early 2002, causing lot of confusion and distrust in the US financial markets. On June 18, 2002, the Senate Banking Committee passed a bill (#2673), a draconian piece of legislation crafted by senator Paul Sarbanes (D-MD).

The bill was expected to die quietly in the House. But, on June 25, 2002, WorldCom dropped a bomb shell on the financial world by announcing that their previous five quarter earnings were overstated by over \$3.8 billion due to improper accounting procedures. “Suddenly, the Sarbanes legislation took on a life of its own,” (Whalen, 2003). Members of both parties, facing the mid-term elections and a very angry electorate, clamored for stringent legislation. On July 15, 2002, the Senate passed Sarbanes’ bill by a vote of 97 -0. House Representative Michael Oxley (R-OH), made very few changes to the bill and sent it to the House floor where it was passed almost unanimously (en.wikipedia.org, 2005). On July 24, 2002, the conference committee’s version of the bill was passed in the Senate with a 99-0 vote and in the House with a 423-3 vote. On July 30, 2002, President Bush signed the Sarbanes – Oxley Act of 2002 into law, describing it as, “the most far-reaching reforms of American business since the time of Franklin Delano Roosevelt,” (Whalen, 2003).

PROVISIONS OF SARBANES – OXLEY ACT

Sarbanes – Oxley Act of 2002 (Sarbox or SOX), also known as Public Company Accounting Reform and Investor Protection Act Of 2002, was intended to provide a proper accounting framework and rules for public companies. The Act’s stated objective is, “to protect investors by improving the accuracy and reliability of corporate financial statements and disclosures made pursuant to the securities laws,” (Berger, 2005). SOX seeks to prevent and punish corporate corruption.

Some of the provisions of the law are presented below:

Title I: Public Company Accounting Oversight Board (PCAOB)

- SOX created a Public Company Accounting Oversight Board (known as the board). The board’s functions are to register, oversee, investigate and discipline all Public Accounting Firms (PAF) that audit public companies.

Title III: Corporate Responsibility – Public Company Audit Committees

- Sarbox requires creation of an audit committee comprising of independent directors of the issuer company.
- The issuer's audit PAF is put under the control of the audit committee.
- The CEO and the CFO of the issuer company shall sign a statement to accompany the audit report certifying that:
 - The report does not contain untrue statements or material omissions
 - The financial statements fairly present the financial condition and the results of operations.
 - Such officers are responsible for internal controls of the issuer and its subsidiaries.
 - The internal controls are reviewed for their effectiveness within 90 days prior to the report
 - Any significant changes to the internal control are reported.
- Violators of SEC rules will be barred from serving as directors of any issuer.
- Attorneys appearing before the SEC are to report any violations of securities laws by a public company to the chief legal counsel or the CEO of the company, or directly to the SEC.

Title IV: Enhanced Financial Disclosures

- Reports filed with the SEC must include all material off-balance sheet transactions and relationships that may have material effect on the financial status of an issuer.
- Prohibits loans to be extended to senior executives.
- Title IV also includes the **Notorious Section 404** which requires annual statement of issuer to contain an **Internal Control Report** which shall:
 - state that the management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
 - contain an assessment of the effectiveness of the internal controls.
- Each issuer's auditor shall attest to and report on the assessment made by the management.

Title VIII: Corporate Criminal Fraud And Accountability

- Makes it a felony for KNOWINGLY destroying, altering, concealing or falsifying a document to impede an investigation.
- All auditors are to maintain audit work papers for five years.
- Statute of limitations of securities fraud increased to five years.
- Increases imprisonment to **25 years** for defrauding shareholders.
- Provides protection to whistleblowers from retaliation by management.

Title IX: White-Collar Crime And Penalty Enhancements

- Increases penalties for mail and wire fraud from five to TWENTY years in prison.
- Increases penalty for violations of ERISA Act of 1974 to a maximum of \$500,000 fine and ten years in prison.
- Establishes criminal liability for failure of corporate officers to certify financial reports (10 years) and for willfully certifying a statement knowing it to be false (20 years).

Title X: Corporate Tax Returns

- Corporate tax returns are to be signed by the CEO.

Title XI: Corporate Fraud Accountability

- Amends Federal criminal law to establish a maximum of 20 year prison term for tampering with a record or otherwise impeding an official proceeding.
- Increases penalties for violations of Securities Exchange Act of 1934 up to \$25 million fine and 20 years of prison time.
- Violators are barred from serving as officers or directors of a publicly traded corporation.

REACTIONS TO SARBANES – OXLEY ACT OF 2002

Critics of SOX argue that the cost of compliance with the Section 404 requirement of companies to prove that they have an adequate system of internal control to prevent mistakes and fraud is too onerous. Yet, many benefits were reported because of SOX. According to a study by research firm Lord & Benoit LLC involving 2,481 large companies that are already reporting on their internal controls, those reporting no problems in either 2004 or 2005 showed an average share-price gain of 27.7% between March 31, 2004 and March 31, 2006. The Russel 3000 share index, a very broad market measure, gained just 17.7% during the same period. Companies that reported internal-control deficiencies in both 2004 and 2005 showed an average share price decline of 5.7% (Reilly, 2006)

The major benefits of the SOX, according to Feldman, (2005) are: SOX law

- established an accounting industry watch dog.
- required CEOs to sign off on their companies' financial statements,
- strengthened the role of the board of directors.
- forbade cozy relationships between accountants and executives.
- mandated the companies and their auditors to assess the effectiveness of internal controls.

According to a survey conducted by CFO Research Services in collaboration with PriceWaterhouseCoopers (2005), companies were found to be reaping some unexpected benefits from the law that many have found to be challenging. Their compliance efforts have been revealing material weaknesses in controls and business processes enabling them to accelerate their efforts to remedy the problems. Nearly two-thirds of the respondents in the survey reported that the SOX compliance effort has increased their understanding of their business and their ability to communicate such understanding across the organization. Key executives are now able to exhibit a greater awareness of their responsibilities for compliance and control (www.pwc.com/extweb/pwcpublishings.nsf). Henry et al, (2005), also found evidence that intense scrutiny under SOX compliance requirements is revealing lingering problems in the companies' operating methods. Timely fixing of weaknesses in the financial controls is helping to nip the problems in the bud. As Saville, et al. (2002) observe, the Act does not alter the substantive standards for indictment or conviction, nor does it render any act criminal that was not unlawful under the already existing securities laws. It has however substantially increased the sentences for white-collar crimes.

THE HIGH COST OF SOX SECTION 404: COMPLAINTS AGAINST SOX.

The act contains many corporate governance reforms. The vast majority of the Act's provisions are positive, but the many benefits are being eclipsed by section 404. A survey by NASDAQ (2005) indicated that:

- Sarbox is not the issue, Section 404, implementation costs are the issue.
- Audit fees have increased permanently. Average cost of Sarbox implementation of a mid size company is over \$1 million. The cost definitely does not justify the benefit.
- Even small cap companies are forced to pay up to \$200,000 for section 404 implementation. A \$ 200 million company cannot have the same standards as a \$ 20 billion company. One size does not fit all.
- Audit firms are compelled to be over-conservative and generate higher fees as a result.
- Auditors keep charging more fees. Audit committee cannot say no. Management cannot say no. Whoever says no will risk being sued if anything goes wrong.

- Many executives consider SOX as onerous and only fattening the bottom lines of accounting firms while costing business firms billions of dollars.

Large and small companies complain that the interpretation of Section 404 by auditors is overly broad, costing them many hours and millions of dollars in fees to document for example, such things as who has access to an office key (Schuman, 2006). Compliance costs may vary with the size of the company. According to Solomon (2005), Companies with less than \$1 million in market capitalization are expected to pay an average of about \$820,000 to comply with the requirements of Section 404. For companies with revenue of less than \$1 billion, the average annual cost of being a public company in fiscal 2004 more than tripled to \$3.4 million, because of SOX. Solomon (2005) states that by far the biggest part of compliance costs are those associated with Rule 404. “The rule requires public companies to perform internal reviews of their control systems and then hire an outside auditor to verify the review findings. Critics hold that this results in a duplication of efforts and a doubling of companies’ costs,” (Solomon, 2005). Arndt (2004) declares that SOX is turning out to be a boon to bean counters (public accounting firms). According to Whalen (2003), Americans must live with a law that greatly expands government regulation of financial markets but probably does nothing to protectors from future acts of fraud. The Law forces lawyers, directors and accountants to police corporate behavior. Under SOX, lawyers are forced into a situation where they end up turning in their own clients to the SEC. The accused is presumed to guilty until proven innocent. The Law is like a dinner bell for the trial lawyers. Chapman (2004) states that the Sarbanes-Oxley Act of 2002 , passed with virtually no debate, is based on several faulty premises – that business is bad, that the CEOs and the management are criminals, and that experienced and knowledgeable directors who understand a company’s business are tainted.

Steve Forbes (2005) recently delivered a scathing criticism of Sox as follows:

- Sarbox is a destructive piece of legislation, rushed through congress in the aftermath of the World Com debacle. This ill-thought, hastily written law has cost shareholders and the US economy infinitely more money than Bernie Ebbers and his ilk ever did.
- SOX imposes hefty costs on publicly held companies. It has become a boon to the accounting industry since in many cases fees have doubled or even tripled.
- It is not only the billions of dollars of mostly wasted money but the long periods of time top management is spending in trying to comply with Section 404 instead of focusing on running their businesses.
- The law has inhibited risk taking. Directors and executives must now ask themselves how a particular corporate decision looks in a court of law. The onerous requirements of SOX fall disproportionately on small and mid-cap companies which are the most innovative and entrepreneurial drivers of change in our economy. According to Wallison (2006), “the most far-reaching effect of Sarbox may be indirect and intangible. By placing a congressional Imprimatur on the notion that managements have to be supervised and controlled by independent boards, the act may have set up an adversarial relationship between managements and boards that will, over time, impair corporate risk-taking and thus economic growth.”
- Sarbox removed a salient pillar of corporate form of business, limited liability. It has brought back the equivalent of the centuries old debtor’s prison. Unlimited liability means less risk taking and less economic growth.
- Finally, Sox miserably flunks the cost-benefit analysis too.

DISADVANTAGE IN GLOBAL CAPITAL MARKETS

Schuman (2006) observes that since the time the law was enacted, a growing chorus of critics claimed that Sarbanes-Oxley Act went too far, saddling companies with costly and unnecessary auditing requirements that put U. S. registered companies and the U. S. markets at a global disadvantage. Wallison (2006) points out that between 1996 and 2001, the New York Stock Exchange (NYSE) averaged 50 new non-US listings per year. In 2005, it came down to 19. In the same year, the London Stock Exchange and its small affiliate company gained 139 new listings. Since the end of 2004, 30 foreign companies have left the NYSE and NASDAQ. Financial capital involving mergers and acquisitions is also finding more comfortable home abroad. Large new offerings this year involving billions of dollars of Russian aluminum and Kazakhstan oil and copper companies are planning to list in London. In fact, a recent study

by Foley and Lardner found that 20% of public companies are considering going private just to avoid Sarbox compliance. As Factor (2006) states, “it is no wonder, then, that the London Stock Exchange (LSE) – eager to exploit a competitive advantage – now promotes itself by reminding companies that by listing on the LSE they are not subject to Sarbox.” Murray (2006) notes that nine out of ten largest Initial Public Offerings (IPOs) this year, and 24 out of 25 largest, last year, were done in overseas markets. That is a remarkable change from the 1990s, when the vast majority of IPOs were made in the U. S. financial markets (Murray, 2006).

Obviously, something is wrong. As Wallison (2006) observes, Sox and its ancillary SEC Regulations contributed to a recent Security Industry Estimate that the industry spends \$25 billion annually on SEC compliance. These costs are naturally passed on to persons and companies that use the U. S. securities markets. A recent study by the London Stock Exchange showed that underwriting costs in London were roughly half of those in the U. S.! Congressman Feeny and Senator DeMint (2006) state that some businesses which were public when the Sox was passed have since then opted to cut off their access to capital rather than comply with SOX. Since 2002, 75 community banks went private, while large corporations such as Vivendi simply de-listed in the U. S. DeMint and Feeny (2006) recently introduced legislation that would require the SEC to create alternative provisions for companies that wish to opt out of Section 404 of SOX.

Mallory Factor (2006), Chairman of the Free Enterprise Fund, claims that Sarbox is “throwing buckets of sand into the gears of our market economy”, and has joined with a team of legal experts to challenge the constitutionality of Sarbox in a lawsuit. Greifeld (2006) suggests a way to address the Section 404 concerns without diluting the essential investor protection provisions that are the main legacy of Sarbox. He calls for adoption of the recent recommendations of the SEC Advisory Committee on Smaller Public Companies. The Committee proposed an exemption from Section 404 for companies with less than \$128 million in market-cap and revenues under \$125 million. Companies with up to \$787 million in market-cap would receive partial exemption as long as their revenues are under \$250 million

SUGGETED REMEDIES AND CONCLUSION

It is widely recognized that the costs of Sarbox clearly outweigh its benefits. The Sarbanes – Oxley Act of 2002 was passed in haste by Congress as a knee jerk response in the wake of large scale corporate implosions at Enron, WorldCom etc. SOX is a piece of legislation enacting the most sweeping anti-fraud corporate reforms since the Securities and Exchange Act of 1934. It is generally agreed up on that such checks and balances embedded in SOX are long over due. However, the provisions on internal control in Section 404 have caused untold misery to a large section of the corporate world. The intent of SOX may be laudable but the law made no distinction between a billion dollar, large-cap company and \$75 million dollar, small-cap company. The law is affecting the ability of our small and mid-cap companies, the back-bone of our economy, to compete in the global markets. SOX Section 404 audits are almost entirely focused on micro-operational details of the firm and are most likely to miss the kind of financial legerdemain orchestrated at the top management level that have previously led to the scandalous bankruptcies of Enron, WorldCom and others. The greatest SOX irony according to Whalen (2003) is that its main beneficiaries are the same big accounting firms that the politicians blamed for Enron, WorldCom type of scandals. The big four public accounting firms audit the majority of public companies. The feds killed Arthur Anderson for its many sins of Enron. But its offending partners simply scooted over to one of the other firms and are now laughing all the way to their vacation homes.

Several remedies are being put forward in the intense debate over Sarbox. The lawsuit about Sarbox’s constitutionality, if successful, would mandate sweeping legislative reforms to Sarbox. Former Senators, Bob Dole and Tom Daschle (2005) suggest that congress could consider tailoring the certification process to provide for less costly alternatives for smaller businesses. The recommendations of the SEC Advisory Committee on Smaller Public Companies would, if implemented, bring a much sought after relief to small and mid-cap companies from the vagaries of Sarbox. Powell (2005) suggests a suitable solution to the SOX provisions of Section 404. He says that Congress can correct the overreach of SOX by simply making Section 404 mandates on internal controls voluntary, while keeping the rest of the provisions of SOX intact. He suggests that such a scaled-back SOX would help keep the U. S. businesses competitive in the world markets while reaffirming the primacy of free market initiatives and innovation.

SUGGESTIONS FOR FUTURE RESEARCH

There is an up roar against the hardships wrought upon U. S. firms by Sarbox, specifically by the mandates of the notorious Section 404 pertaining to compliance of internal control requirements. Some benefits were recognized resulting from the enactment of Sarbox, but present literature on the Act claims that the costs of the Act far outweigh the benefits. Further research on the effects of the Sarbanes-Oxley Act on U. S. companies needs to be conducted to determine whether the increased costs of implementing the provisions of Sarbox outweigh the benefits visualized by the legislation.

REFERENCES

1. Arndt, Michael and Ira Sager (2004). A Boon To Bean Counters, *Business Week*, Issue 3909. November 22, 2004, p. 13.
2. Berger, David (2005). Staying Up To Date With The Sarbanes-Oxley Act, www.plantservices.com/articles/2005/
3. Chapman, Thomas F. (2004). Weapons of Mass Instruction, *Vital Speeches of the Day*, New York: December 1, 2004 pp. 109-13.
4. DeMint, Jim and Tom Feeny (2006). Common-Sense Changes, *The Wall Street Journal*, New York, NY, May 10, 2006, p. A18.
5. Dole, Bob and Tom Daschle (2005). Let's Reform The Reforms, *The Wall Street Journal*, (Eastern Edition). New York, NY October 3, 2005, P. A16.
6. Factor, Mallory (2006). Two Cheers For Nancy Pelosi, *The Wall Street Journal*, New York, NY, March 18, 2006, p. A9.
7. Forbes, Steve (2005). Dump This Destructive Deadweight, *Forbes*, September 5, 2005, 31-32.
8. Greifeld, Bob (2006). It's Time To Pull Up Our Sox, *The Wall Street Journal*, New York, NY, March 6, 2006, p. A14.
9. Henry, David, Amy Borrus, et al. (2005). Death, Taxes and Sarbanes-Oxley? *Business Week*, January 17, 2005, pp.28-32.
10. Murray, Alan (2006). Business: Panel's Mission: Easing Capital-Market Rules, *The Wall Street Journal*, New York, NY, September 12, 2006, p. A2.
11. NASDAQ (2005). Issuer Survey: Sarbanes-Oxley Act, March 2, 2005, www.SOX404.biz/webdocs/nasdaq_SOX_March2005.pdf, March 2, 2005.
12. Powell, Scott S. (2005). Costs Of Sarbanes-Oxley Are Out Of Control, *The Wall Street Journal*, March 21, 2005, p. A-17.
13. PriceWaterhouseCoopers (2005). Compliance and Technology: A Special Report on Process Improvement and Automation in the Age of Sarbanes-Oxley, www.pwc.com/extweb/, 2005.
14. Reilly, David (2006). Moving The Market -- Tracking The Numbers/Outside Audit: Checks On Internal Controls Pay Off; Study Shows Share Prices Can Climb If a Company Uncovers, Fixes Problems, *The Wall Street Journal*, (Eastern edition), New York, NY May 8, 2006, P. C3.
15. Saville, Robert J. (2002). Sarbanes-Oxley Act of 2002: Summary And Analysis of Criminal Provisions, www.thelenreid.com/articles/, 2002.
16. Schuman, Joseph (2006). A Corporate Oversight Rule Looks Set To Be Eased, *The Wall Street Journal*, New York, NY, November 10, 2006.
17. Solomon, Deborah (2005). Accounting Rule Exposes Problems But Draws Complaints About Costs, *The Wall Street Journal*, March 2, 2005, p. A-1.
18. Wallison, Peter J. (2006). Capital Punishment, *The Wall Street Journal*, New York, NY, November 4, 2006, p. A7.
19. Whalen, Christopher (2003). Revisiting Sarbanes-Oxley, *The International Economy*, Washington: Fall 2003, p. 40.
20. www.en.wikipedia.org/wiki/Sarbanes-Oxley (2004). Sarbanes-Oxley Act, 2004