Sarbanes–Oxley Act

Sen. Paul Sarbanes (D–MD) and Rep. Michael G. Oxley (R–OH-4), the co-sponsors of the Sarbanes–Oxley Act.

Accountancy

Key concepts
Accountant · Bookkeeping · Cash and accrual basis · Constant Item Purchasing Power Accounting · Cost of goods sold · Debits and credits · Double-entry system · Fair value accounting · FIFO & LIFO · GAAP / International Financial Reporting Standards · General ledger · Historical cost · Matching principle · Revenue recognition · Trial balance
Fields of accounting
Cost · Financial · Forensic · Fund · Management · Tax
Financial statements
Balance sheet · Statement of cash flows · Statement of changes in equity · Statement of comprehensive income · Notes · MD&A
Auditing
Auditor's report · Financial audit · GAAS / ISA · Internal audit · Sarbanes–Oxley Act
Professional Accountants
CWA/CMA · ACCA · CA · CGA · CMA · CPA · PA

The **Sarbanes–Oxley Act of 2002** (Pub.L. 107-204 [1], 116 Stat. 745, enacted July 30, 2002), also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House) and commonly called **Sarbanes–Oxley**, **Sarbox** or **SOX**, is a United States federal law enacted on July 30, 2002, which set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It is named after sponsors U.S. Senator Paul Sarbanes (D-MD) and U.S. Representative Michael G. Oxley (R-OH).

The bill was enacted as a reaction to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the nation's securities markets.

It does not apply to privately held companies. The act contains 11 titles, or sections, ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the new law. Harvey Pitt, the 26th chairman of the Securities and Exchange Commission (SEC), led the SEC in the adoption of dozens of rules to implement the Sarbanes–Oxley

Act. It created a new, quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. The act also covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure.

The act was approved by the House by a vote of 421 in favor, 3 opposed, and 8 abstaining [2] and by the Senate with a vote of 99 in favor, 1 abstaining [3]. President George W. Bush signed it into law, stating it included "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt."[4]

Debate continues over the perceived benefits and costs of SOX. Supporters contend the legislation was necessary and has played a useful role in restoring public confidence in the nation's capital markets by, among other things, strengthening corporate accounting controls. Opponents of the bill claim it has reduced America's international competitive edge against foreign financial service providers, saying SOX has introduced an overly complex regulatory environment into U.S. financial markets.[5] Proponents of the measure say that SOX has been a "godsend" for improving the confidence of fund managers and other investors with regard to the veracity of corporate financial statements.[6]

Outlines

Sarbanes–Oxley contains 11 titles that describe specific mandates and requirements for financial reporting. Each title consists of several sections, summarized below.

1. **Public Company Accounting Oversight Board (PCAOB)**

   Title I consists of nine sections and establishes the Public Company Accounting Oversight Board, to provide independent oversight of public accounting firms providing audit services ("auditors"). It also creates a central oversight board tasked with registering auditors, defining the specific processes and procedures for compliance audits, inspecting and policing conduct and quality control, and enforcing compliance with the specific mandates of SOX.

2. **Auditor Independence**

   Title II consists of nine sections and establishes standards for external auditor independence, to limit conflicts of interest. It also addresses new auditor approval requirements, audit partner rotation, and auditor reporting requirements. It restricts auditing companies from providing non-audit services (e.g., consulting) for the same clients.

3. **Corporate Responsibility**

   Title III consists of eight sections and mandates that senior executives take **individual responsibility** for the accuracy and completeness of corporate financial reports. It defines the interaction of external auditors and corporate audit committees, and specifies the responsibility of corporate officers for the accuracy and validity of corporate financial reports. It enumerates specific limits on the behaviors of corporate officers and describes specific forfeitures of benefits and civil penalties for non-compliance. For example, Section 302 requires that the company's "principal officers" (typically the Chief Executive Officer and Chief Financial Officer) certify and approve the integrity of their company financial reports quarterly.[7]

4. **Enhanced Financial Disclosures**

   Title IV consists of nine sections. It describes enhanced reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. It requires internal controls for assuring the accuracy of financial reports and disclosures, and mandates both audits and reports on those controls. It also requires timely reporting of material changes in financial condition and specific enhanced reviews by the SEC or its agents of corporate reports.

5. **Analyst Conflicts of Interest**

Title V consists of only one section, which includes measures designed to help restore investor confidence in the reporting of securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of knowable conflicts of interest.

6. **Commission Resources and Authority**

   Title VI consists of four sections and defines practices to restore investor confidence in securities analysts. It also defines the SEC's authority to censure or bar securities professionals from practice and defines conditions under which a person can be barred from practicing as a broker, advisor, or dealer.

7. **Studies and Reports**

   Title VII consists of five sections and requires the Comptroller General and the SEC to perform various studies and report their findings. Studies and reports include the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations and enforcement actions, and whether investment banks assisted Enron, Global Crossing and others to manipulate earnings and obfuscate true financial conditions.

8. **Corporate and Criminal Fraud Accountability**

   Title VIII consists of seven sections and is also referred to as the *"Corporate and Criminal Fraud Accountability Act of 2002*". It describes specific criminal penalties for manipulation, destruction or alteration of financial records or other interference with investigations, while providing certain protections for whistle-blowers.

9. **White Collar Crime Penalty Enhancement**

   Title IX consists of six sections. This section is also called the *"White Collar Crime Penalty Enhancement Act of 2002."* This section increases the criminal penalties associated with white-collar crimes and conspiracies. It recommends stronger sentencing guidelines and specifically adds failure to certify corporate financial reports as a criminal offense.

10. **Corporate Tax Returns**

    Title X consists of one section. Section 1001 states that the Chief Executive Officer should sign the company tax return.

11. **Corporate Fraud Accountability**

    Title XI consists of seven sections. Section 1101 recommends a name for this title as *"Corporate Fraud Accountability Act of 2002"*. It identifies corporate fraud and records tampering as criminal offenses and joins those offenses to specific penalties. It also revises sentencing guidelines and strengthens their penalties. This enables the SEC the resort to temporarily freeze transactions or payments that have been deemed "large" or "unusual".

History and context: events contributing to the adoption of Sarbanes–Oxley

A variety of complex factors created the conditions and culture in which a series of large corporate frauds occurred between 2000–2002. The spectacular, highly-publicized frauds at Enron, WorldCom, and Tyco exposed significant problems with conflicts of interest and incentive compensation practices. The analysis of their complex and contentious root causes contributed to the passage of SOX in 2002.[8] In a 2004 interview, Senator Paul Sarbanes stated:

> The Senate Banking Committee undertook a series of hearings on the problems in the markets that had led to a loss of hundreds and hundreds of billions, indeed trillions of dollars in market value. The hearings set out to lay the foundation for legislation. We scheduled 10 hearings over a six-week period, during which we brought in some of the best people in the country to testify...The hearings produced remarkable consensus on the nature of the problems: inadequate oversight of accountants, lack of auditor independence, weak corporate governance procedures, stock analysts' conflict of interests, inadequate disclosure provisions, and grossly

inadequate funding of the Securities and Exchange Commission.[9]

- **Auditor conflicts of interest**: Prior to SOX, auditing firms, the primary financial "watchdogs" for investors, were self-regulated. They also performed significant non-audit or consulting work for the companies they audited. Many of these consulting agreements were far more lucrative than the auditing engagement. This presented at least the appearance of a conflict of interest. For example, challenging the company's accounting approach might damage a client relationship, conceivably placing a significant consulting arrangement at risk, damaging the auditing firm's bottom line.
- **Boardroom failures**: Boards of Directors, specifically Audit Committees, are charged with establishing oversight mechanisms for financial reporting in U.S. corporations on the behalf of investors. These scandals identified Board members who either did not exercise their responsibilities or did not have the expertise to understand the complexities of the businesses. In many cases, Audit Committee members were not truly independent of management.
- **Securities analysts' conflicts of interest**: The roles of securities analysts, who make buy and sell recommendations on company stocks and bonds, and investment bankers, who help provide companies loans or handle mergers and acquisitions, provide opportunities for conflicts. Similar to the auditor conflict, issuing a buy or sell recommendation on a stock while providing lucrative investment banking services creates at least the appearance of a conflict of interest.
- **Inadequate funding of the SEC**: The SEC budget has steadily increased to nearly double the pre-SOX level.[10] In the interview cited above, Sarbanes indicated that enforcement and rule-making are more effective post-SOX.
- **Banking practices**: Lending to a firm sends signals to investors regarding the firm's risk. In the case of Enron, several major banks provided large loans to the company without understanding, or while ignoring, the risks of the company. Investors of these banks and their clients were hurt by such bad loans, resulting in large settlement payments by the banks. Others interpreted the willingness of banks to lend money to the company as an indication of its health and integrity, and were led to invest in Enron as a result. These investors were hurt as well.
- **Internet bubble**: Investors had been stung in 2000 by the sharp declines in technology stocks and to a lesser extent, by declines in the overall market. Certain mutual fund managers were alleged to have advocated the purchasing of particular technology stocks, while quietly selling them. The losses sustained also helped create a general anger among investors.
- **Executive compensation**: Stock option and bonus practices, combined with volatility in stock prices for even small earnings "misses," resulted in pressures to manage earnings.[11] Stock options were not treated as compensation expense by companies, encouraging this form of compensation. With a large stock-based bonus at risk, managers were pressured to meet their targets.

Timeline and passage of Sarbanes–Oxley

Before the signing ceremony of the Sarbanes–Oxley Act, President George W. Bush met with Senator Paul Sarbanes, Secretary of Labor Elaine Chao and other dignitaries in the Blue Room at the White House on July 30, 2002

The House passed Rep. Oxley's bill (H.R. 3763) on April 24, 2002, by a vote of 334 to 90. The House then referred the "Corporate and Auditing Accountability, Responsibility, and Transparency Act" or "CAARTA" to the Senate Banking Committee with the support of President George W. Bush and the SEC. At the time, however, the Chairman of that Committee, Senator Paul Sarbanes (D-MD), was preparing his own proposal, Senate Bill 2673.

Senator Sarbanes' bill passed the Senate Banking Committee on June 18, 2002, by a vote of 17 to 4. On June 25, 2002, WorldCom revealed it had overstated its earnings by more than $3.8 billion during the past five quarters (15 months), primarily by improperly accounting for its operating costs. Sen. Sarbanes introduced Senate Bill 2673 to the full Senate that same day, and it passed 97–0 less than three weeks later on July 15, 2002.

The House and the Senate formed a Conference Committee to reconcile the differences between Sen. Sarbanes's bill (S. 2673) and Rep. Oxley's bill (H.R. 3763). The conference committee relied heavily on S. 2673 and "most changes made by the conference committee strengthened the prescriptions of S. 2673 or added new prescriptions." (John T. Bostelman, The Sarbanes–Oxley Deskbook § 2–31.)

The Committee approved the final conference bill on July 24, 2002, and gave it the name "the Sarbanes–Oxley Act of 2002." The next day, both houses of Congress voted on it without change, producing an overwhelming margin of victory: 423 to 3 [12] in the House and 99 to 0 [3] in the Senate. On July 30, 2002, President George W. Bush signed it into law, stating it included "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt." [4]

Analyzing the cost-benefits of Sarbanes–Oxley

A significant body of academic research and opinion exists regarding the costs and benefits of SOX, with significant differences in conclusions. This is due in part to the difficulty of isolating the impact of SOX from other variables affecting the stock market and corporate earnings.[13] [14] Conclusions from several of these studies and related criticism are summarized below:

Compliance costs

- FEI Survey (Annual): Finance Executives International (FEI) provides an annual survey on SOX Section 404 costs. These costs have continued to decline relative to revenues since 2004. The 2007 study indicated that, for 168 companies with average revenues of $4.7 billion, the average compliance costs were $1.7 million (0.036% of revenue).[15] The 2006 study indicated that, for 200 companies with average revenues of $6.8 billion, the average compliance costs were $2.9 million (0.043% of revenue), down 23% from 2005. Cost for decentralized companies (i.e., those with multiple segments or divisions) were considerably more than centralized companies. Survey scores related to the positive effect of SOX on investor confidence, reliability of financial statements, and fraud prevention continue to rise. However, when asked in 2006 whether the benefits of compliance with Section 404 have exceeded costs in 2006, only 22 percent agreed.[16]
- Foley & Lardner Survey (2007): This annual study focused on changes in the total costs of being a U.S. public company, which were significantly affected by SOX. Such costs include external auditor fees, directors and officers (D&O) insurance, board compensation, lost productivity, and legal costs. Each of these cost categories increased significantly between FY2001-FY2006. Nearly 70% of survey respondents indicated public companies

with revenues under $251 million should be exempt from SOX Section 404.[17]

- Zhang (2005): This research paper estimated SOX compliance costs as high as $1.4 trillion, by measuring changes in market value around key SOX legislative "events." This number is based on the assumption that SOX was the cause of related short-duration market value changes, which the author acknowledges as a drawback of the study.[18]
- Butler/Ribstein (2006): Their book proposed a comprehensive overhaul or repeal of SOX and a variety of other reforms. For example, they indicate that investors could diversify their stock investments, efficiently managing the risk of a few catastrophic corporate failures, whether due to fraud or competition. However, if each company is required to spend a significant amount of money and resources on SOX compliance, this cost is borne across all publicly traded companies and therefore cannot be diversified away by the investor.[19]

Benefits to firms and investors

- Arping/Sautner (2010): This research paper analyzes whether SOX enhanced corporate transparency.[20] Looking at foreign firms that are cross-listed in the US, the paper indicates that, relative to a control sample of comparable firms that are not subject to SOX, cross-listed firms became significantly more transparent following SOX. Corporate transparency is measured based on the dispersion and accuracy of analyst earnings forecasts.
- Iliev (2007): This research paper indicated that SOX 404 indeed led to conservative reported earnings, but also reduced—rightly or wrongly—stock valuations of small firms.[21] Lower earnings often cause the share price to decrease.
- Skaife/Collins/Kinney/LaFond (2006): This research paper indicates that borrowing costs are lower for companies that improved their internal control, by between 50 and 150 basis points (.5 to 1.5 percentage points).[22]
- Lord & Benoit Report (2006): Do the Benefits of 404 Exceed the Cost? A study of a population of nearly 2,500 companies indicated that those with no material weaknesses in their internal controls, or companies that corrected them in a timely manner, experienced much greater increases in share prices than companies that did not.[23] [24] The report indicated that the benefits to a compliant company in share price (10% above Russell 3000 index) were greater than their SOX Section 404 costs.
- Institute of Internal Auditors (2005): The research paper indicates that corporations have improved their internal controls and that financial statements are perceived to be more reliable.[25]

Effects on exchange listing choice of non-US companies

Some have asserted that Sarbanes–Oxley legislation has helped displace business from New York to London, where the Financial Services Authority regulates the financial sector with a lighter touch. In the UK, the non-statutory Combined Code of Corporate Governance plays a somewhat similar role to SOX. See Howell E. Jackson & Mark J. Roe, “Public Enforcement of Securities Laws: Preliminary Evidence” (Working Paper January 16, 2007). The Alternative Investment Market claims that its spectacular growth in listings almost entirely coincided with the Sarbanes Oxley legislation. In December 2006 Michael Bloomberg, New York's mayor, and Charles Schumer, a US senator from New York, expressed their concern.[26]

The Sarbanes–Oxley Act's effect on non-US companies cross-listed in the US is different on firms from developed and well regulated countries than on firms from less developed countries according to Kate Litvak.[27] Companies from badly regulated countries see benefits that are higher than the costs from better credit ratings by complying to regulations in a highly regulated country (USA), but companies from developed countries only incur the costs, since transparency is adequate in their home countries as well. On the other hand, the benefit of better credit rating also comes with listing on other stock exchanges such as the London Stock Exchange.

Piotroski and Srinivasan (2008) examine a comprehensive sample of international companies that list onto U.S. and U.K. stock exchanges before and after the enactment of the Act in 2002. Using a sample of all listing events onto U.S. and U.K. exchanges from 1995–2006, they find that the listing preferences of large foreign firms choosing between U.S. exchanges and the LSE's Main Market did not change following SOX. In contrast, they find that the likelihood of a U.S. listing among small foreign firms choosing between the Nasdaq and LSE's Alternative Investment Market decreased following SOX. The negative effect among small firms is consistent with these companies being less able to absorb the incremental costs associated with SOX compliance. The screening of smaller firms with weaker governance attributes from U.S. exchanges is consistent with the heightened governance costs imposed by the Act increasing the bonding-related benefits of a U.S. listing.[28]

Implementation of key provisions

Sarbanes–Oxley Section 302: Disclosure controls

Under Sarbanes–Oxley, two separate sections came into effect—one civil and the other criminal. 15 U.S.C. § 7241 [29] (Section 302) (civil provision); 18 U.S.C. § 1350 [30] (Section 906) (criminal provision).

Section 302 of the Act mandates a set of internal procedures designed to ensure accurate financial disclosure. The signing officers must certify that they are “responsible for establishing and maintaining internal controls” and “have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared.” 15 U.S.C. § 7241(a)(4) [31]. The officers must “have evaluated the effectiveness of the company’s internal controls as of a date within 90 days prior to the report” and “have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.” *Id.*.

The SEC interpreted the intention of Sec. 302 in Final Rule 33–8124. In it, the SEC defines the new term "disclosure controls and procedures", which are distinct from "internal controls over financial reporting".[32] Under both Section 302 and Section 404, Congress directed the SEC to promulgate regulations enforcing these provisions.[33]

External auditors are required to issue an opinion on whether effective internal control over financial reporting was maintained in all material respects by management. This is in addition to the financial statement opinion regarding the accuracy of the financial statements. The requirement to issue a third opinion regarding management's assessment was removed in 2007.

Sarbanes-Oxley Section 401: Disclosures in periodic reports (Off-balance sheet items)

The bankruptcy of Enron drew attention to off-balance sheet instruments that were used fraudulently. During 2010, the court examiner's review of the Lehman Brothers bankruptcy also brought these instruments back into focus, as Lehman had used an instrument called "Repo 105" to allegedly move assets and debt off-balance sheet to make its financial position look more favorable to investors. Sarbanes-Oxley required the disclosure of all material off-balance sheet items. It also required an SEC study and report to better understand the extent of usage of such instruments and whether accounting principles adequately addressed these instruments; the SEC report was issued June 15, 2005.[34] [35] Interim guidance was issued in May 2006, which was later finalized.[36] Critics argued the SEC did not take adequate steps to regulate and monitor this activity.[37]

Sarbanes–Oxley Section 404: Assessment of internal control

The most contentious aspect of SOX is Section 404, which requires management and the external auditor to report on the adequacy of the company's internal control over financial reporting (ICFR). This is the most costly aspect of the legislation for companies to implement, as documenting and testing important financial manual and automated controls requires enormous effort.[38]

Under Section 404 of the Act, management is required to produce an “internal control report” as part of each annual Exchange Act report. *See* 15 U.S.C. § 7262 [39]. The report must affirm “the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.” 15 U.S.C. § 7262(a) [40]. The report must also “contain an assessment, as of the end of the most recent fiscal year of the Company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.” To do this, managers are generally adopting an internal control framework such as that described in COSO.

To help alleviate the high costs of compliance, guidance and practice have continued to evolve. The Public Company Accounting Oversight Board (PCAOB) approved Auditing Standard No. 5 for public accounting firms on July 25, 2007.[41] This standard superseded Auditing Standard No. 2, the initial guidance provided in 2004. The SEC also released its interpretive guidance [42] on June 27, 2007. It is generally consistent with the PCAOB's guidance, but intended to provide guidance for management. Both management and the external auditor are responsible for performing their assessment in the context of a top-down risk assessment, which requires management to base both the scope of its assessment and evidence gathered on risk. This gives management wider discretion in its assessment approach. These two standards together require management to:

- Assess both the design and operating effectiveness of selected internal controls related to significant accounts and relevant assertions, in the context of material misstatement risks;
- Understand the flow of transactions, including IT aspects, sufficient enough to identify points at which a misstatement could arise;
- Evaluate company-level (entity-level) controls, which correspond to the components of the COSO framework;
- Perform a fraud risk assessment;
- Evaluate controls designed to prevent or detect fraud, including management override of controls;
- Evaluate controls over the period-end financial reporting process;
- Scale the assessment based on the size and complexity of the company;
- Rely on management's work based on factors such as competency, objectivity, and risk;
- Conclude on the adequacy of internal control over financial reporting.

SOX 404 compliance costs represent a tax on inefficiency, encouraging companies to centralize and automate their financial reporting systems. This is apparent in the comparative costs of companies with decentralized operations and systems, versus those with centralized, more efficient systems. For example, the 2007 FEI survey indicated average compliance costs for decentralized companies were $1.9 million, while centralized company costs were $1.3 million.[43] Costs of evaluating manual control procedures are dramatically reduced through automation.

Sarbanes–Oxley 404 and smaller public companies

The cost of complying with SOX 404 impacts smaller companies disproportionately, as there is a significant fixed cost involved in completing the assessment. For example, during 2004 U.S. companies with revenues exceeding $5 billion spent 0.06% of revenue on SOX compliance, while companies with less than $100 million in revenue spent 2.55%.[44]

This disparity is a focal point of 2007 SEC and U.S. Senate action.[45] The PCAOB intends to issue further guidance to help companies scale their assessment based on company size and complexity during 2007. The SEC issued their guidance to management in June, 2007.[42]

After the SEC and PCAOB issued their guidance, the SEC required smaller public companies (non-accelerated filers) with fiscal years ending after December 15, 2007 to document a Management Assessment of their Internal Controls over Financial Reporting (ICFR). Outside auditors of non-accelerated filers however opine or test internal controls under PCAOB (Public Company Accounting Oversight Board) Auditing Standards for years ending after December 15, 2008. Another extension was granted by the SEC for the outside auditor assessment until years ending after December 15, 2009. The reason for the timing disparity was to address the House Committee on Small Business concern that the cost of complying with Section 404 of the Sarbanes–Oxley Act of 2002 was still unknown and could therefore be disproportionately high for smaller publicly held companies.[46] On October 2, 2009, the SEC granted another extension for the outside auditor assessment until fiscal years ending after June 15, 2010. The SEC stated in their release that the extension was granted so that the SEC's Office of Economic Analysis could complete a study of whether additional guidance provided to company managers and auditors in 2007 was effective in reducing the costs of compliance. They also stated that there will be no further extensions in the future.[47]

Sarbanes–Oxley Section 802: Criminal penalties for violation of SOX

Section 802(a) of the SOX, 18 U.S.C. § 1519 [48] states:

> "Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both."

Sarbanes–Oxley Section 1107: Criminal penalties for retaliation against whistleblowers

Section 1107 of the SOX 18 U.S.C. § 1513(e) [49] states:[50]

> "Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, shall be fined under this title, imprisoned not more than 10 years, or both."

Criticism

Congressman Ron Paul and others such as former Arkansas governor Mike Huckabee have contended that SOX was an unnecessary and costly government intrusion into corporate management that places U.S. corporations at a competitive disadvantage with foreign firms, driving businesses out of the United States. In an April 14, 2005 speech before the U.S. House of Representatives, Paul stated, "These regulations are damaging American capital markets by providing an incentive for small US firms and foreign firms to deregister from US stock exchanges. According to a study by a researcher at the Wharton Business School, the number of American companies deregistering from public stock exchanges nearly tripled during the year after Sarbanes–Oxley became law, while the New York Stock Exchange had only 10 new foreign listings in all of 2004. The reluctance of small businesses and foreign firms to register on American stock exchanges is easily understood when one considers the costs Sarbanes–Oxley imposes on businesses. According to a survey by Korn/Ferry International, Sarbanes–Oxley cost Fortune 500 companies an average of $5.1 million in compliance expenses in 2004, while a study by the law firm of Foley and Lardner found the Act increased costs associated with being a publicly held company by 130 percent." [51]

A research study published by Joseph Piotroski of Stanford University and Suraj Srinivasan of Harvard Business School titled "Regulation and Bonding: Sarbanes Oxley Act and the Flow of International Listings" in the Journal of Accounting Research in 2008 found that following the act's passage, smaller international companies were more likely to list in stock exchanges in the U.K. rather than U.S. stock exchanges.[28]

During the financial crisis of 2007-2010, critics blamed Sarbanes–Oxley for the low number of Initial Public Offerings (IPOs) on American stock exchanges during 2008. In November 2008, Newt Gingrich and co-author

David W. Kralik called on Congress to repeal Sarbanes–Oxley.[52]

A December 21, 2008 Wall St. Journal editorial stated, "The new laws and regulations have neither prevented frauds nor instituted fairness. But they have managed to kill the creation of new public companies in the U.S., cripple the venture capital business, and damage entrepreneurship. According to the National Venture Capital Association, in all of 2008 there have been just six companies that have gone public. Compare that with 269 IPOs in 1999, 272 in 1996, and 365 in 1986."

Hoover's IPO Scorecard notes 31 IPOs in 2008.[53]

The editorial concludes that: "For all of this, we can first thank Sarbanes–Oxley. Cooked up in the wake of accounting scandals earlier this decade, it has essentially killed the creation of new public companies in America, hamstrung the NYSE and Nasdaq (while making the London Stock Exchange rich), and cost U.S. industry more than $200 billion by some estimates." [54]

Previously the number of IPOs had declined to 87 in 2001, well down from the highs, but before Sarbanes–Oxley was passed.[55] In 2004, IPOs were up 195% from the previous year to 233.[56] There were 196 IPOs in 2005, 205 in 2006 (with a sevenfold increase in deals over $1 billion) and 209 in 2007.[57] [58]

Praise

Former Federal Reserve Chairman Alan Greenspan praised the Sarbanes–Oxley Act: "I am surprised that the Sarbanes–Oxley Act, so rapidly developed and enacted, has functioned as well as it has...the act importantly reinforced the principle that shareholders own our corporations and that corporate managers should be working on behalf of shareholders to allocate business resources to their optimum use."[59]

SOX has been praised by a cross-section of financial industry experts, citing improved investor confidence and more accurate, reliable financial statements. The CEO and CFO are now required to unequivocally take ownership for their financial statements under Section 302, which was not the case prior to SOX. Further, auditor conflicts of interest have been addressed, by prohibiting auditors from also having lucrative consulting agreements with the firms they audit under Section 201. SEC Chairman Christopher Cox stated in 2007: "Sarbanes–Oxley helped restore trust in U.S. markets by increasing accountability, speeding up reporting, and making audits more independent."[60]

The FEI 2007 study and research by the Institute of Internal Auditors (IIA) also indicate SOX has improved investor confidence in financial reporting, a primary objective of the legislation. The IIA study also indicated improvements in board, audit committee, and senior management engagement in financial reporting and improvements in financial controls.[61] [62]

Financial restatements increased significantly in the wake of the SOX legislation and have since dramatically declined, as companies "cleaned up" their books. Glass, Lewis & Co. LLC is a San Francisco-based firm that tracks the volume of do-overs by public companies. Its March 2006 report, "Getting It Wrong the First Time," shows 1,295 restatements of financial earnings in 2005 for companies listed on U.S. securities markets, almost twice the number for 2004. "That's about one restatement for every 12 public companies—up from one for every 23 in 2004," says the report.[63]

One fraud uncovered by the Securities and Exchange Commission (SEC) in November 2009 [64] may be directly credited to Sarbanes-Oxley. The fraud which spanned nearly 20 years and involved over $24 million was committed by Value Line (NASDAQ: VALU [65]) against its mutual fund shareholders. The fraud was first reported to the SEC in 2004 by the Value Line Fund (NASDAQ: VLIFX [66]) portfolio manager who was asked to sign a Code of Business Ethics as part of SOX.[67] [68] [69] Restitution totalling $34 million will be placed in a fair fund and returned to the affected Value Line mutual fund investors.[70] No criminal charges have been filed.

Legal challenges

A lawsuit (*Free Enterprise Fund v. Public Company Accounting Oversight Board*) was filed in 2006 challenging the constitutionality (legality) of the PCAOB. The complaint argues that because the PCAOB has regulatory powers over the accounting industry, its officers should be appointed by the President, rather than the SEC.[71] Further, because the law lacks a "severability clause," if part of the law is judged unconstitutional, so is the remainder. If the plaintiff prevails, the U.S. Congress may have to devise a different method of officer appointment. Further, the other parts of the law may be open to revision.[72] [73] The lawsuit was dismissed from a District Court; the decision was upheld by the Court of Appeals on August 22, 2008.[74] Judge Kavanaugh, in his dissent, argued strongly against the constitutionality of the law.[75] On May 18, 2009, the United States Supreme Court agreed to hear this case.[76] On December 7, 2009, it heard the oral arguments.[77] On June 28, 2010, the United States Supreme Court unanimously turned away a broad challenge to the law, but ruled 5-4 that a section related to appointments violates the Constitution's separation of powers mandate. The act remains "fully operative as a law" pending a process correction.[78]

Legislative information

- House: H.R. 3763 [79], H. Rept. 107–414, H. Rept. 107–610
- Senate: S. 2673 [80], S. Rept. 107–205
- Law: Pub.L. 107-204 [1], 117 Stat. 745

See also

- Glass-Steagall Act
- Information technology audit
- Information technology controls
- ISO 17799
- Richard M. Scrushy, CEO of HealthSouth, the first executive charged and to be acquitted under Sarbanes–Oxley
- Fair Funds, established by Sarbanes–Oxley
- Basel Accord
- Reg FD
- Contract Management
- Agency cost
- Data Loss Prevention
- Data governance

Similar laws in other countries

- Bill 198 — Ontario, Canada, equivalent of Sarbanes–Oxley Act
- J-SOX — Japanese equivalent of Sarbanes–Oxley Act
- German Corporate Governance Code (at the German Wikipedia)
- CLERP9 — Australian corporate reporting and disclosure law
- Financial Security Law of France ("Loi sur la Sécurité Financière") — French equivalent of Sarbanes–Oxley Act
- L262/2005 ("Disposizioni per la tutela del risparmio e la disciplina dei mercati finanziari") — Italian equivalent of Sarbanes–Oxley Act for financial services institutions
- King Report — South African corporate governance code

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