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Changes Needed in Sarbanes-Oxley

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By
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I

Introduction

This thesis is a requirement for completion of the Honors Program at Columbus State University. It is to be completed in the final year of the student's undergraduate course work at the institution. Its contents must address a controversial topic related to the graduate's chosen field of study or major. Each student must present his or her argument to a hearing board, which consists of three professors from the related department and the chair of the Honors Program. In order to achieve successful completion of the thesis, the committee must deem that the student's research and arguments are reasonable and that the student has provided adequate support for his or her argument within the body of the thesis. This thesis addresses an accounting issue that has just recently surfaced as a dominant theme in the accounting profession, independence and the applicable Sarbanes-Oxley Act of 2002.

The body of this thesis begins with an explanation of fraud and several ways that it can occur in financial reporting. Although fraud has been an issue for as long as businesses have existed, it was a series of recent events that led to an increasing controversy within the accounting profession. Before the year 2000, the revelation of a major fraud scheme would only emerge about as often as a national census; however, the turn of the century yielded a more frequent discovery of corrupt business practices than ever before. From the year 1999 to the adoption of Sarbanes-Oxley in 2002, there were hundreds of major fraud cases in the United States (Vernich 7). Many business experts attribute the higher frequency of misstatements to the dwindling economy. They believe that business owners/managers are trying to cover up the fact that their companies may be either financially unstable or at a profit maximization standstill, so they will overstate their earnings or assets (Vernich 8). This theory may hold true for many of the guilty parties, but on occasion, companies have also understated their financial statements for one reason or another. Several possible reasons for both overstatement and understatement and cases of each treatment are discussed in sections II and III of the thesis.

Following the introduction to fraud and misrepresentation of financial statements, the focus shifts toward auditor independence and how the lack thereof can prove to be an underlying contributor to dishonesty within a corporation. First, this section explains what exactly is auditor independence, what it requires, and what types of actions or relationships can affect it. Then, it explains why the lack of independence is the main reason that material misstatements can seem to slip through the cracks unnoticed. These auditors often play an extensive role in both the fraud as well as the degree to which the business covers up its deceitful business practices. Several of the cases mentioned in the misstatement sections of the thesis provide examples in which the auditors were not only aware of the fraud, but were also key players in the unsuccessful attempts to cover it up. These cases along with other important information in this section will provide a detailed explanation as to why independence has become such a controversial matter among all business professions and how it led to the adoption of Sarbanes-Oxley in 2002.

The fifth section of the thesis focuses on the contents of the Sarbanes-Oxley Act of 2002. The main purpose of this part of the thesis is not only to introduce the details of the Act, but also to establish why it was created and what purpose it is supposed to serve to the accounting profession as well as audited corporations. The Sarbanes-Oxley Act was signed into law by President George

W. Bush on July 30, 2002, and it took effect immediately. It was established as a reaction to the increasing fraudulent financial reporting, which eventually led to the bankruptcies of several large U.S. corporations and the demise of one of the world's leading accounting firms. In all, the Act has eleven titles with sixty-nine total sections, and it is sixty-six pages in length. Since the first proposal was made on June 14, 2002, over seventy-five proposals passed through Congress virtually unopposed. The need for change was so urgent that the entire Act took less than two months to complete, pass in Congress, and be signed into law. Its main purpose is to establish more strict standards for both auditors and their clients in hopes to decrease fraudulent financial reporting in the future (*www.nlcpi.org/books/pdf/BRIEFLY Apr03(Bost).pdf*).

Section VI of the thesis expands on details of the Sarbanes-Oxley Act and establishes a basis for the argument that some of the standards and responsibilities set forth in the Act need to be removed or changed for one reason or another. In addition, some issues have been overlooked in the creation of Sarbanes-Oxley, and section VI also addresses these concerns. Of the eleven titles in the Act, eight contain information relevant to the incorporation of new rules and regulations for either businesses or auditing firms. Section six discusses several of these titles and acknowledges several arguments that can be made to refute some of these new restrictions. After each argument has been presented to dispute a particular section of the Act, then the issues that have been either overlooked or disregarded in the generation of Sarbanes-Oxley are addressed. Furthermore, this section expands on these issues by providing evidence to support their relevance to the auditing profession. The primary purpose for section VI of the thesis is to dissect the Sarbanes-Oxley Act of 2002, expose the controversial topics that it entails, and provide a basis for the proposed amendments in section VII.

The seventh section of the thesis deals with the suggested solutions to the problems mentioned in section VI. Originally, section VI and VII were supposed to be combined into one section; however, after finding so many problems with Sarbanes-Oxley, one section was devoted entirely to pointing out the problems and another was devoted to solving them. In section VII, there is not only a discussion of the revised Sarbanes-Oxley Act, but also an explanation as to why these changes are important. Although making a revision to something like that seems like it would be a rather straightforward and simple process, it is actually a very complicated and lengthy procedure. For this reason, we rarely ever see changes made to laws or bills that have already passed through Congress. Section VII provides the framework for the final section, which includes both the overall assessment of the findings and a personal synopsis of the thesis as a whole.

As mentioned previously, section VIII is the overall conclusion/summary of the experiences involved with writing this thesis. This section discusses not only the amount of research required and what is found in such research, but also why writing this thesis can prove to be helpful in someone's chosen field of study. Writing a thesis proved to be a difficult task, which requires countless hours of research and preparation. Because of the numerous weeks put into the creation of such a project, it certainly prepares the author for similar projects in the future.

In all, reading this should be both entertaining and educational. The arguments should prove to the reader that mistakes are made at every level of the business world, and that politics are no exception. The adoption of the Sarbanes-Oxley Act of 2002 was founded on good intentions, but before the government can eliminate many of the fraudulent business practices that occur in our society today, some new changes must be made.

II

Understatement of Financial Statements

It has never been unusual to hear of a company that overstates certain figures in their financial statements so that the business appears more profitable; however, understating profits and earnings has recently become a popular practice in the business world. A common question for those involved in this type of fraudulent reporting might be, "Why would you want your company to appear that it is in worse financial shape than it is?" To most outsiders, understating profitability might seem like a disaster waiting to happen, but financial managers and CEO's will often employ this technique for several reasons.

The most common reason for understating financial statements is a process known as "smoothing earnings." This is a rather simple procedure in which a company will understate earnings in a more profitable year so that it can overstate them in a later, less profitable year. For years, financial experts have predicted quarterly and annual earnings for traded corporations. The companies that always seem to barely exceed expectations are the ones that typically experience a consistent increase in their stock price. A consistently increasing stock price usually means both a better reputation and higher compensation for managers (Vernich 16). Therefore, the process of smoothing earnings provides added incentives for managers because it can change the overall outlook for the future of the company. Although this type of fraudulent activity occurs at every level of the business world, it happens more often in industries where each transaction can have a significant impact on yearly earnings (Vernich 19). For example, assume that a small contracting company with an average annual profit of $1,000,000 lands a deal that will increase their profits by $300,000 in the current year. However, the job will last well into the next fiscal year, and the shorter year will result in a significantly lower profit than the $1,000,000 average. Often times, in this situation, the company is required to record all $300,000 of the profits in the current year; however, some companies will attempt to smooth the earnings by reporting $100,000 of the profits in the current year and the other $200,000 in the subsequent year. This way, it will appear that the company is experiencing a trend of constant economic growth. By doing this, the company will become more attractive to both investors and potential clients.

A second reason for understating profit figures is to increase or decrease the value of the company in the case of a potential buy-out or contract renewal. If a business owner knows that he or she wants to sell a particular business in five years from the current year, it is not uncommon to understate profits for the first two years and then show a steady increase by overstating profits in the three year period preceding the buy-out (Vernich 18). By doing this, they can get a higher selling price for the business when they choose to sell it. On the other hand, it is also possible for a company to attempt to decrease the value of the business by understating P & E. Such was the case with Six Flags, Inc. in 1998. Time-Warner Corporation, the principal owner of Six Flags, was accused of understating profits and under-investing in the theme park chain so that it could renew its contract with Six

Flags at a discount. The managers and investors of Six Flags sued and defeated Time-Warner in a multi-million dollar lawsuit in which the jury found Time-Warner Corporation guilty of several intentionally deceitful business practices. The final verdict was a $474 million fine to Time-Warner Corporation, which was upheld despite several attempts by Time-Warner to appeal the decision (Vernich 18). In spite of the hefty fine imposed by the courts, companies still continue to practice the art of financial understatement so as to change the value of the business for buy-out and contract renewal purposes.

The final reason that a company would understate its profit figures involves decreasing the value of its stock for the purposes of buying back its outstanding shares. A company will buy back its outstanding shares of common stock for several reasons. First, a stock buyback portrays a company's confidence in its future performance as well as the future of the economy as a whole. For this reason, a stock buyback will often provide a false assurance to shareholders and will increase the long-run value of the company's stock. Another reason that companies want to decrease the stock value and buy back outstanding shares is to soak up stock options. If the value of common shares decreases, the company can buy more shares with its actual profits and distribute these shares as employee stock options. The third reason that a company approves a buyback is to distract investors from dividends. If a company promises a buyback and investors feel that this buyback will increase the value of their stock, then they will be less likely to pressure the company to increase the amount of dividends paid per share. Companies prefer the buyback option to an increase in dividends because they are not required to follow through with the buyback. The final reason that a company would want to buyback its shares is to inflate profitability. Because earnings per share (EPS) is calculated only on outstanding shares, fewer outstanding shares will increase EPS. A higher EPS can make business look better, which in turn can be attractive to future investors and potential customers alike (Vernich 21). It is easy to see how the buyback option can be attractive to companies, and understating earnings has allowed companies to buy its outstanding shares at a cheaper price. In turn, understating P & E to decrease the price of a company's shares also makes the buyback process illegal.

On the surface, it may seem unlikely for a company to understate its earnings figures, but a closer look reveals several reasons that a business owner or manager would want to disguise profitability. Because hiding profits can be difficult and illegal, managers will often choose a different method of understating financial stability. One way to legally conceal profitability is to inflate depreciation. For example, instead of using the straight-line method, a company can increase depreciation figures by using the double declining balance method. Another way to understate P & E is to inflate tax figures. Although a company can choose one of several ways to do this, the most common method is to not record certain tax deductions to which it is entitled. By doing this, a business will owe more taxes, and the earnings figures will decrease. The final way to understate profits without disturbing revenues is to include future costs in current accounts. If a manager knows that the company will make purchases in the near future, they will often record these purchases before the transaction ever takes place. By doing this, current costs are increased while current P & E are simultaneously decreased (Vernich 24). These are just a few of several methods that managers use to understate the financial condition of a company.

III

Overstatement of Financial Statements

The more common of the two types of financial misstatement is earnings overstatement. This is the process by which a company owner or manager inflates profits to make the company appear more attractive to its current clients and potential investors or creditors. Often times, the financial stability of a company reflects the quality of management; therefore, managers feel added pressure to boost earnings so that they either meet or beat expectations (Vernich 27). In addition, financial stability for the company usually means a larger paycheck for the managers. So managers will sometimes inflate the company's figures to achieve a personal gain and avoid the risk of losing his or her job. Other than the obvious reasons of personal job security and additional compensation, several other aspects of a company provide incentive for managers to overstate earnings. These include greed, fear, regulatory environment, industry conditions, and the economic environment. In order to run any successful corporation, the employees, the clients, the shareholders, and the creditors must all be content with what is going on within the company. If a manager suspects that one of these groups of people is unsatisfied, then he or she will often take desperate measures to alleviate the problem (Vernich 27). The most common reasons for a company to overstate income are to sell the company or publicly offer the company, to satisfy debt covenants, and to increase personal wealth for the upper-level employees.

On most occasions, the board of directors and managers will know far in advance if the owners are planning to sell the company or offer its shares to the public. In fact, this information is usually released to the upper-level managers at least two years in advance with the recommendation that the company perform well before the buy-out or IPO. With these instructions in mind, managers will often influence the numbers so that the company's market value will increase or its stock will sell for a higher price (Vernich 29). In return, in the case of a buyout, the owners will often give a good review of these particular managers to the new owners so that these managers can maintain their current positions in the company. Such was the case with Qwest Corporation in 2001. Although the details of this case are still somewhat unclear, shareholders have made several allegations against four upper-level company executives. According to the accusations, these executives not only boosted earnings to meet quarterly expectations, but they had also had previous discussions about potentially offering the company for sale if the profits showed a consistent increase in the near future. Thus, they and other managers bolstered earnings in order to increase the attractiveness of the company (Vernich 29). Because these executives decided to manipulate the books, they are now facing the possibility of many years in prison and millions of dollars in fines.

In some cases, a company will overstate earnings in order to satisfy debt covenants. On occasion, a company will borrow funds for one reason or another without ample funding to repay the debt in the required amount of time. Financial institutions will often recognize a low income to debt ratio and will either not loan the money or will loan the money under several strict conditions. A business will often employ sketchy tactics to either cover up its inability to pay creditors or to pay creditors with false earnings. This lack of funds became a problem for Parmalat, Inc. at the turn of the century. From the years 2000 to 2003, Parmalat executives had overstated its earnings by as much as $12 billion. One way that they accomplished this elaborate scheme to fool its creditors was by creating false accounts with several multi-million dollar clients and creating false documents to accompany these non-existent income sources (Vernich 31). By doing this, they were proving to creditors that they could meet their current debt obligations, thus persuading new creditors to loan them money. In late 2003, they convinced one bank to loan them a large sum of money in order to purchase another company. The first payment on the debt came due about the time that the fraud scheme was unveiled. It was not until then that the financial institution realized that it had made a huge mistake. Although Parmalat continues its operations, its stock price has fallen to almost nothing, and over twenty of its upper-level executives have been arrested for their involvement in the conspiracy.

The most common reason for overstating profits and earnings in a corporation is for the upper-level employees to increase their own personal wealth. Most of the time, when this situation arises, it happens at companies with a long history of increased earnings. These companies are not trying to get out of debt and therefore lying about earnings. Instead, it is greed among the upper-level executives that causes the fraud to eventually surface. Of the hundreds of fraud cases each year in the United States, over sixty percent of them are a result of the wealthy trying to become wealthier. Such was the case with several recent fraud schemes in the U.S. Within the last four years, Adelphia, Tyco, HealthSouth and Enron Corp. have all experienced a downfall due to greed at the management/owner levels. Adelphia founder John J. Rigas, his three sons, and two other company executives have been charged with overstating earnings to greatly exceed Wall Street expectations. With the extra income that was recorded by the corporation, members of the Rigas family were making stock purchases and buying luxurious condominiums in New York and elsewhere. Corporate funds were also being used to make expensive purchases for the other two executives, who were leaders in the plan to falsify earnings. Overall, these founders and executives spent over $250 million dollars in company funds for personal benefit. At Tyco, the story was pretty much the same. Upper-level executives Dennis Kozlowski, Mark Swartz, and Mark Belnick were accused of selling enormous amounts of company stock without notifying the public and taking out "personal loans" from the company to make purchases that added to their already lavish lifestyles. Although the three men maintain that all borrowed funds were approved by the Board of Directors, some members of the Board have no recollection of any agreement to loan these funds to the men or to have them repay the funds at such a low interest rate. The three executives are charged with corruption, conspiracy, grand larceny, falsifying records, falsifying business reports, and failing to report personal loans to the compensation committee. Unlike Adelphia, this manufacturing giant has hired new management and seems to have overcome the difficult situation. In the case of HealthSouth, the company was overstating its earnings to either meet or beat the profit expectations set forth by Wall Street forecasters. One way that they were accomplishing this fraud was by recording profits for multiple clients or group clients at individual client rates. As imagined, the patients who receive group care have to pay a discounted rate as compared to those receiving one on one care. With the extra earnings that were raked in by HealthSouth, the CFO Richard Scrushy was making personal expenditures in excess of $300 million per year. In addition, when Scrushy believed that the outpatient giant would experience losses due to regulatory changes, he sold over ninety-four percent of his stock in the company. His attempts to increase personal gain and avoid personal loss eventually raised a red flag, and the company went under investigation in September of 2002. Meanwhile, another multi-billion dollar giant was also undergoing investigations for its creative bookkeeping. One of the largest corporate scandals in the history of the United States was emerging in Houston, Texas at the expense of thousands and thousands of shareholders. Enron Corporation was a large energy manufacturer that had experienced financial growth for decades without ever falling under the public eye of scrutiny. However, in late 2001, Enron restated its previous years' earnings by over $591 million. This restatement raised a red flag about how a company could have recognized that much income, when in reality, it was non-existent. The stock price fell by over ninety percent, and the accusations began to fly. Before it was all said and done, over 20 Enron executives, several financial institutions, a few law firms, and two major accounting firms were charged with some sort of involvement in the debacle. Although the Enron executives were persistent that the restatements were a result of a series of mistakes, further investigation revealed that this was not the case. Not only were these upper-level executives involved in a scheme to hide some of Enron's debt and overstate its profits, they were also slapped with charges of insider trading and using company funds for personal benefit. Almost all of the executives charged in the case had been making purchases such as vacations, houses, cars, etc. with Enron-generated funds. In total, these company executives embezzled hundreds of millions of dollars in company funds and cost many shareholders their life savings, which had been tied up in Enron stock for decades (Vernich 31-35). As one can see, greed among the upper-level executives is quite possibly the most damaging form of fraud that a corporation can go through. In all of the cases mentioned above, the company experienced tremendous blows to its profits, its stock price, and its reputation. In all but one of the cases, the covetous actions of only a few people eventually led to the downfall of the multi-billion dollar corporation that made them millionaires in the first place.

IV

The Underlying Problem: Independence

The concept of independence has just recently surfaced as a major issue in public accounting. In fact, during the initial discussions for the adoption of Sarbanes-Oxley, independence was an important topic that led to the creation of several sections of the Act. The reason that independence has become such an important issue in the profession is because many experts believe that the lack thereof is the underlying cause of the fraudulent activity. Before one can understand why this has become a common belief among many accounting experts, he or she must understand what is independence and how it can be affected.

Independence is a concept that requires an external auditor to maintain a certain level of professional skepticism when performing an audit. What this means is that the auditor must try to have a neutral attitude when auditing one of his or her firm's clients. He or she must not be influenced by anything other than the figures that can be supported because any financial information that the auditor finds could be a red flag and could possibly lead to the detection of fraud (Canton 12). If a company knows that it is involved in fraudulent activity, its upper-level executives may try to say things or do things that lead the auditor away from the fraudulent accounts. The easiest way to influence an auditor is to affect his or her independence. The most common ways that an auditor or audit firm can lose independence is by performing other services or working for a client, establishing close relationships with clients, or relying too heavily on the audit fees.

One way that independence is affected is when an auditor either works for or performs other services for a client. In many cases, a CPA will work on the audit staff that reviews a client's financial records and will also serve as a financial consultant for the client. The problem with this is that the CPA wants to see that the financial advice given to the client is working well. If it is, then the client will continue to use that particular

CPA for consulting services. This affects the independence of the CPA because he is more likely to overlook a material misstatement if its results benefit the company to whom he provides consulting. If the misstatement provides a brighter outlook for the company, then the executives will want to continue to use the CPA for the other services he has provided.

Another common way that an auditor loses independence is by establishing close relationships with clients. This situation has become a double-edged sword for most auditors because they want to continually improve client relations, but at the same time, they must maintain a level of professional skepticism. In many cases, an audit firm will keep a client for so long that they become friends with the upper-level managers and executives within the company. When this happens, it becomes very difficult for an auditor to detect fraudulent activity. The first reason is because the auditors begin to trust the managers and the executives to the point where they will not perform the tests necessary to formulate an opinion. Instead, they will simply ask the executives if the financial information is correct, and assuming a confirmation, they will issue an opinion without ever really examining the true financial condition of the company. The second reason that establishing relationships makes it difficult to detect fraud is because no one wants to turn in someone that they consider to be a friend. If an auditor and an executive spend many days on the golf course together and many nights eating dinner with their families, then it is very unlikely that the auditor will report fraudulent activity to the SEC. Historically, auditors have been more reluctant to report fraudulent activity committed by their long-term clients than they have the fraud committed by their newer clients (Canton 13). The reason is because over a long period of time, the auditors and the upper-level executives in the company establish relationships that affect independence.

The most common of all independence factors is heavy reliance on fees and compensation. Most of the larger audit firms in the United States receive millions of dollars from their largest clients for audit fees and other service fees. Each auditor knows that detecting fraud will more than likely lead to the demise of the corporation and the eventual loss of an important client. With this in mind, they are more likely to either overlook a material misstatement, or in some cases, assist in the efforts to cover it up. An auditor knows that the detection of fraud could have several consequences on both the client and the auditing firm. For the client, this means several lawsuits, a huge drop in the stock price, and probably bankruptcy. For the audit firm, this means, at the very least, the loss of millions of dollars in revenues per year. If an investigation ensues and more fraud is uncovered from previous years, it could mean a stream of accusations that the auditing firm knew about the fraudulent activity all along. If this happens, then the audit firm will take a hit to its reputation as well as its bank account, and the upper-level audit managers could spend some time in jail. If this situation occurs, then it is almost certain that the auditing firm will go down with the client. For these reasons, the auditors will more than likely choose to overlook the fraud, take the millions in revenue, and do whatever they can to keep the situation under the table. Most audit firms will choose to follow by the old saying, "Don't bite the hand that feeds you."

As for the cases mentioned in Sections II and III of this thesis, they all have at least one thing in common. They were all situations in which the auditors were either negligent and believed the misleading information that they were given, or the auditors lost independence for one of the reasons mentioned above. In several of the cases, it was the establishment of relationships and the reliance on audit fees that caused the auditors to overlook the fraud. In the cases that the auditors were aware of the fraud but chose to assist in the cover-up, the audit firm experienced losses so severe that they were forced to close their doors as well. Situations like these are the reasons why independence has become such a major issue in the accounting profession.

V

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was adopted in response to the increasing number of fraud cases surfacing in the United States in the last ten years. It was signed into law only a month and a half following its conception, mainly because of the urgent need for action. As mentioned in the introduction, this Act consists of eleven titles and a total of sixty-nine sections. The purpose of Sarbanes-Oxley was to establish a set of standards and regulations to which auditors and their clients would adhere. In this section of the thesis, each title will be listed and followed by a brief explanation of its contents. This will familiarize the reader with the different titles of the Act so that they can better understand why certain sections of Sarbanes-Oxley need to be changed.

Title I- Effective Date- This title simply states that the Act was signed into law by President Bush on July 30, 2002. It also mentions that the SEC will establish rules that will require certification requirements for CEO's and CFO's by August 29 of 2002. In addition, the SEC is required to establish rules concerning the disclosure of off-balance sheet transactions by January 26 of 2003 (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title II- Background- This title provides the reasons that this Act was adopted. It mentions the Enron case along with the collapse of Arthur Andersen and several other large U.S. corporations. It discusses the fact that independence and fraud played a major role in the downfall of these corporations. Also, this section addresses the urgency surrounding the Act and why it is to be implemented immediately (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title III- Overview and Covered Entities- This title includes an explanation of all of the entities that are to adhere to the standards of Sarbanes-Oxley. This Act applies to both U.S. publicly traded companies as well as foreign companies traded on either NASDAQ or NYSE. Investment companies must also follow the standards set forth in Sarbanes-Oxley, and any company with publicly traded debt securities is to abide by the rules and restrictions of the Act as well. There is no mention of companies that file reports with the SEC solely because of covenant provisions in their indentures; however, commentators believe that these companies will also be forced to uphold several provisions of the Act (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title IV- Corporate Governance Standards for Directors and Executive Officers- This title sets the new certification requirements for the CEO and CFO of a corporation. According to Title IV, a CEO or CFO must now submit a written certification that each quarterly or annual report with attached financial statements issued by the company has been reviewed and that the following conditions have been met:

1. The report complies with applicable reporting requirements of the Exchange Act.
2. All information in the report represents fairly, in all material respects, the true financial condition of the company and its operating results.

3. The CEO/CFO have established internal controls that will ensure that the material information in the report has been made known to them, and that they have included in the report their evaluation of the effectiveness of the internal controls.
4. They have disclosed to the company's independent auditors and audit committee all deficiencies in the design and implementation of the controls as well as any fraud that involves management.
5. They have reported whether or not there have been any significant changes in internal controls during that particular reporting period (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title V- Public Company Accounting Oversight Board- The purpose of this section of Sarbanes-Oxley is to establish an SEC-supervised non-governmental Public Company Accounting Oversight Board. This board is responsible for registering all public accounting firms that practice before the SEC as well as establishing quality controls and independence standards. This Board will have the authority to conduct investigations and disciplinary proceedings and impose sanctions where justified. Among the quality controls established in this section are requirements for the maintenance of audit papers for seven years instead of five, second partner review of audit reports, and an evaluation of the internal control structures of the issuer. This Board has the power to suspend firms or individuals within the firm from practice (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title VI- Auditor Independence Standards- This particular section focuses on the independence problem that has recently become such a vital issue in the accounting profession. This portion of the Act specifically prohibits public accounting firms that are registered with the SEC from providing audit clients with non-audit services including:

1. Bookkeeping or other services related to the accounting records
2. Financial information systems design and implementation
3. Appraisal or valuation services
4. Actuarial services
5. Internal audit outsourcing
6. Management functions or human resources services
7. Broker-dealer investment advisor or investment banking services

8. Legal services and expert services unrelated to the audit
9. Any other services that the Board deems to be impermissible (www.nlcpi.org/books/pdf/BRIEFLY Apr03(Bost).pdf).

Notice that there is no mention of consulting services or tax services. These issues are to be left up to the auditing firm as to whether or not they could affect independence. This section also mandates a rotation of auditing firms so that the same firm can not audit one company indefinitely.

Title VII- New Standards for Corporate Responsibility- This portion of the Act can be difficult to understand, but basically, it sets new rules that will prohibit the upper-level executives from cashing in on their benefits before the company goes under because of uncovered fraud. For example, if a company has to make a financial restatement, then the CEO and CFO must reimburse the company for any incentive-based or equity-based compensation received since the reporting of the erroneous financials. In addition, in the case of a restatement, these executives must also reimburse the company for any profits realized on the sale of company securities within a twelve-month period. Also, this section sets new independence standards for audit committees. No longer can any member of the audit committee or Board of Directors (if a company has no audit committee) accept any consulting or advisory fee, nor can they be an "affiliated person" of the company being audited. In Laymen's terms, this means that the members of the audit committees can in no way be associated with the operations of the company (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title VIII- Enhanced Financial Disclosures- Other than the obvious full disclosure of off-balance sheet transactions, this section of the Act also covers the disclosure of a Code of Ethics that each company has established for its senior financial officers as well as the disclosure of the fact that each audit committee consists of at least one "financial expert." In addition, the Act mandates increased scrutiny on the following issuers:

1. those who have materially misstated their financial statements
2. those who have experienced significant fluctuation in their stock price as compared to others in the industry
3. those with a large market capitalization

4. emerging companies with inconsistencies in their price to earnings ratio
5. those whose operations significantly affect a material sector of the economy (i.e. Microsoft)
6. those involved with any other factors that the SEC may consider relevant (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title IX- Analyst Conflicts of Interest- This section of Sarbanes-Oxley focuses on the disclosure of any conflicts of interest that may arise when securities analysts recommend equity securities in research reports and public appearances. Also, this title prohibits the practice of publishing research reports on companies in proximity to public offerings of their securities. In other words, no one can let information pertaining to the operations of a company leak before the company wants the public to know (www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

Title X- Studies and Reports Ordered- This section basically provides a foundation for the Comptroller General to research and report the reasons for both the collapse of major accounting firms and corporations in the U.S. as well as the degree to which federal regulations impede competition among public accounting firms. Also, the study will include an investigation into the types of transactions that allow companies to manipulate earnings and how to keep these transactions from becoming a part of everyday operations (www.nlcpi.org/books/pdf/BRIEFLY Apr03(Bost).pdf).

Title XI- Penalties and Increased Enforcement- This section sets the punishments for CEO's and CFO's who are convicted of certifying non-complying or misstated financials. A CEO or CFO can be fined up to $1 million and/or imprisoned for up to ten years if he or she allows the release of faulty financial statements. If the CEO/CFO knows about the misstatements and then certifies the financials, then the punishment can increase to $5 million and up to twenty years in prison. If an auditor is accused of destroying audit papers, he or she can also draw a fine and anywhere from five to twenty years in prison. This section also includes a statutory protection against employers taking action against whistleblowers who follow the provisions of this Act. It also states that there will be increased penalties for both mail fraud and wire fraud, raising the sentence from five years in prison to twenty years

(www.nlcpi.org/books/pdf/BRIEFLY_Apr03(Bost).pdf).

VI

Problems with the Sarbanes-Oxley Act

**Please note that all claims made in this section of the thesis are solely my opinion and should in no way be taken as fact.*

The Sarbanes-Oxley Act of 2002 was created for the purpose of establishing standards by which audit firms and corporations would abide. It not only creates standards for these companies, but it also separates responsibilities and determines punishments for those who fail to adhere to the provisions set forth in the Act. In the fifteen or sixteen days worth of reading Sarbanes-Oxley over and over, several instances surfaced where an important fact was either disregarded or overlooked. Perhaps it was that the Act was thrown together too quickly for the sake of urgency or perhaps it was merely a lack of attention by those responsible for adopting it, but whatever the case, Sarbanes-Oxley is by no means perfect. For the most part, this Act will serve its purpose; however, the research revealed a few areas in which Congress should make changes. These problems are in the following titles to the Act:

Title IV- Corporate Governance Standards for Directors and Executive Officers- This section of the Act clearly establishes the CEO/CFO as the responsible party for any fraudulent activity. The CEO/CFO must review the financial statements and certify that all of the information is correct and without material misstatement. The only problem with this requirement is that there exists a possibility that the CEO/CFO may not be fully aware of the transactions in every account that exists, especially in a large corporation. For example, it is possible that a person in the Accounts Payable department may be creating false invoices and stealing money from the company. Although this action could have a significant impact on the financial condition of the company, the CEO or CFO may have no clue that this is taking place, especially if this fraudulent activity is committed by a manager. In any large company, there must exists at least a certain level of trust between the CEO and his or her upper-level managers. A CEO must be able to believe a manager when he or she provides financial information. In addition, the CEO/CFO is responsible for reporting any fraudulent activity at the management levels. If there exists fraud within a corporation and the CEO/CFO does not report it, then he or she will be the responsible party. Again, it is possible that the CEO/CFO is unaware of what is going on. Although this is not always the case, it is likely that a CEO/CFO would report any fraudulent activity that he or she knows about, especially if he or she is not involved. One CEO of a large corporation here in Columbus said that he is a bit worried about Title IV because he feels it is unfair to hold the CEO/CFO responsible for something of which he or she is completely unaware. He also feels that it is unfair to hold the CEO/CFO responsible for fraud with which he or she is not involved.

Title V- Public Company Accounting Oversight Board- Title V establishes the creation of a Public Company Accounting Oversight Board. This Board is responsible for establishing quality controls and independence standards as well as conducting investigations into any reported fraudulent activity. One control established by the Board enforces a second partner review of audited financial statements. Although there are no concerns with the establishment of this Board, there are a few problems with the assignment of its duties. First, this Board has the authority to conduct investigation if fraud has been suspected. The problem with this is that by the time fraud has been detected, it could have been taking place for years. Sometimes, the detection of fraudulent activity could prove to be too late. This Board could potentially be implemented in such a way that it stops most fraud before it begins. A further explanation exists in Section VII of the thesis. Also, there is a problem with the standard that requires a second partner review of audited financial statements. Often times, it is not just one partner that will let a material misstatement go unnoticed. Because it is the entire firm that relies on the audit fees, a second partner review would more than likely prove to be unhelpful to the situation (http://www.riscpa.org/files/winter2003.pdf).

Title VI- Auditor Independence Standards- The only problem with this particular title of the Act is that it fails to mention consulting services or tax services in its restrictions for an auditing firm. The reason that these services are not mentioned is because most of a CPA firm's income comes from consulting services, tax services, and auditing services. Congress knew that if an audit firm were not allowed to provide these services to its clients, then the Act would have caused an uproar from these large accounting firms. The services restricted by Title VI of the Act provide, on average, less than five percent of an accounting firm's yearly income. Although these accounting firms should be allowed to provide consulting or tax services, there is a better solution to the problem other than simply avoiding the issue.

Title VII- New Standards for Corporate Responsibility- This title of the Act comes as a direct result of the Enron case. Upon issuing the restatement of Enron's financials, the upper-level executives predicted the downfall of the company and began cashing in on their 401(k) plans, etc. The employees of the company had no idea about what was about to happen, and many of them faced terrible losses at the hands of the executives (http://www.thelenreid.com/articles/article/art_138_idx.htm). In Title VII, the CEO's and CFO's of any company that declares a restatement must repay any incentive-based or equity-based compensation that he or she received beyond the release date of the erroneous financials. Also, these executives must reimburse the company for any profit realized on the sale of company based securities in the twelve-month period following the release of the faulty financial statements. The problem with this again lies in the fact that a CEO or CFO may not know about the fraudulent activity or the material misstatement. According to Sarbanes-Oxley, if this situation occurs, then the CEO/CFO will be punished double. The first punishment will be for certifying the material misstatement in the first place, and the second punishment will be the repayment of any profits or compensation if the misstatement is discovered. What if the CEO or CFO does not know about the misstatement and certifies the financials? Then, at a later date, the CEO or CFO detects the fraud and is the one who discovers what has been going on in the company. Do the punishments and responsibilities set forth in Sarbanes-Oxley for a CEO or CFO provide incentive for the CEO/CFO to report the fraudulent activity? No, instead these provisions provide greater incentive for these executives to try to cover up the misstatements, even if they knew nothing about them in the first place (http://www.thelenreid.com/articles/article/art_138_idx.htm).

Title XI- Penalties and Increased Enforcement- One can provide the same argument against this title of the Act that exists with the others. Where is the justification in punishing the CEO or CFO when he or she potentially had nothing to do with the fraudulent activity? First, an investigation should take place, and the punishments should be given out based on each person's involvement in the fraud or cover-up. If the judicial system is unable to find where a person was involved, then there is no justification in punishing that person. The judicial standard in the United States is "innocent until proven guilty." So why does this basis change for corporate America? In the case of Title XI, the CEO or CFO is punished based simply on the fact that the faulty financials were released in the first place. Also, this title sets forth the punishments for the auditing firm that audited the company. These punishments for the auditors appear to be less strict than the punishments for the CEO or CFO. If any member of an auditing firm is aware of the fraud and assists in the cover-up, then he or she should receive a much harsher punishments than the executives of the company (http://www.thelenreid.com/articles/article/art 138 idx.htm). After all, is it not the job of the auditors to detect the fraud and report it to the public? As humans, we should expect that a corporation would try to get an edge by overstating financials or providing misleading information.

This is the reason that audit firms were established in the first place. However, an auditor should never be influenced to the point that he or she does not serve his or her duty to the public. This is a much worse crime that deserves a much harsher punishment.

VII

Proposed Solutions to the Problems

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Section VI of the thesis pointed out several problems with the different titles in the Sarbanes-Oxley Act of 2002. For each one of the problems listed in Section VI, Section VII proposes a solution that provides a much more effective alternative. These solutions provide better methods of assigning responsibilities and duties, and they also focus on the utilization of the Board in such a way that it prevents a lot of fraudulent activity. The solutions to the problems listed in Section VI are as follows:

Title IV- Corporate Governance Standards for Directors and Executive Officers- As mentioned previously, this section focuses on the new certification requirements for a CEO/CFO and their responsibilities for financial misstatements. The most logical explanation for this problem is to investigate the fraudulent activity or misstatements before assigning responsibility. Because the possibility exists that the CEO/CFO may be unaware of the fraudulent activity or financial misstatements, then investigative procedures performed by the newly established Board should provide the basis for determining punishment. If the Board investigates a financial misstatement only to find that the CEO/CFO had been given misleading information, then the fair thing to do is punish the managers or executives responsible for providing the misleading figures. However, if the Board finds that the CEO/CFO was fully aware of the fraudulent activity, then he or she should be punished to the fullest extent of Title XI.

Title V- Public Company Accounting Oversight Board- The two changes/additions that need to be made to Title V involve the duties and responsibilities of the Board. First, this Board could potentially be a system of fraud prevention in addition to its investigative duties. Along with allowing the Board to conduct investigations upon the surfacing of fraudulent activity, they should also be given the authority to conduct random investigations into any corporation at any time. If a company knows that their activity has become suspect, then they will have time to cover up a lot of the evidence leading to the persons behind the misleading activity. However, the allowance of random investigations could provide the fear factor that stops a lot of fraud before it begins. If a company knows that it could be investigated at any given time, then it might be less likely to try to get away with "cooking the books." In comparison, restaurants know that they could be inspected and shut down at any given time, so for the most part, they keep their places of business clean. However, if restaurants were only inspected when someone complained, then there would be more unsanitary eating establishments all over the U.S. Also, one of the provisions that the Board has established needs to be changed. Instead of requiring a second partner review of audited financial statements, the Board could require that these audit firms submit to them a copy of the work papers used during the audit of suspect companies. In this, the Board could ensure that there is no fraud taking place and that the auditors are doing their job. Because this Board has no reliance on the hefty audit fees, then they have no reason to let anything slip through the cracks.

Title VI- Auditor Independence Standards- The solution to the problem mentioned in Section VI concerning auditor independence standards is to require that audit firms keep all service providing divisions of the company separate. By doing this, audit firms will only be allowed to report their findings to the tax professionals and consulting professionals in the company. They will not be allowed to take part in performing the actual consulting service. Although Title VII of the Act states that no person on the audit committee will be allowed to receive consulting fees, it does not specify the separation of the divisions within a public accounting firm. What this means is that the persons on the audit committee can still provide consulting services and simply charge the consulting as increased audit fees. By separating the divisions, the company will be forced to show the revenues as separate, which will ensure that the services are being provided by two different groups of people. Although this method will not provide the assurance of complete independence, it is definitely a step in the right direction. The fail-safe method for complete independence is to not allow auditing firms to perform consulting services at all, but as mentioned in Section VI, this would definitely cause problems for the major accounting firms. So for now, this approach seems to be the alternative that keeps everyone satisfied.

Title VII- New Standards for Corporate Responsibility- The solution to the problem with Title VII is similar to the solution to the problem for Title IV. Before an upper-level executive should be punished for fraudulent activity within a corporation, the Board should conduct an investigation to make sure that the CEO/CFO knew of what was occurring within the company. If he or she knew nothing about the crooked activity taking place, then it is unfair to force him or her to repay any incentive-based or equity-based compensation along with any profits from the sale of company securities. Instead, these executives should only be forced to repay this compensation if it can be proven that he or she was aware of the dubious activity. This procedure will allow the CEO or CFO the freedom to report the suspicious activity with the comfort of knowing that they will not be punished because they had no idea that it was taking place. If the Act remains the way it was written originally, then investigations will prove that more CEO's and CFO's are getting involved in cover-up attempts instead of taking the proper actions to alleviate the problems.

Title XI- Penalties and Increased Enforcement- Much like the other problems with the other titles in Sarbanes-Oxley, this one also requires attention in the area of assigning responsibility. CEO's and CFO's should only be punished after an investigation proves guilt instead of punishing them based on the assumption that they were involved in the deceitful activity. In addition, negligent auditors as well as those involved in the cover-up of a major fraud scheme should be punished to a much greater degree than the executives of the company. As mentioned previously, human nature gives us the desire to get ahead, and some people will do anything to reach the top. It is for this reason that fraud exists, and fraud is why we need auditors. The public relies on auditors to report any material misstatements in a company's financials, so to whom can we turn if auditors are no longer doing their job? Of all of the cases mentioned in Sections II and III of this thesis, the auditors could have prevented the fraudulent activity had it been detected in the first year that it occurred. However, auditor negligence or involvement at some level allowed the treacherous activity to get out of hand. Some may argue that both sides are to blame for the terrible losses experienced by the shareholders of these major corporations, but it is mostly the fault of the auditing firms. After all, for what reason do they exist if it is not to detect material fraud and report it to the public? Because of this, Congress should modify the punishments set forth in Title XI and make those designated for the auditors much more severe.

VIII

Conclusion

To provide an estimate on the costs of financial fraud, it can be compared to the high-priced concern facing our nation today, The War on Terrorism. In total, the Bush administration has approved over $100 billion of spending to fight the terrorists, but this is mere pocket change compared to the estimated $7.5 trillion that Americans have lost at the hands of greedy corporate executives (Vernich 17). Because of this, the United States definitely needed action, and Sarbanes-Oxley was supposed to be the answer to this ongoing problem. Sarbanes-Oxley was surely going to provide the rules and regulations that would stop corporate America from robbing its investors and put U.S. businesses back on the right track. Although the plan seems noble, it is a far-fetched goal considering the problems within the body of the Act. Unless Sarbanes-Oxley is changed, it could eventually prove to be harmful to the situation. In the past, corporate executives would merely front their lies as restatements when they felt pressure to prove their financial claims. These restatements would provide the suspicion needed to conduct internal investigations that almost always brought out the truth. However, considering the questionable provisions in Sarbanes-Oxley, it is possible that we may face the dilemma of even more elaborate cover-up schemes by both corporate executives and auditors alike. If Sarbanes-Oxley is revised and the focus is shifted towards stopping fraud before it starts and punishing those responsible for the deceitful activity, then these greedy businessmen can eventually be eradicated, and the public can learn to trust corporate America once again. Until then, Sarbanes-Oxley is not a solution. Instead, it is nothing more than just a step in the right direction.

Afterthought:

Before writing this thesis, the Sarbanes-Oxley Act of 2002 was just another unfamiliar law. In fact, some of the original suggestions for provisions were already a part of Sarbanes-Oxley. After twenty-one straight days of writing and researching this Act, all sixty-nine sections of rules and regulations have become second nature. This knowledge will prove useful because it is the type of knowledge and hard work that one can carry into future projects. At times, writing this thesis became very difficult, and quitting was definitely a consideration. However, finishing this type of project allows for the perseverance and strong will that is required by corporate America. Maybe if the greedy upper-level executives of today's society had faced and overcome such tasks, then they would not always be looking for the easy way out.

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