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Dual reforms

Accounting and corporate governance

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Abstract *Adopting the Sarbanes-Oxley Act has provided impetus to reforming corporate accounting and corporate governance. Implementation of this legislation is so broad as to move from mere statutory compliance, to provide authority for changes in the professions of accountants and corporate officers and corporate counsel. This paper describes effects of the Sarbanes-Oxley Act (Public Law No. 107-204, Sec. 1-1107) on the principal management and control functions of the business environment.*

Introduction – the environment of modern business

The business environment of the modern commercial world is built on conflicting influences. In broad perspective, those influences are based on legal systems and the generated regulations. Then the environment of modern business is susceptible to categorization as advocacy, and regulatory. The responsibility of corporate officers in that environment is expansive, and is also challenging for compliance with enhanced regulation.

A relatively novel dimension of the current environment is the stance of officials of the organization, recognized as aggressive, generated by the global and competitive environments for business. A measure of overly aggressive stance is found in bankruptcies of large-to-very large organizations. These bankruptcies involve tens-to-hundreds of billion of dollars.

The need for reform of accounting and corporate governance

Defining a manageable position is a novel activity, within this regulatory environment. Re-definition of those management positions is needed for global markets and changes in officer positions, including new management technologies. Possibilities are driven by the expanding environment of business, and with the expanding modes of performing and communication.

The Financial Executives Roundtable met on the global topic: The Crisis in Accounting, Auditing and Corporate Governance (FER, 2002). To resolve the crisis, a main thrust was identified: the performance reporting was to be trustworthy, timely and transparent (FER, 2002). Once assessment of performance can be established and is reliable, the operational step is to provide the means for performing, with incentives to ensure continuity of performance measurement.

The means considered are both internal to the organization, and in the external environment. A list of these guides and validity are (Thomas, 2003; *Card News*, 2002):

- laws and accounting rules;
- regulation of disclosure and enforcement;

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- corporate governance process;
- internal and external auditing; and
- external analysis of operational and financial performance.

A check on the validity of these guides is essential, as changes occur to the organization, to oversight agencies, and to regulations and laws. It is clear that internal incentives to directors, officers and managers are not effective alone to make the changes.

Incentives for a change come from internal needs and from external oversight. External incentive comes largely from agencies, for example, the SEC. The scope of SEC authority is already focused on securities, and duties regarding disclosure and conduct (as insiders).

That scope is widened under the Sarbanes-Oxley Act (Congress of the United States of America, 2002), to cover individual director, officer and manager, imposing individual duties and liabilities, and regulating the form of compensation salary and earned equity, versus loans, additional compensation paid as perquisites, profit sharing not matching sales profit, and awarded equity (Maco, 2002). A new agency is created, with the apt name the Public Company Accounting Oversight Board (PCAOB). That agency covers the above areas in several ways: internal versus external controls, and accounting and auditing vs non-accounting services. From that dual perspective, a realistic assessment of company performance and actions is made. The agency authority is to inspect and investigate in scope and depth.

It is this dual path that is described in this paper, to identify the issues in accounting and in corporate governance, and proposals of authorities and professional associations in resolving the issues. Appendix 1 describes the role of ethics in this change. The result is a true reformation of practices in accounting and corporate governance.

Violations in accounting practice

Accounting practice is prescribed by professionalism and by regulation, and is slow to demonstrate serious violations of either standards (Reinstein and Weirch, 2002).

At the outset, there is application of standards in practice: letter versus spirit of the standards. Companies can automate, in computer form, its accounting procedures. Yet treating financial information involved in a computer procedure can be distinct from appropriate recognition of the transaction containing the information.

Determination of violation is made clear (amplified) where a large-scale employee situation is involved, as in the Enron case (Reinstein and Weirch, 2002).

Enron employed professionals in accounting for handling its transactions. The transactions proposed to describe multiple businesses, energy brokerage, broadband communication and water supply, all in a complex organization structure.

The mechanical approach, found in form and structure of accounting for the business, leads to misrepresentation by the company. The number and kinds of "partnerships" created off of the balance sheet, and situated in non-consolidated financial statements, lead to hiding billions of dollars of liabilities. This use of accounting was highly professional, and at the same time, was highly unethical and potentially unlawful. For example, while no economic value and no cash flow were generated, sale of stock provided cash for on-going expenses.

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Efforts to resolve the accounting and organizational problems at Enron are discussed below, in a reform sense. Yet violations were readily identified in the cause of the "collapse" of Enron. The conduct of the Chief Executive Officer (CEO) on corporate governance and of Chief Financial Officer (CFO) on accounting and financial controls, have been highlighted. The CFO is recognized as the architect of accounting and internal control systems, neither of which detected fraudulent transactions. The CEO is recognized as the authority for the business and organization changes, and for approval of the accounting system coverage.

The role of professional associations

The role of professional associations is described as basic, in self-regulation of association members, and in service to individual members (Shafer, 2003). Legitimacy of accounting and auditing issues, standards and legislation, is cited as critical to success of the association (Williams, 2003). Auditors and CPAs are professionals. Clearly, the associations lost credibility, and legitimacy, in the range of scandals fostered by those professionals. The result of the scandals led to statutory regulation, to displace self-regulation.

Consequences of the scandals are many-fold, impacting confidence of the public and the investor in the capital markets, the (capital) markets, and a "world view" of US markets. Confidence in the markets is needed for investors and world financial markets. Essential reforms are needed in reporting, and the associated audit process (and its quality).

Crossroads in accounting procedures

The far-reaching impact of the scandals is the switch from self-regulation, to formal oversight based on the pervasive question about practices. The Sarbanes-Oxley Act (2002), and the PCAOB, are evidence of the switch, by adoption of statutory regulation.

Standards of the Sarbanes-Oxley Act (2002), may be similar to those set by professionals. Another view of standards is from the private arena: manager, auditor, investor, deal-maker. Their common view of standards is toward requirements of the market: strength, transparency, liquidity, and fairness and trustworthy.

View of regulators is conditioned to reform, brought about by the issues and controversies. Those views are common in achieving financial reporting that is responsive to the underlying economics of transactions and events.

Restoring confidence in financial markets is reached by establishing shared goals in the market. Financial reporting is said to be at a "crossroads". The corporate scandals based on "massive manipulation" of accounting (system) show lapses in the approach structure: audit process, reporting standards and corporate governance. Reforms of Sarbanes-Oxley addressed those lapses and needs, by statute (Sutton, 2002; *Card News*, 2002).

Violations in corporate governance

The Sarbanes-Oxley Act (2002) places duties on individual officers: duties of officers toward the corporation; and duties of officers toward employees. Breach, as failure to meet the duty, is sanctioned under the Act. Those sanctions are related primarily to securities laws, and to practice before the SEC.

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The main duty from the Sarbanes-Oxley Act (2002) is placed on the CEO and the CFO (*Phillips Business Information*, 2002a). The general duty is to assure that financial statements fully comply with securities laws, and to represent fairly and materially the financial condition of the corporation and the results of its operations.

A new, specific duty is to certify that the financial statements do not contain untrue statements, or omit negative results. Officers are liable to fulfill duties to the corporation (and its structure), and their own duties (Sutton, 2002).

The other main duty is to protect employees, including corporate attorneys, from retaliation for reporting violations within the corporation. This protection is to facilitate full and fair disclosure, as well as compliance with rules and regulations.

Restoring trust

The need to restore trust in corporations and corporate leadership is seen fully from the range and public nature of recent financial scandals. The Sarbanes-Oxley Act (2002) addressed this trust issue in an umbrella fashion: reform accounting, to lessen potential of corporate officers from fraudulent manipulation. At issue (at least in corporate minds) is whether corporations can do the restoration by officers and by performance, or whether a statute must be employed.

A parallel comparison (*The Legal Intelligence*, 2002) is made to describe the futility of self-reformation. The 1930s legislation, the Securities Act of 1933 and the Securities Exchange Act of 1934, was brought about by the "Age of Excess". The "blue-sky" practices of issuing and trading securities, with no substance, required statutory controls. At that time, restoring confidence of investors was essential, to overcome the bizarre securities practices.

The present period of scandals is given a comparable name, "Golden Age of Excess" (Oliver, 2002). Comparison is expansive between the two periods, as the 1930s was ab initio without earlier statutes. Presentation in the earlier period is described as clearly visible to trained observers. Investors are not necessarily alter to the technical aspects of stock offerings and to such bold practice (Oliver, 2002).

The target area of the late 1990s is narrower, with the 1933/1934 securities laws generally enforced. Underlying violations of the securities laws (and regulations) were found; however, practices meeting the-letter-of-the-law were also found. The differences are described as:

- scope;
- scale;
- liability focus;
- investor impact; and
- global impact.

Public interest has also increased, with a higher percent of the US population now as investors.

Congress, tracking interest of the public, came into the "excess", scandal situation with a legislative correction: the Sarbanes-Oxley Act (2002). Criticism of the legislation is on substantive provisions, as well as its procedures (Christopher and Sorabella, 2002).

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Substance treats the population covered as public companies trading on the stock exchange. Jurisdiction is given to the SEC (also for the 1993/1934 Acts), with authority over "registered" firms. Firms are registered again under the Sarbanes-Oxley Act (2002). Substance is addressed by increased penalties for violations, as criminal sanctions and fitting organizational sanctions under Organization Sentencing Guidelines.

The central focus of procedures is the board of directors. Placing "human faces" of board members, on liability again is expansive over the 1933/1934 Acts. Procedures include steps to be taken by legal counsel, to avoid breaching the client-attorney relationship.

Financial reporting at a crossroads

Financial reporting is said to be at a "crossroads" (Sutton, 2002). The corporate scandals based on "massive manipulation" of accounting (system) show lapses in the existing approach: with structures as audit process, reporting standards and corporate governance. (See above subsection "Crossroads in accounting procedures" for impact on markets and on the new basis for standard-setting).

From this focus on securities and the SEC, there is little conflict with state regulation of attorney conduct (state's professional code of ethics).

Scope of the Sarbanes-Oxley Act (2002)

The Sarbanes-Oxley Corporate Fraud and Accounting Act of 2002 was authorized in July, 2002, with the purpose to improve practices of public companies (that is, companies that issue publicly traded securities). These reforms were necessitated by collapse of several large companies and related accounting scandals (see above).

The broadest impact of the Sarbanes-Oxley Act (2002) is cited as the end of self-regulation of the accounting and auditing industry (Thomas, 2003). That reference denotes that the accounting industry will no longer set its own standards of performance, and that those will be set by statute and regulation, under the Sarbanes-Oxley Act (2002)[1].

Statutory standards and duties

Statutory standards have multiple effects, noted in the following categories (Miller, 2002):

(1) *External:*

- registration of public companies, with the PCAOB and registration of associated persons;
- PCAOB authority to discipline violations of pubic companies, including suspension of registration;
- rotation of auditor, serving a maximum of five years for lead, review auditor, not an audit firm itself;
- document retention of workpapers related to audit for time period of seven years; and
- elimination of discharge of obligations as relief under the Bankruptcy Reform Act.

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(2) *Internal:*

- Audit committee, with all members independent officers to appoint the external audit firm with assurance of auditor independence, principally by limiting non-audit services;
- to establish confidential complaint procedure and protection of "whistleblowers"; and
- certification of financial statements, by CEO and CFO, including assessment of internal control system, and reconciliation to GAAP in financial statements on financial condition and results of operations.

Another non-specific impact of Sarbanes-Oxley Act (2002) is to impose duties. A general duty on the organization is to assure qualification to serve in whatever appointed capacity: Board of Directors, and Audit Committee. For example, the SEC is required to define characteristics of "financial expert" for service in certain functions. Compensation is to be "ordinary" for the service rendered. Bonuses, stock profit, and loans are not permitted to officers and directors.

An overriding duty of the organization is to disclose, in "plain English", on areas of significant financial condition and operations. In particular, disclosure of off-balance sheet transactions and arrangements, including organization structure, are required.

Sanctions for violations

A novel impact of Sarbanes-Oxley Act (2002) is criminalization of activities under the Act, and related statutes. Criminalization is added both in substantive areas and in procedure (*Phillips Business Information*, 2002). Substantive implementation include new securities fraud actions, and new obstruction-of-justice actions. Obstruction now includes impeding and impairing investigation and proceeding. Retention and maintenance, and no destruction of workpapers and documents, are newly enumerated under Sarbanes-Oxley Act (2002).

Procedural implementation involved sanctions on activities; penalties are increased, and the Statute of Limitations are increased. Provisions of the US Sentencing Guideline are included. A further umbrella crime is to impose conspiracy charges among the several involved in a violation of a duty here: directors, officers, and managers.

Provisions of related statutes are included in Sarbanes-Oxley Act, by the "incorporation" principle of statutory law.

Attorney disclosures

A particular duty under Sarbanes-Oxley Act (2002), is imposed on attorneys (Davis, 2003). The Act requires disclosure of criminal activity, by attorneys in an up-the-ladder process. On discovery, the attorney is to inform, in sequence, the general counsel, CEO, the audit committee, finally the board of directors. If no response, the attorney is to adopt a noisy position, including withdrawal from the organization. The Sarbanes-Oxley Act (2002) provides a defense to the attorney disclosing against the strict client-attorney relationship.

The duty was provided, without identifying the defense for such disclosure. The process is also defensible as fulfilling the attorney's duty to the SEC. Failure of this duty is to eliminate practice before the SEC.

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Not only is the individual attorney bound under Sarbanes-Oxley Act (2002), but also the associated law firm is exposed. This exposure attaches where criminal activity of the firm was appreciated and understood ("knowing and wilfull").

Reform of corporate governance

The Sarbanes-Oxley Act (2002) rings the "death knell of self-regulation" of accounting/auditing firms. Self-regulation procedures are associated with large-dollar scandals due to accounting manipulation. The The federal government determined to move drastically to statutory regulation of the accounting profession, and its client industry (see subsection "Resulting reform of corporate governance").

Change of standards for corporate governance

To administer effects of the new Act, a new agency, the PCAOB was created within the Act (Calcara, 2002). Its functions are four-fold:

(1) Register public accounting firms, performing audits for public companies.

(2) Establish auditing quality control affecting ethics, independence and other standards.

(3) Conduct inspections of registered firms.

(4) Conduct investigations and hold disciplinary proceedings to sanction violations of the Act.

These provisions are based on assurances that auditing of financial statements will be independent of influences.

To provide this assurance, statutory duties of corporate officers and directors are specified (Christopher and Sorabella, 2002). These duties are specific, described here as broad areas:

- an independent audit committee, composed of all independent directors;
- certification of financial statements, by the CEO and the CFO of the corporation;
- prohibition of relations, including services and communications, between audit firm and corporate management; and
- reporting of material matters of the corporation, including off-balance sheet transactions, adjustments, stock sales.

An added provision of independence is to put PCAOB funding only as a surcharge on registered auditing firms' services. Contributions are on a pro rata revenue basis.

Resulting reform of corporate governance

The Sarbanes-Oxley Act (2002) placed responsibility on corporate officers and directors (O&D), for the large scale financial scandals (noted above). The Act provides for new regulation of O&D duties. The reason for the re-focus is the history of recurring cycles of business scandals. The twentieth-century is known as "the century of corporate calamities". The need for change in corporate governance is not-agency based, but is motivated by investors. Investors have been disturbed by lapses and by the uncertainty introduced by risk.

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From duties imposed by the Sarbanes-Oxley Act (2002), corporate governance is greatly reformed. The most dominant change is brought about in individual duties of O&D, required by new specific statutes. Change also provides the ability to disassociate with an aberrant past; that is, to "take back" control and to "win back" trust and confidence of investors. These are some of the corporate changes due to the Sarbanes-Oxley Act (2002) (Maco, 2002):

(1) *Organization changes*:
- structure of the board;
- audit committee, with member background conform to Sarbanes-Oxley and NYSE search for audit committee financial expert qualification;
- financial and legal SWAT team;
- committee on materiality of information delivering disclosure obligation on timely basis; and
- ethics code, implemented or explain absence.

(2) *Areas of change*:
- Sarbanes-Oxley and SEC restrictions;
- SEC rulemaking actions, with new, shortened timeframe existing policy restricting trading insider shares document retention policy;
- audit committee procedures and company policies executive benefits and compensation vs loans;
- Counsel notification of securities law violations, and breach of fiduciary duty.

(3) *Reporting changes*:
- filing current reports under expanded SEA Rule 8-K;
- filing reports under SEA Sec 16;
- filing quarterly and annual reports certification and evaluation of disclosure controls and procedures due within 90 days after filing reports;
- filing annual internal control reports; and
- SEC included in annual reports.

(4) *The new corporate order*:
- 14,000 companies registered with SEC includes 1,300 foreign issuers; and
- CEO/CFOs of 950 corporations to submit sworn statements attesting accuracy of past financial filings.

From the corporation's point of view, change in corporate governance is essential to prevent "a death spiral" (Byrne, 2002). This requires activist O&D, who understand the function of the financial markets, and the marketing role of a firm selling its forward-looking strategy. Business organizations (business roundtable, conference board, and chamber of commerce) support this re-focus, with its effects all positive for the business, public awareness and investors, that is, the financial community (Oliver, 2002). Yet corporate change of any magnitude requires approval by the board of

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directors. An industrial example of corporate governance is shown below (Sutherland, 2002).

(1) *Board policies*:
- The board's governance policies regulate its relationship with shareholders, the conduct of board affairs, and its relationship with the CEO. The policy recognizes that the board's capacity is limited.
- Board policies emphasize importance of the relationship between the board and the shareholders.
- The board is accountable to the shareholders in a variety of ways, including election to directorship.
- The board uses formal channels of communication, to account to shareholders for company performance
- The board makes broad policy decisions, and delegates to board committees and officers, for detailed consideration of board obligations, to the CEO, for management of company business activities, to officers, defining extent of that authority.
- The board certifies compliance with provisions of the Code Principles of Good Governance, compliance of internal control system no conflict of interest in the board's work.

(2) *Board processes*:
- The board's rules for its own activities covers by a board process policy conduct of members at a meeting, cycle of board activities and its agenda, provision of information to the board, board officers and their roles, board committees, their tasks and composition, qualifications for board membership and the process of the nomination committee, remuneration of non-executive directors, appointment and role of the board secretary, process for directors to obtain independent advice, assessment of the board's performance.
- Qualification of board membership non-executive directors must be free from any relationship with company management limit: to *not* materially interfere with exercise of independent judgment.

(3) *Board committees*:
- The policy allocates tasks to committees monitoring executive actions, and assessing rewards;
- chairman's committee to review the structure and effectiveness of the business organization;
- audit committee to monitor all reporting, accounting, control and financial aspects of management's activities;
- ethics and environment assurance committee to monitor the non-financial aspects of management activities;
- remuneration committee to determine performance contracts, targets and the structure of rewards to monitor the policies applied in remunerating senior officers;

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- nomination committee to identify, evaluate and recommend candidates for appointment or reappointment as directors.

From these aggregate effects, Congress can assess the impact of current legislation, and determine further legislation. The Sarbanes-Oxley Act (2002) is known for multi-dimensional effects (*Texas Lawyer*, 2002). An overall policy of Sarbanes-Oxley Act (2002)'s change in corporate governance is to give all parties a "fresh" start, going back to basics: Directors as representatives of shareholders; Officers as employees of Board of Directors; Board of Directors as custodians of value to shareholders and society.

Changes in corporate governance are required to reform practices, and to set the pattern for future corporate conduct (Christopher and Sorabella, 2002). Goals of these governance practices are:

- officer and director giving shareholder value; and
- openness and transparency of processes and facts.

To this end, written codes are offered: corporate ethics, corporate conduct, and corporate charter. Codes place specific duties on O&Ds[2].

Reform of accounting

Reform of the accounting profession, and its practices, is urgent. Urgency was brought about by accounting scandals, and their rapid occurrence in a variety of corporations. Results of the scandals were huge bankruptcies, precipitous drop of market capitalization, and rapid decline of employee retirement accounts. Underlying the scandals was accounting practices that were "by-the-book" but without reasonable disclosures.

The size of scandals was too great to ignore the need for reform. The focus was on auditing practices. That focus is basic to auditing whose principal function is disclosure. Scandals revealed non-disclosure of transactions, and the creation of organizations to facilitate non-disclosure.

Accounting reforms suggested are (Byrnes, 2002):

- enact statutory regulation, with authority based on experience with the Public Oversight Board which showed that lack of authority and funding was ineffective;
- reform of the audit committee, requiring solely independent directors, and financial literacy (expertise), and size of the committee to be determined by the CFO;
- ban non-audit services to audit clients including consulting, accounting systems[3];
- mandate rotation of audit firms with potential to support independence of auditor;
- impose more forensic auditing given frequency to detect audit failures, requiring earnings restatement; and
- limit auditing personnel moving to client corporations as breakthrough of cronyism, and reestablishing reality.

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An overall reform is to scrutinize and modify accounting rules, including practices, principles and standards.

The cumulative question: could these reforms have averted the scandals so widely publicized? The answer is that references are unlikely to avoid the current scandals: statutes and professional standards are usually based on subsequent correction of malpractice.

Professional impetus

Beyond the need for reform, due to the scandals in accounting practices, is the profession's urgency for regaining its reputation (*Accounting Office Management and Office Report*, 2002). The AICPA, with 350,000 US members, recognizes the value of reputation, even the impetus of confidence in financial statements. The reach of these statements is worldwide, in both financial markets and business headquarters. The profession considers its traditional values are commitment to integrity, and to spirit of the rules; passion to "get it right"; and zero tolerance for violations. The professional goal of reestablishing these values, and values of capital markets is to rebuild confidence in financial statements and in the capital markets.

The AICPA claims that the PCOAB is the result of this professional need. As guidance a published list recognizes the interests involved:

- help investors make informed decisions;
- enhance audit quality, and quality of financial reporting;
- restore confidence in capital markets, and related profession; and
- enhance growth in the national economy and in financial markets.

That goal is to provide a measure on effect of reforms in accounting, and validity of financial statements, in reestablishing values of corporations. An essential part of this reforming of accounting is to assure auditor independence (see next section).

Auditor independence: a critical factor

The key focus of Sarbanes-Oxley Act (2002) is validity of financial statements that reflect operational conditions (Locatelli, 2002). The external auditor is considered to be best positioned to provide the needed verification. Experience, including recent scandals, has shown that external auditors can be impaired in that assignment in a number of ways. The two broad areas are in the engagement procedure (hire and payment), and the auditing charge itself. Where these areas are the engagement responsibility of a single officer, for example, the CFO, independence of the outside auditor becomes questionable.

Auditor independence can be assured in two basic ways (Lousteau and Reid, 2003). One is to limit the audit to financial statements, thereby excluding non-audit services. The other is to enhance quality of the internal control system. Now this responsibility, to assure auditor independence, is with the CFO. The Sarbanes-Oxley Act removes that responsibility, to the Audit Committee.

The SEC's formulation of auditor independence is given in Table I.

The need for independence in auditing

Independence in audits, external and internal, is directly related to confidence in the financial statements and financial markets. Audits requires standards to determine

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Limitations	
Financial relationships	Investment in client
Employment relationships	Family relationship with client
Business relationships	Direct or material indirect
General standards	Appearance, acting without bias
Inconsistent services with the client	
Bookkeeping or other services related to the audit	
Financial information systems design and implementation	
Appraisal or valuation services or fairness opinions	
Actual services	
Internal audit services	
Management functions	
Human resources	
Broker-dealer services	
Legal services	
Other limitations	
Affiliate provisions	Guidance on case-by-case
Contingent fee arrangement	Outcome dependence
Quality controls	
Control and prompt correction	
Proxy disclosure of audit fees for all services, beyond audit	

Source: Locatelli (2002)

Table I. SEC formulation of auditor independence

compliance or non-compliance. To provide standards in broad areas, for use by the Audit Committee, and by auditors employed by the Audit Committees, a broad perspective on standards is required (Locatelli, 2002). A perspective covering the double set of standards meets the requirement for both internal and external auditors (Locatelli, 2002).

As standards reflect directly on independence of the audit, a detached basis is needed: independence from self-interest, advocacy, and familiarity. A method to determine this independence is to assess the probability and the materiality in each element. Another approach is to base the audit determination on a framework (Myring and Bloom, 2003). The framework is required to assess an aggregate risk, over all activities in an audit, and safeguards to limit effects of an individual activity. The framework approach provides an objectivity which supports audits.

The framework proposed by the Independent Standards Board is found in Appendix 2. Implementation of that framework has not been adopted by the various agencies (SEC, AICPA). The approach has the features needed, for determination of independence. Continued development, and effort to implement, is supported by the agencies.

To refresh the audit process: the internal control system

The internal control system exists for dual purposes: One, the obvious purpose, is for internal control; this purpose facilitates a review of transactions mandated by the board of directors. The other is for assurance of independence (Lousteau and Reid, 2003). This independence is both real and apparent, in many areas:

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- assuring compliance with regulation and procedure;
- compensating for lack of controls in the financial system; and
- deterring non-compliance.

The internal audit function is to examine all factors that could lead to prevention and early detection of fraudulent financial reporting. This broader concept requirements involvement and integration of all components of corporation governance board of directors, management, internal auditor team, and the external auditor to create and sustain a culture of accountability by communicating accurate and timely information, identifying risks and understanding controls for good risk management (McConnell and Banks, 2000). This broader involvement assures that the corporation environment with full and fair financial reporting and hence restores public confidence in the reference.

Conclusion: corporate conduct within reform

The Sarbanes-Oxley Act focuses individual responsibility on CEO and CFO, for accuracy of disclosure, and existence of internal control systems, to assure accurate reports. This focus reveals SEC belief that these officers caused the scandals, as SEC rules require disclosure of material information during the reporting period.

The Act protects general counsel and other employees, but require reporting material violations including financial irregularities, up-the-ladder (Parnass, 2002). First, such violations are reportable to the functional officer in violation area, then to the chief legal officer, and with no response, to the board of directors; initially to a committee of independent directors. If no response to the PCAOB; and then to the SEC. This up-the-ladder procedure ensures protection under whistleblower provisions.

The Act also requires directors and officers to take "measure in best interest" of the corporation, subject to minimizing disruption to the organization (Schwartz and Freedman, 2002). If there is no response, and the action is continuing, withdrawal is required. That withdrawal is termed noisy, where the harmful conduct is continuing. Where a counsel is the focus, discovery is limited to the violation in the area of counsel's representation.

The change is from professional regulation, under standards set by professionals and professional organizations, to statutory duties and standards, set by the Sarbanes-Oxley Act (2002). Whether this change will improve quality of control performance, or will extend to improve reaching the goals of viable financial reporting and capital markets, is yet to be determined.

Notes

1. This paper describes the impacts of the Act, not on the technical detail of changes imposed by the Act (see, for example, Statute of Limitations).
2. The corporate charter defines the limits of corporate authority, under state law.
3. Non-audit services provided 51 per cent of income from audit clients.

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Appendix 1. Ethics in corporate governance in the "new" environment

The Sarbanes-Oxley Act (2002) requires public companies (defined under the Act) to adopt a code of business conduct and ethics. Recognizing previous failures of business ethics codes, the Act further requires procedures and standards, for "monitoring compliance". To achieve this level of implementation, the direction of the codes is to be value-oriented, rather than prescriptive.

Changes in the business ethics code

A business ethics code is understood in two categories:

(1) Duty of care on assets, and business judgment in the best interests of the corporation.

(2) Duty of loyalty, on avoiding conflict of interest, and not taking a business opportunity of the corporation.

The current, changing situation poses two different categories:

(1) The classical business ethics code (above).

(2) Recommendation regarding new expectations under the Sarbanes-Oxley Act (2002).

The changing focus is on corporate governance and accounting.

Effectiveness of the business ethics code

These recommendations are founded on a sequential requirement, personal integrity of the CEO, and use of internal controls, to result in effective reporting and enforcement mechanisms.

The integrity of the CEO and the CFO are at the focus of the most important functions of the corporation, the strategic direction of the corporation, and an uplifting of the corporate performance and the ethical character of the corporation.

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While this emphasis can be identified with the newly enacted Sarbanes-Oxley Act (2002), the substance is attributed to the New York Stock Exchange, in its demands on a public company (registered by the NYSE), for adoption of an ethics code, and procedures for its effective operation.

Source: Verschoor (2002).

Appendix 2. A conceptual approach to auditor independence

The Independence Standards Board (ISB) developed a conceptual framework, to serve for:

- standards setting; and
- enhancement of standards over time (Myring and Bloom, 2003).

The ISB was formed (by the AICPA and the SEC) "to establish independence standards applicable to audits of public entities... to promote confidence in the securities market".

Nature of the ISB framework

Four purposes of the ISB framework were identified:

(1) To provide standards on auditor independence.

(2) To assist resolution of questions on independence.

(3) To aid understanding of auditor independence.

(4) To provide a common basis for issues regarding auditor independence.

Interest in this framework approach has been shown internationally: both the International Federation of Accountants and the European Union have released preliminary versions of a standards-setting framework.

The framework, even the concept, poses conflicts with views on standard setting. The rigidity of a framework was considered as threats to independence; that is, impair the objectivity of auditors whom technically adhere to the framework. Threats were enumerated as:

- auditor self-interest; auditor self-review; non-audit service; and
- auditor relation to client; and client/party intimidation.

These threats were shown as two concepts: acting in the capacity of management, and having a mutuality with the client. In both instances, auditors are abandoning their "watchdog" role.

To mitigate the (potential of) threats, ISB identified safeguards:

- restrictions on activities;
- disclosure of circumstances;
- firm policies, procedures and practices;
- announced disciplinary actions; and
- injury to value of reputation of the auditor.

A main feature of the balanced framework is to identify the level of risk to auditor independence.

Risk is a permanent concern to investors; other users of financial statements also have an interest in integrity (lack of risk). Risk is determined for an event (transaction), and as an aggregate collection of events. Users of the framework determine an appropriate level of risk, to the task at hand.

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Issue on adopting the ISB framework

A central issue regarding the framework is consideration of the "appearance" of auditor independence. The framework is focused on elements and aggregates of risk, and risk determination in various contexts. However, the perception of the auditor as independent is considered to be significant with investors and other users of financial markets. Conflict on the issue arises on whether appearance does affect the quality of audit or reliability of financial statements.

The conflict is on whether to include appearance explicitly in the framework. The SEC opted out of framework adoption effort, without express consideration of appearance. The SEC also announced opposition to the threat and safeguard approach of the ISB framework. The purpose of the framework is to provide guidance on audit credibility and result on investor. The SEC considered that the balancing of threat and safeguard eliminates the framework's guidance and transparency of an audit.

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