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Sarbanes-Oxley: Effects on Financial Transparency

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Introduction

During 2002, a number of high-profile accounting frauds and misstatements, some of unprecedented scale, dominated the headlines. The problems at Enron, WorldCom, Adelphia, Tyco, and Global Crossing were practically daily news, as was the rapid fall of Arthur Anderson. A report issued by the General Accounting Office in October 2002 stated that one out of every 10 listed public companies restated its earnings during the last five years, while a recent Gallup poll indicated that 70% of U.S. investors said that corporate accounting issues were hurting the investment climate "a lot" (Atkins, 2002a).

Against this backdrop, Congress began hearings with Enron in February 2002 and rapidly expanded to embrace a wider range of perceived corporate, financial, and oversight problems that were seen as contributing to massive stock market losses for individual investors during the last three years. Since the market's peak in March 2000 through the fall of 2002, the total loss in market capitalization exceeded $5 trillion (Atkins, 2002b). Although only a part of this was attributable to fraud, political momentum built rapidly to install greater controls to decrease the likelihood of future corporate fraud and to increase financial transparency in the U.S. financial markets.

Most of the congressional hearings were held by the House Committee on Financial Services, chaired by Michael G. Oxley, and the bill, H.R. 3763, began there. The Senate Committee on Banking, Housing and Urban Affairs, chaired by Paul S. Sarbanes, took up the bill as S. 2673.

After considerable debate, public hearings, and conference committee meetings, the bill was signed on July 30, 2002, by President Bush as Public Law 107-204, with the short title of Sarbanes-Oxley Act of 2002.

Financial Transparency

The desirability of financial transparency for public corporations and financial institutions was widely discussed during hearings that led to the passage of Sarbanes-Oxley. H.R. 3763, as passed by the House, included the word "transparency" in the title of the bill, although it was later dropped in the final conference committee version. Unfortunately, the term is never defined in the legislation.

In recent years, the term "financial transparency" has generally been applied to developing and emerging countries' monetary and fiscal policies (Beattie, 2000) and efforts by the IMF (International Monetary Fund) and other international financial institutions to encourage clear financial reporting internationally (Hanson, 2003). Considerable discussion has also arisen regarding the mandate within the European Union for countries to adopt International Financial Reporting Standards (Blanchet, 2002) versus those of individual countries. In the first case, the emphasis is on openness and availability of information, while in the second it is on standardization and comparability.

Transparency must be understood from the viewpoint of the user of financial information, not the provider. Users could include individual and institutional investors, banks and other lenders, the Securities and Exchange Commission (SEC) and other governmental agencies, and some related parties such as employee-investors. "Market transparency," a related term, applies to market processes, such as equity trading. From a user perspective, financial transparency involves at least eight related concepts (Blanchet, 2002 and Prickett, 2002):

1. Accuracy. The information follows the standards agreed upon.
2. Consistency. Standards are applied

consistently between periods and between different companies to provide comparability.
3. Appropriateness. Standards used accurately reflect the underlying economic reality of the organization and its industry.
4. Completeness. All information needed by the user to make sound decisions should be available. This includes key performance indicators and other information beyond that presented in the financial statements needed to accurately assess the company's performance and position.
5. Clarity. Information is presented in a manner that is clear and understandable to the user.
6. Timeliness. Information should be presented within a reasonable time after it is known to management and on a sufficiently frequent basis.
7. Convenience. All significant information must be easily and equally accessible to all users.
8. Governance and enforcement. Adequate policies should be in place to assure that the agreed-upon level of transparency occurs.

Sarbanes-Oxley addresses a number of these facets of both financial and market transparency. This paper will be limited to addressing financial transparency aspects of the law.

Sarbanes-Oxley Act of 2002

Public Law 107-204, "an act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes," contains a wide range of provisions affecting many different parties. The impact of most of these provisions is still unknown, as rule-making and interpretation, implementation, and enforcement authority has been delegated to the SEC and a new oversight body, the Public Company Accounting Oversight Board (PCAOB). Deadlines for implementation vary for the different provisions of the Act.

- ***Applicability***

Sarbanes-Oxley applies to organizations that are "issuers" under the Securities and Exchange Act of 1934. Issuers include domestic public companies, foreign public companies trading on a U.S. exchange, banks and savings associations, and foreign private issuers, issuers of asset-backed securities, and small business issuers required to register under section 13(a) or 15(d). Some provisions of the Act have more limited applicability. Provisions applying to public accounting firms and attorneys relate to their work for issuers. The SEC has restated its intention to apply the law to foreign issuers and foreign accounting firms as defined in the Act, and has indicated a willingness to allow more time for compliance from foreign accounting firms (SEC, 2003).

Although specifically not applying to private companies, the law affects these companies in terms of their planning for possible future initial public offerings (IPOs) or acquisitions by public companies.

Additionally, the law applies to securities associations and national securities exchanges in terms of listing requirements, securities analysts, and securities research.

- ***Coverage***

Sarbanes-Oxley is divided into 11 titles (U.S. Congress, 2002) covering: The Public Company Accounting Oversight Board, auditor independence, corporate responsibility, enhanced financial disclosures, analyst conflicts of interest, Commission (SEC) resources and authority, studies and reports (from the SEC), corporate and criminal fraud accountability, white-collar crime penalty enhancements, corporate tax returns, and corporate fraud and accountability.

- ***Implementation***

The SEC is charged with implementing the Act, including oversight and enforcement over the PCAOB (a nonprofit, independent corporation). The SEC has authority to appoint members of the PCAOB, limit their terms, and remove them from office without the approval of Congress.

Major Provisions Affecting Financial Transparency

Provisions of Sarbanes-Oxley can be broken down into several major areas that could affect elements of financial transparency. These include: accounting standards and oversight, reporting timing standards, responsibility standards, conflict and independence standards, document standards, and inspection, discipline, and enforcement.

- ***Accounting standards and oversight***

The PCAOB. The most important duties of this independent, five-member board are: (1) registering public accounting firms that issue audit reports falling under the Act, (2) establishing standards for such firms, including ethics and independence standards, (3) inspecting such firms for compliance (annually for larger firms and every three years for smaller firms), and (4) conducting investigations, providing discipline, and such other functions as may be "appropriate to promote high professional standards . . . and improve the quality of audit services . . . (U.S. Congress, 2002, p. 751)." Foreign firms participating in audits are covered unless exempted by the Board. Additionally, a clear standard for the internal control review is to be adopted. The PCAOB was not set up until January 2003, and did not begin registering accounting firms until July 2003.

The SEC released its Policy 33-8222 on April 25, 2003, making the AICPA's (American Institute of Certified Public Accountants) Auditing Standards Board's Statement of Auditing Standards No. 95 the official interim auditing standards.

The PCAOB provides an additional level of governance and enforcement of transparency standards and helps ensure the accuracy of their application by public accounting firms.

Standards. The PCAOB is charged with overseeing accounting standards for audited firms. It may, if it chooses, elect to recognize standards set by other bodies meeting certain criteria. The Board also must submit a report to Congress within one year (July 2003) of a study of principles-based systems and the feasibility of replacing the current (GAAP) system with a principles-based accounting system (such as International Accounting Standards). SEC Policy 33-8221, released April 25, 2003, reaffirmed the existing accounting standard GAAP and the FASB (Financial Accounting Standards Board) as the official standard setter.

Government oversight of standards is aimed at improving transparency in the areas of consistency, appropriateness, and clarity.

Disclosures. All off-balance sheet transactions and other relationships with unconsolidated entities must be disclosed. SEC Rule 33-8182 requires disclosure in a separate section of the notes, as well as presentation of certain contractual obligations in a tabular format. A report to Congress is required within one year (July 2003) on off-balance sheet disclosure rules.

Inclusion of off-balance sheet transactions and other unconsolidated entities' information addresses the consistency, appropriateness, and completeness criteria of financial transparency.

The SEC was also directed to set standards to improve the quality of pro forma and other non-GAAP financial information. SEC Rule 33-8176 requires that any non-GAAP financial information in reports must also be presented in its closest GAAP form and reconciled to the GAAP presentation.

These requirements improve transparency by improving consistency and appropriateness, as well as by improving clarity by reducing the variety of reporting standards for supplemental information.

Internal controls. Quarterly, semiannual, and annual reports must contain a statement acknowledging the responsibility of management to maintain adequate internal controls, an assessment of the effectiveness of the organization's internal controls, and a statement identifying the framework used by management to evaluate the effectiveness of internal controls. Additionally, management must state quarterly if there were any material changes in internal controls (implemented in SEC Rules 33-8124 and 33-8238). The audit firm is required to attest to management's statement. Additionally, the PCAOB is to adopt rules to describe in the audit report the extent of testing of internal controls.

Appropriate internal controls are critical to assuring the accuracy and consistency components of financial transparency. Management's responsibility for maintaining adequate internal controls and the related auditor's responsibility for review of internal controls add additional assurance that the numbers reported internally are accurate and that internal consistency is maintained.

- ***Reporting timing standards***

The Act requires only that all material changes in financial condition or operations must be reported in a rapid and current manner, referred to as real time disclosure.

The SEC has interpreted this in Rule 33-8128 (effective with fiscal years ending after December 15, 2002) to mean earlier filing of reports. Annual reports are moved from 90 days in year one to 75 days in year two to 60 days in year three. Quarterly reports go from 45 to 40 to 35 days over three years. Under rule 33-8128, companies also are required to notify investors as to whether their reports are available on company Web sites without charge. Rule 33-

8230 requires all listed companies (but not all issuers) with Web sites to post financial information to their sites the same business day it is transmitted to the SEC.

Directors, officers, and 10% stockholders must disclose designated securities transactions within two business days.

The requirement for faster reporting cycles addresses the criteria of timing. Immediate posting of information to company Web sites addresses the criteria of availability by providing universal access to all users.

- ***Responsibility standards***

The audit committee of the board is responsible for appointment, compensation, and oversight of the public accounting firm performing the audit, including disagreements over accounting standards and their application.

The accounting firm must report in writing to the audit committee all critical accounting policies, alternatives to those policies discussed with management, and all other material written communications between the accounting firm and management (implemented in SEC Rule 33-8183).

Centralizing authority and responsibility for financial oversight with the audit committee of the board, along with the requirement for an independent audit committee (discussed later), provide an improved governance structure by removing internal company oversight from management control.

The CEO (chief executive officer) and CFO (chief financial officer) of the company must provide a statement accompanying the audited statements personally certifying their fairness. Violation must be knowing and intentional to give rise to personal liability. Criminal penalties of up to $5 million and 20 years imprisonment are provided (implemented in SEC Rule 33-8124).

The CEO and CFO must also certify to the SEC that they have disclosed to the auditors and the audit committee any significant deficiencies in internal controls and any fraud involving management or employees with a significant role in internal controls (implemented in SEC Rule 33-8124).

The CEO should (but is not required to) sign corporate tax returns.

Requirements for CEO and CFO responsibility and disclosure send a clear signal that accurate financial reporting is a responsibility of top management and that this responsibility cannot be avoided by delegation or the hiring of outside experts. Delineation of clear responsibilities for financial reporting is important in improving governance.

- ***Conflict and independence standards***

Public accounting firms. A registered public accounting firm is prohibited from providing any listed nonaudit services (such as bookkeeping, internal audit, actuarial and valuation services, legal and expert services unrelated to the audit, and financial information system design) to an audit client contemporaneously with the audit. The PCAOB has the authority to issue exemptions on a case-by-case basis. Non-audit services that are not listed in the Act (for example, tax and nonvaluation litigation services) may be provided if pre-approved by the audit committee. Any services pre-approved must be disclosed in periodic investor reports (implemented in SEC Rule 33-8183).

Limitations on possibly conflicting services by the public auditor are aimed at removing possible compromises of integrity. In most of the prohibited areas, such as internal auditing, bookkeeping, and financial systems work, there is clearly a governance issue when auditors are auditing the work of their own firm (Breeden, 2002).

The audit and reviewing partners must be rotated at least every five years, specific written reports on the audit must be provided to the audit committee, and the company may not employ in a financial accounting oversight role any person who was on the company's audit team of the audit firm within one year of the audit (implemented in SEC Rule 33-8183). The PCAOB also is required to report to Congress within one year (July 2003) on the potential effects of requiring rotation of audit firms and to adopt rules requiring a second partner review and approval of audit reports.

Rotating the audit and reviewing partners provides a "fresh look" and reduces the dependence of auditing individuals on specific clients, adding to their independence and improving integrity. The prohibition on an issuer hiring an auditor as a part of its financial reporting team is intended to increase the separation between company staff and audit staff. These changes improve the governance structure.

State regulators are "directed" to consider whether to apply similar standards to nonregistered small and medium-sized public accounting firms within their jurisdictions that do not fall under the SEC rules.

The audit committee. The Act (Section 301) requires that audit committee members are independent, although the SEC can make case-by-case exceptions (implemented for listed companies in SEC Rule 33-8220). The Act (Section 407) also requires a company to disclose in its annual report if at least one member of the committee is a "financial expert" (implemented in SEC Rule 33-8177).

Increased independence of the audit committee serves to improve governance by separating the functions of oversight from management.

The board of directors. Although the Act does not specifically require other changes in governance structure, the SEC has implemented additional governance requirements through Rule 33-8220, which directed the securities exchanges to adopt SEC-approved listing requirements.

In Rule 2002-33, the New York Stock Exchange (NYSE), set the strictest requirements. The NYSE requires that a majority of the board be independent, that independent directors meet at regularly scheduled separate meetings, that each company must adopt and disclose a code of conduct and ethics, and that each company must have the following committees that are composed entirely of independent directors: a nominating or governance committee, a compensation committee, and an audit committee. It also requires that every company have an internal audit function (which may be outsourced to firm other than the company's auditor) that must report periodically to the board's audit committee.

The Nasdaq Stock Market adopted listing requirements (Rules 2002-139 and 2002-141) mandating independent audit committees and a code of conduct as did the American Stock Exchange (Rule 2003-65).

Improvements in corporate governance structure, particularly increasing the independence of board oversight functions, are important in assuring transparency by increasing board control over management.

Management and directors. Officers and directors (and any one acting under their direction) are prohibited from fraudulently influencing or misleading any auditor (SEC Rule 34-47890). If a restatement is required as a result of misconduct of the CEO or CFO, they must forfeit any bonuses received or profits realized from securities sales within 12 months after filing the misstated financial information. Additionally, the SEC is empowered to seek equitable relief for investors in federal court. The SEC also may bar any person found to have violated section 10(b) from serving as an officer or director.

Officers and directors and other insiders are prohibited from purchasing or selling stock during pension fund blackout periods (when employees cannot buy and sell stock within their retirement accounts) (SEC Rule 34-47225).

Personal loans by the company to executive officers and directors are generally prohibited.

Clear prohibitions against company insiders acting fraudulently or engaging in acts that place them in conflict with accepted standards add additional enforcement tools that may lead to greater deterrence.

Attorneys. The SEC is directed to set standards for attorneys practicing before it requiring them to report evidence of violations of securities laws or breach of fiduciary duty to the CEO, and, if action is not taken, to the audit committee. This was mostly implemented in SEC Rule 33-8185, but some sections are still out for comment under proposed Rule 33-8186.

These requirements are aimed at clarifying that attorneys work for the company, not individuals within the company, and that violations of the law must be appropriately reported. Illegal actions by insiders can affect any of the criteria of financial transparency.

Senior financial officers. The company is required to disclose to the SEC whether it has a code of ethics for senior financial officers and to report the code's content. Any change in the code must be reported immediately by issuing an 8-K (implemented in SEC Rule 33-8177).

To deter inappropriate or illegal actions by insiders, a clear code of conduct and ethics is essential to provide guidance to financial staff. Internal codes also encourage and protect individuals aware of inappropriate actions when they report such behavior. Again, this section could affect any of the criteria of financial transparency.

Securities analysts. The SEC must require securities exchanges and professional organizations to adopt acceptable standards regarding conflicts of interest, including required public disclosures, within one year (July 2003).

The next section deals with market transparency. The SEC and national exchanges have issued a number of rules and standards aimed at improving market transparency.

- ***Document standards***

Audit workpapers must be maintained for five years (section 108) and if registered with the PCAOB, seven years (section 103). SEC Rule 33-8180 clarifies this conflict and specifies seven years after the conclusion of the audit and broadens the definition of which workpapers must be retained.

It is illegal to destroy or alter any document with intent to impede or influence any investigation, with penalties of up to 20 years imprisonment.

Maintenance of workpapers is essential to SEC enforcement and to PCAOB oversight of accounting firms.

- ***Inspection, discipline, and enforcement***

As noted, the PCAOB is charged with registering and inspecting covered public accounting firms. The PCAOB also has disciplinary powers over these firms.

The PCAOB provides an additional level of governance and enforcement of transparency standards and the accuracy of their application by public accounting firms.

The SEC is charged with enforcing of the other provisions of the law and has additional authority to temporarily freeze certain payments by companies under investigation.

The SEC is specifically required to review any issuers with material misstatements, large market-cap companies, or companies that meet other stated criteria at least every three years.

Additional provisions of the law include: (1) the statute of limitations for existing securities fraud statutes was extended to the earlier of five years from the fraud or two years after discovery, and maximum penalties were increased from 10 to 20 years; (2) debts from securities fraud were made nondischargeable in bankruptcy; (3) "whistle blower" status was given to company and public accounting firm employees; and (4) a new broadly defined crime of securities fraud was created with penalties of up to 25 years imprisonment.

Penalties for mail and wire fraud also were increased from five to 20 years maximum and for ERISA (Employment Retirement Income Security Act) violations from one to 10 years.

Increasing the powers of the SEC and strengthening criminal and civil sanctions add to enforcement and provide additional deterrence.

Summary of Effects on Financial Transparency

Financial transparency was composed of eight related concepts. Comparing a number of provisions of Sarbanes-Oxley with these eight concepts, it is apparent that many improvements in financial transparency may result from the Act. These were discussed in detail. In general, each major area of Sarbanes-Oxley can improve financial transparency of public company information in several ways:

- Accounting standards and oversight improvements should enhance the accuracy, consistency, appropriateness, completeness, clarity, and governance and enforcement of financial information.
- Changes in reporting timing standards should improve financial information timeliness and availability, particularly as interpreted in the SEC rule.
- Changes in responsibility standards clarify the responsibilities of the audit committee, the CEO, CFO, and others. These are one step in improving governance and enforceability, as the old approach of holding the company responsible was too vague to be enforceable or to provide any deterrence.
- The significant clarification and improvement of conflict and independence standards should improve the accuracy, consistency, appropriateness, and completeness of financial information. In addition, they should improve governance, responsibility, and enforcement.
- Strengthening of document standards should help in enforcement.
- Provisions under inspection, discipline, and enforcement provide additional enforcement methods and improve deterrence.

Conclusion

Sarbanes-Oxley is important legislation producing numerous changes in the financial reporting process. Some provisions remain controversial; however, the overall aim of adding transparency to public companies' financial information and increasing protections for investors appears to have been accomplished.

Although recent scandals have tarnished the reputation of U.S. financial markets, a study by Bhattacharya, Daouk, and Welker of data from 1985 through 1998 (Popper, 2002) indicates that the U.S. still ranks highest in earnings transparency. The same study indicates that countries with high earnings transparency have lower costs of capital.

If the U.S. is to continue to attract international financial capital and maintain the confidence of American investors, improving financial transparency is an important goal. Sarbanes-Oxley provides the tools, although, much of the Act remains to be implemented. Whether these tools are effective and fulfill their promise can only be determined by future research.

Dr. Kulzick, who teaches strategy, information systems, accounting, and fraud prevention, has consulted with many client organizations and also held management positions in government, major corporations, and other organizations.

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