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Cindy J. Burrows
University of New Hampshire

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—**Cindy J. Burrows** (Edited by Jennifer Lee)

On December 2, 2001, Enron Corporation, with a record $67 billion in assets, filed for Chapter 11 bankruptcy protection, unveiling corporate malfeasance fraught with fraud, secret accounts, insider trading, and third party collusion. Nine investment banks conspired with Enron to set up secret accounts, to use off-shore banks to disguise loans as sales or investments, and to underwrite sales of Enron stock while approving incomplete or incorrect financial statements. Enron's corporate counsel helped structure interdependent transactions and prepare false submissions to the U. S. Securities and Exchange Commission (SEC). Twenty–eight Enron directors and officers engaged in $1.2 billion of insider trading (Davies 2002). Finally, Arthur Andersen, LLP, Enron's auditing firm, signed off on Enron's fraudulent financial statements.

Enron's implosion wiped out approximately $40 billion in market capitalization as share prices plummeted, but it was only the beginning. It soon became apparent that corporate malfeasance was widespread among major US corporations as WorldCom, Tyco, and Martha Stewart, to name a few, were soon under investigation by the SEC and the Department of Justice.

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In 2002 this corporate accounting scandal, precipitated by the collapse of Enron, resulted in the passage of the Sarbanes–Oxley Act (SOX) by the US government. The intent of SOX was to institute accuracy, reliability and transparency in corporate accounting practices, thus making it easier for investors and shareholders to determine a company's finances. In essence, SOX was intended to restore both shareholder and global confidence in American financial markets.

The Act was implemented in stages, beginning in July 2004. The results of its passage and implementation are still playing out in today's media and courts. Hardly a day passes without news of a publicly traded company either being issued a subpoena by or settling charges with the SEC.

Praised and criticized by business and Congress alike, can SOX, in the fast–changing global financial world, succeed in reforming corporate accounting practices and restoring integrity to American financial markets? Is it too soon to tell?

Corporate Accounting and SOX

In a 2004 article, David Henry, a senior writer for the finance section of *Business Week*, coined the phrase "fuzzy numbers" to describe the great amount of flexibility built into corporate accounting practices. He found that company management could legally manipulate earnings data to their advantage by using existing accounting rules for estimating sales, predicting bad debts, and forecasting unusual gains or losses. Companies had found additional ways to pump up their short–term cash flows with such strategies as counting money lent to customers as sales, selling accounts receivables, and shrinking working capital. Finally, corporations made their financial statements extremely complex and difficult to understand by employing secret accounts, reporting financial transactions on differing timelines, and using copious footnotes.

To combat these practices, SOX set up five major goals:

- to restore confidence in the accounting profession by creating the Public Company Accounting Oversight Board (PCAOB) funded by fees to public companies,
- to foster an ethical corporate culture and reduce conflicts of interest for corporate directors and auditors,
- to improve corporate disclosure and financial reporting,
- to improve the performance of other professionals (e.g. auditors and corporate attorneys) who are in the position to protect investors, and
- to provide enhanced enforcement tools for the SEC, including the ability to establish "Fair Funds" through which civil penalties can be returned to the investors (Glassman 2007).

In order to achieve these goals, SOX set forth many requirements; these are the most important:

- that the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) accept responsibility for and attest to the veracity of the data supplied (PL 107–204, Title III, Sec. 302) ,
- that the CEO and CFO be responsible for internal accounting controls and for reporting on the effectiveness of these controls (PL 107–204, Title IV, Sec. 302),
- that external auditors verify the accuracy of the CEO and CFO statements (PL 107–204, Title IV, Sec. 404), and that the auditors report to the company's directors (PL 107–204, Title II, Sec. 204),
- that the directors be from outside the company (PL 107–204, Title III, Sec. 301),
- that there be immediate disclosure of material changes in a company's finances or operations (PL 107–204, Title IV, Sec.409), and
- that CEOs and CFOs face criminal liability, with fines up to one million dollars and imprisonment up to ten years for even mistakenly filing inaccurate reports. (PL 107–204, Title IX, Sec. 906)

Responses to SOX

Many companies initially balked at creating an internal accounting framework to generate financial reports, saying it was unnecessary and too expensive; however Christopher Cox, chairman of the SEC, stated in a December 2005 interview, "With just a few years of Sarbanes–Oxley under their belts, most companies are begrudgingly admitting that the exercise has produced benefits." Companies reported improved business processes in such areas as risk management, accuracy of financial information, and internal and external data integration (Labaton 2006).

Despite increased benefits to companies and shareholders, an industry–wide consensus emerged that compliance implementation costs were unduly burdensome for corporations. In 2004 costs for compliance certification work by outside auditors plus increased director and officer insurance premiums ranged from over $8.5 million for large companies to $1.2 million for mid–size companies (Cone 2006). In response to the increased work required of them, directors raised their fees for attending board meetings. Researchers found that the impact of increased auditing and director fees was proportionally greater for smaller companies (Linck, Netter and Yang 2007).

In response to these disproportionate cost burdens, the SEC extended the SOX compliance deadline for foreign and small companies from November 15, 2004, to July 15, 2007. The deadline for outside auditors to verify the company's reports was delayed to December 15, 2008 (Tucci 2006).

The approaching 2004 deadline triggered a second response to the Act: the filing of an increased number of corporate restatements. These restatements correct or complete already filed financial reports presumably found wanting in the face of SOX requirements. In all, 650 restatements were recorded in 2004 and 1,295 restatements in 2005. Most were due mainly to issues with expense classification, misclassified cash–flow items, and equity issues. Fourteen percent, or 181, were "stealth" restatements, that is, amended statements filed with the SEC without proper or sometimes any notice to the shareholders (Taub, Restatements 2006). Research published in July of 2006 revealed that executives were being given the right to purchase stocks at prices timed to stock price low point, second most low point, or just prior to release of positive financial statements (Heron and Lie 2006). This practice gave executives the right to purchase stock at heavily discounted prices which they could then sell for large personal profit. The exposure of this questionable practice led to financial restatements reaching a record 1,876 by the end of 2006. Of these, 254 were stealth restatements (Taub, Study 2007).

Further probable reasons for the high number of corporate restatements include the new criminal penalties that can be imposed under SOX coupled with a higher risk of detection for CEOs and CFOs. The SEC encouraged guilty companies to pay fines, make shareholder restitution and file restated financial reports by promising not to pursue criminal charges against them. This allowed companies and auditors to reduce their liability and exposure to shareholder suits. Since most settlements are covered by insurance and therefore not a company liability, companies have an additional, economic incentive to settle and restate.

A third corporate response to SOX was a significant increase in the number of public companies delisting from the major stock exchanges and citing as reason the high costs of SOX compliance. Within two years of SOX implementation, 370 publicly traded companies delisted from a major exchange and went to over–the–counter (OTC) trading, which exempted them from SOX compliance. The majority of the companies delisting were smaller companies with poor recent stock market performance and higher debt or with lower growth opportunities and capital market interest. After 2006 the number of companies delisting returned to pre–SOX levels. (There was not a significant change in the number of companies going private.)

Researchers concluded that although the higher costs of SOX were cited, poor accounting quality, agency problems (such as not having independent directors) and lack of investor interest were the actual reasons for public companies to delist (Leuz, Triantis and Wang 2006). Corporate decisions to delist may have also been influenced by other market forces such as lower returns, lower stock prices and new listing requirements for the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ). In fact, some of the requirements for company directors adopted by the boards of these exchanges were more stringent than those imposed by SOX (Final 2003).

A fourth response to SOX was two notable legal cases. The first was a challenge by the US Chamber of Commerce to the rule–making authority of the SEC. In 2004 the SEC passed a rule requiring mutual funds' board chairmen to be independent of the fund's investment adviser and for seventy–five percent of the board's directors also to be independent. On April 7, 2006, the United States Court of Appeals for the District of Columbia vacated the rule, stating the SEC had failed to consider sufficiently the costs imposed on the mutual funds by the rule (Wallison 2007).

The second case was a Constitutional legal challenge filed on February 7, 2006, by the Free Enterprise Fund (FEF) in the US District Court of Washington. The FEF alleged the structure of the Public Company Accounting Oversight Board (PCOAB), set up by SOX, violates the principle of the separation of powers established by Article II Section 2 of the US Constitution. The FEF argued that although PCAOB members perform an executive function, they are not appointed or removed by the President; and Congress cannot control the Board's budget (Schmidt 2006). On March 21, 2007, the US Supreme Court found in favor of the PCAOB.

An increase of initial public offerings (IPOs) on foreign exchanges coupled with a decrease in IPOs on American exchanges by both foreign and American private companies choosing to become public was perceived by some as a fifth response to SOX. Allen Greenspan, former chairman of the Federal Reserve, in a surprise reversal from his initial support of SOX, stated that SOX "discouraged risk–taking and was driving foreign companies to shun the New York Stock Exchange for the lighter rules in London" (Bianco 2006). Other prominent economists, however, attributed the trend of private companies choosing to go public on foreign exchanges to globalization. They proposed that foreign stock markets have greatly improved and become highly competitive with the established US markets (Lawder 2007). To combat lost revenue from this trend, both the NYSE and the NASDAQ exchanges engaged in expanding their control to European markets.

Research also explained the smaller percentage of total IPOs on American exchanges as resulting from changes in company characteristics rather than from negative influences by regulations such as SOX. Researchers found that most companies recently completing IPOs on foreign exchanges were small and did not meet the requirements for such offerings on the US exchanges. The researchers concluded that the increased capital–raising activity and governance benefits associated with listing on US markets were unique and not significantly harmed by SOX (Doidge, Karolyi, and Stulz 2007). In addition, from 2003 through mid–2007, the US capital markets were flooded with private money, thereby eliminating the need for companies to tap the public markets for capital.

Enforcement of SOX

Despite criticism, legal challenges and corporate attempts to thwart SOX compliance, the SEC has enforced the implementation of SOX. The year 2004 marked the height of criminal indictments of corporations and corporate management; however, the mix of all cases brought by the SEC has remained constant over the years. Financial disclosure cases represent thirty–five percent of total cases, insider trading represents twenty percent, market manipulation and market fraud each represent twelve percent, and the remaining twenty–one percent of cases is split between issues with brokers, advisors and investment companies (Bruch 2007). Since implementation, the SEC has authorized the disgorgement of penalties totaling $5.15 billion, of which $4.33 billion was collected and placed in Fair Funds accounts for return to shareholders (Glassman 2007).

The SEC has exercised some latitude in enforcing SOX, especially since the successful 2006 challenge by the US Chamber of Commerce. Recognizing the disproportionate implementation costs, the SEC extended the SOX compliance deadline for small and foreign companies. Separately, in 2006 the SEC issued to its enforcement officers a series of factors to consider in determining whether to issue a penalty against a company. Three primary factors were whether the shareholders benefited from the misconduct, whether the current shareholders would be further victimized by a penalty and the pervasiveness of the misconduct within the company (Casey 2007).

Recently, the SEC has done several things to further reduce compliance costs. Among these was changing companies' internal controls audit process to a less costly method than previously required (Casey 2007). The PCAOB followed suit with amended rules that directed companies and auditors to focus only on matters that have a. significant impact on business operations, reputation, profitability, net assets, and other investor interests (Wallison 2007). While not exempting foreign companies listing on US exchanges from SOX compliance, to lower their listing costs the SEC lifted the rule requiring foreign companies to reconcile their financial statements with US accounting standards.

To allay concerns that the SEC might not vigorously enforce SOX provisions, Congress has maintained oversight of the SEC's enforcement of SOX. On June 26, 2007, the commissioners of the SEC were called to testify before Congress. One concern was the new monetary penalty policy established by SEC Chairman Christopher Cox, which required SEC enforcement attorneys to get approval from the SEC commissioners to enter into negotiations with companies over fines and other penalties. A second concern was the perceived conflict of interest by a senior SEC attorney in a pending shareholder lawsuit before the US Supreme Court (Gordon and Yost 2007).

Can SOX Do it?

Whether or not SOX will succeed in reforming corporate accounting practices and restoring integrity to American financial markets cannot yet be definitively answered. Certainly the number of restatements point to the uncovering of accounting problems, which has led to improved reporting. Although some marginally performing companies chose to delist rather than comply with SOX, most corporate leaders reported benefits resulting from compliance. To facilitate this compliance, the SEC has changed deadlines and accounting rules. The SEC also implemented a policy change designed to reduce management's burden for internal controls.

Despite many studies, there is still insufficient data that distinguishes the effects of SOX from that of other market forces. Around the same time that SOX was enacted, both the NYSE and NASDAQ changed their listing requirements. Before SOX was fully implemented, increased competition from foreign financial markets motivated US exchanges to expand into markets beyond SOX jurisdiction.

Suffice to say, investors cried out for relief from the criminal excesses of corporate leadership exposed by the Enron scandal, and the Sarbanes–Oxley Act was created. Despite ongoing attempts by Wall Street insiders to overturn the Act, compliance with SOX is ongoing. Improvements in business processes, risk management and accuracy of financial information have certainly resulted. Of most value to investors and the American people, however, is the damper the Act has put on corporate criminal conduct because of increased risks of detection and penalties. Perhaps credibility will one day return to US financial markets.

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Author Bio

Cindy Burrows *knows what it is like to be a traditional and a non–traditional student at the University of New Hampshire. Close to a Community Development degree in 1978, she left school and started a family. Two years later she studied mechanical drafting at Stratham Vocational Technical College. In 1984 she returned to UNH and completed the first two years of engineering studies before having her second child. In 1995 she went back to Stratham Vocational Technical College to learn computer–aided mechanical design. In 2000 she entered UNH–Manchester and this time graduated in May '07 with a B.S. from the Mechanical Engineering Technology program. Her article grew out of a far more technical report done for an economics course as well as her outrage at the corporate misconduct she found.*

As a single mother, she worked fulltime as a mechanical designer while taking night classes, and at the same time totally rehabbed a 100–year old two–family apartment building—a feat she, her children and grandchildren are proud of. Shortly before graduation she began work at DEKA in Research and Development

as a Quality System Test Engineer. "That means," she explained, "that I look for ways to test devices to ensure they function properly for people. Sometimes that might mean trying to break them." A native of Walpole, New Hampshire, Cindy now lives in downtown Manchester.

Mentor Bio

Cindy was inspired by an assignment in the course, "Economics of Business Activities," taught by ***John R. Tommasi****, lecturer in economics. Mr. Tommasi's special area of research is macro–economic effects on the stock market; however, he teaches a wide range of courses. Since 1998 he has taught business, economics, finance, accounting, statistics and criminal justice at the University of New Hampshire and at other New England colleges. He has first–hand knowledge of the last subject as he is also a part–time patrol officer at Hampton Beach.*