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The Sarbanes-Oxley Act

What consequences have American companies identified after implementation of Section 404 of the Sarbanes-Oxley Act?

Bachelor Thesis in Business Administration

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Thank You,

Angelica Svensson

Abstract

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Title: What consequences have American companies identified after implementation of Section 404 of the Sarbanes-Oxley Act?

Background and Problem: A consequence of the many accounting scandals was that congress passed the Sarbanes-Oxley Act in July 2002. This in order to restore public confidence in the stock market and increase confidence in the integrity of the entire system of public ownership and accountability in the U.S. The legislation establishes new and enhanced standards for all U.S. public company boards and management, and for the accounting profession. One of the Sections in the Act (Section 404) is *Management assessment of internal controls*. I found it of great interest to investigate what consequences American companies have identified after implementation of Section 404 of the Sarbanes-Oxley Act.

Purpose: With this research, my purpose is to explain and analyze the consequences Section 404 of the Sarbanes-Oxley Act has had on American companies. By looking at earlier research on the subject and questioning people who have a great deal of experience and knowledge in the relevant area, this is to be accomplished.

Delimitations: My focus is mainly on section 404 of the Sarbanes-Oxley Act- Management Assessment of Internal Controls. In addition, the legislation only affects companies that you can find on American exchanges and their subsidiaries, so this thesis will focus on a few of these companies in the U.S.

Methodology: This thesis is based on scientific books and articles as well as survey's that was send to people who have a lot of knowledge and experience on the subject. This thesis follows a hermeneutic approach and is both descriptive and explanatory. In addition, the qualitative method is most appropriate for this thesis.

Analysis and Conclusion: Section 404 of the Sarbanes-Oxley Act has caused both positive and negative consequences. The costs of implementing Section 404 became so much higher than were initially predicted and various other problems have also been identified. But most important, nearly all people think that SOX has succeeded to reach its goal; to restore investor confidence and transparency in financial reporting.

Suggestions for further research: My focus in this thesis has been from an American company's perspective. Thus, it would be very interesting to investigate how auditors, on the other hand, have been affected by the implementation of Section 404 of the Sarbanes-Oxley Act.

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Abbreviations

AICPA: American Institute of CPA's

APB: Accounting Principle Board

ASB: Auditing Standards Board

AudSEC: Auditing Standard Executive Committee

CAP: Committee on Accounting Procedure

FASB: Financial Accounting Standards Board

FEI: Financial Executives International

GAAP: Generally Accepted Accounting Principles

ICFR: Internal Control over Financial Reporting

PCAOB: Public Company Accounting Oversight Board

POB: Public Oversight Board

QCIC: Quality Control Inquiry Committee

SEC: Securities and Exchange Commission

SECPS: SEC Practice Section

SOX: Sarbanes-Oxley Act

1. Introduction

In this chapter, a background to the topic will be given. Next, the problem will be introduced, which is then followed by a definition of the problem. This chapter will also provide the delimitations, purpose and the disposition of the thesis.

1.1 Background

In late 2001, Enron, one of the largest public companies in the U.S. at the time, became the subject for an SEC investigation. The investigation uncovered massive financial deception that had been going on for many years (Messier, 2008). In reality, Enron's was worth $1.2 billion less than what was reported. It was revealed that the income was overstated and a lot of the company's debt was excluded from the financial statements (www.enronfraudinfocenter.com). Arthur Andersen, the public accounting firm that audited Enron's financial statements, directly became involved in the controversy; because the firm had failed to report Enron's improper accounting (Messier, 2008). Both Enron and Arthur Anderson took bankruptcy and basically blinked out of existence. Shortly after the Enron scandal, headlines linked Global Crossing, Tyco, WorldCom, Adelphia and other companies to similar frauds (Prentice, 2005). All these scandals weakened not only investor confidence in the stock market but also caused a crisis of confidence in the integrity of the entire system of public ownership and accountability in the United States. Under pressure to restore public confidence, congress passed the Sarbanes-Oxley Act in July 2002.

The Sarbanes-Oxley Act of 2002, commonly called SOX, is a United States federal law enacted on July 30, 2002. This was the most significant securities law change since passage of the original federal securities laws in 1933 and 1934. The legislation establishes new and enhanced standards for all U.S. public company boards and management, and for the accounting profession. It does not apply to privately held companies. The Act contains 11 titles, including auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. Sarbanes-Oxley Act replaced the audit industry's self-regulation with a new federal agency, the Public Company Accounting Oversight Board, or PCAOB. PCAOB is charged with overseeing, regulating, inspecting and disciplining American and foreign accounting firms that audit public companies. The act also requires the Securities and Exchange Commission (SEC) to implement rulings on requirements to comply with the new law (Prentice, 2005).

1.2 Problem Discussion

All publicly-traded companies in the United States, including all wholly-owned subsidiaries and all publicly-traded non-US companies doing business in the U.S. need to comply with Sarbanes-Oxley. Therefore, thousands of companies face the task of ensuring their accounting operations are in conformity with the Sarbanes-Oxley Act (www.sarbanes-oxley-101.com/).

Congress addresses the problem of the accuracy and reliability of public companies' financial statements in section 404 of the Sarbanes-Oxley Act. Section 302 requires CEOs and CFOs to confirm that to their knowledge the reports their company file with SEC are trustworthy and correct. The question is though, how are they to know that the information they rely upon to reach a conclusion about their reports is reliable? In the Enron case, Jeff Skilling, former CEO of Enron, testified before Congress that he had no idea that the company's financial statements were off by billions of dollars?! Congress wanted to deprive all executives of plausible "excuses" and the solution was section 404 (Prentice, 2005).

Section 404 of the Sarbanes-Oxley Act is also the section that seems to cause the most difficulties for compliance. Section 404 of the Sarbanes-Oxley Act requires management of a publicly traded company to issue an internal control report stating that management is responsible for an "adequate" internal control over financial reporting (ICFR). Management must also issue an assertion as to whether ICFR is effective as of the end of the accounting period and shortcomings in these controls must be reported (Messier, 2008). Furthermore, auditors must attest to the accuracy of management's assertions that internal controls are in place, operational and effective (www.sarbanes-oxley-101.com/).

1.3 Problem Definition

The discussion of the problem leads us to the problem definition, which is defined as follows:

What consequences have American companies identified after implementation of Section 404 of the Sarbanes-Oxley Act?

This main problem will be analyzed and explained with emphasis on four different areas that is relevant in order to decide the consequences of section 404 of the Sarbanes-Oxley act. These areas are:

- Costs

- Problems

- Benefits

- The future

1.4 Purpose

In this research, the purpose is to explain and analyze the consequences Section 404 of the Sarbanes-Oxley Act has had on American companies. By looking at earlier research on the subject and questioning people who have a great deal of experience and knowledge in the relevant area, this is to be accomplished.

Most public companies had to meet the requirements of Section 404 of the Sarbanes-Oxley Act for all financial statements filed after November 2004. Therefore it is highly relevant to investigate the consequences now, 2008, since they are now well known and definable.

1.5 Delimitations

My focus is mainly on section 404 of the Sarbanes-Oxley Act- Management Assessment of Internal Controls. Thus, the aim of the study is not to describe and analyze the consequences of all sections of the Sarbanes-Oxley act.

The legislation only affects companies that you can find on American exchanges and their subsidiaries, so this thesis will focus on a few of these companies in the U.S. The empirical research focuses on input from controllers and CFO's that have a lot of expertise, experience and knowledge in the area.

1.6 Disposition

- *Introduction*

In this chapter, a background for the research will be given. Next, the problem will be introduced, which is then followed by a definition of the problem. This chapter will also provide the delimitations, purpose and the disposition of my research.

- *Methodology*

The methodology of the research is presented in this chapter. The different options for gathering and processing information are discussed which then follows of a description of how the collection of data and questionnaires were conducted. The chapter is concluded with a research evaluation which includes the validity, reliability, relevance and criticism of the sources.

- *Theoretical Framework*

In this chapter, the theoretical framework is presented. The chapter includes the historical background, the Enron scandal, the Sarbanes-Oxley Act and finally the consequences of Section 404 of the Sarbanes-Oxley Act.

- *Empirical Research*

The outcomes of the empirical research are given in this chapter. First, a presentation of the respondents will be given followed by their answers. The answers are organized into the four areas mentioned in the problem definition; costs, problems, benefits and the future.

- *Analysis*

This chapter connects and analyzes the theoretical framework and the empirical result in order to accomplish the purpose with this thesis and answer the questions that was stated in the problem definition.

- *Concluding Discussion*

To meet the purpose with this thesis, this chapter will present the conclusions that have been drawn from the analysis. This chapter is concluded with some suggestions for further research.

2. Methodology

The methodology of the research is presented in this chapter. The different options for gathering and processing information are discussed which then follows of a description of how the collection of data and questionnaires were conducted. The chapter is concluded with a research evaluation which includes the validity, reliability, relevance and criticism of the sources.

2.1 Scientific Approach

There are two central approaches within scientific research, the hermeneutic and the positivistic approach. The hermeneutic approach, deals with the interpretation and understanding of text, including text analogous. Many hermeneutic scholars have even extended their conception of text to include individual behavior, group behaviors and social institutions, all of which have meanings that can be read and interpreted. Similar in all forms of hermeneutics is the concept of the hermeneutic circle or spiral. This concept expresses the idea that, in an attempt to understand the true meaning of something, one seeks a pre-existing understanding of the article under study from one's own experience. This, as a consequence, enhances and expands knowledge and understanding of the article and leads to greater understanding (Webb &Pollard, 2006).

On the contrary, the positivistic approach holds that the goal of knowledge is to describe the phenomena that we experience. The purpose of science is basically to focus on what we can observe and measure. Knowledge of anything more than that is impossible according to a positivistic approach. Therefore, since we can't directly observe emotions and thoughts, these were not valid topics for a scientific psychology (www.socialresearchmethods.net [a]).

The hermeneutic approach fits this thesis best of the two approaches as the aim with this thesis is to describe and analyze the consequences of Section 404 of the Sarbanes-Oxley Act. The concept of the hermeneutic spiral has also been helpful when conducting the research. This for the reason that it helps to better interpret the answers gathered from the questionnaires and all the other facts.

2.2 Research Approach

A research can be either descriptive or explanatory or a little bit of both. The descriptive approach aims mainly at gathering descriptions and explanations (knowledge) about the object of study but it tries to avoid bringing about any changes in the object. The aim is to find out how things *are*, or how they *have been*. This is mainly accomplished through the theoretical framework**.** In addition, the researcher sometimes wants to collect opinions about the desirability of the present state of things, which are done in the empirical research **(**www2.uiah.fi/projects/metodi/144.htm). The explanatory approach aims at explaining why the outcome has become what it is. For this reason, the research also includes an explanatory

approach (Eriksson & Wiedersheim-Paul, 2001). This is accomplished through the empirical research as well.

2.3 Research Method

Research methods can be classified into two ways, quantitative and qualitative research. Quantitative data normally involves numbers and are interpreted with the help of statistical techniques. The main objective of quantitative research is to decide if the expected generalization of a theory turns out to be right (http://www.unr.edu). Here, the researcher is ideally an objective observer who neither participates in nor influence what is being studied. Furthermore, quantitative research is deductive, meaning that a hypothesis is required before research can begin (http://writing.colostate.edu). In contrast, the main objective of qualitative research is to understand a complex problem from many different perspectives. The purpose is to find underlying meanings and relationships that will help you to understand and explain the fact of interest (http://www.unr.edu). Under this method, the researcher can learn the most by participating and being immersed in a research situation. In addition, qualitative research is inductive, meaning that a hypothesis is not required in order to begin research (http://writing.colostate.edu).

The qualitative method is the most appropriate for this research as my goal is to describe and analyze the consequences of Section 404 of the Sarbanes-Oxley Act in a way that does not involve mathematical models.

2.4 Data Collection

The two major types of data that can be collected are primary and secondary data. Primary data is data you collect yourself and secondary data is collected by others to be “re-used” by the researcher (http://oassis.gcal.ac.uk).

2.4.1 Primary Data

Primary research is any type of research that you go out and collect yourself using methods such as interviews, observations and surveys (using a questionnaire). This data is unique to you and your research and no one else has access to it until you publish the research (http://owl.english.purdue.edu [a]). Primary data is gathered by the researcher, particularly to meet the current problem of the research. It is completely tailor made and there is no problem of adjustment. It is also more helpful than secondary data as it shows the most current information (www.adfoster.com). “Primary data can be relied on because you know where it came from and what was done to it. It’s like cooking something yourself. You know what went into it”. Unfortunately, primary data is expensive and difficult to acquire (Kelly, 2005).

In order to collect the primary data for this study I decided to carry out a survey. This involved using a questionnaire to ask respondents questions to secure the information I needed in order to answer the research question posted earlier. This was done both by mail and in person. My

survey consisted of four broad questions, as this was found to be most suitable for the study. It is a very sensitive subject here in the U.S., so I wanted to leave it up to the respondent's how much, and what kind of information they felt was appropriate to give out. It was also a way to get information about things I might not have thought of asking. Closed questions are easier to analyze but they do not provide the rich responses you may get with open-ended questions (http://owl.english.purdue.edu [b]). Below, the survey questions are presented:

1. **Costs**
- What types of cost?
- Amounts?
2. **Problems**
- By the time of implementation and today?
- What kind of problems?
- How did your company deal with the problems?
3. **Benefits**
4. **The Future**
- Costs
- Problems
- Benefits

I send out the questionnaire to The Big Four Accounting firms and to about 30 public companies that are affected by the Sarbanes-Oxley Act. The reason for sending out to so many was that I knew that many of the companies would not respond, so I wanted to make sure to get enough responses in order to answer my research question. It is important not to have too few surveys because you then won't have enough answers to support any generalization or findings you may make. On the other hand, you do not want to have too many surveys because you will be overwhelmed with analyzing your data (http://owl.english.purdue.edu [b]).

I ended up with only four responses from public companies, so I definitely got proof on how unwilling companies and auditing firms are to give out Information about the Act, its consequences and the way they have been working to meet the Act's requirements. In another effort to get more input, I tried to call the companies that I had not received any responses from, but without success. All of the respondents that I received answers from though, work on a daily basis with the Act and hence has a lot knowledge and experience on the subject. Moreover, one of the respondents preferred to be anonymous, which is another sign on how sensitive this subject is. I have respected this by referring to him/her as anonymous.

The reason for using written surveys is that it let you collect considerable quantities of detailed data to a low cost per respondent. Surveying is also good because it is a great way to find out what people think about a certain issue and it can be conducted relatively easily (http://owl.english.purdue.edu [b]). In addition, carrying out a survey allowed me to consider the

responses and avoid interviewer bias. From the respondent's point of view, written surveys allowed them to stay anonymous if they desired and they also had time to consider the responses.

I also got help from my auditing professor at San Diego State University, Professor Martha Doran. She gave me very useful advice on what could be important and relevant to include in the thesis and where to find the information needed.

2.4.2 Secondary Data

Secondary research is a means to reprocess and re-use information collected by others. This information relates to a past period. Hence, the information may not be relevant today and therefore has unsatisfactory value (http://www.adfoster.com). Secondary data is collected from external sources such as internet, TV, magazines, newspapers, and research articles. Secondary data is a lot cheaper and easier to acquire than primary data. The problem is that the reliability, accuracy and integrity of the data are unsure. Who collected it? Can they be trusted? Is it biased? How old is it? Also, secondary data has often been pre-processed and the original details are lost so you can't confirm it by replicating the methods used by the original data collectors. In conclusion, secondary data is cheap and easy to collect, but must be treated with carefulness (Kelly, 2005).

Secondary data has been collected by searching on the internet and in various databases. The literature is also something that has been used for this purpose. In order to find articles about earlier research on the subject, the databases were used. The Internet has been used to download regulations and also in order to find facts about the era of self-regulations and the Enron Scandal. The literature, when applicable, is used primarily in the theory chapter.

Considering that a few years have gone by since the implementation of SOX, a lot of secondary data is now available about the consequences of the Act. When using secondary data I have tried to always go back to the original author to avoid any misinterpretations. I have also looked at how old the data is in order to be able to analyze it correctly.

2.5 Research Evaluation

When conducting a research, it is very important to be skeptical to the sources used, and to the conclusions made in the research. This can be accomplished by looking at relevance, validity, reliability and criticism of the sources. In order to produce a high quality research, high validity, reliability and relevance are necessary.

2.5.1 Validity

Validity is "the best available approximation to the truth of a given proposition, inference, or conclusion" (http://www.socialresearchmethods.net [b]). Validity involves the degree to which you are measuring what you are supposed to, in other words, the accuracy of your measurement. Validity can be said to be more important than reliability because if an instrument does not

accurately measure what it is supposed to, there is meaningless to use it even if it measures consistently (reliably) (http://www.socialresearchmethods.net [c]).

There are different types of validity; two of them are internal and external validity. External validity is linked to generalizing. It is the degree to which the conclusion in a study would hold for other persons in other places and at other times (http://www.socialresearchmethods.net [d]). Internal validity on the other hand, is the approximate truth about inferences concerning cause-effect or causal relationships. Thus, internal validity is not highly relevant in this study because the aim is not to establish a causal relationship.

This thesis is considered to have good validity. I send out questionnaires only to people with relevant knowledge on the subject whom could give me information that was relevant for the purpose of the study. This is necessary in order to reach a high validity and in order to come to an adequate conclusion about the consequences of Section 404 of the Sarbanes-Oxley Act. When it comes to the secondary data, validity is considered to be high as well, as they all have close connection to the topic of the thesis.

2.5.2 Reliability

In most cases the word reliability means “dependable” or “trustworthy”, but that is not a precise enough definition. “In research, the term reliability means “repeatability” or “consistency”. A measure is considered reliable if it would give us the same result over and over again (assuming that what we are measuring isn’t changing!)” (http://www.socialresearchmethods.net [e]). For example, if another person would ask the respondents the same questions as I did, would they get the same answers? Several criteria can be used to determine reliability. First, who is the respondent? A respondent’s background may reflect their personal, political or professional bias. Second, what are their qualifications and experiences? Knowing a respondent’s credentials can help you decide whether they are trustworthy source of information (http://www.library.uow.edu). I have used respondents with a great knowledge and experience in the subject which, in my opinion, helps out to improve the reliability in the research. A perfect reliability is hard to reach though because there is always a chance that I interpret the answers I get from the respondents incorrectly or that the respondents give me the answers that make them or their company look good instead of the actually truth.

2.5.3 Relevance

According to Eriksson & Wiedersheim-Paul (2001), a relevant research is one that is of interest and importance to people other than the researchers themselves. When implementing the Sarbanes-Oxley Act, there will be many changes in the business environment and in the way people are working. This make me believe that a thesis about the consequences of the Act can be of high relevance for public companies and auditors that are already affected by the Act and for other companies that might be affected by the Act in the future.

2.5.4 Criticism of the Sources

Criticism can be given to the type of primary data gathered. As mentioned earlier, surveys involves using a questionnaire to ask respondents questions. Downfalls with using questionnaires are that they are not flexible, cannot be adapted to individual respondents, generally have low response rates and may give misleading responses. The researcher has also no control over who completes the questionnaire (http://telecollege.dcccd.edu). Other disadvantages are that questions have to be relatively simple and time delay while waiting for responses to be returned, several reminders may be required and respondent can read all questions in beforehand which may lead them to not respond because the survey is too long, too complex or too personal (http://brent.tvu.ac.uk).

Criticism can also be given to the number of surveys. If more companies and auditing firm would have responded to the survey, the research could have been in even more depth. Considering that my primary research included a small group of people and companies, it is important not to over-generalize the findings. In other words, my findings might not necessarily be representative of the population as a whole. On the other hand, it is possible to mitigate this by combining primary research with secondary research. This is called data triangulation and arises when a finding or a generalization is able to be verified with several different research methods. This helps to make my findings stronger (http://owl.english.purdue.edu [c]).

In this chapter, I have outlined the methodology that I have used in the research. In the next chapter, the theoretical framework will be presented including historical background, the Enron scandal, the Sarbanes-Oxley Act and consequences of the Act.

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3. Theoretical Framework

In this chapter, the theoretical framework is presented. The chapter includes the historical background, the Enron scandal, the Sarbanes-Oxley Act and finally the consequences of Section 404 of the Sarbanes-Oxley Act.

3.1 A brief history of Self Regulation (Prior to 2002)

When Enron filed for bankruptcy, more focus than ever was put on the accounting profession and its self-regulatory system. Self-regulation by the accounting profession can be traced to just after the Securities and Exchange Commission (SEC), the Securities Act of 1933 and the Securities Exchange Act of 1934 was established. These new laws were passed by congress in response to the losses investors faced in the stock market crash of 1929 and the following financial depression. In charge for setting accounting standards and watching over the activities of auditors was given to SEC. In addition, the accounting profession's responsibility was to establish auditing standards.

3.1.1 Auditing Standards

The first auditing standard was issued in 1939 by the American Institute of Accountants, the AICPA's predecessor organization. A few years later the committee also issued a number of statements that were intended to help the independent auditor in its work. In 1972, the American Institute of Accountants changed name to the Auditing Standard Executive Committee (AudSEC). In 1978, the Auditing Standards Board (ASB) was created as AudSEC's successor. The ASB is now the committee within AICPA (American Institute Of CPA's) that sets the rules for how an auditor decides whether the information reported in a financial statement is reasonable and if it conforms to Generally Accepted Accounting Principles (GAAP).

3.1.2 Accounting Standards

The AICPA's Committee on Accounting Procedure (CAP) issued fifty-one Accounting Research Bulletins between 1938 and 1959. These Accounting Research Bulletins became the basis of what is today known as generally accepted accounting principles (GAAP). The CAP was later replaced by the Accounting Principles Board (APB), which during the following years issued thirty-one new standards. The APB was a part-time committee and by the late 1960s, it was realizes that a part-time committee was not enough in order to develop high-quality standards in an increasingly complex business environment. Therefore, the responsibility for setting accounting standards was transferred from the AICPA to the Financial Accounting Standards Board (FASB), which was a full time independent body. The FASB is the committee that today has the responsibility to decide the rules for reporting, measuring and disclosing information in financial statements.

3.1.3 Peer Review

One way for accounting firms to improve audit quality is through peer review. In 1977, peer review became a requirement by the AICPA. Since 1984, all members who audit publicly-held companies are required to work for a firm that belongs to the AICPA's SEC Practice Section (SECPS). The goal is to give some assurance that a company performing auditing and accounting services has an effective control system. This control system should then give assurance that its auditors and accountants are following the guidelines in GAAP and GAAS (http://thecaq.aicpa.org). How does a peer review work then? A CPA firm will appoint another CPA firm to conduct the review. This CPA firm however, cannot be just anyone, there are some limitations. The reviewing CPA firm must be independent of the CPA firm being reviewed, plus be qualified with matching industry experience. It is the peer review committee that makes sure this is being met (www.aicpa.org). Concurring review by a fellow partner and rotation of audit partner are other necessities for SECPS membership.

3.1.4 Public Oversight Board (POB)

In 1977, the Public Oversight Board (POB) was created. The POB's responsibility is to oversee the Auditing Standards Board and the SECPS's activities including the peer review. The POB take part in field reviews of all firms with a minimum of 30 SEC audit clients. It also participates in sampling of one of every five reviews of companies with less than 30 SEC clients. The POB is an independent body; it hires its own staff and board members, and takes care of its own budget.

3.1.5 Quality Control Inquiry Committee (QCIC)

In 1979, the Quality Control Inquiry Committee (QCIC) was established. QCIC duty's is to give reasonable assurance that companies are following the professional standards and also to investigate claimed audit deficiencies. If the QCIC find audit deficiencies, it will require the firm to take corrective actions immediately. The QCIC may also do a "follow up" to make sure that these corrective actions have been made.

3.1.6 Professional Ethics Division

Within the AICPA, there is a professional ethics division. The duties of the staff within this division are to interpret, maintain and enforce the AICPA Code of Professional Conduct. They may also suggest improvements and changes to the Code. Another responsibility the professional ethics division has is to investigate any accusation of wrongdoing by members (http://thecaq.aicpa.org).

3.1.7 Regulation Overhaul

The bankruptcy of Enron 2002 put an enormous focus on the accounting profession and its self-regulatory system. Accountants' image rapidly fell from the top to near the bottom of all professionals. The accounting profession has had a successful, 100-year tradition of self-regulation, which was in the process of replacement. The problem arose to some extent because many executives at Enron and Andersen focused on the "letter of the law" rather than on whether the proposed accounting was ethical and "fair". Understanding the crisis in 2002 and the major changes that was on its way requires starting with what happened with Enron (Reinstein & Weirich, 2000).

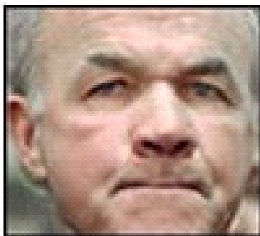
3.2 The Enron Scandal

In 1985, Enron began its business as a natural gas company founded by Kenneth Lay. Enron rapidly changed its business over the next 16 years, making it one of the world's largest energy traders (www.enronfraudinfocenter.com). Enron was labeled "Americas Most Innovative Company" by Fortune magazine in 2000 (Socialism Today). It was also on the top 10 list over the greatest companies to work for in America (Gavridis & Ficarella, 2004). The problem for Enron was that after a long time of success, the company was no longer really making a profit. Enron, however, was really good at hiding this fact to the public. One way of doing this was through Mark-to-the-market accounting. Mark-to-the-market accounting is a legal type of accounting for a company that is dealing with buying and selling securities. For example, the final value of an investment which is expected to have a life of several years will not be known until it expires. However, under Mark-to-the-Market accounting, an investment's present and future cash flows are entered into the books at the time the investment is completed. In other words, anticipated future profits from any deal were classified as if real today. This is exactly what Enron did even though the company had not yet received a penny of revenue. Thus, Enron could record gains from what over time may turn out losses.

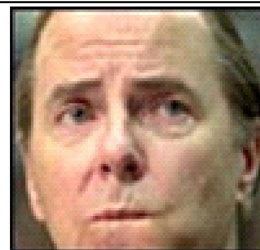
Another tactic Enron used to hide its losses was to borrow the money necessary to hide the losses and at the same time, keep these loans off the books. Enron's CFO Andrew Fastow was the brain behind this (Thomas, 2002). Debt and losses were put into entities formed "offshore" that were not included in Enron's financial statements. Other complicated financial transactions between Enron and related companies were also used to take unprofitable entities off the company's books. In 1997, Enron created a subsidiary named Whitewing which was formed to purchase Enron's underperforming assets and then sell them off. As a subsidiary however, Whitewing's financial statements would be included in Enron's financial statements. Therefore, in order to get around that, Enron sold off slightly more than half of Whitewing in 1999 so it would no longer be a subsidiary of Enron. Whitewing was formed to buy underperforming assets from Enron at a price higher than they were actually worth and in doing so, take losses on them instead of Enron doing so. Of course, Enron had to reimburse Whitewing for any losses on its sale of the underperforming assets with shares of Enron. How did this work then? Assume Enron invested

in something for $10 million, predicting the investment to be worth $15 million and put a $5 million profit in its financial statements. When the investment did not perform as it was supposed to and had a market value of only $8 million Enron should have taken away the $5 million profit and put a $2 million loss on its books. As an alternative, Enron sold the investment to Whitewing for $15 million so it did not look like it was anything wrong with the $5 million in profit on Enron's books. Next step for Whitewing was to sell the investment for $8 million and as compensation receive $7 million worth of Enron stock. In this way, Enron changed a $2 million loss into a $7 million accounting profit (http://www.applet-magic.com).

These entities made Enron look more profitable than it in fact was. This practice drove up their stock price and in August of 2000, stock price hit its highest value of $90. At this point the executives and insiders at Enron knew about the offshore accounts that were hiding losses for the company and began to sell their stock. The general public and Enron's investors knew nothing of this and were told to buy the stock. Executives told the investors that they believed that the stock would continue to climb until it reached the $130 to $140 range. The stock price began to drop when the executives sold their shares but investors were still told to continue buying because the stock price would recover in the near future. By August 15, 2001, Enron's stock price had fallen to $42 and in the end of October; the stock had fallen to as low as $15. Many saw this as a great opportunity to buy Enron stock because many of the investors still trusted Lay and the things he had been telling them in the media about staying optimistic. The stock fell to 26 cents a share on November 30, 2001 and on December 2, 2001 everything was over, Enron filed for bankruptcy. Enron's founder, Kenneth Lay, was found guilty of all 10 charges against him; e.g. covering conspiracy, false statements, securities fraud and bank fraud. He faced a total sentence of up to 45 years in prison but died on July 5, 2006, of heart disease, before sentencing was scheduled. Enron's former CEO, Jeffrey Skilling, was found guilty of 19 counts of fraud, conspiracy, insider trading and lying to auditors. He was sentenced to 24 years, 4 months in prison (Lozano, J.A, 2008). Enrons Former CFO, Andrew Fastow, will serve a 10-year sentence, plus that he must pay $23 million in civil and criminal penalties (Eichenwald, 2004).



Kenneth Lay



Jeffrey Skilling

In addition, the scandal caused the dissolution of Arthur Andersen, which at the time was one of the “Big Five” large international accounting firms. Arthur Andersen’s job was to make sure that Enron’s accounts were a truthful reflection of the state of the business. The company also carried out consulting work for Enron which can lead to a conflict of interest (BBC NEWS, 2002). Enron was paying Arthur Andersen millions of dollars in audit and consulting fees and as a consequence, made it almost impossible for Arthur Andersen to stay independent towards is client (Reinstein & Weirich, 2000). On June 15, 2002, Arthur Andersen was convicted of obstruction of justice for shredding sensitive documents related to the bankruptcy of Enron. According to Deputy Attorney General Larry Thompson “Dozen of large trucks were brought in to haul documents from Andersen’s office and Enron’s building to Andersen’s office in Houston in order to destroy literally tons of documents”. Thompson added, “Employers were told to work overtime if necessary to finish the job of destroying documents. The shredder at the Andersen office and Enron building ran virtually constantly” (Taub, 2002).

JAMES NIELSEN/AFP
THE SCENE: Arthur Andersen's Houston branch

3.3 The Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 is also recognized as the Public Company Accounting Reform and Investors Protection Act of 2002 (Ho & Oddo, 2007). The Act is a United States federal law enacted on July 30, 2002, by President Bush and is named after its authors Michael G. Oxley and Senator Paul Sarbanes. The Sarbanes-Oxley Act was created in response to a series of very high profile accounting scandals; e.g. Enron, Tyco International and WorldCom. All these scandals made investors to lose confidence in the U.S. markets and according to them, no company could no longer be trusted (Grumet, 2007)

The Sarbanes-Oxley Act's main objectives are to re-establish investor confidence in the securities market and to prevent future corporate frauds. Included in the act are sections addressing legal liability, stricter independence rules, audits of internal controls, and increased reporting responsibility. The creation of the PCAOB is the single most noteworthy aspect of the legislation, ending decades of self- regulation by the accounting profession. Congress did not develop the detailed accounting and securities rules and regulations needed to carry out the Act's provisions. Instead, the task and responsibility to create the detailed rules and regulations was given to SEC. Furthermore, the most important provisions of the Sarbanes-Oxley Act are intended to increase the responsibility of CEOs and CFOs for the reliability of their company's financial statements. Congress understands that the primary wrongdoers in corporate fraud are untruthful officers and directors (Messier, 2008). The act also introduced a number of deadlines, the most important ones being:

- Most public companies must meet the financial reporting and certification mandates for any end of year financial statements filed after November 15th 2004.
- Smaller companies and foreign companies must meet these mandates for any statements filed after 15th July 2005.

The Sarbanes-Oxley Act itself is organized into 11 titles, even though sections 302, 401, 404, 409, 802 and 906 are the most considerable with respect to compliance and internal control. Particularly section 404 seems to cause most concern (http://www.sarbanes-oxley-forum.com/).

3.3.1 Summary of the Sarbanes-Oxley Act

Here, a summary of the first four titles of the Sarbanes-Oxley Act will be provided. These are the sections I believe is the most important ones.

Title I: Public Company Accounting Oversight Board

Title one establishes the Public Company Accounting Oversight Board, "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for public companies" (Prentice, 2005, p. 11). Title 1

also gives the PCAOB authority to require mandatory registration of public accounting firms, establish the processes and procedures for compliance audits, conduct continuing inspections, and establish fair procedures for investigations and disciplining of registered public accounting firms. Title I consists of nine sections.

Title II: Auditor Independence

Title II strengthening the independence of public company auditors. Congress required the PCAOB to ban provision of several types of non-audit services to public company audit clients in order to limit conflict of interest. Title II requires that the client company's audit committee pre-approves all auditing services and that each public accounting firm shall report to the audit committee of the board of directors regarding critical accounting policies and alternative treatments. Title II also addresses audit partner rotation requirements. Title II consists of nine sections.

Title III: Corporate Responsibility

Title III requires that audit committees must be composed of entirely independent directors, people who are not officers of the company and do not accept any consulting or advisory fees from the issuer or its subsidiaries in any significant way. Title III requires senior executives to certify that based on their knowledge the reports do not contain any material misstatements and the financial information is fairly presented. They must also certify that they take individual responsibility for establishing and maintaining their company's internal controls, that they have designed such controls and that they have recently evaluated the effectiveness of the internal controls. Title III also state that it is unlawful for any officer or director to fraudulently influence, manipulate or mislead an auditor for the purpose of financial statements misleading. Title III consists of eight sections.

Title IV: Enhanced Financial Disclosures

Section IV mandates that all material off-balance sheet transactions, arrangements, obligations, and other relationships with unconsolidated entities that might have a material impact in the financial statement must be disclosed. It also requires internal controls so that accurate financial statements can be produced and an assessment of the effectiveness of the internal control by management. Auditors must audit the internal control assessment of the company as well as the financial statements. Title IV also prohibits public companies from making personal loans to executive officers and directors. Furthermore, title IV requires public companies to disclose whether or not they have adopted a code of ethics for senior financial officers and that at least one member of the audit committee is a "financial expert". Timely reporting of material changes in financial condition must also be done. Title IV consists of nine sections (Prentice, 2005).

3.3.2 Section 404

Section 404 of the Sarbanes-Oxley Act is the part which I have focused on in my thesis. For that reason, I have included a direct citation from the Sarbanes-Oxley Act of 2002, section 404, (found at: http://fl1.findlaw.com):

> "**SEC.404. MANAGEMENT ASSESMENT OF INTERNAL CONTROLS.**
>
> **(a) Rules Required.** The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 to contain an internal control report, which shall--
> (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
> (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
> **(b) Internal Control Evaluation and Reporting.** With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement" (Title IV, SEC 404, p 45).

3.3.3 SEC

When the stock market crashed in October 1929, public confidence in the markets decreased. Investors and banks lost huge amount of money in the resulting Great Depression. In order for the economy to recover, the public confidence in the capital markets needed to be restored. During the peak year of the Depression, Congress passed the Securities Act of 1933. This law together with the Securities Exchange Act of 1934, which created the SEC, was designed to bring back investor confidence in the capital markets. The main purposes of these laws can be summarized as follows; companies publicly offering securities for investment dollars must be honest with the public about their businesses, the securities they are selling, and the risk associated with investing; people who sell and trade securities must treat investors fairly and honestly, placing investor's interest first.

The Securities and Exchange Commission (SEC) is a government agency that administers the Securities Act of 1933, the Securities Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002 etc. (Messier, 2008). The mission of the SEC is to protect investors, maintain fair and efficient markets and facilitate capital formation. The laws and rules that govern the securities industry in the U.S. originate from a simple and straightforward idea: all investors should have access to certain basic facts about an investment. To accomplish this, the SEC requires public companies to disclose meaningful financial and other information to the public. "Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions." Essential to the SEC's effectiveness is its enforcement authority. Every year the SEC

brings hundreds of civil enforcement actions against individuals and companies for violation of the securities laws, including for example, insider trading and accounting fraud (http://www.sec.gov/.).

3.3.4 PCAOB

In creating the PCAOB, Congress was addressing the breakdown of the accounting industry's self regulation model. During the 1990's, the Big Six (now the Big Four) strived in every possible way to increase their streams of revenue, paying little attention to the public trust. The Sarbanes-Oxley Act of 2002 transferred authority for standard setting, investigation, inspection and enforcement for public company audits from the profession (AICPA) to the PCAOB.

"The PCAOB is a private sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports" (PCAOB, 2002).

Section 102 of SOX provides for mandatory registration of public accounting firms and prohibits any person who is not registered with the PCAOB from preparing or issuing audit reports on U.S. public companies and from participating in such audits.

Section 103 of the SOX orders the PCAOB to establish auditing, quality control, ethics and independence standards to be used by public accounting firms in the preparation and issuance of audit reports.

Section 104 of the SOX requires the PCAOB to conduct continuing inspections of public accounting firms to assess their compliance with the Sarbanes-Oxley Act, the rules of the Board and the Securities and Exchange Commission.

In addition, no rule of the PCAOB becomes effective without prior approval of the SEC.

Section 105 of the SOX instructs the Board to establish fair procedures for investigations and disciplining of registered public accounting firms and associated persons of such firms (Prentice, 2005).

3.4 Consequences of section 404 of the Sarbanes-Oxley Act

Almost six long years has gone by since George Bush signed the Sarbanes-Oxley Act into law on July 30th 2002. George Bush called its tough new rules the “most far-reaching reforms of American business practices since Franklin Roosevelt was president” (Economist, 2007, p. 1). The Sarbanes-Oxley Act became “hated” by many businessmen in America and even its authors questioned the act, saying that the quick passage of the law meant it was poorly written in parts. Michael Oxley, one of the former congressmen who drafted the act said in March, “Frankly, I would have written it differently”. He also said that his co-author, Paul Sarbanes thought the same. “But it was not normal times.”

One of the charges against SOX is the price of compliance. This because the costs of implementing SOX, far exceeded the sums that was predicted from the beginning, especially Section 404. Some people have reached the conclusion that the costs of SOX outweigh the gains. Others claimed that the Act had backfired. Instead of re-building confidence in public companies, it has weakened America’s stock markets. In addition, SOX stands accused of undermining America’s entrepreneurial spirit (Economist.com).

Despite all these complaints, a lot of people say that SOX has caused some positive consequences as well. For example, managers can now be more confident about the trustworthiness of the numbers and the public have got back some confidence in the markets (Economist).

3.4.1 Costs

Section 404 of the Sarbanes-Oxley act has probably received the most negative publicity due to the additional compliance costs it implies. In a response to numerous inquires about the implementation costs for Sarbanes-Oxley Section 404 compliance (internal controls), Financial Executives International (FEI) has surveyed members from public companies every year since 2004.

FEI surveyed its public member companies twice in 2004 about their implementation costs for compliance with Sarbanes-Oxley Section 404. The first survey was conducted in January, 2004, and FEI received responses from 321 companies. The size of the responding companies tended to be large. 20% of the companies had more than $5 billion in annual revenues and only 3% of the companies had less than $25 million in annual revenues. The second survey was conducted in July, 2004, and here, FEI surveyed 224 public companies with revenues of $2.5 billion in average. Total estimated average “year one” costs for compliance with Section 404, per company, increased from $1.93 million in January to $3.14 in July. For companies with over $5 billion in revenues, “year one” costs almost doubled from $4.6 million to over $8 million. The increase in costs stems from a 109% rise in internal costs, a 42% jump in external costs and a 40% increase in the fees charged by external auditors.

After the survey in March, 2005, it was clear that public companies have had to dig even deeper than previously estimated to pay the costs of complying with section 404 of the Sarbanes-Oxley Act. The total cost for compliance averaged $4.36 million, up 39% from the $3.14 million they expected to pay based on FEI's earlier July 2004 cost survey. The increase steams from a 66% leap in external costs such as consulting and software and a 58% increase in the fees charged by external auditors.

Costs of compliance in year two ended up being less than in year one according to FEI's survey in March, 2006. Total cost in average for compliance with Section 404 during fiscal year 2005, were anticipated to be about $3.8 million. Compliance with Section 404 has brought with it efficiencies for most companies. However, financial executives believe that clarification is still needed from the PCAOB when it comes to auditor guidance. Without a doubt, compliance with section 404 has enhanced investor confidence according to financial executives, but it has done so to a high price. There was a 13% decrease in auditor fees, but this was less than anticipated in the March 2005 survey, when auditor fees were expected to drop 26% in the following year. When the companies were asked if the positive consequences of compliance with Section 404 have exceeded the negative ones, only 14.9% agreed. This is a little bit less than in the March, 2005 survey, when 16% said they agreed.

The survey conducted in May 2007 found that Section 404 compliance cost was less in year three of adoption than in each of the first two years. FEI surveyed 200 companies with average revenue of $6.8 billion. Companies with market capitalization above $75 million, total average cost for compliance was $2.9 million during fiscal year 2006. This represents a 23% decrease from 2005 totals. The result also shows reductions in internal and external costs of compliance which can be attributed to companies increased efficiencies in complying with Section 404. However, audit fees are virtually unchanged (FEI).

In the study "Lessons Learned from Section 404 of the Sarbanes-Oxley Act", Shih-Jen Kathy and Alfonso R. Oddo examined compliance with SOX section 404 from management perspective. The authors interviewed compliance officers from two U.S. Fortune 500 companies referred to as LMN and UVX. LMN has annual sales of $14 billion and the total compliance cost in 2004 was $18.1 million of which $7.1 million was paid to the external auditor for its work related to SOX. LMN incurred a loss in 2004. UVX has annual sales of $25 billion and the company spent over $20 million in the implementation phase of SOX. Furthermore, like most companies, its audit fees went up during that time period as well. LMN's biggest challenge of the compliance project was how to control project cost. There are no low-cost alternatives when it comes to the compliance work and it is not something that is possible to cut back on if the company is having a bad year. Another challenge for LMN was how to take the level of documentation and testing to a higher level. Other challenges include keeping people's interest in the project and getting the internal audit and finance staff to stay focused and exited about the project. In contrast, the benefits of the compliance project for LMN include enhanced documentation of business processes and business controls; operational efficiencies; a better

understanding and a more-detailed linkage of how its business operations relate to its financial statement and financial reporting. One benefit for UVX is better discipline in the company's financial processes. Also, the company improved documentation around all of its key controls and got a more thorough understanding of controls and risks. Both the companies were asked what they think might happen to SOX in five years. According to LMN, SOX will be less administratively complex and it will be simplified and focus more on corporate governance and enterprise risk management instead of the lower-level requirements we see today. UVX said that SOX improvements will be made, but in general it's become a standard, the framework is there and the discipline is in place (Ho & Oddo, 2007).

3.4.2 Problems

Most corporate commentators do not dispute that SOX, especially section 404, are beneficial. Most of them however, also complain of high cost. The biggest problem is that corporations do not know where the line is drawn and must, as a consequence, make sure they are well past the spot where they believe it to be. "A common theme among the SOX Act's corporate commentators even today is a demand for more detailed guidance and rulemaking that would provide some certainty". This is also true when it comes to records and documentation. SEC gives only the vaguest of guidance as to what records it expects to see. As a result, corporations have no choice but to create exhaustive sets of documentation that in many cases are far in excess of what the SEC actually expects to see. The alternative is to face the risk of regulatory actions and lawsuits (Montana, 2007).

3.4.3 Benefits

All the complaining aside, there is some evidence that suggest that SOX offers companies something more than just problems. Even companies that do not need to comply, sometimes choose to because they see that the audit controls bringing order to their operations. In addition, a lot of companies that are being taken private decide to maintain their SOX compliance operations. They think SOX is a good tool to have because they might one day go public again and then they would not want to have to start from the beginning again (Karlin, 2007).

It has been a lot of complaints about that SOX worsen the competitiveness of U.S. markets in the world and that it also makes companies risk-adverse. The cost to comply with SOX has been higher than expected from the beginning and the costs to comply with SOX section 404 have been said to be unfair, particularly for smaller companies. Despite all these complaints, one thing is for sure, SOX has enhanced both public confidence in the U.S. markets and corporate accountability. According to Louis Grumet, publisher, The CPA Journal, all complaints about that SOX would have a negative effect on American business's risk taking and competitiveness are overstated. Furthermore, SOX does not apply to small, private companies, and those are the ones that most often come up with the big ideas. It is not correct to judge SOX solely by its direct fiscal impact. "The law was drafted and implemented hastily, but our government needed a

symbol- an immediate display of strength- that showed the world we would not tolerate any more Enron's or WorldCom's. SOX became that symbol, and have become a beacon for the kind of controls needed for large corporations in the 21st century" (Grumet, 2007, p. 7).

According to a random telephone survey, conducted by Lynn Stephens and Robert G. Schwartz, of 108 U.S companies, it appears that SOX has not played a primary role in companies' decisions to not go public. Instead, the majority of companies were either unfamiliar with SOX or had no plans to go public. While there might be a chance that SOX delay companies that lack the necessary organizational or reporting structures from going public, when companies were questioned about whether their decision to go public was delayed by SOX, they highly disagreed (Stephens & Schwartz, 2006).

Proponents of SOX say that the law was not only necessary, but has been effective in helping cut down the frequency of corporate wrongdoing. During 1996-2004, three economists, Mr Zingales, Alexander Dyck and Adair Morse, investigated 230 corporate frauds in America. The result of this study was that, prior to SOX, no more than one-third of big corporate frauds were revealed by auditors, industry regulators or the SEC. Instead, employees were the ones that were most likely to report frauds. In contrast, after SOX, 50% of serious frauds were discovered by those responsible for finding them. On the other hand, successful whistle-blowing by employees fell from 20% of cases to 15% since the law took effect (Zingales, Dryck & Morse, 2007).

SOX rules appear to have played a role in cutting down one of the biggest risks a company can face-accounting-related fraud. According to a recent study by PricewaterhouseCoopers, accounting fraud in the U.S. decreased by almost two-thirds, from 36% down to 13%. SOX controls contributed to the drop and the new risk management climate that has encouraged a more proactive approach and a stronger corporate culture which include a better communication of the code of ethics. However, while there are fewer companies reporting fraud, those committing it seem to be getting greedier. In the past two years, the loss per company from fraud averaged $2.42 million, up from $1.73 million between 2003 and 2005 (Karlin, 2007).

It does not really work to say that the bosses in America have lost their capitalist enthusiasm because in 2007, profits and prices were reaching record highs. Board members have become "watchdogs" instead of entrepreneurs but that could be a good thing. It might also be true that managers take fewer risks now than they did prior to SOX but that might be a good thing as well. In this way, they may be taking the reasonable risks and avoiding the bad ones. It is also correct that companies are escaping from public markets, but that is happening all over the world though, so it might not be because of SOX. As for capital-market competitiveness, financial centers like London have gone better than America's financial centers. It is still not clear however, whether that loss is due to improvements in other financial centers or regulatory excesses in America. We don't know yet if SOX have made American capitalism stronger or weaker because it is still too soon to judge that. When the next economic downturn comes, we will know for sure (Economist).

In a survey by FEI in March 2006, companies were asked if they agreed or not to that any of the following benefits have been an outcome of compliance with Section 404 of the Sarbanes-Oxley Act:

- Confidence in financial reports has increased? 55.9% agreed
- It is now easier to rely on financial reports? 44.3% agreed
- Financial reports have become more accurate? 38.4% agreed
- Fraud is now easier to prevent or detect? 32.7% agreed

(FEI)

3.4.4 The future

When SOX celebrated its fifth anniversary, *Accounting today* polled a number of regulators, practitioners and analyst to give their opinion on both the effectiveness of the legislation and its future in the boardrooms of corporate America.

*Sen. Paul Sarbanes (ret.), co-author of Sarbanes-Oxley; "*I think we've come a long way toward restoring investor confidence and transparency in financial reporting. There were a lot of egregious things going on before. But there are still elements in the business community that are recalcitrant. You hear a lot of criticism about the cost of 404. But the SEC and the PCAOB are making efforts to address that to get balanced regime where you've achieved the purpose of 404. Yes, it was expensive at first, especially for companies that didn't have a good system and they needed to put one in place. I don't think it has harmed us internationally, either. For years we've encouraged other companies to create capital markets and now they're doing that. But that was happening before SOX."

Rep. Michael Oxley (ret.), co-author of Sarbanes-Oxley; "I'm happy with the general direction of the economy, and pleased with the law's contribution to that prosperity. While not perfect, it did help restore investor confidence, as well as increase corporate transparency and accountability in the areas of reporting and governance."

Mark Olson, chair of the PCAOB; "The Sarbanes-Oxley Act has been vital to the renewed investor confidence in financial reporting that we have seen over the past few years. High-quality financial disclosure by public companies is a cornerstone of U.S. capital markets and is necessary for the continued growth and competitiveness of the U.S. economy."

David Hardesty, vice president and partner Wilson Markle Stuckey Hardesty & Bott, and a leading authority on Sarbanes-Oxley: "It appears that it's here to stay. Congress hasn't touched it. But my feeling is that it will take at least a generation of accountants to get 404 down. Neither the companies nor the accounting profession was ready for it in terms of training or business models. Auditors went at it with what they were used to using- checklists. What it really required

was partners and senior managers to make difficult judgments. Change and training needs to come through a change of mindset in accounting education" (WebCPA Staff).

In the March 2006 FEI survey, companies were given the chance to speak up about how the implementation of Section 404 could be made better. The companies had the following suggestions:

- Less documentation (67.3%)
- More reliance on internal audit data (65.5%)
- Roll-forward procedures should be allowed (58.0%)
- Make clear what "key controls" mean (55.3%)
- Reliance on year one testing and documentation should be permitted (53.1%)
- Systems that have been installed in the second half of the year should be accepted (44.7%)
- Make clear what "significant deficiency" means (41.6%)
- Make clear what "material weakness" means (34.5%)

In addition, it was not more than one percent of the companies that answered that no changes are necessary (FEI).

In this chapter, the theoretical framework has been outlined. In the following chapter, the empirical result will be given. The facts will be organized into the four areas that were presented in the problem definition.

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4. Empirical Research

The outcomes of the empirical research are given in this chapter. First, a presentation of the respondents will be given followed by their answers. The answers are organized into the four areas mentioned in the problem definition; costs, problems, benefits and the future.

4.1 Respondents

Mark Harrison, Cubic Corporation

Vice President and Corporate Controller

John M. Radak, Quidel Corporation

Chief Financial Officer

Greg Fahey, Realty Income Corporation

Vice President, Controller

Anonymous

4.2 Responses

In this section, I will summarize the answers received from the respondents.

4.2.1 Costs

According to Mark Harrison at Cubic Corporation, their costs of SOX 404 compliance have included increased audit fees, the hiring of consultants to help with implementation, and the hiring of additional employees to conduct ongoing assessment and testing. Their audit fee approximately doubled from the pre-SOX level, and has remained at that level in the subsequent two years. In the first year, Cubic Corporation's consultant cost was quite high. However, they are now down to one part-time consultant to help them with IT documentation and testing. In addition, they added three full-time employees in the first year of SOX 404 compliance, but last year they cut that down to two.

John M. Radak at Quidel Corporation said that the cost of Sox compliance comes in four forms:

1. External fees paid to their independent public accounting firm.
2. External fees paid to consulting firms to either assist in first year Sox implementation or ongoing compliance support for testing activities.
3. Internal costs of labor to manage the process, maintain write-ups, and perform testing.
4. Management distractions.

According to Greg Fahey at Realty Corporation, prior to SOX, their annual external audit costs were approximately $110,000. For 2007, their external audit costs were approximately $600,000. In addition, their internal audit costs were approximately $170,000. These costs represent fees paid to KPMG for independent auditor work (external audit) and fees paid to Deloitte and Touche for internal audit work. They have elected to hire Deloitte to perform their internal audit work. In addition, their accounting department has spent a significant amount of time working on or preparing documentation for the SOX audit process. This does includes work to perform new procedures and sign-offs that were created after SOX became effective.

As said by “Anonymous”, for their first year SOX audit, they spent several hundred thousand dollars both in internal audit costs to get them prepared for their external auditors and then they had their external SOX audit.

4.2.2 Problems

When it comes to problems, Mark Harrison said that they had a lot of internal problems caused by differing views of the level of detail required by 404. Initially they put their internal audit department in charge of SOX 404 implementation and the Director of Audit believed they needed to document every process in the company that had any financial implications. Mr. Harrison’s own view was that they should take a more pragmatic approach and only focus on key processes and controls. This difference of opinion created quite a bit of friction as they began to form two “camps” within the company and people took sides in the dispute. The situation was resolved by their CFO, giving Mr. Harrison (the Corporate Controller) full responsibility for SOX 404. As a result, most of the internal audit department resigned and the accounting department took the lead in the implementation. They took a pragmatic approach to the implementation and have not had any significant problems since. Mr. Harrison have since transitioned the responsibility for the annual assessment and testing back to internal audit and this has worked quite well.

At Quidel Corporation, Mr. Radak said that most problems arose from getting non finance departments to adhere to the compliance activities. He said that education really helps here. Other problems included ensuring that personnel performing controls record written evidence that they performed the control.

According to Mr. Fahey; “Like everyone else, we experienced problems during the initial implementation of SOX in 2004. Most of our accounting staff had worked together for between 15 and 20 years, so there was a lot of internal knowledge and cohesiveness. This had lead to our policy and procedure documentation to become very stale. We spent much of the first year rewriting our policies and procedures to update them or to formalize them on paper for the first time. A second problem we experience in 2004 was that the senior part of the audit team for KPMG (the Partner, Senior Manager and Manager) all left KPMG during 2004, so we had to educate a new audit team regarding our company and its policies and procedures all while

implementing SOX for the first time. Due to SOX we added one new accountant to our accounting department, increased the size of our Information Technology department from 1 ½ persons to 3 people. We also added one additional person to our legal department to handle the increased documentation. In 2007, we had no deficiencies, significant deficiencies or material weaknesses. In 2006, we had no significant deficiencies or material weaknesses. We did have a few deficiencies, which were corrected during 2006."

"Anonymous" said that they are a very small publicly held company (5 employees) and they had a hard time convincing their external auditors to stop comparing their IT and accounting functions to large publicly held companies. Due to their small size there was segregation of duties issues, etc. They solved their problems by establishing SOX procedures that satisfied their auditors that their internal control was working.

4.2.3 Benefits

At Cubic Corporation, Mr. Harrison said that SOX 404 has helped them to improve their procedural documentation and has made people more aware of their responsibilities. "Almost everyone has taken compliance with SOX seriously". Through the SOX 404 implementation process they were able to identify a couple of key areas where they did not have strong controls and were able to improve processes. The ongoing testing of controls gave Mr. Harrison much greater confidence that they were following their own procedures. He wish though, that they did not need to spend the money to have their external auditors audit their systems of controls, however, realistically he said, "if it was not a requirement we might easily slip into complacency and lose the benefits we have gained. Overall I believe that it has been worth the investment we made".

According to Mr. Radak, the greatest benefit for Quidel Corporation is the organizations better knowledge and appreciation of what it's key financial reporting controls really are and therefore be better able to defend resources during budget cutting exercises.

Mr. Fahey was optimistic as well and said that they have seen significant improvements in their documented policies and procedures. He believes that their SOX compliance has also helped to make each department more aware of their role as it relates to their financial reporting.

The benefits to "Anonymous" of SOX compliance were that they now have strong policies and procedures in place to satisfy any outside auditor that they have good internal controls. Additionally, if they were to acquire a company that is not publicly held, they would already have good established SOX procedures to put in place at the acquisition company.

4.2.4 The Future

At Cubic Corporation, they have really settled into a good routine at this point and they don't see their future costs increasing dramatically. The one concern Mr. Harrison have is what will happen when they make acquisitions in the future (they have not made any significant acquisitions since implementing 404). He point out though, "that it is a benefit to the accounting department to have the "clout" that SOX 404 gives to accomplish what we need to do in setting up good procedures and holding people to their commitments."

As far as Mr. Radak is concerned, the biggest issue is appropriately maintaining a reasonable cost/benefit relationship of internal controls.

Mr. Fahey believes that their SOX costs have leveled off and may be slightly lower in 2008 than in 2007. Their 2007 costs were also slightly lower than their 2006 costs. They have fully integrated the established controls and procedures into their daily processes and they do not anticipate any future problems with their SOX compliance. Future benefits for Realty Income Corporation will be continued strong financial reporting controls and compliance.

"Anonymous" said that they are currently undergoing their second year SOX audit and they expect it to cost much less than their first year audit due to their now established SOX compliance procedures. Furthermore, as the years pass they expect the costs to continue to decrease.

Here, I have outlined the outcomes of the surveys that were carried out, organized into the four areas mentioned in the problem definition. In the next chapter, the empirical result and the theoretical framework will be analyzed together in order to come to a conclusion on the consequences of section 404 of the Sarbanes-Oxley Act.

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5. Analysis

This chapter connects and analyzes the theoretical framework and the empirical result in order to accomplish the purpose with this thesis and answer the questions that was stated in the problem definition.

It is no doubt that Section 404 of the Sarbanes-Oxley Act has been highly criticized by almost everyone that has something to do with the Act. First and foremost, criticism has come from the public companies that had to pay the highest price to accomplish the main objectives of the Act; to re-establish investor confidence in the securities market and to prevent future corporate frauds. Furthermore, what can be seen in both the empirical research and my own research is that compliance with SOX has caused companies a lot of other problems in addition to the problem high costs have caused them. Despite all these problems though, benefits can also be identified.

When it comes to the costs associated with the compliance work it is clear that there are no low-cost alternatives. What can be seen in both the empirical research and the theory is that the “types” of costs for compliance is the same and includes audit fees, hiring of consultants to help with implementation, internal costs of labor to conduct ongoing assessment & testing and management distractions. It can be seen in the theory that total estimated average “year one” costs for compliance with Section 404, per company, increased from $1.93 million in January to $3.14 million in July. This increase in costs came from a 109% raise in internal costs, a 42% jump in external costs and a 40% increase in fees charged by external auditors. It later became clear though that the first year of compliance ended up being $4.36 million, up 39% from the $3.14 million they expected to pay earlier. This increase steamed from a 66% leap in external costs and a 58% increase in the fees charged by external auditors. This raise in costs is one of the findings in the empirical research as well. The audit fee approximately doubled from the pre-SOX level for one company and for some companies the audit fee increased as much as six times, from $110,000 prior to SOX compliance to $600,000 subsequent to SOX compliance. The consultant cost (external cost) was also quite high in the first year of compliance.

What can be found in both the theory and the empirical research is that the cost of compliance decreased in the following years. This was due to companies increased efficiencies in complying with Section 404. For example, the cost for consultant went down due to that the companies did not need all the extra labor they hired during the first year of compliance. What could be found in the theory but not in the research was that the audit fees also decreased but not as much as expected.

The biggest problem identified in both the research and the theoretical framework is that the SEC gives only the vaguest guidance as to what records and documentation it expects to see. As a consequence, the companies do not know where the line is drawn and must make sure that they are well past the spot they believe it to be. In the empirical research it was recognized that the companies had a lot of internal problems caused by differing views of the level of detail required

by Section 404. A part of the staff believed they needed to document every process in the company that had any financial implication while the corporate controller wanted to focus on only key processes and controls. This gives even stronger evidence on that even today is it a demand for more detailed guidance and rule making that would provide more certainty. As a matter of fact, as seen in the theory section, when companies got the chance to speak up about how the implementation of Section 404 could be made better, reducing the degree of documentation and clarifying definitions of different kinds was two of the most common suggestions.

Another problem that was found in the research but not as much in the theory was that implementation of SOX caused a lot internal instability amongst the staff. As mentioned above, in some cases, the staff had different views on how much documentation that was necessary. This caused a bit of hostility because the staff began to form two “camps” within the company and people took sides in the dispute. It was also hard to get non finance departments to adhere to the compliance activities. It was identified in the theory though that one challenge was to keep people interested in the compliance work and to get the internal audit and finance staff to stay focused and excited about the project.

As second problem identified in the research but not in the theory was when companies had accounting staff that had worked together for many years. This create a lot of internal knowledge and cohesiveness which make policy and procedure documentation to become very stale. As a consequence plenty of time is needed to rewrite policies and procedure in order to update and formalize them on paper for the first time. This is very time consuming and can cause problems for the companies.

It was recognized in the theory that some people believe that SOX has backfired and weakened America’s stock markets more than restoring confidence in public companies. Plus, according to the theory, SOX is also accused of undermining the America’s entrepreneurial spirit and making companies risk-adverse. This was not recognized in the research but this could be due to that the companies in the research were focused more on the problems SOX have caused them privately, not on the overall picture. However, this finding is not supported by all research in the theoretical framework. For example, SOX does not apply to small, private companies, which most often are the ones that come up with the big ideas. So according to some researchers, SOX do not undermine America’s entrepreneurial spirit. Furthermore, it appears that SOX has not played a primary role in companies’ decisions not to go public. Instead, this is something that is happening all over the world, so for that reason, it should not be blamed on SOX. The fact that financial centers like London has gone better than America’s could be due to improvements in other financial centers, not to regulatory excesses in America. Yes, it seems to be correct that manager might not be taking as many risks now as they did prior to SOX, but that is not necessarily a bad thing. They might just be taking the reasonable risks and avoiding the really bad ones.

What has been found in both the research and the theory is that the costs to act in accordance with Section 404 of SOX have been said to be unfair, particularly for smaller companies. It was identified in the research that one of the biggest problems for one of the companies was to convince their external auditors to stop comparing their IT and accounting functions to large publicly held companies. For example, it is not easy for a smaller company to get rid of "segregation of duties" issues etc.

As mentioned earlier, despite high costs and a lot of problems, benefits with SOX compliance can be identified both in the research and in the theory. The most important benefit that has been identified in the theory is of course that the Sarbanes-Oxley Act has helped restoring investor confidence and transparency in financial reporting. This was one of the main objectives of the law together with preventing future corporate fraud.

What can be found in the theory as a benefit of SOX compliance, but not identified in the research, is that it appears that SOX has been effective in helping cut down one of the biggest risks a company can face-accounting-related fraud. Unfortunately, while there are fewer companies reporting fraud, those committing it seem to be greedier. Prior to SOX, employees were the ones that were most likely to report corporate fraud. Now days, on the other hand, the auditors, industry regulators or the SEC are the ones that hold that position.

All of the companies in the research mentioned that they have seen significant improvements in their documented policies and procedures. Also, all companies believed that SOX compliance has made people more aware of their responsibilities and their roles as it relates to financial reporting. Furthermore, through the SOX Section 404 implementation, almost everyone agreed that they were able to identify key areas where they did not have strong controls and were able to improve processes. These benefits are also identified in the theory where you could find evidence on that even companies that do not need to comply with SOX, sometimes choose to because they see that audit controls bring order to their operations. The benefits recognizes in the theory include enhanced documentation of business processes and business controls; operational efficiencies; a better understanding and a more detailed linkage of how its business operations relate to its financial statement and financial reporting.

When it comes to future thoughts about the consequences of Section 404 of the Sarbanes-Oxley Act, the respondents in the research says that they have really settle into a good routine at this point and they have fully integrated the established controls and procedures into their daily processes. This makes the respondents to believe that the cost will continue to go down in the future and most of them do not anticipate any future problems with their SOX compliance. This belief could also be found in the theory that identified that companies believe that SOX improvements will be made, but in general it's become a standard, the framework is there and the discipline is in place. In contrast, according to the theory chapter, some people believe that it will take at least a generation of accountants to get 404 down. Neither the companies nor the accounting profession was ready for SOX in terms of training or business models.

The results from the empirical research have been analyzed in this chapter. In the chapter that follows, this analysis will help to present an answer to the problem definition.

6. Concluding Discussion

To meet the purpose with this thesis, this chapter will present the conclusions that have been drawn from the analysis. This chapter is concluded with some suggestions for further research.

6.1 Conclusion

This thesis aimed to clarify the consequences of Section 404 of the Sarbanes-Oxley Act. My main problem was defined as follows:

-What consequences have American companies identified after implementation of Section 404 of the Sarbanes-Oxley Act?

Looking back at the empirical research and the theory I can conclude that the consequences of SOX have been numerous. It is almost four years now since most public companies needed to meet the requirements stated in Section 404 of the Sarbanes-Oxley, so the consequences of the Act are by now clearly identifiable.

It is no question about that the price of compliance has been the most criticized and the biggest problem for the majority of companies. Most people do not dispute that the cost for compliance has been high but it is still not clear whether the cost of SOX really outweigh the gains. Year one costs for compliance with Section 404 ended up being really high, more than was first expected. The costs decreased in the following years though and it seems like that the costs will continue to decrease in the future. This can be attributed to companies increased efficiencies in complying with Section 404. I believe that it could have been the high "first year" costs that made so many people feel that SOX compliance was not really worth the cost. It did not really matter that the cost for compliance decreased in the following years, people had already got their opinion about SOX and then it is really hard to see the benefits that came along because all they can think about is the costs. The incurred costs associated with SOX are clearly identifiable and consist of; audit fees; external fees paid to consulting firms to either assist in first year SOX implementation or ongoing compliance support for testing activities; and internal cost of labor to manage the process maintain write-ups and perform testing. In the beginning, internal costs were the biggest expenditure for the companies. This seems logical because most of the companies needed to spend much of the first year rewriting policies and procedures to update and formalize them on paper in order to meet the requirements in Section 404 of SOX. This takes a lot of time and internal labor hours. In the following years, audit fees and other external costs were the biggest burden for the companies. It was especially the audit fees that companies complained about because they did not decrease as much as expected.

Another factor that contributed to the high cost was that SEC only gives vague guidelines as to what records and documentation it expects to see. As a consequence, the companies must make sure that they are well past the spot they believe it to be. This might cause the internal costs to

raise more than what is actually necessary because companies have no choice but to create exhaustive sets of documentation that in many cases are in far excess of what the SEC actually requires. In conclusion, it is a demand for more detailed guidance and rulemaking that would provide more certainty.

Another consequence that has been identified is that implementation of SOX caused internal instability amongst the people in the organization. People had different views how to interpret the law and over how much actually needed to be done in order to meet the requirements of the law. This caused group-building within the organization and people needed to take sides in the dispute. This created a lot of hostility and instability within the organization which might have, in my opinion, hindered and delayed the implementation of SOX to some extent. This also might have contributed to that it was a challenge to keep people interested in the compliance work and to get the internal audit staff and finance staff to stay focused about the project.

There are positive consequences that have been identified as well. Most important, nearly all people think that SOX has succeeded to reach its goal; to restore investor confidence and transparency in financial reporting. In addition, SOX has also been effective in helping cut down the frequency of corporate wrongdoing, which was another goal of the Act. Another consequence of the Act is that now days, industry regulators, the auditors or the SEC are the ones that are most likely to report fraud.

Other benefits that have been identified as a consequence of SOX are; significant improvements in documented policies and procedures; people have come more aware of their responsibilities and their roles as it relates to financial reporting; the possibility to identify key areas where the companies did not have strong controls; operational efficiencies; and a better understanding and a more detailed linkage of how its business operations relate to its financial statement and financial reporting.

It is still unclear whether SOX undermines America’s entrepreneurial spirit or not. Some believe it does, other people disagree. The opinions also differ when it comes to if SOX has weakened America’s stock markets or not. It seems to be true though that SOX has made companies more risk-adverse, but that is not necessarily a bad thing. Can SOX be accused of playing a primary role in companies’ decision not to go public? It does not seem like it.

So the question is; have the costs of SOX compliance really outweigh the benefits? That is a really hard question to answer and the opinions differ depending on who you ask. Maybe is it true, that we don’t know yet if the tighter rules have made American capitalism stronger or weaker, because it is still too soon to judge that. We might need to wait until the next economic downturn for the final verdict on SOX. To sum up, despite all complains about high costs and various other problems, the Sarbanes-Oxley Act needs to get credit for succeeding to accomplish the main objectives of the Act; to re-establish investor confidence in the securities market and to prevent future corporate frauds. If the costs really outweigh the benefits is up to each individual

to judge, it is clear though that Section 404 of the Sarbanes-Oxley Act has caused both positive and negative consequences.

6.2 Suggestions for Further Research

My suggestions are as follows:

- As brought up several times in the thesis, it might be too soon to judge SOX and the consequences of it, and not until the next economic downturn will we know for sure. So it would be very interesting to do a research about the consequences of Section 404 when the nest economic downturn comes.
- I have only focused on American companies in this thesis. So for that reason, it would be very interesting to look into how auditors have been affected by Section 404 of the Sarbanes-Oxley Act.
- Finally, it would be interesting to do a research later on and see if the opinions have changed concerning SOX or if it is still a lot of talk about that the cost of SOX far outweigh the gains.

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