CHAPTER 1

History and Legislative Background of the Sarbanes-Oxley Act of 2002

INTRODUCTION

As a small business owner, on a daily basis you have to deal with multiple crises that demand your attention and require you to juggle resources. You have to cope with regulations, and may feel there is no time left over to ponder the finer details of legislation that seems to apply only to *Fortune* 500 companies. The truth of the matter is that, in spite of the countless problems that you deal with every day, it's essential for you to understand how Sarbanes-Oxley legislation affects your company. The good news is that by leveraging these requirements (there are only two that apply to private companies) and best practices, you can save your company money, lower overhead costs, and improve sales.

BACKGROUND: THE ECONOMIC HISTORY BEHIND SARBANES-OXLEY LEGISLATION

The Sarbanes-Oxley Act (SOX) is the latest in a long progression of regulatory reform aimed at rectifying corporate misdeeds. SOX has its roots in the Great Depression, which began in 1929 and lasted more than a decade and distinguished itself as one of the deepest economic slumps to ever affect the United States, Europe, and other industrialized countries.

Although the actual causes of the Great Depression are still intensely debated, some of the factors believed to have contributed to it in the United States were: the mass stock speculation that occurred during the 1920s; a general imbalance of purchasing power and wealth, in that a large percentage of the population was poor while a small percentage was very wealthy; the laissez-faire economic philosophy adhered to by Presidents Warren Harding (1920–1923), Calvin Coolidge (1923–1928), and Herbert Hoover (1929–1933); and the catastrophic nosedive of stock prices on the New York Stock Exchange (NYSE) on October 29, 1929. On that day, known as "Black Tuesday," the U.S. stock market crashed, and the value of stock steeply plummeted. Black Tuesday was one of the worst trading days in the history of the stock market. Not only did stock prices collapse, but most of the financial gains of the previous year were wiped out within the first few hours of the market's opening. And because most Americans viewed the stock market as the chief indicator of the health of the economy, the 1929 crash also destroyed public confidence in both the stock market and in the U.S. economy.

Stock value continued to fall for approximately three years, until late 1932. By that time, stocks had lost 80 percent of their value from 1929. Individual investors suffered devastating losses and, overnight, large fortunes were wiped out. Many banks and other financial institutions, particularly those holding a large portion of stocks in their portfolios, also suffered severe losses in assets and, by 1933, 11,000 of the 25,000 banks in the United States had failed. In part, the 1929 crash was blamed on wildly inflated stock prices; poor monetary policies imposed by the Federal Reserves Board; fraud, concealed, or misleading financial information; the rampant buying of stock on margin; and inadequate controls on trading in the U.S. market. In 1932, newly elected President Franklin D. Roosevelt and Congress sought to regulate the market by imposing controls on trading, and requiring organizations that were offering securities for public sale to provide financial and other significant information about the securities being offered.

Two important pieces of legislation emerged from this turbulent time. The first, the Securities Act of 1933—frequently referred to as the "Truth in Securities" law—focused on, one, assuring that investors be fully informed about the financial aspects of securities being offered for sale and, two, on prohibiting deceit, misrepresentations, and other fraud in securities transactions. The second piece of legislation was the Securities Exchange Act of 1934, which created the Securities and Exchange Commission (SEC) and gave it the power to regulate many aspects of the securities industry. The act also provided the SEC with the authority to require periodic reporting of financial information by organizations that offered publicly traded securities, and gave the commission the power to register, regulate, and oversee brokerage firms, transfer agents, and the stock exchanges. The two acts gave the SEC the power to:

- Regulate and register stock exchanges as well as all securities listed on an exchange.
- Regulate investment advisors and all dealers and brokers who are members of an organized exchange.
- Require that audited and current financial reports be filed.
- Set accounting standards.
- Prohibit all forms of stock price manipulation, such as insider trading.

The availability of properly audited and current financial reports enables investors to make informed and rational choices about whether to invest in a particular company. The audited financial reports are available from the organizations selling the securities in their stockholders' annual reports.

Report of the National Commission on Fraudulent Financial Reporting

The impetus for Sarbanes-Oxley legislation can trace its roots to long before the corporate misdeeds of Enron. Corporate misbehavior never seems to go out of style, and evidence of it reemerged in the late 1980s, following a series of high-profile corporate offenses. The National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission (reflecting the name of its first chairperson, James C. Treadway, Jr.), took the lead in examining the factors that led to fraudulent behavior and making recommendations to reduce the potential for future fraud.

The 1980s were also a time of corporate scandal, the scope of which pales in comparison to today's corporate catastrophes. Corporate takeovers in the 1980s cost many people their jobs, but the scale of those problems cannot compare to the corporate implosion of Enron, which resulted in tens of thousands of people losing their jobs and their life savings. The Commission of Sponsoring Organizations (COSO), a voluntary private sector organization, was formed in 1985 to sponsor the aforementioned National Commission on Fraudulent Financial Reporting (the "Treadway Commission"), which was jointly supported by the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants. The purpose of the Commission was to identify the factors that can lead to fraudulent financial reporting and to develop recommendations to address these factors. Independent of each of its supporting organizations, it consisted of representatives from industry, public accounting, investment firms, and the New York Stock Exchange.

In 1987, the Commission published its findings in the *Report of the National Commission on Fraudulent Financial Reporting* (COSO, 1987). The report indicated that fraud occurs as "the result of certain environmental, institutional, or individual forces and opportunities." Examples of these forces include:

- Weak or nonexistent internal controls
- Weak ethical climate
- Desire to earn a higher price from a stock or debt offering
- Attempts to meet shareholder expectations
- Desire to postpone dealing with financial difficulties
- Personal gain, such as additional compensation, promotion, or escape from penalty for poor performance

- Unrealistic budget pressures, particularly for short-term results
- Absence of a board of directors or audit committee to properly oversee the financial reporting process
- Ineffective internal audit employee

Many of the findings and recommendations from the Commission were incorporated into SOX, and it was the *Report of the National Commission on Fraudulent Financial Reporting,* plus additional COSO publications, that were major factors driving the swift passage of SOX.

Internal Controls Integrated Framework

As part of their work in identifying the factors that contributed to corporate fraud, the members of the Commission also designed a model for corporations to use to address the remedies in a coherent fashion. In 1992, COSO published the "Internal Controls–Integrated Framework" (the "Framework) for developing an effective internal control system. The Framework provides direction to any business that wishes to establish an effective internal control system. Specifically, it breaks effective internal control into five interrelated components: control environment, risk assessment, control activities, information/communication, and monitoring.

Although the Sarbanes-Oxley Act of 2002 was passed primarily in response to wrongdoing and fiscal mismanagement in public companies, one of its effects has been to promote greater accountability within the private sector, regardless of the size of the company and regardless of whether the company is public or private.

FAST-FORWARD TO THE TWENTY-FIRST CENTURY: SOX IS PASSED

The Sarbanes-Oxley Act of 2002—formally, the Public Company Accounting Reform and Investor Protection Act of 2002 (P.L. 107–204)—was signed into law by President George W. Bush on July 30,

2002. SOX has been described as the "most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt" (Office of the Press Secretary, July 30, 2002). Only the Securities Act of 1933 and the Securities Exchange Act of 1934 rival SOX in its effects on public accounting, financial disclosure, and corporate governance. The act significantly broadens the authority and resources of the SEC to monitor and regulate the securities market, and imposes stiff penalties for noncompliance. In essence, the legislation complements the aim of the Securities Act of 1933 to provide "truth in securities" by improving the quality of financial reporting, independent audits, corporate accountability, and accounting services for public companies.

Compared to other legislative acts passed by Congress, SOX became law relatively quickly. On February 14, 2002, House Representative Michael G. Oxley (R-OH), the chairperson of the House Committee on Financial Services, introduced H.R. 3763 (H.R. 3763, 2002). The purpose of the proposed legislation was "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" (H.R. 3763, 2002). The bill had 30 House cosponsors, and was passed by the House on April 24, 2002, by a vote of 334 to 90.

On June 25, 2002, Senator Paul S. Sarbanes (D-Maryland), the chairperson of the Senate Committee on Banking, Housing, and Urban Affairs, introduced S. 2673 (S. 2673, 2002). The purpose of this proposed legislation was "to improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes" (S. 2673, 2002). The Senate passed the bill on July 15, 2002, by a vote of 97 to 0.

Both the Senate and the House passed, almost unanimously, the Conference Committee Report (H.R. Rep. No. 107–610, 2002) that resolved the differences between the two bills: 423 to 3 in the House and 99 to 0 in the Senate. On July 30, 2002, President George W. Bush signed the bill, and the sweeping reforms required by the act became public law (P.L. 107–204, 2002).

FACTORS DRIVING THE SWIFT PASSAGE OF SOX

Corporate Scandals

One of the drivers of the swift passage of the legislation was the tidal wave of corporate and accounting scandals that rocked the U.S. financial markets in 2000, 2001, and 2002. The SEC, the Department of Justice, the Federal Energy Regulatory Commission, the Federal Bureau of Investigation, and the U.S. Attorney Offices in New York, Denver, and Houston were all investigating a number of publicly held companies for falsifying financial statements, using questionable accounting procedures, mismanaging assets, or otherwise misleading their shareholders and the public about their financial standing.

Here are some examples of allegations of corporate fraudulent behavior:

- Adelphia Communications gave the founding Rigas family and other executives $3.1 billion in off-the-books loans, and hid the loans.
- Bristol-Myers Squibb inflated its 2001 revenues by forcing wholesalers to accept more inventory than needed.
- Enron boosted profits and hid debts by improperly using off-the-books partnerships, manipulated the California and Texas energy markets, and bribed foreign governments to win contracts abroad.
- Global Crossing inflated revenues by engaging in network capacity "swaps" with other carriers and shredded documents related to accounting practices.
- Halliburton recorded $100 million in annual construction cost overruns before clients had agreed to pay for them.

- ImClone CEO Sam Waksal engaged in insider training and improperly used ImClone assets as collateral for a personal bank loan of $44 million.
- WorldCom recorded $3.8 billion in operating expenses as capital expenses and gave founder Bernard Ebbers $400 million in off-the-books loans.

Enron

For several years, the Enron Corporation, an energy company, participated in a number of partnership transactions that lost the organization a substantial amount of money. In 2001, Enron reported that it had failed to follow generally accepted accounting practices (GAAP) in its financial statements for 1997 through 2001 by excluding these unprofitable transactions. In these fallacious financial statements, the organization reported large profits when, in fact, it had lost a total of $586 million during those years. Neither internal nor external controls detected the financial losses disguised as profits. The revelation of the misleading financial reporting led to a collapse in the price of Enron stock: it fell from $83 per share in December 2000 to less than $1 per share in December 2001. Nevertheless, some of Enron's managers made millions of dollars by selling their company stock before its price plummeted. In stark contrast, other investors experienced substantial losses, including Enron employees who had invested a large portion of their retirement portfolios in Enron stock.

Several aspects of the scandal made Enron's behavior seem particularly egregious. The first was the sheer volume of losses. Thousands of employees, many who had worked for decades at Enron, lost their jobs. Many also saw their life savings dissipated, as they were prohibited from selling off their Enron stock when the value of the stock went into freefall. They had been given routine assurances that all was well by senior managers—who are currently facing prosecution.

Millions of people who were not Enron employees also were adversely affected by the scandal. In the months immediately preceding Enron's implosion, the company, along with other power suppliers, manipulated the supply of electric power to states such as California, causing a series of rolling blackouts throughout the summer of 2002. Electricity rates soured, and the governor of California was eventually recalled because of his inadequate response to the manipulation of the state's electric power supply by Enron and others. Media attention on Enron at this time was near constant, and the public was demanding immediate action. Still, it took until January 2006 for the trials of Enron's founder and former Chairman, Kenneth Lay, and former CEO, Jeffrey Skilling, to commence.

WorldCom

In 2002, WorldCom, Inc., a prominent telecommunications company, admitted that it had failed to report more than $7 billion in expenses over five quarterly periods. Its financial statements indicated that WorldCom had been profitable over those quarters, when the company had actually lost $1.2 billion. WorldCom's market worth plunged from $200 billion to only $10 billion in July, when the company filed for Chapter 11 bankruptcy, raising concerns among its investors, creditors, and telecommunication customers.

Enron and WorldCom were not the only companies that released questionable financial statements during this period. Other firms involved in corporate and accounting scandals included Tyco, Adelphia Communications, Xerox, and Global Crossing. These incidents, understandably, shook the public confidence in the capital markets and in the integrity of corporate financial statements. In response to public outrage and the downward spiral in the stock market, the 107th Congress passed the Public Company Accounting Reform and Investor Protection Act, which was signed into law by President George W. Bush on July 30, 2002.

Auditor Scandals

Certified public accounting firms also had their share of high-profile scandals, prompted by the release of false or misleading financial information in connection with high-profile scandals such Enron. Public companies registered with the SEC are required to have their financial statements audited by an external auditor. When an auditor from a public accounting firm examines the financial statements of public companies and gives an unqualified opinion regarding those statements, the shareholders and the public should have increased assurance that the statements were prepared in accordance with GAAP, that GAAP was applied on a consistent basis, and that the statements included all of the information necessary to fairly present the company's financial standing. Based on these requirements, how, then, were public companies able to produce such misleading financial statements?

There are a number of reasons why the auditor's opinion does not necessarily represent the accurate condition of the financial statements. In some cases, auditors simply make errors. In other cases, however, an auditor's opinion may be biased, or the auditor may have a financial incentive to misrepresent the accuracy of the financial statements. If, for example, the firm performing the audit is also receiving substantial compensation for providing consulting, tax work, or other services, the accounting firm has a financial incentive to maintain a good relationship with the company being audited. The desire to maintain the relationship—and the compensation—may bias the auditor to report a more positive financial position than actually exists. Biased auditor reports can also occur when the relationship between management of the company being audited and the auditor is too "cozy"; that is, the loyalty of the auditor may lie with management, rather than with the shareholders; thus, the auditor's evaluation of the statements may be swayed by that loyalty.

Arthur Andersen LLP and Enron

For several years, Enron participated in a number of partnership transactions that lost the company a substantial amount of money. In 2001, Enron reported that it had failed to follow GAAP in its financial statements for 1997 through 2001 by excluding these unprofitable transactions. In these misleading financial statements, the organization reported large profits when, in fact, it had lost a total of $586 million during those years. Neither internal nor external controls detected the financial losses disguised as profits. The revelation of this fallacious reporting led to a collapse in the price of Enron stock, which, as stated previously, fell dramatically, from $83 per share in December 2000 to less than $1 per share in December 2001. In spite of this, as also noted earlier, some of Enron's managers made millions of dollars by selling their company stock before its price plummeted, whereas other investors experienced substantial losses, including Enron employees who had invested a large portion of their retirement portfolios in Enron stock (*Securities and Exchange Commission v. Timothy A. DeSpain*, 2005; *Securities and Exchange Commission v. Richard A. Causey, Jeffery K. Skilling and Kenneth L. Lay*, 2004).

The certified public accounting firm of Arthur Andersen LLP, which had been one of the largest accounting firms in the world, served as Enron's auditor during the years of these erroneous statements were released. Allegedly, the firm "overlooked" Enron's questionable accounting practices because it was making a large amount of money for providing Enron with consulting services and did not want to lose this lucrative client.

Arthur Andersen was indicted by the U.S. Department of Justice, and, in June 2002, a jury convicted the firm of obstructing justice by shredding Enron-related documents requested by the SEC. U.S. District Judge Melinda Harmon sentenced the firm to a $500 billion fine and five years' probation. The conviction also essentially decimated the formerly powerful "Big Five" firm—it lost most of its clients.

Subsequently, however, the firm got a lucky break, courtesy of a judicial mishap. Though the 5th U.S. Circuit Court of Appeals affirmed the jury verdict, on May 31, 2005, the U.S. Supreme Court overturned the obstruction-of-justice conviction. According to Supreme Court justices, the conviction was improper because the instructions given jurors during the trial were too broad and vague, hence they were unable to correctly determine whether the company actually committed the crime. Thus, the reversal of the firm's criminal conviction was based entirely on a trial technicality (*Arthur Anderson LLP v. United States*, 2005).

Certainly, the relationship between Enron and Arthur Andersen LLP is a dramatic example of failure in the auditing process, but the auditing practices and relationships with clients of a number of other accounting firms also came under fire. Examples include Deloitte Touche and Adelphia, Ernst & Young and AOL, KPMG and Xerox, and PricewaterhouseCoopers and Bristol-Myers Squibb.

RESPONSE OF PRESIDENT BUSH AND THE 107TH CONGRESS

As more and more scandals came to light, understandably, the public confidence in the capital markets and in the integrity of corporate financial statements was badly shaken. To both assuage public dissatisfaction and to halt the downward plummet in the stock market, President George W. Bush and the 107th Congress presented a plan to upgrade public expectations of corporate responsibility.

On March 7, 2002, the President announced his Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders, based on three core principles: information accuracy and accessibility, management accountability, and auditor independence. The points of the plan were:

- Each investor should have quarterly access to the information needed to judge a firm's financial performance, condition, and risks.
- Each investor should have prompt access to critical information.
- CEOs should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including their financial statements.
- CEOs or other officers should not be allowed to profit from erroneous financial statements.
- CEOs or other officers who clearly abuse their power should lose their right to serve in any corporate leadership positions.
- Corporate leaders should be required to tell the public promptly whenever they buy or sell company stock for personal gain.
- Investors should have complete confidence in the independence and integrity of companies' auditors.
- An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards.
- The authors of accounting standards must be responsive to the needs of investors.

- Firms' accounting systems should be compared with best practices, not simply against minimum standards.

On July 9, 2002, President Bush issued Executive Order 1371, which established the Corporate Fraud Task Force within the Department of Justice. Former Deputy Attorney General Larry Thompson led the task force, which included U.S. attorneys, the FBI, and the SEC, and was charged with overseeing the investigation and prosecution of financial fraud, accounting fraud, and other corporate criminal activity; and with providing enhanced interagency coordination of regulatory and criminal investigations. He explained the goal of the president's Corporate Fraud Task Force as follows: "As we establish with ever increasing certainty the prospect that corporate criminals will lose both their fortunes and their liberty, we will have gone a long way to restoring the integrity of the market and the confidence of the nation" (Office of the Press Secretary, 2002).

The response of Congress was the relatively quick passage of SOX, a substantial piece of legislation. It took less than six months (from February 14 to July 15) for both chambers of Congress to pass the bill and to send it to President Bush for signature, which, as noted previously, he did on July 30, 2002.

COMPONENTS OF SOX AFFECTING SMALL BUSINESSES

Many would agree that SOX is the single most important piece of legislation affecting corporate governance, financial disclosure, and public accounting since the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. SOX contains sweeping reforms for issuers of publicly traded securities, auditors, corporate board members, and lawyers. It adopts new provisions intended to deter and punish corporate and accounting fraud and corruption, and imposes stiff penalties for noncompliance. In essence, SOX seeks to protect the interest of shareholders and employees by improving the overall quality of financial reporting, independent audits, corporate accountability, and accounting services for public companies.

Several sections of the law address requirements and/or best practices for small businesses. At this point in time only whistleblower protection and document preservation are specific requirements for all organizations, including private companies. However, indications are that more requirements will be imposed on private companies as fraud continues to occur across all sectors.

Title II

Title II of SOX details the rules for establishing the independence of the auditor from the company being audited. It defines which additional services the auditing firm may and may not provide, defines and prohibits conflicts of interest between auditors and the audited company, requires that the audited firm rotate its auditors on a regular basis, and requires the audit committee of the audited company to be responsible for the oversight of its auditors. Although auditor independence is mandatory for publicly traded firms, small businesses also can benefit from the best practice of auditor independence.

Titles III and IV

Titles III and IV of SOX detail the responsibilities and roles to be played by the audited company in regard to the audit and reports. For example, the principal executive and financial officers of the company are directly responsible for certifying that the information in the annual or quarterly reports required by the SEC Act of 1934 is accurate, complete, and fairly presented. In addition, rules are included to address insider trading and the professional responsibility of attorneys to report violations of securities law or breech of fiduciary duty. Titles III and IV also outline the disclosure requirements of relevant financial information, such as off-balance-sheet arrangements and relationships.

Titles VIII, IX, X, and XI

Titles VIII, IX, X, and XI outline the penalties for securities fraud and document destruction or alteration; create whistleblower protection for employee informants; and establish corporate responsibility for financial reports.

Title VIII, also referred to as the Corporate and Criminal Fraud Accountability Act of 2002, creates criminal penalties for fraud and document destruction, provides protection for whistleblowers who provide evidence of fraud, specifies that debts incurred in violation of securities fraud laws are nondischargeable (Section 803), extends the statute of limitations on securities fraud claims, and creates a new crime for defrauding shareholders of publicly traded companies (Section 807).

Document destruction: Section 802 amends the federal obstruction-of-justice statute. It is now a felony to "knowingly" destroy, conceal, cover up, add to, or falsify documents or records in order to impede or obstruct any federal investigation or bankruptcy proceeding. Destruction of documents with intent to obstruct a federal investigation was already a criminal offense under the existing statute, but it applied only to ongoing investigations. The new offense also covers contemplated investigations and provides for the imposition of fines, imprisonment for up to 20 years, or both, for the violation of the statute.

Preservation of audit materials: Auditors can also be charged with a felony if they fail to retain all audit and review work papers and materials for a period of five years from the end of the fiscal year in which the audit was conducted. Section 802 provides for the imposition of fines, imprisonment for up to 10 years, or both, for the violation of the statute.

Whistleblower protection: Under Section 806, employees of public companies and accounting firms who disclose private company or firm information as evidence of accounting or auditing violations or fraud to a supervisor, federal regulator, law enforcement agency, or member of Congress are extended whistleblower protection. Under whistleblower protection, it is unlawful for the employer to discriminate against the employee in any manner if that employee engaged in the protected activity. Discrimination includes actions such as discharge, demotion, suspension, threats or harassment, blacklisting, and disciplinary actions. Under this section, whistleblowers are granted a remedy of special damages and attorney's fees. The Public Company Accounting Oversight Board (PCAOB) has established the Center for Enforcement Tips, Complaints, and Other Information to provide employees with an easy avenue for submitting evidence to the PCAOAB (Public Company Accounting Oversight Board, 2003).

Title IX states that each periodic report containing financial statements filed with the SEC must be accompanied by a written statement by the issuer's CEO and CFO certifying that the report fully complies with the 1934 Act and that information contained in the periodic report "fairly presents, in all material respects, the financial condition and results of operations of the issuer." Publicly traded companies are required to have their CEO and/or CFO attest, under penalty of law, that their financials are accurate. Small business CEOs and CFOs should incorporate the best practice of ensuring that all financials are accurate and fairly depict the financial condition of the company.

NEXT STEPS

Sarbanes-Oxley legislation was not the first attempt to deal with corporate malfeasance. Shareholder activism and public outrage over the loss of tens of thousands of jobs and millions of dollars in individual investments by employees of Enron, WorldCom, and other corporations ensured that the provisions of this law would have "teeth." The law's expectations of transparency and accountability also offer the means by which small businesses can leverage their compliance and the best practices to reduce costs and improve competitive positioning.

In Chapter 2 we will examine the reasons why small businesses should care about Sarbanes-Oxley compliance, whose practices are now considered the gold standard in business management.