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Commentaries on Sarbanes Oxley Law of 2002 - Impact on Accounting Profession, Corporate Governance and Management

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Abstract

Before the late 1980's, the number of accounting and auditing scandals caused by U.S. corporate financial reporting was not as prevalent as in 90's and early 2000'. However, in the late 1990's there were an alarming number of accounting scandals involving large U.S. firms; Enron Corporation, IBM, Xerox, to name a few. These audit failures helped to diminish both the credibility of audited financial statements, accounting profession and the efficiency of the securities markets. In 2002, in an effort to remedy the shortcomings of the current system, the U.S. Congress passed and the President Bush signed the Sarbanes-Oxley Act (SOX) into law, which changed the way firms provided their financial information. SOX was created with a number of checks and balances designed to identify problems within organizations, ensure organizations and auditors were acting ethically and responsibly. This paper will explore many ways that SOX has changed the corporate landscape. Although much can be said about the way SOX altered financial reporting and encouraged transparency for investors, many are still opposed to SOX because of the substantial costs associated with being in compliance with SOX. While many people are still skeptical about SOX's ability to mitigate future scandals a series of empirical research provides evidence that SOX is working as it helps US corporations to produce financial statements with less misstatements and discretionary accruals.

Keyword : Sarbane Oxley Law, SOX, Financial Reporting, Accounting Transparency

1. Introduction

More than 10 years after US Congress passed SOX of 2002 a convincing research result that SOX is actually working is presented. Gilliam et al. (2014) report that the zero earnings discontinuity has finally disappeared for post-SOX period. This zero-earnings discontinuity has been cited as one of the most credible evidence of earnings management in the accounting literature (Burgstahler and Dichev 1997, Degeorge et al. 1999).

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The disappearance of zero earnings is in fact that the intended objective of SOX has accomplished, and the oversight agencies such as Securities and Exchange Commission's (SEC) and Public Firms Accounting Oversight Board (PCAOB) are vindicated to some extents. This is so because US firms have been complaining about huge compliance costs of SOX without any obvious and immediate benefits.

Enron, Tyco, and WorldCom fiascos wreak the havocs with the catastrophic results when greedy and unethical individuals with the shareholders' fund operate in a lax internal control environment. Prior to SOX, the level of scrutiny of a corporation's financial reporting and its enforcement were suboptimal, to say the least. Consequently, executives of several major corporations were able to take advantage of lax financial reporting environment for their personal financial gains. The need for an immediate remedy resulted in the legislation of SOX in 2002. It aimed to stop misrepresentation of financial reporting by implementing numerous checks and balances, heightened governmental scrutiny. This paper will analyze the effectiveness of SOX by focusing on some of the key aspects of the legislations.

There are checks and balances such as independent auditors and SEC that intend to keep corrupt management from getting away with intentional mistakes or constructive fraud. However, Gladwell (2007) argues that senior management is able to make accounting records that are too complex for independent CPAs to reasonably audit. According to The Journal of Accountancy (2007), a 1999 Committee of Sponsoring of the Treadway commission (COSO) report identified that a staggering 83% of 200 financial statement frauds were conceived by CEO, CFO, or a collaboration between the two. This report and AICPA (American Insti tute of Certified Public Accountants, 2005) report claim that senior management overrides internal controls in many instances. Many financial statement frauds were the result of management overriding internal controls such as Bausch and Lomb accounting fraud case back in 1996. They conclude that internal controls are not reliable enough for preventing, detecting, or deterring constructive fraud or fraud perpetrated by upper management since upper management could simply overrides these controls in place.

SOX aims to reduce or prevent accounting failures such as Enron and WorldCom, where senior management's fraudulent behaviors cost employees their jobs and investors hundreds of millions of dollars of their investments. SOX was passed to add greater regulation of public firms and deter fraud, but it certainly falls short of guaranteeing the accuracy of public firm financial statements as was the case with any previous legislations including 1934 SEC Act.

SOX was in part designed to create a spirit of transparency within the internal control structure. Corporate top management, as in the cases of Enron and WorldCom, had been enriching themselves at the expense of shareholders, employees, creditors, government and the general public. In fact this, labeled "agency problem," had led to a series of moral hazards, which resulted in excessive increases in executive compensation despite poor performance, excessive bonuses and perks, adopting inadequate corporate governance mechanism to protect incumbent managements. Enron alone cost its investors close to $25 billion, and its shareholders $60 billion due to fraudulent financial reporting, despite being audited by Arthur Andersen (Lenn, 2013). WorldCom lost its shareholders close to of $175 billion dollars as it was found that the board of directors had little involvement with their financial reporting and pretty much rubber-stamped CEO's agenda to falsely report financial health, contrary to the true pictures of financial health (Lenn, 2013). Corporate management and audit firms created to attest their financials were colluding to enrich each other, not to monitor each other's activities. Investors were losing faith in corporate financial reporting system which lacked transparency and objectivity. The public outcry against corruption and colossal damages finally led US Congress to come up with one of the most sweeping security law legislation in 2002.

According to Lenn (2013), one of SOX objectives was "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" (2013). It made corporate top managers legally responsible for preparing and presenting accurate financial information to the public. It also was designed to ensure Certified Public Accountants (CPAs) perform their watchdog functions by providing reliable audits, and the ability to resist top management pressure to certify misleading or fraudulent financial reports. In addition, it established higher and more defined penalties for individuals who violated standards. For the first time in US an independent auditor could now faces the criminal liability for knowingly issuing financial statements contained with misrepresented financial numbers.

2. Pros and Cons of SOX

The primary intended advantage is investors having more accurate, reliable information about the firms they're investing with. By providing numerous checks and balances as required by SOX, investors are left with more thorough, reliable financial information that is attested by independent audit firms and certified by officers of the firm. Being more confident in the information they are receiving will allow investors to make better decisions with their investments. Nagy (2010) provides evidence that firms complying with SOX 404 report lower level of misstatements in the financial statements, while firms with material weakness in their internal control structure report higher level of misstatements.

Another purported advantage of SOX is that it makes much more difficult for managers to conceal misleading information from independent CPAs. A typical defense from CEOs in previous scandals was "I didn't know what's going on with our financial reporting." SOX completely deprives this defense away from them. Not only do independent auditors attest to the reliability of audits, but CEO and CFO have to sign off firms' financial statements, certifying that the financial statements do not contain materially misleading information. Independent auditors also have to report back to the client's audit committee and the management any issues with their reporting or internal controls. With these rules in place, it is virtually impossible for a manager to claim ignorance. These possible criminal liabilities highlight advantage of SOX, which requires both CEO and CFO to sign off on the financial statements before they are formally submitted. This holds the executives accountable for the reliability of the statements, not just the internal accounting and audit teams that prepare or review them. Without these guidelines in place, senior leadership would have the opportunity to alter the financials and blame inconsistencies or misrepresented numbers on the employees who prepare them.

One great advantage brought on by SOX, was not a formal law but more of a change in culture. According to Orin (2008), "one of the principal challenges corporations have faced in handling ethical matters is that ethics historically have not been taught in this country in any sort of systematic, formalized, or reliable way". Previous fraud scandals have brought corporate ethics to center stage and SOX demonstrates that the stakeholders are serious about a change. While corporate ethics may have been an informal practice before, SOX puts a formal structure around what is expected as well as serious consequences for violations.

Along the similar vein an advantage includes the processes that are in place so directors and officers are prohibited from fraudulently influencing, coercing, or manipulating the independent auditors. This helps to alleviate the possibility of auditors being coerced to ignore irregularities or falsified information in financial statements, although it's not always followed through.

According to Cunningham (2005), SOX "is one of the most significant changes to federal securities laws in history" and it has helped "boost shareholder confidence and it may even boost shareholder value". The remarkable benefit is that the corporate financial reporting fraud has been on the decrease since SOX. There were at least ten major accounting scandals between the late 1990's and early 2000's where firms were covering up or misrepresenting their transactions, which resulted in major blows to stakeholders' confidence in the financial reporting systems. The first area of discussion is internal controls. According to Grumet (2007) "standardization and efficiency gains have significantly reduced the costs of SOX compliance"(p.1). In one public firm with average annual revenues of $6.8 billion, the cost of compliance dropped by about 23% between 2005 and 2006. As a result of compliance, firms now have a clear code of ethical conduct and employee guidelines with policies and procedures. This enabled auditors to uncover fraud and non-compliance issues; an increase of 17% in exposure was reported (Grumet, 2007).

Accountability is one of the more positive outcomes of SOX. This enhanced public confidence in the US capital market. Although Lenn (2013) argues that only 10 new foreign listings were registered in 2004; Grumet (2007) exposes the omitted information whereby 22 foreign firms went public on the NY Stock Exchange and Nasdaq in 2007. Thus, there was a tremendous advantage of cleaning house and establishing strict accountability guidelines.

While SOX has had tremendous positive impacts, it is certainly not without disadvantages. Many firms cite the biggest disadvantage of SOX is the cost of compliance. Implementing SOX hasn't been an easy transition for many publicly traded US firms. One of the most difficult aspects is keeping up with the number of bylaws since SOX was put into place. Some guidelines have been taken out, replaced, or added but it's difficult to keep up with the adjustments. Many firms, especially smaller organizations, find Section 404 (the internal control system certification provision) to be especially costly. In 2005, a survey of the 200 largest firms found they each spent an average of $3.8 million in compliance with this Section. However, data has shown that this cost is beginning to decrease due to standardization and efficiency gains. In 2006, these same firms spent $2.9 million in compliance, a 23% reduction (Grumet, 2007). In order for firms to comply, they have had to spend hundreds or even thousands of dollars to hire employees and auditors to put their own systems into place. At first there weren't any guidelines of how to put SOX into operation so firms had to make their own plans and procedures, which has been costly. The only way to reduce these costs is to take what has been learned in the last eleven years since SOX was enacted and outline ways that firms can be compliant but streamlined and efficient, as well. While SOX was very specific in what firms needs to start producing, it didn't define how they were to do this at first. While SOX told firms that had to report on internal controls, it did not provide steps or an example of how to do this. Many firms were forced to invest significant time figuring this out and incurred costs of outside vendors to help. Again, while this was a huge disadvantage when SOX first came out, it has decreased as firms have become more acquainted about how to comply. To make sure one is in compliance with SOX, financial documents are reviewed by more people than before. Instead of having one person in charge of an entire transaction, the job is passed through many different people to ensure separation of duties. Documents are also now being double and triple checked for accuracy, greatly slowing down processing times, sharply increasing the compliance cost.

Together with compliance costs the increased audit fee is also added burden to the public firms. Raghunandan and Rama (2006) report audit fee increase in the first year after Section 404 implementation, and even greater fee increases for firms with material weakness in their internal controls. Hogan and Wilkins (2008) find that audit fees in the fiscal year preceding the year of an internal control deficiency disclosures are higher for firms with internal control deficiencies. Another disadvantage is the minimal protection and support that whistleblowers have. There is an immediate need for protection for honest auditors who need to "blow the whistle" as they currently have no one to report it to. A specific review board or guidelines could be put into place so whistleblowers are valued instead of scoffed at, and they are rewarded for their honesty and reliability.

Another perceived disadvantage in SOX lies in Section 102. It requires all certified public accounting firms to register with PCAOB. This board was established as part of SOX to "oversee the audit of public firms that are subject to the securities laws, and related matters" (Lenn, 2013, p. 7). The registration with the board requires a registration fee, a list of accountants, their standing and certifications, internal control procedures. The firms are also subject to inspection and quality control oversight. Additionally, the firms are forbidden from offering any non-audit services that may present a conflict of interest, i.e, bookkeeping or internal audit management. The requirements set in Section 102 place public accounting firms under financial and resource pressure. Those opposed to SOX feel that this particular section limits the range of services a firm can provide while placing a higher financial costs on the firm.

There are other effects of the law that are more subtle. The first is the impact it had on foreign firm exchange and public firm registration. Critics claim that SOX placed so much pressure on US firms that they are afraid of risk-taking and are no longer competitive internationally. Moreover, Congressman Ron Paul states that "these regulations are damaging American capital markets by providing an incentive for small US firms and foreign firms to deregister from US stock exchanges" (Lenn, 2013, p. 9). The withdrawal from the public market weakens the economy and undermines the US influence in the global market.

On the national scene, SOX doesn't provide enough protection for auditors who are reporting fraud and issues on corrupt management. Although there is substantial penalty or even imprisonment for corruption, there is no known punishment for the coercion and dismissal of auditors who do blow the whistle. In addition, SOX has no protection for stockholders in cases of fraudulent reporting that result in losses. The penalties incurred do not cover the unemployed or the ones who lost their lifetime savings.

While there may be opponents to SOX because of these disadvantages, taken together, most would agree the advantages greatly outweigh them. While the cost of compliance is an aggravation, it is a necessary price to pay for investor confidence. No capital market can properly function and survive in the long term if investors are not informed and cannot rely on the information given to them from the firms in which they invest.

3. The Implications of SOX on the Accuracy of Financial Statement

Although SOX tries to implement the concept that "sunshine is the best disinfectant," (US Supreme Court) by taking a full disclosure approach using independent auditors, corporate directors, and SEC players serving to check and balance corruption of CEOs and CFOs, there is no guarantee that they will adequately serve their intended purposes. Management still holds great influence over the process because SOX doesn't give enough encouragement or protection from retaliation for whistle-blowers; it gives little prevention of firings, or support for auditors when pressured by management; it provides little compensation for stockholders or employees who suffer loses as a result of corruption; and finally internal controls required are costly to firms and can easily be averted through collaborative efforts.

In addition, many of the practices that SOX requires from the audit committee aren't being fully complied with. SOX requires that there be oversight of the financial reporting process, of the firms reporting only 84% of audit committee chairs reviewed their quarterly statements, and only 63% discussed these reports with management or external auditors (Keinath and Walo, 2004). SOX also proposed that firms adopt a code of ethics for senior financial officers, but it wasn't clear on who would perform oversight. In the study only 40% of audit committees assumed responsibility (Keinath and Walo, 2004). SOX also requires open communication between management, internal auditors, external auditors and the audit committee; this requirement is only being met 82% with external auditors, 61% with management, and 46% with internal auditors, meaning that internal audit resources are being underutilized (Keinath and Walo, 2004). The lack of oversight and responsiveness to these and other SOX requirements show a pattern that firms aren't being proactive or accountable to their shareholders.

Some CEOs and CFOs have already skirted SOX required independent board member oversight, by establishing social ties with members via current or prior employment, education and other activities, i.e., golf clubs or charity organizations (Krishnan et al., 2011). It's apparent that CEOs and CFOs are choosing more socially connected directors in the post-SOX era as a way to avoid the mandated independence requirements, and reduce the oversight by a more independent board. Then, why are CEOs and CFOs paying close attention to SOX? The main reasons are the transparency of the financial reporting process in post-SOX era, and the risk deterrent measures put into effect by SOX. The penalty for failing to certify financial reports by CEOs and CFO is a fine up to one million dollars, or imprisonment up to ten years or both; and willfully certifying false statements could result in fines up to five million dollars, or imprisonment up to 20 years, or both (Lenn, 2013).

4. Effects on Audit Committees of Public Firms Boards of Directors

SOX creates a system of checks and balances on the board of directors. It separates the roles of the CEO and the Chairman of the Board of Directors, prior to which the two roles were held by the same individual, creating undue influences on the audit committee's functions. According to its Section 301, "Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties" (SOX, 2013). The committee has the authority to act independently from the board of directors in the execution of its duties. SOX not only gives the committee authority over the financial reports done by the executives, but it also allows the committee to determine efficiency of the executives' financial management.

SOX aimed to improve the accuracy of financial reporting by publicly traded firms. The audit committees of these firms had a direct influence on the accuracy of reporting information; therefore, SOX sought to ensure that the committee worked honestly, effectively, and efficiently. One way in which it tried to change these audit committees is by shaping the construction of the committee itself. SOX creates a certain level of autonomy by requiring that the "audit committee [to be] composed of entirely independent members of the board of directors" (SOX, 2002). An independent person would be any person whom has no stake or interest in the firm whether directly or indirectly through secondary relationships. This principle allows the committee the ability to freely operate without implications of bias, whether it is in fact or in appearance.

SOX transferred the authority to engage independent auditors from the CEO to the audit committee. Consequently, the committee has the authority to scrutinize the candidate chosen to fulfill this role. The committee is better able to ensure that their process is being objectively followed by someone who has no incentive to distort the figures. By being able to hire the independent external auditor, the committee is able to operate without the executive influence through the engaged auditor. The independent auditor provides an additional means of ensuring the integrity of the review process. There are no preexisting relationships between the committee and the executives that would allow any incentive to influence the outcome of the committee's procedures.

SOX required that at least one member of the audit committee be a financial expert (SOX, 2002). Since one of the main objectives is to ensure the accuracy of financial information being reported to the public, intuitively, it is necessary to have a person with knowledge in the area. This financial expert is able to find any areas of oversight present in the financial records. The expert would expect to know the key areas in the financial records that require extra scrutiny. This financial expert is able to provide explanation to the other members if there are any areas of ambiguity in the report. Furthermore, the financial expert is able to detect any distortion in the figures in an attempt to conceal the firm's true financial condition. In this investigative capacity, the expert is also able to detect any unethical practices conducted by executives in their attempt to increase profits.

The final implication of SOX on the structure of audit committees is in the frequency of the committee meetings. In order to ensure a consistent and efficient presence of the committee members, SOX requires that the committee meet frequently to discuss the financial operations and reporting of the firm. By meeting frequently, the committee is able to discuss any current financial situations affecting the firm. It provides the committee the opportunity to collectively have immediate and accurate knowledge of the firm's operations.

5. Managers (CEO's and CFO's) of Public Firms

The regulation reforms the accountability of the CEO and the CFO and creates new penalties for each. This is meant to govern and hold the accounting of publically-traded firms accountable for the reporting of factual information. SOX is also meant to deter any corporation from committing fraud by enhancing the disclosures which are now required by law (SEC, 2013). These disclosures include what CEO and CFO need to report. With the help from PCAOB, corporate auditors are now able to report fraud and even remove CEO or CFO if needed (Wang, 2010). Specifically, SOX significantly increases the monitoring function of corporate boards (Wang, 2010). The intent is to prevent incidents of fraud from occurring and to have a form of checks and balances built within public firms that can see problems arising and act on them before they escalate in severity.

SOX is likely to affect CEOs and CFOs of publicly traded firms for several reasons, most of all because it makes them ultimately responsible for the financial statements that their firms produce. SOX section 302 requires CEO and CFO to certify financial statements with the threat of civil penalties. According to Herlihy et al. (2002), SOX made effective a requirement in Section 906 that each periodic financial report be accompanied by a written certification by the CEO and CFO of the respective firm. This stipulation will prevent managers from concealing from accountants or auditors when fraud is discovered and hold them accountable for their involvement.

Section 204 requires the audit firm to report to the audit committee. This Section aims to reduce the level of influence CEOs and CFOs have on the audit firm, making it more independent. CEOs and CFOs may still try to cultivate relationships anyway, but at least the formal hierarchy is set in place to reduce these chances.

Section 301 lists the duties of the audit committee. A more formal set of responsibilities likely aims to provide auditors more power over CEOs and CFOs, who may have guided auditors in the past. Recent studies by (Lobo and Zhou, 2006) claim that CEOs and CFOs are more conservative in financial reporting following SOX, measured by lower discretionary accruals in financial statements. They also found financial reports incorporate losses more quickly than gains, evidence of conservative approach to the financial reporting.

Section 304 mandates the forfeiture of incentive compensation, which is known as claw-back provision. The threat of forfeiture of incentive compensation will likely be an effective deterrent for CEOs and CFOs. This section includes forfeiture of any profits made from the sale of securities to the issuer during the timeframe.

Section 404 describes internal control, which has been proved to be the most expensive clause of SOX legislation. Each annual report must contain an internal control report that describes the responsibility of management to implement formal control structures and procedures for financial reporting. The annual report must also contain an assessment of the effectiveness of the internal control structure and processes. This will likely make it harder for CEOs and CFOs to commit fraud. They would have to work harder given the parameters of formal internal controls, which provide auditors more power than before. Also, formal structure and processes provide auditors a clearer path to assessing financial statement integrity, so CEOs and CFOs have less discretions with financial reporting. (Wang, 2010) studied how increased internal control disclosure requirements from SOX affect corporate governance decisions regarding CFOs. Wang found that CFOs of firms with weak internal controls are paid less and have a higher forced turnover rate. In another study of internal control, Krishnan (2011) claims that CEOs and CFOs pick more socially connected directors in post-SOX time period. Gopal assesses that CEOs may look at social ties with directors as a way to circumvent the formal independence of directors instituted by SOX.

Section 806 protects whistleblowers. In many cases of corporate fraud, employees or other stakeholder were aware of the fraud but chose not to speak up in fear of retaliation. By giving formal protection to "whistleblowers", SOX hopes to encourage people to report fraud and speak up when they think something is wrong.

6. The Impact of Section 404 on Internal Control

SOX stipulates that with each annual report, the issuing firm must provide an internal control report. It should not only state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, but also an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. WorldCom and Enron debacles were two of the primary examples of what can occur when internal control is not properly functioned. Enron's former CEO, Jeff Skilling, testified before Congress that he and other senior managers simply had no clue that their financial statements were off by billions of dollars (Pineno and Tyree, 2010). This incident demonstrated a lack of accountability, integrity, and use of best reporting practices, which in turn deceived and shook the faith of investors. Even going back to the days of the Watergate scandal from which the Foreign Corrupt Practices Act (FCPA) was born, top level executives had similar grievances; many of them testifying before Congress indicating that they had no idea as to how parties underneath them were misappropriating funds under their supervisions.

The overarching goals of this section of SOX are: (1) to further protect shareholders from fraudulent corporate reporting and auditing practices and (2) to improve confidence in financial reporting. This portion of SOX places emphasis on implementing "best practices" in the efforts of ensuring accuracy within financial statements. Some of these changes brought about as a result included obtaining sub-certifications from lower-level employees prior to submitting information up the chain, codes of conduct for all financial and accounting employees, an appointed disclosure committee and co-ordinator, and a timeline and responsibility chart.

So what changes have stemmed from the enactment of Section 404? For starters, PCAOB was established as a non-profit corporation under the laws of the District of Columbia to do the following (Spillane, 2004):

"Register public accounting firms that prepare audit reports for public firms; to establish rules for auditing, quality, control, ethics, independence, and other standards relating to the preparation of audit reports; to conduct inspections of registered public accounting firms; and to conduct investigations and disciplinary proceedings and impose appropriate sanctions of these firms and their staffs (p. 32)."

Section 404 has also changed various aspects of the auditing process. Roughly two weeks after SEC extended compliance deadlines, PCAOB issued a guideline on how external auditors should comply. First, this standard requires the external auditor to evaluate and issue an opinion on management's process for making its assessment and another for the efficiency of the firm's internal control over financial reporting. Second, the external auditor must evaluate the effectiveness of the audit committee. Other measures and assessments of material weakness and auditor independence are also included in PCAOB's standard for compliance with this particular section of SOX for external auditing firms. As an indirect result of the additional legal liability placed upon auditing firms, the enormous amount of time to reach a state of compliance, and the additional measures taken to ensure accuracy, a substantial increase in audit fees has become a commonly experienced phenomenon among publicly traded corporations. Financial Executive International (FEI) conducted a study that showed that on average, firms spent about $4.3 million towards auditors and additional consultants and spent over 26,000 hours in their efforts toward reaching compliance (Sinnett et al., 2005).

Ge and McVay (2005) and Doyle et al. (2007) provide an identification of firm characteristics that are associated with weak internal control; younger, more complex, rapidly growing, financially weaker, or undergoing restructuring firms are more likely to be associated with internal control weakness.

7. Previous Legislation and the CEO and CFO Roles

SOX is unlike any previous regulation because prior regulations did not include the level of oversight SOX includes. The Investment Advisers Act of 1940, the Investment Firm Act of 1940, and the Trust Indenture Act of 1939 were each over 70 years old and did not include the level of corporate governance SOX created. Under all three of these previous Acts, CEO and CFO were not required to disclose their financial conditions to investors. Neither of these Acts held any regulation on what was reported and this made it easy for the CEO and/or the CFO to hide information about the firm's finances and make the firm appear to be in good financial standing. Under SOX, CEO's and CFO's are paying much more attention because they are now held accountable to what is being reported.

Another major part of SOX is that previous regulations did not have SEC supervision of the activities of public firms. For example, The Investment Firm Act of 1940 did not permit SEC from having direct supervision of the decisions or activities of firms (SEC, 2013). SOX directly affects the directors of public firms with strict penalties. With added regulation, SOX also considerably increases the potential penalties on CEO and CFO of a publically traded firm (Lobo & Jian, 2010). CEO's or CFO's can lose their bonuses and can even be barred from holding these positions in the future (SEC, 2013). There are also criminal penalties for forging financial documents, mail and wire fraud, among others. These are but a few reasons as to why so many CEO's and CFO's are paying attention to the various impacts that SOX is having on their operations.

The biggest impact intended from SOX is to create an atmosphere of transparency within the internal audit process. Congress developed SOX to address these agency issues in financial reporting. Congress realized large fines and penalties alone, which they increased, weren't enough to deter corrupt executives. Thus, they increased the risk factors by adding the prospect of prison sentences for those who continued these "white collar crimes" (Lenn, 2013). President Bush, who signed SOX into law stated, "The Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interest of workers and shareholders" (Lenn, 2013). Both CEOs and CFOs were now required, under Section 302, to take responsibility for and sign a letter certifying that the financial data provided were not materially misleading (Verleum et al, 2011).

8. Outside Independent Audit Firms

The provisions of SOX have affected the outside independent audit firms that perform audits on public firms. First, SOX required these firms to be registered with PCAOB. PCAOB regularly inspects the audit quality control systems of these independent audit firms. PCAOB has the power to discipline any firm that does not adhere to their standards and rules for public firm audits. There are currently 1,867 audit firms registered with PCAOB.

The main provisions for outside audit firms provided by SOX can be found in Sections 201, 203, 204, 303, and 404. In Section 201, outside audit firms are prohibited from performing any non-audit services for public firm audit clients. The aim of this provision was to increase the independence of the outside audit firm, both in fact and in appearance. The belief was that if an auditor did other work with a firm beyond audits, they may form a relationship with the client and be biased during audit engagement. However, opponents of this provision argue that firms that do routine audit work with firms throughout the year have a better knowledge of their operation and procedures, and are therefore for better equipped to complete an audit. According to the opponents auditors will have less knowledge of the firm and their audits efficiency will be negatively affected.

Section 203 mandates the lead auditor and reviewing partner from the firm must rotate every five years. Similar to Section 201, the aim of this provision is, again, to keep auditors independent and unbiased. Proponents of this section believe that an auditor can become too comfortable over the years with the firm their auditing, form relationships, and become biased during an audit. Rotating the auditor every 5 years will ensure a new set of eyes with no biases. The opponents of this provision argue the same negative effects of provisions in Section 201. Some believe it is better to have an auditor that is very familiar with the firms' control environments.

Section 204 says that outside audit firms must report all critical accounting policies and practices to the firm's audit committee. This section was adopted in order to ensure that auditors within the firm are aware of all accounting requirements and policies. This section will eliminate any excuses of "ignorance" if a firm is found to not been in compliance with accounting principles.

Section 303 makes it unlawful for any director, officer, or person acting under the direction of one of these, to have improper influence the performance of an audit. Improper influence includes bribes, coercion, providing fraudulent/misleading information, etc. This section is another attempt to keep independent auditors independent and separate from the firm they are auditing. By providing penalties against the firm for violations, this rule should deter any attempts to manipulate an audit.

Section 404 states the auditor must attest to and report on the assessment of internal controls made by the management of the public firm. This assessment would address the "scope and adequacy of the internal control structure and procedures for financial reporting (Addison-Hewitt Associates, 2006)." This section expands the responsibility of outside firms to include not only auditing, but also bringing to light any issues with the firm's internal management. This information would be helpful to the firm and investors as it can alert them to potential problems in the future.

The independent auditors are regarded as the final arbiter to certify the work of inside accountants on the firm's financial report. This responsibility naturally establishes a high level of public confidence of independent auditors in approving or disapproving the financial statement generated internally as 'clean report' or 'modified audit report' for the firm.

The effect of SOX on outside independent audit firms could be viewed as positive and negative effects. The positive effects of SOX on outside independent audit firms could be seen in the area of curbing the consulting services which the independent audit firm renders. This consulting service brings about charges above the usual auditing fees which are more beneficial to the auditing firm. The enactment of this law prohibits independent auditors from performing certain business consulting services for their audit clients but its effectiveness is not certain. This new act saved the firm a lot of money spent on audit reports that could be subjected to restatement in future. SOX further strengthened the auditor's independence by removing consulting services which on the other hand would make auditors totally dependent on audit fees which may lead to less effective auditing.

9. What Changes Should Be Made to SOX

There are several changes that may benefit SOX while still ensuring its goals to improve the accuracy and reliability of financial statements prepared for publicly held firms are met. While the intention of SOX is noble, some previously discussed disadvantages can make the standards set by SOX difficult to meet for even large organizations.

Decreasing the cost of compliance and regulatory fees would be very beneficial for US firms. Smaller firms may struggle in an effort to conform to the standards established by SOX. The costs associated with SOX can make smaller firms less competitive within the market, which can damage the market and hinder their ability to be competitive. These smaller firms need to establish independent auditors to monitor the costs and finances of their organization. This can be very costly and potentially detrimental to smaller firms. Reducing the costs or creating a separate optional bypass for smaller firms may be a positive change for SOX. Moreover, SOX did not account for very large organizations with numerous complexities and compartments. SOX imposes hefty fines and penalties for non-compliance. To avoid these penalties, firms hire extra staff to ensure compliance, which greatly increases their operating costs. SOX also increased the role of independent auditing firms, which has caused the price of these services to significantly rise (Lenn, 2013).

Previous accounting and audit failure has raised awareness regarding the financial statements and accuracy of businesses. SOX increased the maximum sentencing ranges for white-collar crimes. SOX also enabled judges to exercise discretion regarding the punishment for white-collar crimes. Furthermore, the legislation provided guidelines for sentencing. These guidelines however fail to discriminate between small white-collar crimes and those that affect a large number of people. Subsequently, white-collar criminals who commit small fraudulent crimes can receive the same penalty as their counterpart who commits a large crime. Typically, those who commit large “white collar crimes” have the means to evade punishment by utilizing lawyers and other resources. This can lead to over-criminalization. In order to prevent these disparities, SOX should be revised to add in mandatory penalties for certain crimes. These punishments should be based upon the action and severity of the crime (Harvard Law Review, 2009).

Viewed in its entirety, it is imperative that the costs associated with SOX be reduced to accommodate smaller businesses that do not bring in that much revenue. The smaller businesses should be able to negate at the very least some of the costs associated with compliance. It is unreasonable for some smaller businesses to acquire independent auditors, which are necessary for compliance. Lastly, there needs to be more explicit punishment established for lack of compliance. If punishment were written into legislation that provided officials with specific actions there would be less discretion and irregular punishment for white-collar crime.

Academics have suggested areas of possible improvements with SOX. Fleischer(2002) claims that financial statements did not reveal the status of Enron, but the taxes did. He claims that from the perspective of the tax code, Enron had a much different picture than that of its financial reports. In order to catch such fraud as Enron, analysts would need special training in the tax code.

10. Conclusions: Will This Work and Servive?

While many proponents of SOX view it as a solution to corporate fraud, some are still asking, and rightfully so, will this work? Why will SOX ensure the accuracy of public firm financial statements when so many laws before it have failed? The biggest thing SOX has going for it is how comprehensive it is. Instead of just focusing on the CEO, the accountants, the board of directors, or the auditors, SOX addresses all stakeholders. The lack of this in prior legislation may be the reason they were not affective. Some of this legislation includes The Securities Act of 1933, SEC Act of 1934, and The Investment Firm Act of 1940. While these laws made many of the same things as SOX, they were not comprehensive and became very dated in modern finances. SOX will, and has been, much more effective than these laws as it addresses more modern concerns that have arose in recent scandals. While SOX is comprehensive, it is by far the last piece of legislation needed. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was brought about in response to the financial meltdown in 2008. Despite the formal controls, duties, and processes that SOX mandates of publically traded firms, it cannot guarantee fraud will not occur.

As effective as SOX was designed to be, it cannot guarantee the accuracy of financial statements. So, why are CEOs and CFOs paying close attention to laws within SOX? The main reasons are the transparency of the financial reporting process post-SOX, and the risk deterrent measures put into effect by SOX. The penalty for failing to certify financial reports by CEOs and CFO is a fine up to one million dollars, or imprisonment up to ten years or both; and willfully certifying false statements could result in fines up to five million dollars, or imprisonment up to 20 years, or both (Lenn, 2013). So it befits managers to know the law in order to comply, and also to know the law if they intend to test its limits.

A FEI survey states financial reporting has become better; 50.3% say they are more accurate, 56% agree they are more reliable, 43.5 % agree 404 has helped detect fraud, and 69.1% agree that investor have more confidence (Lenn, 2013). Positive signs, but indications the securities industry still has work to do in ensuring the accuracy of financial reporting.

An interpretation of the merits of SOX reveals that, while it is expensive to implement and leave whistleblowers vulnerable, SOX act has substantially improved the quality of financial practices and reporting done by corporate executives. SOX holds executives accountable for their actions by imposing financial and criminal sanctions for lack of compliance. It grants auditing committees a greater scope of power to perform its functions and the level of independence necessary to avoid undue influences. Essentially, SOX provides shareholders and the general public the peace of mind that financial records are accurate and corporations are being ethically run.

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