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Could SOX Be Better?

EXPLORING THE ACCOMPLISHMENTS AND SHORTFALLS OF SARBANES-OXLEY

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Could SOX Be Better?: Exploring The Accomplishments and Shortfalls of Sarbanes-Oxley

I.Introduction

In the early 21st century, a series of corporate frauds coming to light spurred passage of The Sarbanes-Oxley Act of 2002 (also referred to as the Public Company Accounting Reform and Investor Protection Act; Corporate and Auditing Accountability, Responsibility, and Transparency Act; Sarbanes-Oxley; or SOX). The stated purpose of SOX was "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" [1]. In their article "The Causes and Consequences of Accounting Fraud" Dr. Mason Gerety and Dr. Kenneth Lehn assert the following:

> One of the fundamental purposes of corporate accounting is to facilitate the monitoring of managers. Since managers are instrumental in the production of accounting numbers, and since it is costly to monitor their behavior in this regard, firms sometimes report fraudulent accounting numbers.[2]

This article was written in 1997, before the adoption of Sarbanes-Oxley, and it shows why SOX may have been necessary. The idea at the time was that corporate accountants should be the ones who detect the fraud of their managers, not outside auditors. In addition to that idea, much of the auditing of public companies then was done by auditors who would not be

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[1] *United States. 2002. Sarbanes-Oxley Act of 2002: conference report (to accompany H.R. 3763). [Washington, D.C.]: [U.S. G.P.O.].*

[2] Gerety, Mason, and Kenneth Lehn. "The Causes and Consequences of Accounting Fraud." *Managerial and Decision Economics* 18, no. 7-8 (April 28, 1997): 587–99. https://doi.org/10.1002/(sici)1099-1468(199711/12)18:7/8<587::aid-mde855>3.0.co;2-r.

considered “independent” under Title II of SOX. These variables in addition to a host of other issues with the way public companies and their executives were held accountable lead to a business climate that encouraged rampant fraud. This paper addresses the question “Was Sarbanes-Oxley as effective as possible in protecting investors?”.

II. Review of SOX and Its Intentions

The goal of SOX was to protect investors from fraud perpetrated by managers of the public companies in which they are investing. Since the only substantial information to which a typical investor has access is the what is publicly available through EDGAR (the SEC’s Electronic Data Gathering, Analysis, and Retrieval system), it is important that the publicly available information is accurate and faithfully reported without material misstatements. SOX mandated several regulations to public companies to ensure that their financial position was faithfully represented in their financial statements and supplementary data and disclosures.

Some of the key provisions of SOX include, but are not limited to, the following.

- Section 103 authorized the newly created Public Company Accounting Oversight Board (PCAOB) to create rules to ensure auditor independence, the standards of which are spelled out in Title II. This removed the industry’s right to self-regulate through the AICPA.
- Section 302 requires the CEO and CFO to sign the 10K and be held legally responsible for the content therein.
- Section 404 requires an internal control report to be included with each issuance of financial statements. This report was to be completed by outside auditors and had to

state management's responsibility in implementing adequate controls as well as the assessment of the effectiveness of the company's internal controls system.

- Section 806 protects whistleblowers from retaliation and Section 1107 criminalized such retaliation. This section was expanded under the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Section 902 dictates that any person who conspires to violate any of the regulations set out in SOX can receive the same punishments as those who violate them. This section also discusses enhanced penalties for white-collar crimes (the specific sentences are laid out in Section 906).[3]

The goal of all these regulations is to ensure that the information presented to investors and potential investors is faithfully represented and is as accurate and comprehensive as possible. The intent was to take a two pronged approach: to dissuade people from attempting to commit fraud by imposing strict penalties for those who are caught and to improve the auditing process to decrease audit risk which is "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated."[4]

III. Predictions About SOX

The immediate response to the Sarbanes-Oxley Act was overwhelmingly negative. Predictions ranged from SOX being a waste of time in daily business practice, to the Act completely removing any incentive for a company to go public. While some critics thought that

[3] United States, "Sarbanes-Oxley"

[4] "Auditing Standard No. 8." Public Company Accounting Oversight Board. PCAOB, December 15, 2010. https://pcaobus.org/Standards/Archived/PreReorgStandards/Pages/Auditing_Standard_8.aspx.

some provisions in SOX could help reduce fraud and increase consumer confidence, they were still reluctant to label Sarbanes-Oxley as positive overall.

Frank Bowman III, a law professor from the Indiana University School of Law, wrote an editorial in the *Federal Sentencing Reporter* about one of the downsides of SOX in April of 2003. According to Bowman, the criminal sections of SOX were largely about optics. The public needed to see that their government was doing something to protect them from the corporate misconduct that appeared to be everywhere. Bowman asserts that because of this, Congress pulled together SOX too quickly and without careful planning. In 2001, the United States Sentencing Commission raised penalties for executives who committed fraud. SOX decided to focus on increasing maximum penalties as well, even though the Department of Justice initially stated that the recent increase in sentencing was adequate, and that what was really needed were resources for investigators and prosecutors. However those resources were expensive, and after President Bush gave a speech to Wall Street expressing the "need" for stricter sentencing, the DOJ changed its initial assessment to back the President. Bowman says that "[i]n the end, Sarbanes-Oxley's criminal sections created some new niche crimes…, raised statutory maximum sentences…, and suggested or mandated a few specific guideline changes aimed at high-level corporate offenders."[5] Bowman did not believe that these increased penalties would substantially decrease the amount of corporate fraud occurring and, in this way, the Sarbanes-Oxley Act was insufficient.

[5] Bowman, Frank O. "The Sarbanes-Oxley Act and What Came After." *Federal Sentencing Reporter* 15, no. 4 (2003): 231–33. https://doi.org/10.1525/fsr.2003.15.4.231.

There were some who took a more optimistic approach to the effectiveness of increasing criminal penalties for white-collar crimes. Jennifer Recine argued in her 2002 article entitled "Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act" that harsher prison sentences in SOX would be an effective deterrent to fraud. She argues that "the more white-collar criminals who are convicted and sentenced for the crimes they commit, the greater the deterrent effect produced by the legislation. Second, jail sentences generally can provide some kinds of deterrence that fines cannot."[6] Her argument is essentially that it was possible for the criminal sentencing portion of Sarbanes-Oxley to be effective in deterring future crime, but only if the courts were willing to consistently sentence those who commit fraud and other white-collar crimes to substantial time in prison. Otherwise, the risk of spending time in prison is just as low as it was before SOX, and no one would be further deterred. This does, however, point to the idea that the enhanced fines and civil penalties would be ineffective in deterring future fraud, since Recine herself noted that fines do not have the same psychological effect as potential incarceration. This goes hand in hand with Bowman's claims that the enhanced penalties of SOX were, at least largely, about public perception, not preventing fraud.[7]

In his 2002 article "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work), Lawrence Cunningham argued that SOX was not the "sweeping reform" that it was touted to be by Congress, the President, the media, regulatory agencies, and several others

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[6] Recine, Jennifer S. "Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act." *The American Criminal Law Review* 39, no. 4 (Fall, 2002): 1535-1570. https://proxy.lib.utc.edu/login?url=https://search-proquest-com.proxy.lib.utc.edu/docview/230344402?accountid=14767.
[7] Bowman, "The Sarbanes-Oxley Act and What Came After"

in the world of business. Instead, he argued, "all changes made by the Act had been discussed among corporate governance and accounting devotees for years" [8] and that SOX was "dominantly a federal codification of extant rules, regulations, practices, and norms." But that was not a bad thing necessarily in Lawrence's view. He argued that "Incrementalism, rather than an overhaul, may be exactly what the market and regulatory machine need[ed]." Lawrence believed that Sarbanes-Oxley was mostly a patchwork restatement of existing regulations, restated "with the force of federal law." He stated, however, that SOX would "promote the ability of those with integrity to deter (and perhaps educate) those lacking it and, thus, provide underlying fairness on which public investors may justifiably rely and in which they may place earned trust and confidence." Lawrence did assert that there was one aspect of the Act that was truly meaningful reform, and this was "the structure and funding of those who set the standards for auditing and accounting in the United States."

In 2004, Dr. Charlie Cullinan's article "Enron as a symptom of audit process breakdown: can the Sarbanes-Oxley Act cure the disease?" argued that the only ways in which SOX can help prevent fraud are in the ways through which it enhances independence. [9] These enhancements were implemented by the "silver bullet" of SOX: the newly structured and funded standard setters for accounting and auditing.[10] According to Cullinan,[11] there are three things that must happen in order for shareholders to be made aware of a misstatement:

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[8] Cunningham, Lawrence A. "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)." *SSRN Electronic Journal*, October 15, 2002. https://doi.org/10.2139/ssrn.337280.

[9] Cullinan, Charlie. "Enron as a Symptom of Audit Process Breakdown: Can the Sarbanes-Oxley Act Cure the Disease?" *Critical Perspectives on Accounting* 15, no. 6-7 (November 2004): 853–64. https://doi.org/10.1016/j.cpa.2003.06.007.

[10] Lawrence, "The Sarbanes-Oxley Yawn"

[11] Cullinan, "Enron as a Symptom of the Audit Process Breakdown"

1. The auditor must become aware of the problem transaction
2. The auditor must recognize that there is an issue with the transaction
3. The auditor must be willing to step in and give a less than unqualified opinion

SOX has no provisions that would enhance the chances that an auditor would be made aware of the transaction. Because even though SOX created the PCAOB, they largely coopted the standards of the Auditing Standards Board which would not increase the number of transactions seen by the auditor. While requiring a larger sample of transactions could help reduce fraud by increasing the likelihood of the auditor being made aware of the problem transaction, Sarbanes-Oxley included no such requirement. While there is no SOX regulation that would help with the cognitive ability facet of recognition issues, greater independence of the auditor would help avoid one of the issues that happened at Enron (auditors providing consulting services that carefully tip-toed around GAAP). It would also mean that the auditor was looking at the information with fresh eyes. The third step is the main issue where SOX could make a difference. Provisions aimed at increasing independence include restricting the "auditor from conducting certain consulting services for their audit clients" and "requir[ing] audit partner rotation at least once every 5 years." These are both based on the idea that "If an auditor were more independent of the processes and assumptions underlying the financial statements, the auditor may have an enhanced ability to recognize problems because he or she will be viewing the process and assumptions… with greater objectivity." Cullinan also argued that this greater objectivity could help auditors feel more comfortable issuing an opinion other than an unqualified opinion since they would feel more comfortable standing up to their

clients. However, he still argues that SOX did not include provisions that would help auditors to become substantially more aware of misstatements in the financial report.

Cullinan's theory was partially based on the perceived causes of the fraud that occurred at Enron. In 2001, Enron paid $25,000,000 to its auditor, Arthur Andersen, for auditing services. While this in itself is not cause for concern, Enron also paid Arthur Andersen $27,000,000 in the same year for non-auditing services.[12] By post-SOX standards, this is clearly an impairment of independence, but it was legal in 2001. It has been widely accepted that Arthur Andersen not only overlooked certain misleading assertions in Enron's financial statements, but they also advised management on how to exploit loopholes in the law to mislead shareholders. While this was never an acceptable practice (Arthur Andersen was even originally convicted of obstruction of justice for destroying documents relating to its audit of Enron to cover up their misdeeds, but this conviction was eventually overturned by the Supreme Court), it is not surprising that it happened when Enron was paying one million dollars every week to Arthur Andersen for their services.

One widespread criticism of the implementation of The Sarbanes-Oxley Act was that it would be exorbitantly costly to implement, both in terms of dollars and efficiency. Some critics even went so far as to assert that because of the cost of SOX, "any advantages gained by going public [would] most likely be off-set by the increased cost of Sarbanes-Oxley compliance."[13] Several CFOs also argued that SOX, and specifically Section 404, were nothing but an "efficiency

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[12] Hirsch, Jerry, and Thomas S Mulligan. "Safeguards Failed to Detect Warnings in Enron Debacle." *Los Angeles Times*, December 14, 2001.

[13] Wilkins, J. Brent "The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence," Southern Illinois University Law Journal 29, no. 2 (Winter 2005): 339-360

tax" that slowed productivity. In a survey by PWC conducted in 2003, only nine percent of the executives that responded said that they believed Sarbanes-Oxley was a good law, and only half of them believed that SOX would increase investor confidence.[14] If that were to be the case, then it makes sense why a large segment of the general public believed the act was not going to be worth the cost.

IV. Efficacy of SOX

Sarbanes-Oxley was written and passed as a response to a series of high profile corporate frauds commonly referred to as the Big Four Frauds: Enron, Global Crossing, Qwest, and WorldCom. However these were by no means the only frauds of the era, once public attention was drawn to the issues of accounting and corporate fraud, several other stories that "had been buried in the business section of top newspapers for years […] became front page news everywhere and feature stories on broadcast and cable television shows."[15] There was clearly a business landscape in the US that fostered fraud to some extent, or at least failed to curtail it.

Eliminating all fraud in public companies with absolute certainty is impossible, and it was never the intent of Sarbanes-Oxley, so to judge it by that metric is unfair. The goal of any regulation is to reduce the unwanted behavior to an acceptable level. Since the amount deemed an "acceptable level" could reasonably vary significantly for each individual, the real question to determine the efficacy of Sarbanes-Oxley to reduce fraud becomes "Do the

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14 Yoon, Lisa. "Sarbanes-Oxley Increases Risks, Costs." CFO.Com (Mar 25, 2003): 1. https://proxy.lib.utc.edu/login?url=https://www-proquest-com.proxy.lib.utc.edu/docview/200854870?accountid=14767.

[15] Lawrence, "The Sarbanes-Oxley Yawn"

provisions of Sarbanes-Oxley reduce fraud to the greatest extent possible without increasing compliance costs?”. [16] There are two ways that SOX sought to significantly reduce corporate fraud: increasing penalties for white-collar crime to deter others and imposing new standards around auditing designed to decrease the chance that any material misstatements in the financial statements goes unnoticed or unreported by the auditing team.

A. New Sentencing Guidelines as a Deterrent to Corporate Fraud

Sections 302 and 902 of Sarbanes-Oxley listed in section II of this paper are intended to deter people from committing corporate fraud. Section 302 requires the CEO and CFO of a public company to sign the 10K which holds them legally responsible for the information therein. Section 902 states that any person involved in a conspiracy to commit fraud can be held liable for the actions of every person in a conspiracy. This discourages people from coming close to fraud, even if they do not technically commit any other crime besides conspiring to commit fraud. This section also discusses the white-collar crime penalty enhancements (the specific penalties are discussed more in depth in Section 906).[17]

The first factor to consider when examining the effectiveness of the increased penalties as a deterrent is whether executives prosecuted for fraud in the early to mid-2000s were held accountable. As Recine argued, the only way for the criminal provisions in SOX to act as a deterrent to fraud, those who commit fraud must be consistently sentenced to time in prison.[18] In her 2006 article “In Enron’s Wake: Corporate Executives on Trial,” Kathleen Brickey breaks

[16] To answer this question, any improvements discussed have been theorized or found not to increase implementation costs for companies.
[17] United States, “Sarbanes-Oxley”
[18] Recine, “Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act”

down the cases of seventeen companies[19] that were accused of participating in corporate fraud, wherein seventeen companies, "between March 2002 and July 2004, charges against eighty-seven defendants were resolved."[20] Of the eighty-seven defendants whose charges had been resolved, seventy-three had pled guilty (sixty-eight of whom became cooperating witnesses in the cases against their colleagues), eight were convicted, four were acquitted, two had a hung jury, and two were dismissed. While this study began before the passage of Sarbanes-Oxley, it is still relevant to Recine's argument. She states that the criminal sentencing provisions of Sarbanes-Oxley acting as a deterrent to corporate fraud are dependent upon white-collar criminals being convicted and going to prison for the crimes they committed.[21] The initial wave of defendants having a conviction rate of over ninety percent certainly fulfills the stipulation that those who commit fraud be convicted.

By January 31, 2006 (the end of Brickey's study), there were twenty-three convictions by jury and five defendants had entered a guilty plea without a cooperating agreement with investigators.[22] Notably absent from this group are Enron's Ken Lay and Jeffrey Skilling since their trials were still underway as of January 31, 2006 (they were both convicted on May 25, 2006[23]), however due to their significance in the discussion of corporate fraud in the early

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[19] These companies are Adelphia Communications Corp., Cendant Corporation, CSFB, Duke Energy North America LLC., Dynegy Inc., Enron Corporation, HealthSouth Corp., ImClone Systems Inc., Impath Inc., McKesson HBOC, NewCom Group, Ogilvy & Mather LLP, Qwest Corporation, Rite Aid Corporation, Tyco International plc, Westar Energy Inc, and WorldCom

[20] Brickey, Kathleen F. "In Enron's Wake: Corporate Executives on Trial." *The Journal of Criminal Law and Criminology (1973-)* 96, no. 2 (2006): 397-433. Accessed September 18, 2019. http://www.jstor.org.proxy.lib.utc.edu/stable/40042771.

[21] Recine, "Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act"

[22] Brickey, "In Enron's Wake." Those who entered a guilty plea with a Cooperating Agreement are not included in the analysis of sentencing as their sentences are not based solely on the magnitude of the crimes they committed.

[23] Sunseri, Gina, and Sylvie Rottman. "Enron Verdict: Ken Lay Guilty on All Counts, Skilling on 19 Counts." *ABC News*, May 26, 2006.

twenty-first century, they will be included in the analysis of sentencing in this section. Twenty-eight of thirty defendants mentioned were sentenced (the Arthur Andersen verdict was over turned by the supreme court, and Ken Lay died on July 5, 2006 before he was sentenced[24]). Of those twenty-eight, all of them were sentenced to prison time.[25]

Of those convicted by a jury, the shortest prison terms were five months which were given to Martha Stewart and Peter Bacanovic in relation to insider trading of ImClone securities. Stewart was convicted of Conspiracy, False Statements, Obstruction of Justice, and Securities Fraud. Bacanovic was convicted of Conspiracy, False Statements, Making and Using False Documents, Perjury, and Obstruction of Justice. The longest prison sentence was a 25 year sentence given to WorldCom CEO Bernard Ebbers. Ebbers was convicted of Conspiracy, Securities Fraud, and Making False Filings with the SEC. The average sentence for those convicted by a jury was approximately nine years and two months, and the median sentence was eight years.

Of those who entered a guilty plea (without a Cooperating Agreement), the shortest prison term was three months which was given to Anu Saad, the former Chairman and CEO of Impath, who plead guilty to Conspiracy, Securities Fraud, and Making False Filings with the SEC. The longest prison sentence was seven years and three months which was imposed upon Sam Waksal, the founder of ImClone, who plead guilty to Conspiracy, Fraud, and Perjury. The

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[24] Peters, Jeremy W., and Simon Romero. "Enron Founder Dies Before Sentencing." *The New York Times*, July 5, 2006.

[25] Brickey, "In Enron's Wake." Many of the sentences also included fines, restitution, probation, or home detention. However since Recine's article argues increased penalties may deter fraud only if the sentence is time in prison, those facets of any sentences other than time in prison will not be considered.

average sentence for those who plead guilty (without a Cooperating Agreement) was approximately three years and four months, and the median sentence was two years.

According to Recine's claim that "the more white-collar criminals who are convicted and sentenced for the crimes they commit, the greater the deterrent effect produced by the legislation,"[26] the convictions and sentences including jail time of the executives in Brickey's study would seem to indicate that fraud would have dropped drastically as a result of this deterrent post Sarbanes-Oxley. However, the 2008 article "Go Directly to Jail: White Collar Sentencing after the Sarbanes-Oxley Act" from the Harvard Law Review argues that there are further requirements for criminal sentencing to act as an effective deterrent to white-collar crime.[27] The article states that "[d]eterrence works best when punishment is swift and certain. White-collar sentencing in the years since Sarbanes-Oxley, however, has been anything but." The article argues that, "rather than acting upon the base Guidelines[28] and average sentences for white-collar crime, the bill simply increased the maximum sentence, thereby expanding the range within which judges may sentence. An expanded range, without a rubric for sentencing within that range, invites unfair disparity between sentences for similarly situated offenders." This all but removes any level certainty about punishment as "[a]n individual who contemplates committing a crime has no way of predicting whether he will face ten, twenty, or more years in prison, or receive merely a slap on the wrist for his actions." With the aspect of certainty removed from sentencing, the penalty enhancements for white-collar crimes would not be an

[26] Recine, "Examination of the While Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act"
[27] "Go Directly to Jail: White Collar Sentencing after the Sarbanes-Oxley Act." *Harvard Law Review* 122, no. 6 (2009): 1728-749. Accessed October 18, 2019. http://www.jstor.org/stable/40379766.
[28] The Federal Sentencing Guidelines

effective deterrent according to this article. The Harvard Law Review article also argues that this point is supported by the rise in section 2B1.1-crime sentencings between 2002 and 2007, saying that these are the exact crimes that were supposed to be deterred by stricter sentencing in SOX. However, section 2B1.1 crimes include “Theft, Property Destruction, and Fraud Offenses”[29] which includes several crimes not mentioned in Sarbanes-Oxley, and it does not include insider trading (found in section 2B1.4), which is a white-collar crime that violates SOX Section 807. Additionally, their evidence only includes how many people were sentenced in relation to this type of crime. This notably ignores those who were committing white-collar crimes in 2002 that were not caught. In addition to enhanced criminal penalties, Sarbanes-Oxley put into place regulations to enhance auditing. If those were effective, then it would stand to reason that there were fewer cases of undetected fraud in 2007 than there were in 2002. If fewer cases in 2007 were undetected, the it is possible for the deterrent to have worked and still have more people sentenced for those crimes. While it is possible that the upward trend in section 2B1.1 sentencings since Sarbanes-Oxley could be in part due to decreased certainty in white-collar sentencing, it is unfair to conclude that the increased maximum penalties and the consistent sentences including jail time[30] “are not deterring the kind of criminal activity that the [Act] was enacted to prevent.”[31]

B. Increased Effectiveness of Auditors

As noted earlier, there are three key provisions that exist in order to increase the effectiveness of the auditing process. SOX Section 103 created the PCAOB which imposes

[29] “Sourcebook 2019.” United States Sentencing Commission, June 12, 2020. https://www.ussc.gov/research/sourcebook-2019.
[30] Brickey, “In Enron’s Wake”
[31] “Go Directly to Jail”

"Auditing Standards, Ethics and Independence Rules, Quality Control Standards"[32] and more. Section 404 required for auditors to issue a report of a company's internal controls along with their audit of the financial statements. Because of this, corporations are required to document their internal controls, and auditors are able to use their assessment of the internal controls of a company to inform how they should conduct the audit of the financial statements as weak internal controls can be a warning sign for potential material misstatements in the financial statements. Section 806 details whistleblower protections which encourage people to come forward about fraud occurring in their company.

There is not an expectation of an auditor to provide a complete guarantee that all financial statements are completely free from fraud and error. An unqualified opinion from an auditor only provides reasonable assurance that there are no material misstatements in the financial statements due to either error or fraud. As stated in Cullinan's article, SOX did not have any provisions whatsoever that increased the likelihood of an auditor becoming aware of any problem transactions.[33] He argues that the only way to guarantee that the auditor would become aware of any problem transactions is to have them examine every single transaction that took place over the auditing period. This is currently an unrealistic standard that would undoubtedly raise compliance costs and would make it impossible for the audit to be completed in the time allotted, which is between 60 and 90 days from the end of the company's fiscal year based on the cost of outstanding shares of stock.[34] According to Cullinan,

[32]"Protecting Investors through Audit Oversight." PCAOB, 2003. https://pcaobus.org/.
[33] Cullinan, "Enron as a Symptom of the Audit Process Breakdown"
[34] SEC. "Form 10K: Fast Answers." SEC.gov, June 26, 2009. https://www.sec.gov/fast-answers/answers-form10khtm.html.

this leaves two possible places where fraud can be reduced: recognizing a problem transaction as a problem, and reporting any realized problem transactions.[35] He argues that the only way that SOX improved either of these is through the ways it increased auditor independence (Section 103 and Title II). However, internal controls and whistleblower protections and awards can also help to meaningfully reduce fraud.

Section 806 made it a crime to retaliate against whistleblowers who worked in public companies, subsidiaries of public companies, and nationally recognized statistical ratings organizations.[36] The *Dodd-Frank Wall Street Reform and Consumer Protection Act* amended Sarbanes-Oxley to extend the same protections to employees of privately held companies, as well as started the SEC Whistleblower Program which gives financial incentives to whistleblowers.[37] While the extension to private companies does not affect corporate fraud at public companies, the SEC's whistleblower program absolutely does.[38] Since its inception in 2012, the SEC whistleblower program has "awarded almost $562 million to 106 individuals."[39] The fiscal year 2020[40] set the record for most individual whistleblowers as well as highest dollar payout with "39 individual awards of approximately $175 million."[41] An increased number of

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[35] Cullinan, "Enron as a Symptom of the Audit Process Breakdown"
[36] United States, "Sarbanes-Oxley"
[37] "Whistleblower Program." Dodd-Frank Act Rulemaking: Whistleblower Program. The Securities and Exchange Commission, 2011. https://www.sec.gov/spotlight/dodd-frank/whistleblower.shtml.
[38] While not originally included in SOX, the Act was amended by Dodd-Frank which means that this is the current way that Sarbanes-Oxley is enforced.
[39] "SEC Whistleblower Program Ends Record-Setting Fiscal Year With Four Additional Awards." *Securities and Exchange Commission*. SEC, September 30, 2020. SEC. https://www.sec.gov/news/press-release/2020-240.
[40] October 2019 – September 2020
[41] Award dollar amounts are significant as the amount of the award is tied to the severity of the fraud. See "SEC Whistleblower Program Ends Record-Setting Fiscal Year With Four Additional Awards."

whistleblowers unquestionably increases the amount of detected fraud occurring and can also act as an effective deterrent.

SOX Section 404 is also meant to prevent material misstatements, and it was effective in mitigating some of the pervasiveness of financial statements issued with material misstatements. Albert Nagy's 2010 article "Section 404 Compliance and Financial Reporting Quality" details a statistical study conducted by Nagy in which "results show a negative association between S404 [sic] compliance and the issuance of materially misstated financial statements."[42] Essentially, the companies that complied with Section 404 were less likely to have material misstatements on their financial statements. By requiring the internal controls system to be audited by an external auditor, the quality of internal controls should improve. In theory, a strong system of internal controls would deter, prevent, or detect any transactions that are misstated due to either error or fraud. However, many people argue that Section 404 fails to emphasize the most important facets of strong internal controls, and that it could be much more effective. Section 404 has faced scrutiny since its inception for being control-based versus risk-based. In their article "Preventing the next Wave of Unreliable Financial Reporting: Why US Congress Should Amend Section 404 of the Sarbanes–Oxley Act," Tim Leech and Lauren Leech call for an amendment from congress to require an opinion from management and the

[42] Nagy, Albert L. "Section 404 Compliance and Financial Reporting Quality." *Accounting Horizons* 24, no. 3 (09, 2010): 441-454. https://proxy.lib.utc.edu/login?url=https://www-proquest-com.proxy.lib.utc.edu/docview/751584026?accountid=14767.

external auditor on the "effectiveness of risk management processes" rather than "control effectiveness." [43]

Section 404 was first imposed by the PCAOB in Auditing Standard No. 2 which focused on documenting and testing controls, rather than optimizing the system to reduce the risk of material misstatements. Auditing Standard No. 2 was ineffective and much more costly than the SEC originally predicted, so it was replaced with Auditing Standard No. 5[44] (also referred to as "AS5") which was supposed to incorporate a more risk-based approach. However, many critics assert that AS5 did not do enough to move from a control-based approach to a risk-based approach.[45] Even though AS5 states that the auditors evaluation of internal controls is to be made based on the assessment of risk, Leech and Leech argue that in order to move to a true risk-based approach, "the risks that statistically have been at the root of materially wrong financial statements over the past 50 years [must] be identified and assessed, as well as statistically probable risks… relevant to a company's specific business sector and personal accounting restatement history." After the statistically highest risks are determined, management and external auditors should be required to "evaluate the likely effectiveness of the current 'risk treatments'… in place to mitigate the statistically most dangerous risks to reliable financial disclosures." AS5 required neither of these. Theoretically, this true risk-based

[43] Leech, Tim, and Lauren Leech. "Preventing the next Wave of Unreliable Financial Reporting: Why US Congress Should Amend Section 404 of the Sarbanes–Oxley Act." *International Journal of Disclosure and Governance* 8, no. 4 (2011): 295–322. https://doi.org/10.1057/jdg.2011.18.

[44] Auditing Standard No. 5 was recodified Auditing Standard No. 2201 once the PCAOB "adopted amendments to reorganize its auditing standards" on March 31, 2015. See "PCAOB Auditing Standards Reorganized and Pre-Reorganized Numbering" document from Jan 2007.

[45] Auditing Standard No. 12 (now AS 2110) does require auditors to assess the risk of material misstatements for the company being audited, but it is not a "risk based approach" as it emphasizes internal controls and does not produce the statistically most likely risk for a company, then attempt to mitigate it.

approach would decrease the number of misstatements on the financial statements even before they are reviewed by the auditor, as the company is mitigating much of the risk of material misstatement on its own. This also allows the auditor to focus their time and resources on the parts of the business most likely to be misstated for that individual business, which reduces waste in auditing by not requiring so much of the auditor's time and resources to be directed toward aspects of the business that are low risk. So while Section 404 has reduced the number of materially misstated financial statements for public companies, it could be far more effective at doing so.

V. Cost of SOX

At the time of implementation, many critics of SOX predicted that the cost of implementation would place an undue burden on companies, with some even predicting that the costs would erase any benefits of going public.[46] The question to determine the cost-effectiveness of SOX is the inverse of the question to determine its efficacy: "Is the cost of implementing Sarbanes-Oxley as low as possible without reducing effectiveness?".

The most pervasive complaint about Section 404 is not its effectiveness, but its high cost of implementation. When Section 404 was implemented, the SEC predicted that first year costs for the average public company would be $91,000,[47] but a study conducted by the consulting group Charles River Associates found that the actual average first year implementation cost of

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[46] Wilkins, "The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence"

[47] Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission § (2003).

Section 404 among public companies was $5.9 million,[48] roughly sixty-five times what the SEC had predicted. These costs did come down after the first year of implementation to an average of $2.87 million per company right before AS5 replaced AS2, and then again to $2.33 million the year after that reform,[49] but even $2.33 million is over twenty-five times the amount the SEC estimated for initial implementation. Leech and Leech argue that shifting to a risk-based model would not only improve effectiveness of Section 404, but would also decrease the costs of compliance.[50] Currently, Section 404 forces companies to document and verify the effectiveness of their internal controls related to all aspects of their business whether or not they represent a significant risk of material misstatement. Under a risk-based approach, the management and auditor would be able to focus on the areas that present the highest risk of material misstatement while using less time and resources on the lower risk aspects of the business, which Leech and Leech argue would not hurt the effectiveness of Section 404 at all, but could actually improve it. Determining the statistically most likely risks based on the company and industry could be more costly up front, but is likely to substantially lower the cost of compliance, audit fees, and the man hours taken to fully comply with an updated Section 404.

The costs faced by companies related to SOX compliance is not measured only in dollars and man hours. The article “Sarbanes-Oxley and Corporate Risk-Taking” by Leonce L. Bargeron,

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[48] Charles River Associates. “ Sarbanes Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies.” Charles River Associates International, 2005. https://www.crai.com.

[49] SEC. “Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements.” *OFFICE OF ECONOMIC ANALYSIS UNITED STATES SECURITIES AND EXCHANGE COMMISSION*, September 2009.

[50] Leech and Leech, “Preventing The Next Wave”

Kenneth M. Lehn, and Chad J. Zutter argues that the adoption of Sarbanes-Oxley reduced corporate risk-taking[51] among public companies in the United States.[52] Bargeron, Lehn, and Zutter conducted a study which compared risk taking behavior[53] in US and non-US corporations before and after SOX and found that risk taking behavior declined in US firms, but not in the non-US firms which were not subject to SOX.[54] The authors assert that this decline can be attributed to three provisions of SOX: the provision regarding board structure (Sections 301 and 407), Sections 302 and 906, and Section 404. Sarbanes-Oxley requires that the majority of the board of directors be independent of the business, and encourages that one member of the audit committee be judged a “financial expert.” One of the authors of the article, Kenneth Lehn, conducted another study that found that an inverse relationship between risk taking behavior and the proportion of independent directors on the board.[55]

Bargeron, Lehn, and Zutter also attribute part of the decline in corporate risk taking post SOX to Section 302 which held management legally responsible for the contents of the financial statements and Section 906 which increased maximum sentences for managers who knowingly and/or willfully sign financial statements containing material misstatements. While these sections were meant to act as a deterrent to fraud, “the increase in expected penalties for

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[51] Risk-taking in this context refers to actions intended that have an unsure result. This is not the same risk being discussed in Leech and Leech’s article which is the risk of material misstatement on a financial statement.
[52] Bargeron, Leonce l, Kenneth M Lehn, and Chad J Zutter. “Sarbanes-Oxley and Corporate Risk Taking.” *Journal of Accounting and Economics* 49, no. 1-2 (February 2010): 34–52. https://doi.org/10.1016/j.jacceco.2009.05.001
[53] Risk taking behavior was determine by analysis of volatility of stock prices, capital expenditures, R&D costs, and cash holdings.
[54] The study controlled for a number of non-SOX variables that could have affected corporate risk taking including changes in GDP, the tech bubble burst, and the attacks on September 11, and the 2006 rule that required companies to expense stock-based compensation which could have disincentivized companies from awarding stock options to management thereby reducing management inventive to take more risks.
[55] Lehn, Kenneth, Sukesh Patro, and Mengxin Zhao. “Determinants of the Size and Structure of Corporate Boards: 1935-2000.” *SSRN Electronic Journal*, September 2004. https://doi.org/10.2139/ssrn.470675.

fraud under SOX is expected to reduce the incentives of officers and directors to initiate and approve risky projects."[56] Section 404 compliance is most expensive for businesses that are considered more complex (which includes having more risk taking behavior such as high research and development costs), so reducing the appearance of riskiness in a company can lower their costs. This leaves management to decide between higher compliance costs and less risk taking, and it appears that most managers are deciding to take fewer risks.

Bargeron, Lehn, and Zutter clarify that they are not making a judgement "as to whether the reduction in risk-taking after SOX is socially efficient," but they do argue that since, presumably, "average firms adopted value-maximizing governance structures before SOX…, then the changes in risk-taking induced by SOX are inefficient." Essentially, businesses were already balancing the amount of risk assumed to achieve the maximum value, so a SOX-induced decrease in risk would be moving away from the strategy each company had adopted to achieve the highest possible value and return for shareholders.

As for the reorganization of the board of directors to include more independent directors, this should only ensure that management takes risks to benefit the shareholder, which should not lower the overall amount of risk. As long as management has sufficient cause to believe that the risks they take and the strategy they put in place will pay off for shareholders, then a higher proportion of independent auditors should not curb that behavior. Because independent directors would only reduce risk-taking that would reasonably be

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[56] Bargeron, Lehn, and Zutter "SOX and Corporate Risk Taking"

considered harmful to investors and improve management accountability, this is not an issue that needs to be fixed.

In regards to Sections 302 and 906, while they do expand penalties for management participating in fraud, they do not provide legal consequences for poor business decisions. So once again, this would only curb risk-taking behavior that can be reasonably determined to likely harm shareholders.

The provision that could be changed to improve this issue is Section 404, and the solution, again, is the move to a risk-based approach. Having management and auditors focus on the facets of the business that are statistically most likely to produce a material misstatement instead of just the parts that appear the most complicated would remove some of the pressure on management when making decisions regarding risk-taking behaviors. The increases in risky endeavors would not necessarily increase their audit fees and compliance costs because it would not change the areas of the business that are statistically the most likely to produce a material misstatement.

VI. Conclusion

The intent of Sarbanes-Oxley was to protect investors by making disclosures from companies more reliable and accurate,[57] but protecting investors also includes not placing an undue burden of cost on public companies since that burden is passed on to the investors. It

[57] United States "Sarbanes-Oxley"

would be difficult and unwise to argue that SOX did nothing to help protect investors, however it would also be unwise to state that it does not need improvements.

Sarbanes-Oxley's most positive impact comes from Section 103 (and subsequently Title II) which authorized the PCAOB to impose new standards requiring auditor independence. These rules prevent a repeat of the situation between Enron and Arthur Andersen. A company paying millions of dollars in consulting fees to the same firm that is their auditor is unheard of in the post-SOX world. Having an auditor who lacked independence had such an obvious potential to impair the judgement of the auditor in their work that it is hard to believe that it used to be an accepted practice. SOX was incredibly effective in increasing auditor independence through its establishment of the PCAOB which denied the accounting industry the right to almost entirely self-regulate.

In order to increase the effectiveness and reduce compliance costs of SOX, two sections of the act need to be amended: Section 906 and Section 404. Section 806, which protected whistleblowers, decreased the amount of undetected fraud since its implementation (and even more so since its subsequent enhancements in Dodd-Frank), and Section 302 was effective in holding management legally responsible for the content of the financial statements, but getting caught and being legally responsible do not inherently deter fraud if there are not consequences that are "swift and certain."[58] 906 raised maximum criminal penalties for white-collar crimes, but did nothing to affect minimum sentences or standardize sentencing based on the severity of the crime. This resulted in a wider range of possible punishments for those

[58] "Go Directly to Jail"

convicted of white-collar crimes which only decreases certainty of what punishment a potential white-collar criminal would receive for their crimes. This certainty is a vital part of the deterrent effect of criminal penalties. By amending section 906 to include minimum sentences for those convicted of white-collar crimes as well as a progressive sentencing structure based on the severity of the crime, the section would act as a much more effective deterrent to fraud and other white-collar offenses. Moreover, this change would not put any more of a tax or compliance burden on public companies or their investors.

An amendment to Section 404 to shift from judging control effectiveness to judging risk management effectiveness would increase the effectiveness SOX and lower compliance costs and auditing fees. By focusing on the most likely aspects of a business to produce material misstatements, strong risk management systems would reduce material misstatements better than internal controls which are not currently tailored to an individual industry or company. It would also eliminate the cost of management assessing and documenting internal control procedures that are not valuable to the shareholder, and would eliminate time wasted by the auditor investigating low risk areas of the business. Were these amendments to be enacted, Sarbanes-Oxley would be much more effective in achieving its goal to protect investors.

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