THE SARBANES-OXLEY "REVOLUTION": TWO YEARS AND COUNTING

It is more than two years now since the U.S. Congress voted to approve—and then rushed to the White House—the final version of the Sarbanes-Oxley package of legislation (SOX).[1] President George W. Bush quickly put his signature to the bill, making it "instant" federal law. (Some provisions took effect upon signing.) Compared to other recent legislative initiatives, SOX was a simply stated document, unlike tax reform measures or the complex Medicaid "reform" legislative packages also passed by committees or full chambers of Congress.

While political pundits and journalists were calling the original Sarbanes bills (named for sponsor Senator Paul Sarbanes, Democrat of Maryland) "dead-on-arrival," or impractical, American public opinion—and finally, public outrage at corporate scandals—quickly drove compromise in the two houses and between the two political parties of the national legislature.

Enron's collapse in late 2001 began public demand for serious reform of corporate financial reporting rules and for greater government oversight of corporate behavior. President Bush included recommendations for far-reaching corporate governance reforms in his January 2002 State of the Union address to Congress, setting in motion a series of moves by the Securities and Exchange Commission (SEC) and other agencies to toughen investigations and sanctions. It was the subsequent chain of uninterrupted corporate scandals, climaxing with the collapse of WorldCom—which had employees, subcontractors, customers, facilities, and so on in many congressional districts—that gave final momentum to compromise on and passage of SOX.

Republican support for the extraordinary enforcement, financial reporting, corporate governance, and accounting process changes and other far-reaching reforms called for in the bill was spearheaded by Congressman Michael Oxley of Ohio. The resulting"Sarbanes-Oxley" laws began a revolution in corporate governance, accountability, and oversight of the corporate sector that continues unabated two years later.

As we noted in an earlier column, "the comprehensive package of laws is not legislative arcana; SOX features plain English components that address specific aspects of issuer and capital market governance and behavior." In a mere 75 pages, a revolution in corporate governance was launched. The questions in the public mind were: Would the corporate reform effort be sustained, and what would be the long-term effects on corporate and capital markets behavior? We are still learning the answers to both questions.

On to rule making and implementation

Putting simple legislative language and intent into equally understandable regulations has proved to be a massive task that continues on the second anniversary of the White House signing ceremony. The SEC is the primary implementer of the rules and regulations issuers will have to follow to be in compliance. Debate has been steady and often contentious as proposed rules flow from the SEC and public comment follows. Many new or updated rules are in place, some adopted at a rapid pace in 2003. For example, disclosure requirements set forth by Sections 406 and 407 were adopted in January 2003 and since amended. At this writing, however, a number of proposed regulations are still being discussed. SOX is a work in progress.

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FASB HAS INCREASED AUTHORITY AS ONE OF TWO ACCOUNTING RULES STANDARD-SETTERS.

Section 404—vexation for issuers

Judging by the comments coming from corporate America, the most vexing rule is Section 404, which becomes effective in November 2004. Title IV of SOX embraced "Enhanced Financial Disclosures," a topic that could fill an entire issue of the *Federal Register* and still not do justice to all aspects of *full and fair disclosure.* Companies were already learning to live with the previously adopted "Reg FD" (Fair Disclosure) when SOX came along.

Congress intended that the SEC would have the power to move rapidly and with vigor to address important corporate disclosure issues. Internally, before SOX passage, the SEC staff was already moving under the direction of then-chairman Harvey Pitt to get issuers closer to having continuous, complete disclosure of material changes. SOX provided further momentum with its provision requiring "real time" disclosures in "plain English ... for the protection of investors and in the public interest"[2] (as a result, many more 8-Ks are now being filed and on a much tighter deadline).

Under Section 404, management must deem certain activities "key to the company's business" and set internal controls in place to ensure that sound financial controls govern these business processes. In addition, controls must be tested quarterly. (This can be done manually, by automation, or some combination of the two.) The Hackett Group consultants estimate that the average $1 billion company maintains almost 50 financial programs and up to 3 enterprise resource planning (ERP) systems. Some companies operate in 100 or more countries, and some have arcane or unique "key processes" for which controls must be totally customized. All of these considerations complicate Section 404 compliance.

Small-cap and some mid-cap companies are "discovering" the profound implications of SOX as they face the deadline of Section 404 certification (controls compliance certified by senior officers). To judge by news reports, many are simply not prepared. The tests for Section 404 will come in 2005 and 2006, as real deadlines for compliance fall into place.

The publicity and constant buzz surrounding SOX compliance sets up public expectations that issuers will be communicating regularly and reporting expansively (in required periodic filings) material information in a way that creates *full and fair disclosure*—a tall order! (The simple test for plaintiff bar seems to be: Was this information provided or withheld by the issuer of a nature that an intelligent investor would be influenced to make a buy, sell, or hold decision? Shareowner lawsuits are now filed literally on the day after a restatement or problematic announcement by issuers.)

Beyond SEC rules—other measures

SOX also required federal agencies to address specific topics within their areas of responsibility, including conducting research or upgrading guidelines, leading to more recommendations for action and, in some cases, additional or enhanced compliance rules.

U.S. Sentencing Commission. The U.S. Sentencing Commission, which develops uniform sentencing guidelines for the federal courts, was directed to consider the serious nature of white collar crime and to adopt more stringent guidelines, including mandated penalties for senior corporate officers signing periodic filings that contain false or misleading information. (In 2003, the commission completed this action. Tougher guidelines now include freezing of personal assets and greatly increased jail time and personal fines and/or disgorgements of profits by offenders.)

IRS. The Internal Revenue Service (IRS) was directed to put additional teeth into penalties by adopting regulations that addressed the same type of violations—CEOs must sign off on all corporate tax returns, said the legislators. Criminal penalties under IRS codes could then be enforced as well.

U.S. Comptroller General. The Comptroller General of the U.S. was ordered to study the requirement of mandatory rotation of registered accounting firms. (The short-term compromise is to rotate engagement lead partners after five years' time. Since there are only four large auditing firms left, rotation of firms may be left for the future.)

FASB. The Financial Accounting Standards Board (FASB) was provided with new sources of revenues (to be fees and assessments vs. the "voluntary" contributions of the accounting industry), as was the Public Company Accounting Oversight Board (PCAOB), and the FASB has increased authority as one of two accounting rules standard-setters (the other being the SEC). In addition, the FASB was assured of some insulation from political interference (now being tested by the political battle in Congress over mandatory expensing of stock options; FASB is in the political crosshairs again).

GAO. The General Accounting Office[3] (GAO) of the U.S. Congress was directed to study and report on (1) the effects of the consolidation of public accounting firms; and (2) whether investment banks helped public companies manipulate earnings or conceal their true financial condition.

SEC. The SEC was instructed to study and report on the activities of credit rating agencies, such as Standard & Poor's and Moody's. The SEC was also directed to establish an independent arm that would "license" public auditors; this was the basis of the formation of the PCAOB (sometimes called "Peek-a-Boo" by insiders), now in daily operation.

Recall these additional highlights of SOX:[4]

- SOX contains eleven "titles" or sections.
- Two titles specifically create tough new criminal penalties for executives convicted of fraud, issuing misleading information or data, or related offenses.
- Six titles update provisions of the Securities Exchange Act of 1934.
- Rules, regulations, guidelines, etc. were formulated for each of the sections.

Practical aspects of living with SOX

What is now happening on Wall Street and in corporate suites, day to day? Daily life in corporate American has been affected in the following ways:

- For public auditing firms, specific services that cannot be provided to audit clients have been spelled out. Gone are dual engagements—for example, performing a public auditing function plus information technology consulting for the same client. More rules for services to be prohibited for audit clients are expected.
- Companies' audit committees have the primary responsibility to hire, fire, and monitor the work of the public auditor. All members must be independent. The committee chair must be a financial expert, and it is assumed that, to be on the safe side, other committee members will have similar financial backgrounds.
- The PCAOB reviews the qualifications of public auditors and issues permission to operate (as an auditor of public issuers), under constant monitoring and review. The PCAOB is also now reviewing several hundred recent public auditing engagements as part of its mandated oversight of the audit profession.
- The self-regulating organizations (SROs), such as the New York Stock Exchange (NYSE) and NASDAQ, issued comprehensive listed company corporate governance rules of their own. (The Securities Exchange Act of 1934 provides clear authority for SROs to impose penalties, including delisting of securities.) The NYSE's enhancements of listed company rules were more comprehensive than expected by corporate leaders, but the rules are in effect, as are NASDAQ's upgraded rules, which are more restrictive than in the past but somewhat milder than NYSE's.
- Financial analysts operate at arm's length (on the sell-side) from brokerage and investment banking operations, and "independent" financial research firms have emerged to fill the void. The long-term viability of both the separation of research from profitable operations (such as banking) and of totally paid-for research is still in question. (Will users pay for research they received for "free," as trading customers? Answer to be determined.)

Corporate reaction to SOX

What has been the corporate world's reaction to SOX implementation? Corporations

GONE ARE DUAL ENGAGEMENTS.

certainly have been vocal about the additional costs involved in preparing for deadlines for full compliance with SOX provisions, particularly with Section 404 (internal controls) requirements, which could end up being a very costly affair for some companies. One consultant survey claimed the average cost in the first year after passage for preliminary compliance was $5 million for a large-cap firm. One software company executive acknowledged spending $3 million on first-year compliance, calling SOX "an efficiency tax."

It doesn't appear that the plain English approach in SOX has yet inspired all corporate executives to adopt simple language in their communications with investors and the public. According to business communications company Addison in New York, the latest annual reports do show a continuing effort by *some* companies to rebuild strained stakeholder relations through candid, plain-spoken language.[5] But *many* companies still fall short of "clarity" in their financial sections. In up to 50 percent of the mid-cap and large-cap reports reviewed by Addison, companies missed an opportunity to extend their positive "communication reach" into the 10-K and MD&A, which in many cases remain "dense and dismal forms of compliance," says Elliott Saltzman, Managing Director of Addison's Annual Reports practice.

COMPANIES HAVE ESTABLISHED "WHISTLE-BLOWER" MECHANISMS.

Foreign companies issuing debt or equity instruments in the U.S. capital markets did not like SOX on first reading of the headlines and still do not, judging by their public comments. On passage, only limited aspects of SOX extended to non-U.S. issuers, but experts predict that, eventually, there will be mission creep and much more compliance with SOX will be required by American Depositary Receipt (ADR) and other issuers (to protect U.S. investors).

Investment bankers and brokerages have been dropping analyst coverage of some companies. Citigroup's Salomon Smith Barney unit quickly led off with a layoff of analysts and dropping of coverage of several hundred firms. Some issuers now have no coverage at all and cannot find a single analyst to follow their company. Some firms have turned to paid-for research, a controversial move.

The PCAOB appears to be playing tough under the direction of Chairman William J. McDonough, former head of the New York Federal Reserve Bank. The "accounting czar" and his band of overseers can levy harsh penalties on errant auditing firms (or individuals), setting the tone for the future for accountants and auditors. On taking office, McDonough said: "The task before us is to restore the confidence of the American people and others around the world that audited financial statements present a complete, true and timely report that can be relied on."

Companies have established "whistle-blower" mechanisms, as ordered by SOX. The long-term efficacy of this approach to protecting insiders who blow the whistle on financial and accounting misconduct is in question. Former SEC chairman Harvey Pitt recently commented that the only systems that would probably work are those turned over to independent and objective outside providers. "Did you ever see an internal reporting system that the rank and file would really trust?" he asked.

What's ahead?

At the time of passage in July 2002, two major related issues were still outside the scope of SOX legislation (and SEC rules): the future of stock options and pension plan security. Both issues have been addressed in various ways in the intervening months, but with no real resolution of either at press time.

If a major corporate pension fund goes belly-up any time soon—or a series of failures of smaller plans occurs — the government's Pension Benefit Guaranty Corp. (PBGC) will have to step in to rescue (or guarantee) the plan for beneficiaries. PBGC officials claim that their potential vulnerability is up to $300 billion or more in shaky plans (in the airline, steel, and other industries) and that they are now operating at a yearly deficit, as crippled plans are propped up. A major failure could be the flash point for passage of "Son of Sarbanes-Oxley" or some other equally dramatic package of federal laws addressing private pension plans, in response to public opinion.

The options issue is being resolved somewhat by the voluntary adoption of expensing schemes by issuers. In summer 2004, the count stood at 753 companies expensing stock options, according to Pat McConnell, Bear Stearns accounting and taxation research analyst.[6]

In this writer's view, a real revolution in corporate governance, institutional and personal accountability, financial reporting, disclosure practices, and related issues was jump-started by the passage of SOX in July 2002. We will be living with the consequences for years to come. After all, as noted, SOX expanded the 1934 securities legislation of the New Deal Era, demonstrating that, once such legislation is in place, it is not likely that a session of Congress will repeal laws that "protect the investor" and provide some assurance about the safety of the nation's capital markets.

Former SEC chairman Harvey Pitt, now a consultant, observed recently: "Ethical conduct is good business. Good businesses know it, and practice it. More federal laws are not necessarily needed now. Everything that went wrong at Enron was already illegal before SOX passage. My advice to clients is don't cut corners. Do the right thing . .. and be able to prove you did." Senator Sarbanes and Congressman Oxley likely had this in mind when they fashioned the final language of their revolutionary bill. •

NOTES

1 *Sarbanes-Oxley Act of 2002,* Public Law 107-204, 107th Cong., 2d sess. (30 July 2002).

2 *Ibid.,* sec. 409.

3 In July 2004, the GAO changed its name to the General *Accountability* Office, an important signal to executives in the capital markets and corporate world that the mandate for research on behalf of the Congress is now much broader than accounting.

4 For a detailed discussion of the critical provisions of SOX, see H. Boerner, "Sarbanes-Oxley Law: Creating a Challenging Operating Environment for Corporate Finance Professionals," *Corporate Finance Review* (March/April 2003): 32-38.

5 E. Saltzman, "The Road to Babel: More Words, Less Communication," available on the Addison website at www.addison.com/perspective-details.aspx7PerspectiveID=46.

6 To request Bear Stearns' comprehensive rundown on recent stock option actions, e-mail Ms. McConnell at AccountingIssues@bear.com.