

“A Question of Ethics:” Implications of the Sarbanes-Oxley Act for the Accounting Profession and the Investing Public

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Introduction

A memorable moment from the Cohen brothers' 1990 film *Miller's Crossing* has a gangster, incensed at being double-crossed by a criminal colleague, say with righteous indignation, “It’s a question of ethics!” Since the double cross spoiled his attempt to fix a boxing match, the audience realizes that in the world of these gangsters, any real sense of ethics has long been lost.

In the recent past, the business community seems too much like the upside down world of *Miller's Crossing*. On a daily basis across the United States, media detail a new financial reporting scandal. These financial reporting scandals emerge from the lack of integrity and a reduced adherence to auditing and financial reporting standards. Venerable giants like audit firm Arthur Andersen, external auditors for publicly held companies and notable corporations such as Enron, WorldCom, and HealthSouth have all been involved in some of the largest corporate scandals and bankruptcies in history. This recent fraud has contributed considerably to the decline in respect for corporate entities and financial reporting. Mary Beth Armstrong, author of “Professionalism and Ethics in Accounting Education,” explains that “expertise . . . acquired through higher education and extensive training . . . requires professional judgment, not just technical skills” (2). Many of the participants in the recent debacles lack this professionalism, which requires individuals to behave in a manner that benefits the public interest.

At no other time has it been more important for corporate America to uphold the integrity and standards of accountants, managers, and all other individuals on whom the public relies for expertise. The tone of management of publicly held companies and accountants, particularly auditors, is expected to improve as a result of Congress’s enactment of the Sarbanes-Oxley Act of 2002, known as Sarbox. Sarbox was enacted to force management of publicly held corporations and auditors to abide by guidelines set forth to govern financial reporting. The purpose of this study is to highlight the impact of Sarbox on the accounting profession, the modifications that Sarbox will have on the duties and responsibilities of the members of the accounting profession and American corporations, and the expected benefits to the investing public.

According to Arens, Elder, and Beasle in *Auditing and Assurance Services: An Integrated Approach*, ethics, or a “set of moral principles or values,” must play a major role in financial reporting, and the accounting profession (74). However, E. John Larsen, the author of *Advanced Accounting*, notes that many “critics have alleged that ethical standards of accountants have deteriorated and that the interest of users of financial statements and financial reports have been subordinated to the desires of preparers of such reports to present the most favorable picture of the financial status of a reporting entity” (1). The result may be, Larsen adds, fraudulent financial reporting in such forms as these:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared

- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant economic information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure (1).

Whether it be by cute accounting, “stretching the form of accounting standards to the limit, regardless of the substance of the underlying business transactions or events,” or cooking the books, the behavior of many executives has greatly contributed to the enactment of the Sarbanes-Oxley Act of 2002 (Larsen 1).

Even before the enactment of Sarbox, many leaders were concerned with the reliability of financial reporting. In a speech given on September 28, 1998, at the New York University Center for Law and Business, the chairman of the Securities and Exchange Commission, Arthur Levitt, noted the following ominous signs about earnings management:

This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America’s financial reporting system

Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. . . . Managing may be giving way to manipulation; Integrity may be losing out to illusion.

Levitt sees this loss of integrity in the “gray area” of “cutting corners,” and wants reform: I am . . . calling upon a broad spectrum of capital market participants, from corporate management to Wall Street analysts to investors, to stand together and re-energize the touchstone of our financial reporting system: transparency and comparability. (American Accounting Association, para. 4)

Levitt’s list of specific fraudulent tactics is a primer on how to deceive the public. It includes such fudging as “Big Bath Charges,” a tactic of describing operating losses as a result of restructuring rather than poor performance. Another example is “Revenue Recognition,” or overstating financial performance by recognizing revenues before they are earned (para. 4).

Reforming such tactics calls for an informed ethics. According to Mary Beth Armstrong, ethical behavior results from sensitivity, reason, and motivation (5). In other words, business people must identify possible ethical issues, think the situation or issue through, and have the desire to do what is morally correct. The Sarbanes-Oxley Act of 2002 was designed to help ethically challenged business people to acquire such behavior.

According to Chris Scherpenseel, the Sarbanes-Oxley Act is “considered the most critical piece of legislation in corporate governance, financial disclosure, and public accounting since the United State Securities laws of the 1930s” (“New Rules,” para. 2). This landmark act, which is formally known as the Public Company Accounting Reform and Investor Protection Act, was introduced by Senator Paul Sarbanes and Representative Michael Oxley and ratified on June 30, 2002. Experts agree that it is far-reaching in its implications. According to Jim Heskett, transparency, or the “accessibility of information to stakeholders of institutions, regarding matters that affect their interests” will be applied equally to public companies, governmental, non-governmental, not-for-profit, and other organizations (para. 2). Phillip Britt, the author of “Implications of Sarbanes-Oxley,” adds that Sarbox will force organizations to “evaluate, plan and change corporate behavior for years to come” (para. 6).

The accounting industry has its own excesses to blame for the time-consuming provisions of Sarbox. Numerous financial reporting scandals such as the bankruptcies of WorldCom Incorporated, Enron, and Tyco International all led to the development of further legislation to govern public companies. The most well known scandal involved the seventh-largest public company, Houston-based Enron Corporation. According to the University of Pennsylvania's Wharton School of Business, "Enron was able to take enormous risks while keeping shareholders in the dark because it could exploit accounting principles for subsidiaries that are available to most publicly traded companies" ("University" para. 5).

Enron was able to overstate earnings by millions from 1997 through 2000 using a form of cute accounting known as Special Purpose Entities (SPEs) ("University"). Accounting guidelines permit the use of off-the-balance sheet financing as long as the company does not own more than 50 percent or exhibit control of the entity ("University" para. 30). Enron used these entities to keep liabilities off its balance sheet; hence, the company was able to appear as if it was performing much better than it was. However, Enron's creativity could not be concealed forever. Once the company's erroneous reporting was discovered, stock prices plummeted and bankruptcy followed on December 2, 2001 (Knapp 10).

Enron did not commit this scandal alone; the company's aims to misstate financial information were furthered by the accounting firm of Arthur Andersen, LLP. Arthur Andersen was the world's largest professional service organization with more than 1000 partners and operation in various countries worldwide (Knapp 1).

The firm was able to reap many benefits from its relationship with Enron. Not only did the firm audit Enron's financial statements but it also performed consulting services for the company. Andersen was criticized because of the approximately \$52 million in fees it earned from Enron in 2000, only \$25 million came from auditing services (Knapp 18). After its ties with Enron were revealed, the firm lost clients and was forced to lay off employees. In June of 2000, Arthur Andersen was found guilty of obstruction of justice, which, in turn, led to the demise of the organization and thousands of lost jobs for innocent employees (Knapp 22).

In addition to the loss of two powerhouses, the Enron scandal also led to mistrust of investors regarding the reliability of financial information and a need for more regulation of the accounting profession. Hence, Sarbox is specifically harsh in its attempt to regain public trust by ensuring economic decision makers of the reliability of financial information presented by the closely watched publicly-held organizations.

Why does fraud persist? As Arthur Levitt suggests, it does so in part because of the contingent nature of the business world. Accountants are wise enough to know they cannot anticipate every business structure or every new and innovative transaction, so they develop principles that allow for flexibility to adapt to changing circumstances (American Accounting Association). However, the flexibility of accounting principles is one of the primary reasons that fraudulent financial reporting has become common. Ellen Heffes, author of "Former SEC Commissioner Assesses Governance, Sarbanes-Oxley," observes that a move towards a "knowledge-based economy" also made the creation of financial statements discretionary to individual managers (para. 7). In many cases, managers were able to value assets in any manner they desired, often ignoring generally accepted accounting principles (GAAP) (Scherpenseel).

Others also believe that the aforementioned scandals were, in many cases, caused by individuals or groups who were primarily concerned with getting the largest return from their executive compensation plans and/or accounting, consulting, and auditing fees. Employee ownership is a key technique used by organizations to reward employees and to encourage

behavior consistent with the aims and strategies of the organization, but these ownership plans have demonstrated that “reward systems enhance or defeat ethical decision-making” within organizations (Armstrong 5). In too many cases, defeat is the outcome of the system.

Spurred by the profit motive, officials forgot the purpose of the audit, which is to supply external users with an independent view of the reliability of financial information presented by public companies. Audits were seen as a means to revenue rather than a technique to serve the public interest. Increased reliance on consulting and other nonassurance services led to a decline in professional skepticism, or “an attitude that includes a questioning mind and a critical assessment of the audit evidence” (Arens, et al. 137). For these reasons, in the wake of Sarbox, many firms have sold their consulting divisions.

Although Sarbox was designed to improve financial reporting and reduce the reoccurrence of debacles such as those of Enron and Arthur Andersen, the accounting profession and academic observers are divided on the question of whether Sarbox will ultimately have a negative or positive influence on financial reporting.

First among perceived weaknesses, Sarbox, some feel, unnecessarily punishes innocent individuals and companies. Former Securities and Exchange Commissioner Roderick M. Hills believes that the recent scandals should not change one’s view of Corporate America as a whole. He notes that a “dozen or so scandals is not justification for saddling thousands of honorably run companies with the burden[some] ... legislation” (para. 7). Although supportive of Sarbox, current Secretary of the Treasury, John W. Snow, claims that the “system may have become too prosecutorial” (qtd. in Henry 30).

Another perceived weakness of Sarbox involves the financial burden on organizations of all types and sizes trying to implement it. According to Christopher Koch, the author of “The Sarbox Conspiracy,” about \$3 billion dollars was spent on Sarbox compliance in 2003 (3). Furthermore, David Henry notes that compliance will cost an estimated additional \$35 million this year for large companies (28). Heskett adds that for some publicly traded companies, compliance expense can equal up to five percent of income (para. 3). In other words, compliance strains the budgets of complying organizations. Although the cost of satisfying Sarbox’s requirements vary depending on the size and complexity of companies, many smaller firms wishing to go public for either credit or capital purposes are unwilling or unable to do so because of the increased costs of Sarbox compliance (Colsen). Hence, many of these organizations will be forced to merge with other publicly held companies.

A third major weakness of Sarbox is the fact that its benefits are not easily quantifiable (Henry). For example, it is hard to measure exactly how much Sarbox has restored public faith in financial reporting.

Finally, critics of the act claim that many talented executives are fearful of taking on the responsibilities and liability that accompany membership on the board of directors and leadership positions of publicly held companies. Thus, the likelihood of innovative leadership is reduced, and along with it, potential shareholder wealth. Many critics believe that Sarbox limits the profession too much and that it will not last.

Despite the above reservations about Sarbox, its champions point out many benefits.

For example, Roderick Hill, who acknowledges the financial and time burdens of Sarbox, believes that the arduous act will improve financial reporting, and hence, restore the economic decision-maker’s confidence in the fairness of financial information (Heffes). Steven A. Solieri notes that Sarbox “places additional responsibilities on key participants in the financial reporting process, restricts their activities and mandates additional and more time-lay disclosures”

in order to improve financial reporting (“Increasing Confidence,” para. 1). Dennis Callaghan, author of “Sarbanes-Oxley: Road to Compliance,” predicts that the expenses of Sarbox will be overshadowed by higher-quality business processes and a higher-level awareness and controls in the long run, which will in turn lead to higher-quality staff, automation, and processes (“IT’s Role” para. 13).

Another strong aspect of Sarbox is the increased reliability of financial information. Robert Colson writes that the improvement of “accounting principles and auditing standards are fundamental to the infrastructure of the public’s concern about valuation and accountability” (“Public Goods” para. 1). He also believes that Sarbox’s highly visible enforcement of improvements in financial reporting can change the public’s view of the accounting profession and the American business environment (Colson). Sarbox has also “unearthed lingering problems in the ways companies operate,” discoveries which can only better accounting methods and internal controls in the long run (Henry 30).

Sarbox has also greatly contributed to the high demand for accountants and any other individuals who may impact internal controls. Because complying with Sarbox “requires an army of people to do the paperwork,” companies are spending top dollars to accountants and other key personnel (Henry 30).

One of the most important changes made by Sarbox is that chief executive officers, boards of directors and other managers of publicly held companies are finally placing shareholders’ interest at the top of their lists. To ensure this priority, accountability for financial information is no longer placed with one individual but with all members of the organization. Those members who violate the public trust demanded by Sarbox will be punished individually. No longer will the entire organization suffer because of the actions of a few.

In order to see more clearly the positive changes of the Sarbanes-Oxley Act, we must appreciate its reshaping of responsibility across the corporate landscape: accountants, executives, audit committees, and members of the board of directors. Specific guidelines for these groups are the basis for many of the sections of Sarbox.

Chief executive officers and chief financial officers have been given much more responsibility. These officers are now required to certify that information presented in the company’s financial statements is to the best of their knowledge a fair statement of the firm’s financial condition and the results of operations of the organization. These officers are also required to document and express their opinions on the effectiveness of financial reporting and internal controls.

These requirements make it easier to prosecute executives who intentionally report misleading information to external decision makers. CEOs and CFOs must adopt policies and procedures that provide, first, sufficiently detailed records to accurately and fairly reflect the company’s transactions and asset disposals. Secondly, these officers must give reasonable assurance that financial statements are prepared in accordance with generally accepted accounting principles. Further, management and directors need to have properly authorized receipts and expenditures. Finally, companies must install procedures to prevent or detect unauthorized acquisitions and disposals of material assets (Arens, et al. 273).

Sarbox has also had a great effect on the accounting profession, which, as suggested earlier, for years was able to develop its own guidelines for ethical behavior. This is not the case today. As a result of Sarbox, accountants are subject to increased scrutiny.

Although the Securities and Exchange Commission has the ultimate power to make accounting rules and guidelines, it has always allowed the private sector to formulate these

guidelines through the Financial Accounting Standards Board (FASB) (Arens, et al.). However, the FASB is criticized for the length of time it takes for it to develop rules. According to the authors of “Accounting in Crisis,” critics believe that some of the ambiguity in accounting principles such as those concerning SPEs, could have been reduced or eliminated if the FASB had responded with standards in a more timely manner (Byrnes et al.).

Before the Arthur Andersen debacle, the rulemaking body for auditors was the American Institute of Certified Public Accountants, and auditors were expected to abide by the Generally Accepted Auditing Standards (GAAS). Peer review was used to monitor the effectiveness of auditing firms. Although this was supposed to deter and/or eliminate fraudulent behavior, it was not successful. This is evident by the fact that Arthur Andersen successfully passed a review that was conducted by a fellow Big Five firm, Deloitte and Touche (Byrnes et al. para. 8).

Sarbox transformed a self-regulated profession into a highly scrutinized field in which the only constant is change. As Colsen suggests, “Accountancy has developed sufficiently to become part of the national business fabric, subject to regulation like other important national institutions” (para. 1). Arthur Levitt agrees and emphasizes the need for unimpeachable ethical standards: “[Investors] rely on auditors to put something like the good housekeeping seal of approval on the information investors receive. The integrity of that information must take priority over a desire for cost efficiencies or competitive advantage in the audit process” (American Accounting Association para. 1).

With media reports documenting a decline in respect and trust for the accounting profession as a whole, Sarbox established the Public Company Accounting Oversight Board (PCAOB) to “provide oversight for auditors of public companies, including establishing auditing and quality control standards, performing reviews of auditing firms and investigating and disciplining firms [and individuals] that are not following the legislation” (Arens, et al. 32). Members of the PCAOB are appointed and overseen by the SEC. Under the oversight of the PCAOB, public accounting firms that audit more than 100 issuers must be inspected annually (Arens et al 32).

To ensure needed independence from companies for which they work, audit firms are prohibited from providing many of the services that brought trouble in the past, including bookkeeping, financial information systems design and implementation, broker, dealer, or investment advice, and legal and expert services (Arens et al. 83). By providing the aforementioned nonassurance services, the auditors were acting as advocates. Auditors must be independent, meaning that these firms cannot act as “cheerleaders for their clients” (Armstrong 2). As a result of the Sarbox emphasis on audit independence, companies are now required to disclose the amount of audit and non-audit fees paid to the audit firm for the two most recent years (Arens et al. 84). In addition, Sarbox also requires adherence to a number of other independence guide-lines. The managing partners must rotate off the engagement every five years (83). Members of an audit team must wait at least one year before accepting employment positions with previous clients (84).

Sarbox has also provided new opportunities to audit firms. Companies are now able to perform audits of some companies while providing nonassurance services to other firms. For example, KPMG audits Home Depot. KPMG cannot perform advocacy services such as documenting internal controls for Home Depot because the firm must remain independent. However, PricewaterhouseCoopers could perform these services. So, if one firm does not win over a certain client to perform assurance services, it can perform other services for that organization (Arens).

In addition to the independence demanded of external auditors, the audit committee, a “select number of members of a company’s board of directors whose responsibilities include helping auditors remain independent of management” of publicly held companies, is also subject to increased scrutiny (Arens, et al. 84). These committees are forbidden to receive compensation from the firm other than for board service. The most troublesome requirement for audit committees is Sarbox’s requirement that at least one member be a financial expert. These committees are having great difficulties in finding individuals who can be considered financial experts because in all cases the CEO or CFO does not qualify for committee membership due to independence issues. Another important duty of the audit committee is appointing, overseeing and compensating a public accounting firm to perform the company’s financial statement audit (Arens et al 84). These tasks will be monitored much more closely to ensure the committee’s and the external auditor’s independence.

Levitt also notes that “[q]ualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest . . . [T]hey ask tough questions of management and outside auditors; and [create an atmosphere]where, ultimately, the investor interest is being served.” (American Accounting Association, “Strengthening the Audit,” para. 1). In light of this important role, committee membership is yet another duty that has received much more attention and responsibility since Congress’ enactment of Sarbox.

Similar to the audit committee, members of the board of directors are also expected to be as independent as possible. This group is in charge of the appointment of a chief executive officer who is dependable and has a reputation for ethical behavior. In addition, these executives are no longer able to reap favorable conditions through loans from the company, a practice that impairs independence and has been a major factor in recent financial reporting scandals.

Section 404 of Sarbox requires that all public companies issue an ‘internal control report’ that makes management accountable for a control structure as well as proper procedures for financial reporting. It also includes an annual assessment of internal controls (Arens, et al. 271).

As a result of Sarbox implementation, many companies are discovering that their internal controls are insufficient. This finding is not limited to small, unknown companies, but has also been reported in large, well-known organizations such as Ford Motor Company and SunTrust Banks, Incorporated (Henry 30).

The grand effect of the Sarbanes-Oxley Act of 2002 has been to increase the quantity, timeliness, and quality of corporate disclosures.

All organizations, public and nonpublic, for profit and not for profit, must change operations in order to comply with the legislation. Organizations not subject to Sarbox are encouraged to adhere to the procedures in order to demonstrate awareness of the importance of internal controls and proper accounting procedures (Scherpenseel). Companies choosing to implement the legislation in their organizations although it is not yet required will have a jumpstart on legislation bound to trickle down to all organizations, public and private, small and large, profit and not for profit.

An adoption of the policies now can prevent major outlays in the future. These outlays may include fees to go public, fees for correcting or improving controls that could be addressed through an early adoption of Sarbox guidelines. Furthermore, an adoption of the legislation now may pinpoint individuals who do not share in the company’s aims to maximize shareholder wealth in an ethical manner, hence, preventing a loss of public faith and respect for the company due to the selfish actions of some members of the organization.

The Sarbanes-Oxley Act of 2002 was enacted by Congress to prevent future occurrence of the financial reporting scandals and unethical behavior that led to some of the largest bankruptcies and lawsuits in history. Although imposing many inconveniences on all members of organizations, including top management and their subordinates, Sarbox will improve financial reporting and will reassure present and potential investors, creditors, and all other stakeholders of publicly held organizations of the reliability of information presented in financial reports.

The increased regulation offered by Sarbox will also eliminate many of the complaints that accounting and auditing standards are vague and difficult to follow. Auditors now have set guidelines that must be followed. Those that choose not to obey these standards will be punished accordingly. Discipline is fundamental to the enforcement of all rules and that is just what the Sarbanes-Oxley Act of 2002 is designed to achieve.

Corporate America must rededicate itself to restoring its reputation. With a return to integrity and high standards, the bad news of corporate financial reporting scandals that have so frequently been read in newspapers and heard on news broadcasts will become a distant memory, and for the public, the question of corporate ethics will have a more reassuring answer.

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