## Reforming Corporate America

### How does the Sarbanes-Oxley Act impact American business?

By [Larry Bumgardner, JD](http://gbr.pepperdine.edu/author/bumgardner_l/)

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The new law seeks to require greater accountability by management and boards in the reporting of financial data. Will it be enough?

[The Sarbanes-Oxley Act](http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.21&filename=publ204.pdf&directory=/diskb/wais/data/107_cong_public_laws), Congress’ effort last July to respond to corporate scandals and to restore confidence in the stock markets, is off to such a rocky start that one is tempted to ask whether Congress will have to try again to accomplish significant reform.

A study of congressional response to an even worse period of market turmoil, the Crash of 1929 and the subsequent Great Depression, provides some interesting parallels that suggest the job may not yet be complete. After congressional hearings into allegations of corporate fraud in the early 1930s, Congress first passed the Securities Act of 1933. However, that law was viewed as inadequate, and just one year later Congress returned to pass the far more sweeping Securities Exchange Act of 1934.

However, even if Sarbanes-Oxley ultimately proves to be only the first act, it does include a number of provisions requiring changes in how business is done. This is particularly true with regard to auditors and the role of the audit committee.

### Congress’ Initial Response to the Scandals

When the Enron/Andersen scandal first unraveled in late 2001, followed quickly by ImClone, Global Crossing, and similar stories, Congress did very little. Several committees did hold hearings, and a number of bills were introduced to address corporate misconduct. However, the differences between the Senate, under Democratic control at the time, and the House of Representatives and White House, under Republican control, on how to address the problems were so great that no legislation appeared imminent. In fact, it appeared that the corporate reform effort had completely stalled.[[1]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn1)

Then came a second wave of scandals, led by WorldCom and Adelphia in the summer of 2002. As the stock market continued to plummet only a few months before the fall elections, Congress and the White House saw the need for action. This time, Congress rushed to pass the complicated Sarbanes-Oxley Act before the August recess. The previously controversial proposal had suddenly become very popular, passing 99-0 in the Senate and 423-3 in the House. President Bush, who had earlier expressed skepticism about some of the bill’s main provisions, signed the measure into law on July 30.[[2]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn2)

However, implementation of the act did not go as smoothly. One of the most important provisions of the act establishes the Public Company Accounting Oversight Board, designed to prevent auditing abuses such as those seen at Enron. The Securities and Exchange Commission (SEC) was given the responsibility of naming the five members of this new board.

The search for a chairman and members of the new accounting oversight board was led by SEC Chairman Harvey Pitt, who previously had represented the major accounting firms and many large corporations as a highly successful securities lawyer. John Biggs, head of a major pension fund and an advocate for strong accounting oversight, appeared to be the SEC’s initial choice to chair the new board.[[3]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn3)However, after substantial opposition to Biggs surfaced, the SEC apparently changed course.[[4]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn4)

Rather, on a contentious 3-2 vote of the SEC, Pitt and the two other Republican commissioners selected William Webster, a former federal judge and former head of both the CIA and FBI, to be the first chairman. However, Pitt’s staff failed to disclose that Webster himself had been on the audit committee of a nearly insolvent public company whose accounting practices were being investigated by the SEC.[[5]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn5) Within a few weeks, both Pitt and Webster had announced their resignations. The incident embarrassed the SEC and marred the reputation of the new accounting oversight board before it was even officially in business.[[6]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn6)

### Major Provisions of Sarbanes-Oxley

The Sarbanes-Oxley Act set the broad outlines for reform, but left it to the SEC to provide many of the details by regulation. [(Check the SEC “Final Rules” website.)](http://www.sec.gov/rules/final.shtml) The majority of these regulations were adopted in late January, although some have delayed effective dates.[[7]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn7)The rule-making process was the subject of heavy lobbying by the interest groups most affected.[[8]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn8) The following is a broad overview of some key requirements of the law and the rules. (These are provided only to alert the reader to general issues of concern. They do not constitute legal advice.)

**Restrictions on Auditors**

Once the accounting board begins operation, its job will be to register, oversee, investigate, and discipline all accounting firms that audit public companies. The new law also instructs the board to set auditing standards to be used by these accounting firms — a crucial point if auditors are going to be more successful in uncovering future efforts at corporate fraud.

Sarbanes-Oxley also imposes new auditor independence standards in response to concerns that Andersen’s audits of Enron may have been compromised by the fact that the accounting firm was earning more from Enron for consulting services than for auditing. An auditor is prohibited from “contemporaneously” providing a public company auditing client with the following specific types of consulting or other non-audit services:

* Bookkeeping or other services related to the accounting records or financial statements of the audit client;
* Financial information systems design and implementation;
* Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
* Actuarial services;
* Internal audit outsourcing services;
* Management functions or human resources;
* Broker or dealer, investment adviser, or investment banking services;
* Legal services and expert services unrelated to the audit;
* Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

However, the exceptions could prove to swallow the rule, as Congress chose not to impose a complete ban on consulting services. Under the new law, an auditor still can provide its audit client with tax services and any other services not specifically precluded in the act, so long as the company’s audit committee approves that work in advance. Further, the oversight board has the authority in specific cases to grant exemptions that would allow an auditor to perform even any of the prohibited non-audit services.

The SEC regulations also require both the lead and concurring audit partners for any client company to rotate off of that client’s audit after five years, with a five-year time-out before they can return to audit that company. Other audit partners are subject to a seven-year limit with a two-year time-out. Smaller audit firms with five or fewer public audit clients and ten or fewer partners are not subject to the rotation requirements, but any work that would otherwise be barred by the rotation rules must be reviewed by the oversight board every three years. Once again, though, Congress and the SEC stopped short of more drastic measures, such as a proposal for mandatory rotation of entire auditing firms, rather than merely partners in such firms.

**Audit Committee**

Auditors are not the only targets of Sarbanes-Oxley, as the act also includes a broad range of provisions dealing with corporate governance. The audit committee of the board of directors at any public company gains new power and responsibilities, and there are more safeguards to ensure that audit committee members are not controlled by top management. Audit committees now must pre-approve numerous audit and non-audit services, although in many instances they may do so by putting in place policies and procedures to be followed rather than actually reviewing each decision. Auditors must communicate to the audit committee all “critical accounting policies” and any discussions of “material accounting alternatives” that may affect how results are reported.

**Officers and Directors**

CEOs and CFOs of public companies are required to personally certify the accuracy of various financial reports, with significant criminal penalties for false certifications (up to 10 years in prison for “knowing” violations; up to 20 years if “willful”). While the penalties sound significant, the government’s difficulty in enforcing this provision will likely come in proving that a corporate officer’s inaccurate certification was done at least “knowingly,” as opposed to negligently or even recklessly.

In addition, if a public company makes a “required” accounting restatement due to “misconduct,” that company’s CEO and CFO can be forced to forfeit any bonuses or profits gained from selling company stock for a one-year period. But the lack of definitions for the terms “required” and “misconduct,” other potential loopholes, and the SEC’s power to grant exemptions could combine to dilute the strength of this provision.

The new law makes it somewhat easier for the government to prohibit officers and directors who have committed securities law violations from ever again serving in those positions. However, that potential sanction was at least theoretically available even before passage of Sarbanes-Oxley.

**Disclosure Requirements**

A number of provisions add to or strengthen disclosure requirements placed on public companies. All material off-balance sheet transactions or special purpose entities must be disclosed in annual and quarterly financial reports. If a company uses pro forma numbers in its financial reports or press releases, it must also show what the financial results would be using generally accepted accounting principles. Legal insider trading by company officers or directors must be reported much sooner, within two business days. Other material changes to a company’s financial condition must be reported on a “rapid and current basis.” Even the presence or absence of a company ethics code for its senior financial officers, or any waiver of that code, must be disclosed.

**Criminal Penalties**

In theory, the crime and punishment section appears to be one of the law’s tougher provisions. It creates new or broader federal crimes for obstruction of justice and securities fraud, with maximum prison time of 20 or 25 years, respectively. Sentences for many existing federal crimes were enhanced. Mail and wire fraud maximum penalties were quadrupled, from 5 to 20 years. The maximum sentence for some securities law violations was doubled from 10 to 20 years, and the maximum fine against a company for the same offense was increased from $2.5 million to $25 million.

Furthermore, the U.S. Sentencing Commission, which sets guidelines that federal judges must use in deciding a particular defendant’s actual sentence, is instructed to consider revising its guidelines to ensure longer sentences for securities, pension, and accounting fraud, especially for officers and directors of public companies. The Sentencing Commission has already adopted a temporary plan to respond to Congress’ directive, with many actual sentences likely to increase by at least 25 percent. However, the Justice Department has objected to the temporary guidelines, saying they do not adequately enhance the sentences in smaller-scale fraud cases.[[9]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn9)

In practice, the strength of the criminal penalties portion of Sarbanes-Oxley will depend on the government’s success in prosecuting specific individuals. The statute’s harsher penalties, of course, cannot be used for any crimes that occurred before the new law was passed. If corporate officers considered to be the prime culprits in the scandals of the past year ultimately serve little or no prison time, the deterrence effect of the tough penalties may prove to be minimal.

### Historical Precedent?

One certainly hopes that the Sarbanes-Oxley Act will accomplish its purpose and deter corporate fraud. However, skeptics note that Congress left many things undone in passing the law.[[10]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn10)With the accounting oversight board still not in full operation, it may be some time before the statute’s effect can be thoroughly assessed. Ultimately, if the law is found to be lacking, Congress may need to recall its response to a prior market crisis.

While no one claims that the severe bear market of 2000-02 is as bad as the Crash of 1929 and the Great Depression, the past three years have seen the worst stock market performance since the 1930s. Moreover, Sarbanes-Oxley has been called the most significant corporate reform legislation since the Depression.[[11]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn11)

**The Scandalous 20′s**

The 1929 Crash came after a remarkable rise in stock prices during much of the 1920s, similar to the bull market of the 1990s. After the Crash, many members of Congress introduced bills to provide for federal regulation of the securities markets, since most securities legislation then came from the states. Extensive congressional investigations followed in 1931 and 1932. The Senate Banking Committee’s hearings included reports of payments to publicists intended to inflate stock prices, of family members of corporate insiders profiting from trading in their own company’s stock, and of various other efforts to manipulate the market and specific stock prices.[[12]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn12) Nevertheless, no legislation was passed until after the 1932 election, when Franklin Roosevelt became president and Democrats gained strong majorities in both houses of Congress.

As congressional hearings resumed after the election, there were yet more revelations strikingly similar to those heard in 2002. The 1933 testimony dealt with high salaries and interest-free loans for corporate executives, various tax avoidance schemes, and an investment bank allowing politicians and corporate executives to make quick profits by being sold stocks at low prices before the companies went public.[[13]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn13)

**The Legislative Response**

Ultimately, these hearings and the strong backing of President Roosevelt led to the passage of the Securities Act of 1933. Although landmark legislation at the time, the 1933 act was actually rather limited in its scope due to compromises in the legislative process and an initial decision by Roosevelt not to seek more far-reaching regulatory power.[[14]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn14)As a result, the 1933 law applied only to the issuance of new securities. It did nothing to regulate already issued securities or stock exchanges.

It soon became apparent to many that the first securities act had not done enough. With far more controversy and opposition, Congress passed the Securities Exchange Act the following year. This much broader law, which remains today as the bulwark of most securities regulation, gave the federal government the additional authority to regulate stock markets and all securities.

The 1934 act also required that public companies make continuing disclosures of important information and allowed the government to prosecute any manipulation of the market. Finally, it created the Securities and Exchange Commission. Roosevelt’s choice to be the first SEC chairman was Joseph Kennedy, father of President John Kennedy. In yet another ironic parallel to 2002, Kennedy was criticized for being tied to the manipulative practices that the SEC was intended to stop, just as Harvey Pitt was viewed as being too close to the accounting industry to be a serious watchdog.

### Will The Parallels Continue?

Will Congress conclude that the Sarbanes-Oxley Act alone is inadequate and decide to pass more corporate reform legislation? For the short term, Congress is not likely to change Sarbanes-Oxley, other than making some technical corrections to clear up ambiguities. But many observers question if Sarbanes-Oxley in its present form will be sufficient to deter corporate malfeasance.[[15]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_edn15) If shortcomings of the 2002 law become apparent, or if more corporate scandals are unearthed in the next few years, Congress may feel compelled to do much more to deter corporate fraud. There is a precedent.

[[1]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref1) Stephen Labaton and Richard A. Oppel, Jr., “Enthusiasm Waning in Congress for Tougher Post-Enron Controls,” NY Times, June 10, 2002, p. A1. 2\_Elisabeth Bumiller, “Bush Signs Bill Aimed at Fraud in Corporations,” NY Times, July 31, 2002, p. A2.

[[3]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref3) Stephen Labaton, “Chief of Big Pension Plan Is Choice for Accounting Board,” NY Times, Oct. 1, 2002, p. C4.

[[4]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref4) Michael Schroeder and Cassell Bryan-Low, “GOP Objects to Biggs to Run Oversight Board,” Wall Street Journal, Oct. 2, 2002, p. C12.

[[5]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref5) Kathleen Day, “Agency Faults SEC on Handling of Audit Panel,” Washington Post, Dec. 20, 2002, p. E1.

[[6]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref6) In December President Bush nominated William Donaldson, co-founder of an investment banking firm and a former dean of the Yale School of Management, to replace Pitt. He was confirmed by the Senate in February. He has said that his first job will be to select a new permanent chair of the accounting oversight board.

[[7]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref7) The SEC must still finalize more regulations, and there are unresolved issues remaining. Most notably, the SEC postponed final action on the [“noisy withdrawal” rule](http://www.sec.gov/rules/final/33-8185.htm) for outside attorneys. Sarbanes-Oxley requires that an attorney who discovers evidence of a material violation of securities laws or breach of fiduciary duty inside a company must report it to senior management. The SEC had proposed that in addition, if management or the board did not take corrective action, the attorney would have to resign and notify the SEC that he or she had done so “for professional reasons.” Attorneys have argued that this would violate attorney-client confidentiality.

[[8]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref8) Anonymous, [“Lawyers and Accountants Can Expect Curbs and Compromises in New SEC Rules,” Knowledge@Wharton](http://knowledge.wharton.upenn.edu/articles.cfm?catid=1&articleid=707&homepage=yes) (You must register with Knowledge@Wharton to access this article. Registration is free); Dan Ackman, [“SEC’s New Rules Are Snoozers,” Forbes.com](http://www.forbes.com/2003/01/24/cx_da_0124topnews_print.html); Anonymous, “Finance and Economics: Wishy-washy; The Sarbanes-Oxley Act,” The Economist, 366 (8309), Feb. 1, 2003; Kathleen Pender, “Investor Advocates Grade SEC,” San Francisco Chronicle, Jan. 26, 2003, p. G1.

[[9]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref9) Eric Lichtblau, “Panel Clears Harsher Terms in Corporate Crime Cases,” NY Times, Jan. 1, 2003, p. C1.

[[10]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref10) Stephen Labaton, “Will Reforms With Few Teeth Be Able to Bite?” NY Times, Sept. 22, 2002, Section 3, p. 4.

[[11]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref11) Anonymous, “Setting the Rules,” The Economist.com/Global Agenda, London, Jan. 24, 2003.

[[12]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref12) Joel Seligman, The Transformation of Wall Street, NY:Houghton Mifflin, 1982 p. 16-17. Ibid., p. 25-26, 34.

[[13]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref13) Ibid., pp. 25-26, 34

[[14]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref14) Michael E. Parrish, Securities Regulation and the New Deal, Princeton: Yale University Press, 1970 p. 72.

[[15]](http://gbr.pepperdine.edu/2010/08/reforming-corporate-america/%22%20%5Cl%20%22_ednref15) Pender, 2003; The Economist, Jan. 24, 2003; Knowledge@Wharton.

### About the Author(s)

[Larry Bumgardner, JD](http://gbr.pepperdine.edu/index.php/author/bumgardner_l/), is an associate professor of business law at Pepperdine University's Graziadio School of Business and Management. Previously, he served as executive director of the Ronald Reagan Presidential Foundation and the Reagan Center for Public Affairs in Simi Valley, California. A graduate of Vanderbilt University School of Law, he has also taught political science, public policy, and communications courses at Pepperdine.