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Sarbanes Oxley: An Antidote To Executive Greed?

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INTRODUCTION

Since the initial separation of corporate ownership from corporate management, the abuse of power by management has been a concern. Early in the last century a small number of Industrialists owned and controlled the major corporations. Slowly, as these individuals aged and retired, their vast holdings were transferred to a large number of decedents who were, for the most part, disinterested in managing the firms in which they held an ownership share. The shareholders relied on experienced managers to direct their corporations. This transfer of power gave rise to agency problems wherein the agent of the organization (manager) is likely to place their own interest above those of the actual owners of the firm. There is a vast body of literature addressing the issues of agency problems and clearly defined Agency Theory to which the majority of scholars subscribe (Van Ness, Miesing, and Kang, 2009)

The original attempt to create an antidote to agency problems was the formation of corporate boards of directors (Van Ness and Seifert, 2007). These directors were given the legal authority to oversee executive decision-making and strategic actions. Nevertheless, they have demonstrated a lack of enthusiasm or motivation to effectively oversee management decisions and actions. Proactive boards, those that are conscientious about their fiduciary responsibilities and fulfill them, effectively represent a small minority of corporate boards. On the other hand, sedate boards, those that inadvertently enable executive excess, represent the vast majority of boards (Van Ness and Seifert, 2007).

The United States congress deliberated the issues of carelessness, excesses, and greed within the business community and as an antidote to the problem, introduced the Sarbanes-Oxley Act. The Sarbanes-Oxley Act takes a stringent approach on the criminalization of white-collar crime and the prevention of financial distress and scandals within public companies and public accounting firms. The Act has been criticized as excessively intrusive, too expensive to implement, and ineffective. Nevertheless, others believe it may be the last best hope for stemming the tide of careless corporate decision-making, management excesses, and executive greed.

UNETHICAL BEHAVIOR WITHIN CORPORATIONS

Corporate executives associated with scandals often act with arrogance and frequently portray a sense of invincibility. This sense of invincibility has resulted in some of the most astonishing "cover up" fraud in the history of corporate America over the past several decades involving such high-profile companies as Enron, Tyco, WorldCom, and Arthur Andersen (Giroux, 2008). Decisions and courses of action taken by executives acting in unethical ways resulted in the collapse of companies, the loss of jobs, pensions, and life savings of both employees and investors. Common themes of the companies involved included the executives' expectations of being capable enough to escape repercussions and their desire to manipulate earnings (Giroux, 2008).

In 2001, the Enron scandal took the world by storm. Enron was one of the world's largest companies at the time. The company had over 22,000 employees and revenues of over $100 billion in 2000. The company collapsed in 2001 after an accounting scandal was uncovered involving auditor Arthur Andersen and senior executives. The scandal involved a corrupt company in various different aspects. The misleading, publicly released financial statements masked liabilities and debts through offshore accounts and misstated assets and profits. The company deceived the public, investors and employees to appear more fiscally sound then the reality. Rockness describes the path that Enron and its employees followed as one that began with slight accounting adjustments that eventually developed into accounting fraud. He cited personal, gain, ego and survival as possible motivation for employees involved (Rockness and Rockness, 2005).

Along with accounting fraud, the investigation further revealed unethical behavior within the executives of the firm. "These big companies will topple over from their own weight", stated Jeffrey Skilling, former Chief Executive Officer of Enron. Fearless of competitors, this quotation accurately portrays the atmosphere of arrogance at the top of the organization. Enron executives had large expense accounts and were compensated far beyond competitors within the industry. Over his 17 years with Enron Chief Executive Officer Kenneth Lay received over $250 million in compensation from the company (Sloan, Rust, Naughton, Ordonez, and Ganeles, 2006). The arrogant culture of Enron was aided by a two year increase in revenue of almost $70 billion from 1998 to 2000. The statistics supported the attitude of the executives. Executive compensation within Enron's energy services division was established by a market valuation formula that was influenced by internal estimates. According to a former executive, this created a pressure to inflate contracts despite having no effect on the generation of cash. Jeffrey Skilling was also responsible for instituting a policy in which employees ranked in the bottom 20% of the company were forced to leave. This atmosphere created competition internally and in many cases caused workers to overlook potential errors and mistakes (Mclean, Varchaver, Helyar, Revell, and Sung, 2001).

It was difficult for employees to notice and actively try to blow the whistle on fraud internally, within the atmosphere that Enron created. This is evident with the treatment of a former Vice President, Sherron Watkins who attempted to bring the accounting situation to the attention of upper management. She attempted to inform Kenneth Lay of "an elaborate accounting hoax", before the company went under. In response to her actions, Watkins was demoted 33 floors from an executive suite to an older office (Morse and Bower, 2003). The tyrannical actions of the Chief Executive Officer included the confiscation of her hard drive and work materials. During her testimony to Congress, a letter was released dated two days after Watkins meeting with Lay, that discussed the possibility of her termination (Morse and Bower, 2003). The actions of Sherron Watkins are inspiring to combatants of corporate fraud, yet the results are discouraging. Instead of being rewarded, and attempting to fix the problem at hand, Enron and Lay pushed her away to further mask accounting inaccuracies.

Arthur Andersen was the independent auditor responsible for the financial statement audit of Enron. At the time there was no significant legislation in place that separated the limits of public accounting firms and their duties to clients. Enron was both an audit and consulting client of Arthur Andersen. This conflict of interests along with fears that the revenue received from the consulting practice could be in jeopardy, contributed to the lackadaisical standards to which the auditor conducted its business. Sherron Watkins consulted a former Andersen employee before contacting Kenneth Lay. After the Enron scandal there was documentation by Andersen employees that showed skepticism with retaining the company as a client due to its accounting procedures and inaccuracies but actions were never taken (Sloan, Isifoff, Hosenball, and Thomas, 2002). The downfall of Enron led directly to the downfall of Arthur Andersen. Arthur Andersen was one of the largest public accounting firms of the time period and one scandal contributed to its demise. After an investigation was made public, the company tried to cover it up by shredding and deleting thousands of documents (Barron, L.M., 2009).

Public accounting firms such as Arthur Andersen are responsible for the independent financial statement audit. The objective of the audit is to examine the financial statements of the company and ensure that they are in accordance with Generally Accepted Accounting Principles (GAAP) through the use of Generally Accepted Auditing Standards (GAAS). The importance of client independence is shown with the hiring of a separate company to prepare and audit already existing financial statements. The accuracy of these financial statements is a foundation for the confidence of all stakeholders and is guaranteed by the audit. It is a direct contribution to investor confidence and must achieve "reasonable assurance" in its accuracy (Kueppers and Sullivan, 2010). Auditors from Arthur Andersen along with the internal accounting department within Enron exploited weaknesses in GAAP to find loopholes and use tactics to disguise credit risks and mask the financial problems of the company. Manipulations in accounting created approximately 3,000 special purpose entities in order to move debt off of the balance sheet. The accounting of hedge and derivative transactions was inaccurate along with the disclosure and lack of disclosure of related party transactions (Rockness and Rockness, 2005). The corruption of one company spread to the company whose purpose is to protect and ensure the integrity of the other. The release of financial statements of all companies', especially public ones is an extremely important task. The integrity of these financials is of crucial importance to investors and global markets. The audited financial statements of a company are the authority for reliable information regarding fiscal stability.

Enron and WorldCom were the two largest scandals in the history of the United States but both scandals executed fraud using different methods. Enron used the complication of complex financial instruments to disguise fraud while WorldCom simply capitalized billions of dollars of operating expenses (Giroux, 2008). Similar to Enron, Andersen was the independent auditor of WorldCom until KPMG took over the duties. Despite the appearance of sound financial statements in the 2001 annual report, investigation found an accounting error of almost $4 billion due in part to the double counting of revenue (Giroux, 2008). Tyco was another famous scandal that illustrated unethical behavior by a corporation. The conglomerate participated in accounting fraud through the financial statements of the multiple companies acquisitioned. Chief executive officer Dennis Kozlowski was also charged with lending himself noninterest loans from the company (Giroux, 2008). Enron, WorldCom and Tyco are just a few examples of corporations that have partaken in unethical behaviors. Although these scandals have been highly publicized through various media outlets, the frequency of occurrences of unethical practices and corruption within organizations is unidentifiable and difficult to measure.

THE SARBANES-OXLEY ACT OF 2002

The government of the United States of America has played an historical role in regulating facets of the economy and business sector. This was evident in the late 19th and early 20th century. Industrialization created a boom in business and commerce. The era was highlighted by the monopolistic, industrial companies built by Carnegie, Rockefeller and Vanderbilt in steel, oil and railroads, respectively. Technology created a growth in the economy that caused several consequences. The time period included a growth in transportation with an increase of railroad miles from 30,000 in 1860 to 250,000 in 1916 along with a population boom in America from 4 million in 1790 to 31 million 1860 to 106 million in 1920 (Blackford, 2010, 10). The Industrial Revolution brought about a need for government involvement. Since the nature of the economic boom was sudden, the government tried to regulate this growth. This regulation included the Interstate Commerce Act, introducing the Interstate Commerce Commission (ICC) to regulate transportation industries, the Meat Inspection Act (1906), the Pure Food and Drug Act (1906) introducing the Food and Drug Administration, the Federal Reserve Act (1913) introducing the Federal Reserve System (Blackford, 2010). Similar to today, economic growth led to governmental intrusion and legislation such as the Sherman Antitrust Act. The application of this act is prevalent in America today and has affected major corporations including Microsoft, and The National Football League. The important facet of the Act was not to abolish the existence of big companies but to make sure they grew to their sizes and potential through "reasonable" means. The act was a response to the American Tobacco and Standard Oil Company whose methods for growth were deemed as unreasonable (Blackford, 2010).

In a parallel situation, the United States government was faced with accounting scandals involving Enron, WorldCom and Arthur Andersen. The need for government regulation became evident and The Sarbanes-Oxley Act of 2002 was a result. On July 30, 2002, President Bush signed the act into legislation of which he described, "Today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. This new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law"(Bush, 2002). The act legislated reforms that promote corporate responsibility, improve financial disclosures and hinder corporate and accounting fraud. The law birthed the PCAOB, or Public Company Accounting Oversight Board to regulate and safeguard auditing professionals and firms (SEC).

The Sarbanes–Oxley Act of 2002 was introduced to help enforce financial regulation and strengthen the guidelines by which companies and public accounting firms practice. One of the main facets of the legislation is to directly combat the conflict of interest scenario that occurred when Arthur Andersen was responsible for both consulting and audit functions for Enron. After the passage of Sarbanes–Oxley public accounting firms cannot offer different services to the same client. Clients are rather forced to utilize different firms for advisory, audit and tax procedures. This facet of Sarbanes–Oxley is a crucial one that directly combats careless auditing practices.

Another crucial aspect of Sabanes-Oxley was the White-Collar Crime Penalty Enhancement Act of 2002 which strengthened penalties for different types of fraud (Harvard Law Review, 2009). The act allows the government and regulatory bodies to have stricter penalties and guidelines for executives and boards that commit these crimes. Before Sarbanes–Oxley sentences and penalties for white–collar crimes were flexible and lenient and fell on the shoulders of different governing bodies. The legislation quadrupled the maximum sentences for mail and wire fraud (common types of fraud) and further criminalized actions that beforehand were previously overseen by regulatory agencies (Harvard Law Review, 2009). The hope of the legislation was that criminalizing behaviors pertaining to white-collar crime would be an effective deterrent. The problem with many cases of corporate fraud and scandals was a lack of fear of repercussion and prosecution by the individuals and firms involved.

SARBANES-OXLEY AND ITS' RAMIFICATIONS

The introduction of legislation as substantial as The Sarbanes-Oxley Act of 2002 had various implications that extended beyond the desired results. The effectiveness of this Act has been examined through a range of publications from varying perspectives. The Act was implemented out of necessity but the ramifications have affected firms and individuals in several ways. One of the results has included a dedication of firms' internal audit resources to compliance of the legislation (Schneider, 2008). Sarbanes–Oxley caused companies to devote time, money and resources to compliance issues. Internal audit departments within companies have significantly felt the impact. The Sarbanes–Oxley Act of 2002 has affected the functions for internal auditors in their work pertaining to external audits of internal controls and has expanded their roles in serving audit committees and top corporate management (Schneider, 2008). Schneider goes on to discuss various surveys to qualify the effect of Sarbanes–Oxley on internal audit departments. These surveys involved companies in the years from 2005 – 2007. In a 2005 survey involving 117 companies, the Chief internal audit executives stated their budgets planned for Sarbanes–Oxley work. 22% of the companies stated that over half of their budgets were scheduled for this type of compliance. In another 2005 survey involving 270 companies, almost 60% of the involved subjects also used half or more of their internal audit resources for Sarbanes–Oxley work. In 2007, a study of 717 internal audit managers showed a slight decrease to 41%. These studies illustrate remarkable statistics. Internal audit departments, which have been a part of companies and corporations before the introduction of Sarbanes-Oxley are now dedicating much of their resources solely for these compliance issues. The importance of the Sarbanes–Oxley Act has become evident to companies.

The increase in the burden on internal audit departments correlates to a need for more resources including professionals with knowledge and education of the compliance of Sarbanes–Oxley (Schneider, 2008). Externally, the legislation and accounting scandals have directly contributed to a rise in the need for accounting professionals within the government, regulatory bodies and public accounting firms. A report by Inc.com states the increase in auditing and reporting procedures has caused a shortage in qualified accountants and that the prices for "Sarbanes-generated" audits have raised 30-50 percent (Hyman, 2011). The new legislation increased the need for recent college graduates who are educated within their accounting courses and programs on the Act. According to the Bureau Of Labor Statistics, the job market for accountants and auditors is expected to grow significantly by 22% and create approximately 280,000 jobs from 2008-2018 (Velshi, 2011). The increasing complexity of the financial world (Velshi, 2011) and rise in accounting fraud are reasons behind this increase. The need for qualified professionals is a response to Sarbanes–Oxley.

Sarbanes-Oxley has caused foreign companies to be hesitant to list securities in the United States and caused domestic companies to remain in the private market (Fanto, 2008). The Act applies to all issuers including foreign private issuers that have registered securities under the United States Securities Exchange Act of 1934, that are required to file reports under Section 15 (d) of the Exchange Act, and that have filed a registration statement under the United States Securities act of 1933 (Cohen and Brodsky, 2004). These foreign companies have been directly affected by Sarbanes-Oxley. The compliance issues that arise from following such a strong piece of legislation can prove to be costly and a direct deterrent for foreign investment and involvement within the domestic market. Since the establishment of the Public Companies Accounting Oversight Board, the same cost-benefit analysis is being made by private companies considering a public offering. The private sector is not affected by Sarbanes-Oxley and thus saves money and resources necessary to deal with its compliance.

The increased criminalization crackdown on white-collar crime has introduced an era of executives being brought to justice via the United States Justice system. These increased penalties, and prevalent court proceedings, are leaving the sentencing ofthe violators of the White-Collar Crime Penalty Act to the discretion of the presiding judge rather than a uniform system (Harvard Law

Review, 2009). The author argues that in response to Sarbanes-Oxley and the WCCPA judges have reacted to the stronger sentences by disregarding Federal Sentencing Guidelines. A disparity has been created with the sentencing of this type of criminal and it is diminishing the effect of Sarbanes-Oxley and the WCCPA as a deterrent of white-collar crime. It has created the need for Congress to intervene and impose a uniform sentencing system applicable to all violators of the legislation (Harvard Law Review, 2009). In many cases of white-collar crime, few executives come to trial but rather enter guilty pleas, becoming cooperating witnesses assisting the government in building cases against their former friends and coworkers (Brickley, 2006). In her analysis Brickley, studied the proceedings and cases of many executives indicted on varying white-collar offenses. In one study between March 2002 and July 2004, 87 defendants' charges were resolved but the percentage determined by a jury verdict was just 10. The rest were all entered into plea agreements. These results can be contributed to usual multiple defendant prosecution techniques utilized by the government (Brickley, 2006) or a reflection of the character of the individuals involved. The defendants' eagerness to benefit themselves at the expense of another directly illustrates the reason they are in the criminal proceeding in the first place.

CONCLUSION

The Sarbanes-Oxley Act of 2002 is a landmark legislative representation, born out of necessity to curb executive greed and establish preventative measures against the downfall of American corporations through accounting scandals that send resonating effects through the whole economy. The recession of the 2000s, illustrates the results of the demise of major corporations due to fraud and lackadaisical regulation and restriction by governing agencies. As with most pieces of legislation, there are advocates and critics whose sides both have evidence to support their cases. Despite the varying effects of Sarbanes-Oxley and the stringent policies and resources it is costing domestic and foreign companies, the social value of the Act is the prevailing factor (Fanto, 2007,08). The law is designed to successfully curtail the atmosphere of arrogance and invincibility illustrated by the officers and directors of Wall Street before the Sarbanes–Oxley implementation. Increased criminal liabilities prevent executives from placing blame solely on employees below their pay grades and rank (Fanto, 2008). The days of blatant passiveness to fraud and misstatements in accounting procedures are slowly coming to an end, and Sarbanes-Oxley is responsible. The reaches of this milestone legislation, offset the fiscal burden it has placed on companies.

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