SOX in the boardroom: The impact of Sarbanes-Oxley 2002 on the corporate reporting of the Fortune Fifty

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Background of Sarbanes-Oxley 2002

Out of the ashes of Enron arose Sarbanes-Oxley 2002. Enron began as a small gas pipeline company and quickly rose into corporate prominence, at one time reaching as high as seventh on the Fortune Fifty. While it is possible for companies to reach great heights in small amounts of time and do so legally, Enron chose the quickest path regardless of consequences. Often in the corporate world individuals in positions of power will take the risk that any financial reporting fraud they may engineer will never be discovered. In the 1970s and 1980s great emphasis was placed on a company's stock price. Stock began directly correlating to the chief executive officer's salary through a complicated system of executive stock compensation plans. These plans were of added financial benefit to the company, at least on paper, because most companies did not expense stock options.

Also during this time analysts as well as investors demanded that a company's earnings rise steadily, in a predictable straight line. Any deviation, no matter how insignificant, would cause the stock prices to change. Growth in a straight line is virtually impossible; no company grows in constant increments. Another important element to remember when talking about corporations not meeting profit expectations is the executive's ego. The 90s created star-like executives, complete with private jets and Hollywood parties. Executives began to compete with each other with respect to personal income and perks. Improvement in corporate stock value led to increased social standing for the executives. Outside pressures along with the fear of failure can easily persuade a CEO to be creative with financial numbers. Enron created several off balance sheet financial agreements, which allowed the company to overstate revenues as well as to understate expenses and liabilities. Merrill Lynch has recently pled guilty to assisting in establishing a deal in which Enron was to sell their financial holdings in a company but Enron actually put up most of the money themselves, taking almost no money from the other company. This allowed the company to create a false sale and a fake profit. While it is easy to see where Enron began to collapse and even easier to see where to place the blame, it is difficult to place blame on just certain individuals in a single company when similar situations began popping up in corporations across the USA.

Geofferey Colvin offers criteria that lead to companies committing fraudulent acts. "The first element is a baby company's culture in a giant company's body. One of the most difficult phases in every company's life is growing from one person's reflection into an institution of its own"(Colvin, 2003). This situation refers to an entrepreneur who refuses to let the company expand to its own entity. Whenever something is to be done it must either originate with the original owner or be approved by the CEO. This creates an atmosphere in which employees do not feel able to approach the CEO about a possible idea or criticism. Outside auditors also seem to have an issue standing up to the executive.

"The second element is personal greed, exquisitely disguised as a sense of entitlement. The founders and many others at these companies believed deeply that they deserved everything they got, regardless of how they got it, because they had created their success"(Colvin, 2003). Corporations of today are being run by individuals, many of whom consider themselves to be of an intelligence far surpassing any normal individual. Executive greed was enhanced by the reliance of corporate Board of Directors on huge stock option compensation packages. These powerful individuals saw the company as their personal finance tool, to be used in any way at their discretion.

> "The third element is slavery to the Wall Street expectations machine. All these companies achieved huge valuations during the bubble, often trading at giant multiples. In such cases it takes only a quiver in underlying earnings to bring the stock price tumbling. So the standing order for executives within these companies was to make their number and meet Wall Street's expectations at all costs, especially because these founder CEOs would lose tons of personal wealth—to which they were entitled! —if the stock fell" (Colvin, 2003).

The company became tied to the CEO's ego and sense of personal pride. If the CEO felt underpaid, well then he or she would have to create a boost in stock prices to raise their compensation worth; if the company's numbers became questionable, then the CEO would alter them in order to save face.

It is important to note that just as author Colvin states, none of these criteria alone has the power to create a corporate crisis such as the one we find our business world involved in but that all three in combination must be present.

Thus it seems simple to boil down the cause of the corporate turmoil to issues concerning corporate governance. Management of a company has a fiduciary duty to the investors. A fiduciary duty involves looking out for the best interests of another party as well as making decisions that increase their well-being. Remember that this is not the first time in history when investor confidence has been shattered. There are a number of issues in the disaster that is corporate governance that have led directly to this immediate crisis. Jorge Guerra gives a listing of the more common problems associated with corporate governance:

> "executive compensation grossly disproportionate to corporate results, stock promotion that has gone to an extreme in the creation of very questionable or unproven business concepts, misuse of corporate funds, trading on insider information, particularly by managers exercising stock options that have been rewarded short-term thinking, misrepresentation of the true earnings and financial condition of too many companies, and obstruction of justice by concealing activities or destroying evidence"(Guerra, 2003).

It is easy to look through this list and find corporations in which a number of these problems existed and led to the company's ultimate demise. Enron was plagued by executive stock compensation, which eventually led to the leaders of the corporation selling their stock before the dissolution of the company while forcing employees to retain their shares eventually resulting in massive losses of retirement funds.

Other companies also had problems with excessive executive compensation and perks. Let us not forget about the very expensive shower curtain, which furnished the housekeeper's bathroom, as well as the birthday party thrown for the executive's wife featuring a live performance by Jimmy Buffet, all paid for out of Tyco's business funds. It is important to realize that while the stock compensation and executive perks exposed by the financial woes of companies the size of Enron and Tyco may seem to be recent developments, the potential for these misuses of corporate power and funds is long-standing. Seventy years ago, in the aftermath of the stock market crash, two researchers wrote about the danger of managers of large corporations being in a position to act in their own best interests, regardless of whether those interests are aligned with the best interests of the stockholders. These researchers warned against a situation in which the shareholders who own the company cannot adequately control the agents who manage their property and warned that this was a danger of dispersion of ownership (Stelzer, 2004).

With blatant disregard for corporate ethics as well as the investing public occurring more frequently and with greater consequences, the government recognized that they must act quickly. Through the darkness and fog of corporate disillusionment came Sarbanes-Oxley. Two different bills were circulating through the House and the Senate after the economic earthquakes of the later part of 2002. However, it quickly became apparent the corporate turmoil was far from over and the politicians realized that something needed to be done quickly and a unified message needed to be sent. The two bills merged into Sarbanes-Oxley (referred to as SOX) and was quickly passed by the House of Representatives and the Senate. William Donaldson, the SEC Chairman, states that SOX "has been heralded by government officials as the most important securities legislation since the original federal securities laws of the 1930s, and it has effected a dramatic change across the corporate landscape to reestablish investor confidence in the integrity of corporate disclosures and financial reporting" (Guerra, 2003).

Even with the law now in place it is imperative that people continue to support the movement to increase corporate responsibility and enforce what has been put into place.

> "The Act includes sweeping changes in the areas of corporate governance and federal securities law, including reporting obligations, in response to recent corporate scandals and bankruptcies such as those involving Enron and WorldCom. The Act seeks to prevent the reoccurrence of such scandals by increasing corporate accountability, enhancing financial disclosure, strengthening audit committees, and creating new and harsh criminal penalties for violations." (The Sarbanes-Oxley Act of 2003: effect on the securitization industry, 2002).

Sarbanes-Oxley has been surrounded by a cloud of skepticism, but continues to forge ahead towards the goal of returning the corporation back to the shareholders. A difficult road lies ahead but two sections of the Act seek to add at least superficial support to investors by requiring top-level executives to put their own futures on the line and certify that the company's financial statements are to their best knowledge correct and non-misleading.

Discussion of Section 302 of Sarbanes-Oxley

Section 302 of Sarbanes-Oxley requires that CEOs and CFOs of all public companies certify each annual and quarterly report. "The certification states that to their best knowledge the report does not contain any untrue statement or omission of a material fact, and fairly represents in all material respects the company's financial condition and results of operations" (Sarbanes-Oxley certification requirements and best practices, 2002). The securities legislation that was created back in the 1930s also sought to protect the stock consumers from misrepresentations by management. The idea of Section 302 is to reaffirm shareholder confidence; this has created a clash between professional levels. Executives are now being required to include any additional knowledge of underlying events as well as choosing the appropriate accounting methods that are in the best interest of the shareholder. The CEO and CFO sign a standardized form of certification, which may not be changed under any circumstances. The certification form is attached to the 10K report.

According to the SEC (Sarbanes-Oxley certification requirements and best practices, 2002) there are six different elements to the certification by the CEOs and CFOs:

1. He or she has reviewed the periodic report

2. Based on his or her knowledge, the periodic report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the periodic report

3. Based on his or her knowledge, the financial statements, and other financial information included in the periodic report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the periodic reports

4. He or she and the other certifying officer
    a. Are responsible for establishing and maintaining disclosure controls and procedures for the company
    b. Have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared
    c. Have evaluated the effectiveness of the company's disclosure controls and procedures as of a date within 90 days prior to the filing date of the periodic report
    d. Have presented in the periodic report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date

5. He or she and the other certifying officer have disclosed to the company's auditor and to the audit committee of the board of directors
    a. All significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data and have identified for the company's auditors any material weaknesses in internal controls
    b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls

6. He or she and the other certifying officer have indicated in the periodic report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Sarbanes-Oxley 2002 also discusses the concept of materiality. Materiality is really found "in the eye of the beholder" (Sarbanes-Oxley certification requirements and best practices, 2002). Information must stand up to the reasonable person standard. This particular standard implies that information will be considered to be material in nature if the ordinary, reasonable user of the information would consider it when making decisions.

The new legislation also proposes that management go above and beyond in terms of keeping shareholders informed. Governmental officials found it imperative that executives realize that merely conforming to generally accepted accounting principles (GAAP) would no longer suffice. According to the SEC in Sarbanes-Oxley Certification Requirements and Best Practices (2002) a fair presentation of a company's financial condition, results of operations and cash flows encompasses the following points:

1) The selection of appropriate accounting policies
2) The proper application of appropriate accounting policies
3) The disclosure of financial information that is informative and reasonably reflects the underlying transactions and events
4) The inclusion of any additional disclosures necessary to provide investors with a materially accurate and complete picture of a company's financial condition, results of operations and cash flows.

> "The statement also contains language regarding maintenance of disclosure controls and procedures. For purposes of the new rules, the term disclosure controls and procedures means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports file by it under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms" (Sarbanes-Oxley certification requirements and best practices, 2002).

This new definition is included in order to comment on the importance of information disclosure. Companies must continue to maintain and update their commitment to keeping shareholders properly informed.

Discussion of Section 906 of Sarbanes-Oxley

On the surface Section 906 may seem to be a mere continuation of Section 302 but there are important differences to be noted. Section 906 exceeds the severity of Section 302 in that it imposes criminal sanctions "for knowingly false certifications" (Sarbanes-Oxley certification requirements and best practices, 2002). However, the certification requirements actually referred to in Section 906 are more specific than the requirements of Section 302. "The Section 906 certification represents that the periodic report which it accompanies fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the company" (Sarbanes-Oxley certification requirements and best practices, 2002).

Section 906 also carries harsh criminal penalties for violators. Any officer who makes the certification knowing that the periodic report does not comport with the requirements set forth can be fined not more than one million dollars or imprisoned not more than ten years, or both, or if the violation is willful, can be fined not more that five million dollars or imprisoned not more than twenty years, or both.

While both sections discussed above have found themselves embroiled in controversy, Section 906 seems to raise the most concerns. One of the issues involves the placement of the certification form required for Section 906. Part of the problem hinges on the inclusion of the certification within the financial report and whether or not the executives would then potentially also be liable for civil penalties (Sarbanes-Oxley certification requirements and best practices, 2002). Even though the two sections are similar there has been no conclusive action to incorporate them into one certification form and filing. Also there has been some controversy concerning the opinion that the Section 906 certification can be viewed as private conversation between the SEC and the particular company. As of now there is no penalty for failure to file a Section 906 certification form and penalties can only occur if certifications are made and they related to false financial reports.

August 14, 2002, was the date that the first signed certifications were to be turned in. "Cynics have called it 'restatement' day while others deemed it as inconsequential as theY2K threat. Optimists hope it will mark the end of the worst year for corporate scandals in recent memory" (Taub, 8/14/2002). In all about 947 companies must certify their statements but many companies had different deadlines due to the fact that they do not report on a calendar year basis. Several companies felt the need to revisit prior year figures and restate figures before signing off on this year's financials (Taub, 8/15/2002). "One theme seemed crystal clear—CEOs and CFOs don't want to go to jail" (Taub, 8/15/2002). While the day passed with little additional scandal, it seems that shareholders were not incredibly swayed by the act of confidence. It may appear on the surface that not much had been affected by the first round of signatures; however, it is important to remember that Sarbanes-Oxley's impact will still have far reaching implications in the accounting environment.

Discussion of Research Project

When I began this research project I believed that I would find some major differences in reporting between the 2001 and 2002 financial reports of major corporations. My research question was, "What was the impact of the Sarbanes-Oxley

Act of 2002 on the corporate reporting of the top 50 corporations in America as identified by Fortune magazine." Each year Fortune magazine lists the top 500 public corporations in American with the rankings based upon revenues. The results of the 2001 financial reports of these corporations led to the 2002 listing in the magazine; the results of the 2002 financial reports led to the 2003 listing. To narrow the research down to a manageable level, I decided to focus on the top fifty of these public corporations. These companies are listed in Appendix A.

Once these corporations were identified, I needed to gather the information reported by these corporations. I focused my research on the annual reports of the companies as well as information retrieved from the SEC's EDGAR website. I gathered the 2001 and 2002 annual reports as well as 10-K filings for the companies included on the 2002 list.

I set up an initial spreadsheet document to gather the information gleaned from these annual reports and SEC filings. I looked at the following specific information:

1) Did these corporations file the required CEO and CFO statements with the SEC?

2) If the corporations filed the required statements, were those statements found in the annual report to the stockholders or only in the filings with the SEC?

3) What audit firm was used in 2001 and in 2002; if there was a change in auditor, what reasoning was given in the SEC filing?

4) Was Sarbanes-Oxley mentioned in management's letter to the stockholders in the annual report; if so, what information was shared concerning the effect of SOX on the corporate reporting?

5) Were there changes in the reporting and disclosure of related party transactions, or disclosures of joint ventures previously held off balance sheet?

6) How was executive stock compensation reported each year; if the method of reporting changed, what was the explanation given in the footnotes to the financial statements?

As I read through these annual reports, focusing on the management letters and the notes to the financial statements, I began to realize that there were very few differences in the reporting between the two years. Of the Fortune 50 from 2002, only one (Enron) failed to provide the necessary statements to the SEC; only ten of these companies included the statements in the annual report while the others simply included them in the SEC filings. Other than those companies who had used Arthur Anderson as their auditor, there were only two changes in auditor reported. A few of the management letters included in the annual reports discussed corporate ethics and the ways in which those particular companies utilized an Audit Committee from the Board of Directors to enhance internal control.

One possible conclusion from my research is that well-run corporations did not need to make sweeping changes to comply with Sarbanes-Oxley. A more likely conclusion is that Sarbanes-Oxley had just been passed and the reporting requirements were just being implemented; therefore, many corporations simply complied with the statement requirements for the CEO and CFO and will be making additional changes in the future. It is also very likely that Sarbanes-Oxley will have more of an impact on the public auditors than the public corporations. Public accounting firms are going to have to determine whether they wish to provide management advisory services or audit services to a corporation, and will have to change their fee structures so that audit services can stand alone financially rather than being subsidized by profits on the management advisory services provided to that corporation.

Realizing that I was not going to find the data to support my original statement of purpose, I decided to look again at Sarbanes-Oxley and its origin. After reading through many articles discussing the impetus for SOX 02, I realized that there were three main accounting issues that were at the center of the storm, so to speak:

1) Off balance sheet financing and investing activities, such as those involving Enron that were not adequately disclosed to the users of the financial statements. Some of these activities involved related party transactions with inadequate disclosure and others disclosed the nature of the activity without disclosing the true level of risk involved.

2) Executive perks and excess expenses, such as those involving Tyco executives, which seriously eroded company earnings.

3) Stock based compensation plans for executives that often allowed top executives to pull in millions more in compensation than that reported to the users of the financial statements.

Of these three activities that contributed to the atmosphere that led to Sarbanes-Oxley, I decided to explore the area of stock-based compensation plans more thoroughly. In my opinion unexpensed stock options were a main factor in the corporate fallout. Stock options created a forest of money trees and unrestricted power.

> "Thanks to their free money allure, options made up more than 40 percent of executive compensation during the late '90s. This gave executives an enormous incentive to pursue risky, even illegal strategies to boost stock prices so they could exercise their options and immediately sell their stock" (Sweeney, 2001).

This was one area that the annual reports had to address, either through the financial statements themselves or through the notes to the financial statements.

For many years the authoritative pronouncement regarding the treatment of stock-based compensation plans has been APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB 25 corporations were allowed to use the intrinsic value method in reporting compensation expense related to these stock-based compensation plans.

Under the intrinsic value method the value of a fixed stock option for reporting purposes is equal to the difference between the option exercise price and the market price at the grant date. So, as long as a corporation set the exercise price at the current market price of the stock, no expense would be recorded either at the time of option or the time of exercise.

So, as an example, let us say that Corporation X gives its CEO options on 10,000 shares at $20 per share in 2000 when the market price is also $20 per share. No compensation expense would be recorded with respect to that grant. Now, if the CEO exercises those options in 2003 when the market price is $30 per share, the CEO will be receiving compensation of $100,000 ($30 - $20) times the 10,000 shares. Under the intrinsic value method, there would still be no compensation expense reported in the financial statements.

The accounting profession has been concerned over this treatment of stock-based compensation plans and FASB began work on this issue in the early 1990s. In 1994 FASB proposed that stock-based compensation expense be recognized annually over the life of the grant, with annual comparisons to the current market value of the options. As Warren Buffett stated in the 1993 annual report of Berkshire Hathaway, "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Under the fair value method of reporting stock-based compensation plans, our previous example would have resulted in the actual expensing of the $100,000 during the two years that the option was in place.

This proposed statement set off a huge outcry from the corporate world that if this accounting policy was adopted corporations would have to take large hits to income as a result of these stock-based compensation plans, which they said would slow the economic growth of the country. These corporations went to their congressmen and women and the issue was debated in the House and Senate. The U.S. Senate threatened to legislate accounting rules if FASB persisted with this change in accounting for stock-based compensation, with one Senator remarking "I will not allow U.S. companies to be sacrificed for the sake of double-entry accounting rules; if necessary, we will legislate accounting rules" (Sweeney, 2001).

FASB felt the better course of valor was to back off, and Statement 123, *Accounting for Stock-Based Compensation*, was issued. Statement 123 is very much a compromise statement. Corporations are still allowed to use the intrinsic value method of accounting for stock-based compensation plans; however, they are encouraged to adopt the fair value method. If a company chooses to continue using the intrinsic value method, they are required to disclose in a note the details of the option plans outstanding, including the exercise price, the length of the contract period, and the fair value of the options as well as what their net income would have been if they had used the fair value method. This somewhat mollified those accountants who believed that all compensation expense should be reported as an expense in the Statement of Earnings with the effect on net income clearly shown while allowing those opposed to the expensing of the options to keep the expense off the face of the Statement of Earnings.

A few companies in the Fortune 50 of 2002 have already begun to adopt the fair-value method of accounting for these stock-based compensation plans. These include

General Electric, Citigroup, Proctor and Gamble, and Warren Buffett's Berkshire Hathaway. Others, including AT&T moved to the fair-value method in their 2003 reports. These companies are leading the way and are reporting this compensation expense on the face of the earnings statement. Some companies, including Microsoft, have discontinued the practice of compensating executives with stock options (Risen, 2003).

Other companies in the Fortune 50 are continuing to take the easy way out and are complying with the form rather than the spirit, of Statement 123. They are providing the information in a buried footnote, along with the pro forma information showing what the income would have been if the fair value method had been included. What has struck me as very interesting is that a few companies have gone into a belligerent, defensive mode in writing this footnote.

> "We are continuing to follow APB 25 with respect to reporting stock-based compensation plans. We provide the following information required by Statement 123 regarding changes to net income if expense had been recognized as a result of these plans. However, we continue to believe that stock-based compensation plans do not represent an expense to the corporation; these plans only have value if the executives assist in increasing shareholder value and therefore should only impact the shareholders' equity section of the balance sheet" (Wells Fargo 2002 Annual Report).

An article in the December 2003 Journal of Accountancy noted that "many accounting experts think it is only a matter of time before companies will have to report stock options as an expense at fair value" (Myers, 2002). Many accounting experts are disappointed that corporations are merely following the letter of the law of Statement 123, continuing to employ the intrinsic value method rather than moving toward reporting under the fair value method of these stock-based compensation plans. In March 2004 FASB introduced a new exposure draft that is intended to lead toward option expensing beginning in 2005. The current SEC chairman is fully supporting this new standard (Loomis, 2004).

Congress appears ready to get involved in this debate once again, this time on the other side of the debate. In the early 1990s, it was siding with the corporations in blocking FASB's efforts to require the use of fair value accounting for these plans. Now Congress appears ready to assist in encouraging corporations to adopt the fair value reporting method. A bill has been introduced requiring corporations to treat stock options the same way on its tax returns as it treats them on its financial statements. Currently a corporation has been allowed to use the intrinsic value method for its financial statements, showing no expense, while simultaneously being allowed to take a tax deduction for the value of the options.

If FASB does decide to require the use of the fair value method in expensing these stock-based compensation plans, another issue will immediately arise: what alternative pay programs should corporations consider? If one of the main reasons for the popularity of the stock-based compensation plans was related to the lack of an accounting charge on the books, once there is an accounting charge options are on a level playing field with other incentives. Corporations and their compensation committees will then need to look at the full range of compensation plans and select the one that best fits its goals.

Summary of Research Project

I began my exploration of Sarbanes-Oxley 2002 with the expectation that I would find significant changes in the reporting of major corporations. In that, I was wrong. Sarbanes-Oxley has had a much more profound impact in the areas of internal control and limitation of management advisory services provided by CPA firms than it has had in the actual reporting arena.

When I began to focus on stock-based compensation plans, it soon became obvious that in spite of FASB Statement 123 most of these corporations (a staggering 41 of 50, or 82 percent) were continuing to use the intrinsic value method of reporting these plans. As I stated earlier, some of these corporations were even belligerent about having to provide the pro forma information required by Statement 123. Many accounting industry insiders have noted that Sarbanes-Oxley was quickly written and passed and that it will take time and revision before the true intent of the law becomes a reality. I definitely found this to be true in the area of reporting, particularly with respect to stock-based compensation plans.

It is difficult to assess the successes and failures of Sarbanes-Oxley when so many problems and questions remain. There seem to be many unintentional repercussions of the legislation partly due to the hasty nature with which SOX was passed.

At the time Sarbanes-Oxley was being implemented, the national economy was suffering a downturn due in large part to the lack of investor confidence. Many people believe that Sarbanes-Oxley has impeded the economy's recovery by stifling CEOs with rules and regulations. The consequences created by this new legislation have created a new brand of executive who is increasingly conservative.

> "Managers of successful companies must take business risks. The directors who oversee them must encourage them to do so. I want to be clean using business judgment; taking risks; and even losing money when a risk worth

> taking materializes, does not act against the notion of good corporate governance. In my view, good corporate governance informs good business judgment. It compliments risk taking" (Millstein, 2003).

It is imperative that leading executives realize that Sarbanes-Oxley attempts to increase investor confidence through executive reliability. It does not mean that leaders cannot continue to take business risks. It just implies that the risks taken must be legal and non-misleading in nature and in the event of failure; executives must continue to be truthful to investors in their disclosures. In order for the economy to improve CEOs must once again take risks in order to increase company profitability.

"The Sarbanes-Oxley Act and stringent new oversight of the accounting profession are causing friction in the once-smooth relationship between management and outside auditors" (Farrell & Backover, 2003). With the fall of major corporations also came the demise of the aura of the auditing profession as watchdogs of investor well-being. Arthur Anderson's disappearance increased the vulnerability of the remaining firms. Under Sarbanes-Oxley, auditors found their current practices under tremendous scrutiny. It is hard to pin down exactly when outside auditors actually became company insiders. The accounting industry realized that there was higher profitability to be experienced in selling consulting services than in selling quality audits. Auditors began advising executives on the best way to cheat the system while turning a blind eye to questionable accounting practices.

With the passage of Sarbanes-Oxley auditors now find themselves in a real dilemma. Gone are the days where accounting firms could sell unlimited consulting services to a company and audit the same company. Auditors must now scrutinize financial statements and accounting practices. Many firms have pressed companies for restatement of prior year financial statements.

"Last summer, the first wave of these signatures arrived at the SEC without much incident. But if some of the current battles result in restatements, those signatures could come back to haunt their owners. "You will see an unbelievable amount of finger-pointing in the next few months from CEOs that all signed off last August" (Farrell & Backover, 2003).

Already some companies are siding with the auditors and showing their executives the door. It remains to be seen what type of relationship between auditors and executives will be created in the post Sarbanes-Oxley era.

Along with Sarbanes-Oxley came increased compliance costs. Companies must pay for internal control programs as well as increased insurance costs for both executives and board members. These increased costs have made more public companies rethink the benefits associated with being a public company.

> "The number of U.S. public companies to announce privatization plans has continued to steadily rise since the inauguration of the Sarbanes-Oxley Act. Privatization transaction announcements increase 30 percent following the legislation's enactment from August 2002 to November 2003, in comparison to the 16-month period preceding the Act's initiation form April 2001 to July 2002" (Grant Thornton Press Release, 12/15/2003).

There are many benefits to be found in going private. "By going private, companies can greatly reduce their level of risk associated with shareholder litigation, while cutting costs and regaining a sense of control and confidentiality. For many companies, theses benefits are very appealing" (Grant Thornton Press Release, 12/15/2003). It is important to note that many of the companies going private were really public companies in name only. Also of considerable importance is the slow down being experienced in the IPO market. Many companies who had previously considered going public are changing their minds and are staying private.

Sarbanes-Oxley came out of the remains of a corporate culture created by failure at every level of the system.

> "We looked away as directors gave free reign to CEOs and management. We looked away from unprecedented CEO compensation. We looked away as accountants, bankers, and lawyers replaced responsibilities to the corporation and it shareholders with loyalty to the management team that hired them. And as shareholders, we stopped paying attention; we stopped reading footnotes. We were so enamored by performance that we just didn't care about why and how it was happening " (Millstein, 2003).

Because of this massive failure at every level, Sarbanes-Oxley will face many challenges associated with being a hastily passed piece of legislation. One of the most interesting moments in the near future regarding the effectiveness of Sarbanes-Oxley will be the trial of HealthSouth's former CEO Richard Scrushy. As of December Scrushy's lawyers were planning a lawsuit regarding the constitutional validity of section 906's criminal penalties. Scrushy's lawyers contend that the wording of this particular segment is too vague and should be considered void (Taub, 12/11/2003).

The Sarbanes-Oxley Act of 2002 seeks to prevent the reoccurrence of recent scandals by increasing corporate accountability, enhancing financial disclosure, strengthening audit committees, and creating new and harsh criminal penalties for violations" (The Sarbanes-Oxley Act of 2002: Effect on the Securitization Industry, 2002). Sarbanes-Oxley has been surrounded by a cloud of skepticism, but continues to forge ahead towards the goal of returning the corporation back to the shareholders. A difficult road lies ahead but these two sections of the Act seek to add support to investors by requiring top-level executives to put their own futures on the line and certify that the company's financial statements are to their best knowledge correct and non-misleading.

"How real is corporate reform? The test will come in the next bull market, when the temptation to cut corners will be back in force. Just avoiding jail should not be the goal here...It should be building great companies. That will depend on whether these key groups have embraced the spirit of reform or just its letter" (Byrnes, Henry, Thornton & Dwyer, 2003).

Appendix A

Fortune 50 Companies, 2001
Annual Reports Studied for Fiscal Years Covering 2001 and 2002

Wal-Mart
Exxon Mobile
General Motors
Ford Motor
Enron
General Electric
Citigroup
Chevron Texaco
IBM
Philip Morris (Altria Group)
Verizon Communications
American International Group
American Electric Power
Duke Energy
AT&T
Boeing
El Paso
Home Depot
Bank of America Corporation
Fannie Mae
J.P. Morgan Chase
Kroger
Cardinal Health
Merck
State Farm Insurance
SBC Communications
Hewlett Packard
Morgan Stanley
Dynegy
McKesson
Sears Roebuck
Aquila
Target
Procter & Gamble
Merril Lynch
AOL Time Warner
Albertson's
Berkshire Hathaway
Kmart
Freddie Mac
WorldCom
Marathon Oil
Costco Wholesale
Safeway
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