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The Effects of Sarbanes-Oxley on Small-Capital and Foreign Corporations

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Abstract

The Sarbanes-Oxley Act of 2002 was instated in response to extensive audit failures and the resulting lack of confidence in the American public market. However, the regulations can be costly and small-capital and foreign companies are seeking to be exempt from the regulations altogether. Through extensive research, I have determined the validity of these arguments and the possible effects of these companies not complying with Sarbanes-Oxley. I have found that while there are initial costs incurred to meet the regulation requirements, the benefits to the public market, investors, and the companies themselves outweigh them considerably. I have documented this evidence and also given tips on creating the most value out of Sarbanes-Oxley in the most cost-effective manner.

The Effects of Sarbanes-Oxley on Small-Capital and Foreign Corporations

In 2002, Congress passed an Act that imposed tremendous changes to corporate America. The Public Company Accounting Reform and Investor Protection Act of 2002, generally referred to as the Sarbanes-Oxley Act, was established with the most honorable of intentions (Agami, 2006). After the horrific Enron scandal, Congress sought to protect investors from fraudulent executives and dishonest auditors by refining the regulations of corporate financial reporting and practices. While the benefits of the Act are evident, Congress admits that the cost of complying with Sarbanes-Oxley regulations are higher than expected (Swartz, 2005). Foreign and small-capital companies are feeling the excess cost burden more than anyone. Many corporations are arguing that these types of companies should be exempt from the regulations altogether (Braddock, 2006). They claim that the costs of implementing the reforms are much higher than the benefits they produce. However, evidence suggests that, when implemented properly and as Congress intended, the benefits will far outweigh the initial cost burden and its goal of protecting investors and strengthening the public market will be accomplished. While the costs of complying with Sarbanes-Oxley are significant and occasionally burdensome on small and foreign companies, I will attempt to prove that increased costs is not an adequate reason to be exempt from the regulations as trust in financial reporting needs to be restored and investor confidence regained.

In order to establish a basis for my theory, I will first present the reasons behind the implementation of Sarbanes-Oxley. This will show the purpose and goals outlined in the Act and give us a basis for determining its benefits. I will also give an overview of the regulations established by SOX in order to explain the portions of the Act critics are

complaining about. I will then proceed to individually examine the main arguments against Sarbanes-Oxley's affects on small and foreign companies. In doing so, I will prove that their arguments are not valid and the positives outweigh the negatives. Lastly, I will give tips on utilizing the Sarbanes-Oxley regulations in such a way that small companies can reap tremendous benefit.

Why the Sarbanes-Oxley Act Was Established

While Sarbanes-Oxley might have been created and implemented rather quickly, the concept of revamping the regulations placed on financial reporting of publicly traded companies was not thought up overnight. Many factors influenced its establishment. The prevalence of fraud in financial reporting was a major contributing factor (Tackett, 2004). Another was the evidence that auditors had forgotten their responsibility as public watchdogs which gave way to pervasive audit failure (Braddock, 2006).

Fraud in Corporate America

The entrance into the 21st century will be forever marred by the scandals that cost investors billions of dollars in lost value. Large corporations like Enron, Tyco, WorldCom, and Adelphia were discovered to have disastrous frauds within their financial accounting procedures. This resulted in a public market where investors were terrified of losing their financial stability to greedy executives and accountants. The accounting profession came under extreme scrutiny as the press began to reveal the absolute absence of integrity in many well-known audit firms. For example, the investigation of the Enron scandal revealed that its auditor, Arthur Andersen, had shredded audit documents in order to hide any evidence of the fraud it was perpetrating. The investigation also revealed that Arthur Andersen was paid an elaborate \$25 million dollars in audit fees and another \$27

million in consulting fees (Tackett, 2004). According to a study by a prominent accounting firm, an estimated 20% of every dollar earned by a company is lost due to some type of workplace fraud (Cherry, 2004). This exposure not only raised questions within the SEC, it destroyed any thread of confidence investors had in the financial reporting of publicly owned companies.

Audit Failure

Another reason Sarbanes-Oxley was needed was because auditors were working for the executive board rather than for the investors. Economists Luigi Zingales, Alexander Dyck, and Adair Morse performed a study of corporate frauds and found that the majority of frauds reported in the US were not reported by the auditors but rather by employees of the companies. Only one-third of corporate frauds reviewed in their study were discovered and reported by auditors – the people who are responsible for uncovering fraud (Grumet, 2007). This revealed prevalent audit failure.

According to the Managerial Auditing Journal, there are four root causes of audit failure (Tackett, 2004). The first is auditor blunders caused by unintentional human error. The second is auditor fraud. The next is undue influence caused by financial interests. This was becoming very common as auditors were being offered lucrative bonuses and charging extravagant audit fees in exchange for having a blind eye to improper business practices. Lastly, audit failure is caused by undue influence caused by personal auditor-client relationships. Auditor independence was lost as auditors were golf buddies or family relatives with the clients they audited. These situations jeopardized the quality of audit reporting and led to audit failure.

Transparency of Financial Statements

With the increase in fraud and the realization that the independence of auditors had become a long-forgotten concept, the SEC realized that the financial statements of companies were becoming ineffectual (Tackett, 2004). There was no way to look at them and see an actual depiction of a company's financial standing. Investors had no way of knowing whether the asset and liability figures they were given were even remotely close to being accurate. Therefore, a major goal of Sarbanes-Oxley was to provide transparent financial reports to investors.

Overview of Sarbanes-Oxley Regulations

The purpose of the Sarbanes-Oxley Act is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" (Braddock, 2006, p. 177). There are many provisions that aid in fulfilling this purpose. First, the act established the Public Company Accounting Oversight Board. This board essentially audits the auditing companies. They establish auditing rules and enforce regulation compliance. This board falls under the jurisdiction of the Securities and Exchange Commission.

Auditor Independence

Another provision limits the duties of the auditor in order to strengthen the independence of public auditors. It is now unlawful for auditors to perform both consulting and auditing services for the same company. This aids in deterring fraudulent management practices. Also, companies must switch to a new lead audit partner every five years. This helps maintain independence between auditors and company management.

Sarbanes-Oxley sought to make auditors realize their duty of providing investors with a clear depiction of a company's financial position rather than seeking to please greedy executives. Chief Justice Burger states:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

(Braddock, 2006, p. 182)

This "public watchdog" role helps to prevent the concealing of deceptive practices of management by auditors who fear the risk of losing their prosperous client.

Verification of Financial Statement Accuracy

Sarbanes-Oxley also requires Chief Executive Officers and Chief Financial Officers to verify the accuracy of financial statements. If illegal behavior is detected regarding the laws requiring a company to restate their financial reports, the CEO and CFO will be required to repay any bonuses or profits received in conjunction with the offense. This places responsibility on management to ensure accurate and legitimate reports of financial standing. Also, companies are required to have a "financial expert" on the auditing committee or provide an explanation for their lack of such an expert (Carney, 2006, p. 145).

Code of Ethics

Corporations are also required to adopt a code of ethics for senior financial officers. Any company that does not adopt a code must report its failure to comply and give an explanation as to why. Although a stated code of ethics is not a guarantee that corporate management will adhere to its contents at all times, it is a form of accountability. It can be used to hold those responsible who violate the code's contents.

Section 404

One of the most debated provisions of the Act is Section 404 which deals with internal control procedures. The PCAOB defines internal control over financial reporting as,

A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that: (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) Provide

reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements. (Public Company Accounting Oversight Board, 2004)

Under Sarbanes-Oxley regulations, every publicly traded company is required to assess the effectiveness of its internal control over financial reporting. This requires two stipulations:

- 1) A statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- 2) Management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting (Swartz, 2005, p. 23)

These requirements often necessitate external consulting services in order to properly establish internal control procedures. Under Section 404 auditors must also verify and report on management's evaluation of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with the standards set forth by Sarbanes-Oxley.

Significant deficiency and material weakness.

When evaluating internal control, company management and the internal auditor must determine the probability and size of a potential financial misstatement. When a problem is recognized, management and the internal auditor must determine whether it is a significant deficiency or a material weakness (Agami, 2006). The PCAOB defines significant deficiency as

A control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected (Public Company Accounting Oversight Board, 2004).

It also defines material weakness as “a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected” (Public Company Accounting Oversight Board, 2004). This determination should be considered using the materiality principle. If a significant control deficiency is detected, it must be disclosed to the company’s audit committee as well as external auditors. If a material control weakness is detected, it must be disclosed to the public via its periodic financial statements filed with the SEC (Gupta, 2006).

Arguments Against the Implementation of SOX in Small-Capital Companies

Since the inception of Sarbanes-Oxley, there have been numerous critics of its existence. A lot of the arguments have been directed towards the Act’s effects on small-capital and foreign companies. Some say that Sarbanes-Oxley has damaged the American economy by making companies scared to list on our markets. Others also say that companies are not as willing to take necessary business risks because of the possible implications from these regulations. The majority of critics say that the costs incurred in

order to comply with the regulations are too burdensome and not worth the effort (Grumet, 2007).

Affect on Companies Choosing to List on the American Market

Many critics argue that the extensive regulations required by Sarbanes-Oxley will hinder foreign companies from listing on our market. While it is useful to have foreign companies listed on our stock exchange in order to offer investors a diversified portfolio and keep the market competitive, there has not been substantial evidence to show that SOX is significantly hindering their participation in the American market. As stated in the CPA Journal, “The United states currently controls 45% of global mutual fund assets and 70% of global hedge funds. A record 22 foreign companies executed IPO’s on the New York Stock Exchange and Nasdaq during the first six months of 2007. Only 17 foreign companies did so in the first half of 2000, before SOX was enacted” (Grumet, 2007).

Even though there has not been a significant drop in the number of companies making the decision to de-list from the American market and turn private or list in foreign markets due to the increased regulation of Sarbanes-Oxley, there are some who have and it is actually a benefit to our market. As Braddock claims, “a direct result of delisting is that the delisted company is less transparent than one that is publicly traded” (Braddock, 2006, p. 197). Investors can be confident that the publicly traded companies are transparent in their financial presentation. Investors can clearly determine what companies are worth investing their hard-earned money in and have confidence that their funds are secure. With the American market being more rigorously regulated, even with

slightly fewer publicly traded companies, investors are not exposed to corrupt public firms.

Affect on Risk Taking Activities of Businesses

Many argue that the Sarbanes-Oxley regulations make companies too risk-averse. Business is all about taking risks and making deals. With the strict regulations, some companies don't jump at new opportunities as easily as they used to. This is not necessarily a negative affect of SOX as some claim. Senator Sarbanes says that being risk averse is not always a bad thing. He believes "the rules are forcing companies to clean up their acts and the unintended consequences are not as many as many people feared" (Solomon, 2003, p. C1). With the regulations, businesses now are realizing their responsibility to their shareholders. Sarbanes-Oxley is merely making executives recognize their responsibility to adequately examine potential business risks.

Arguments Regarding Compliance Costs

One of the main arguments given by those against Sarbanes-Oxley regulations is the increased compliance costs. This increase in cost is due to many factors. A major factor is that additional auditing services are typically required as regulations are more time-consuming and detailed. Management must take on an increased workload in order to ensure that their company is meeting the new standards. This results in higher compensation for these managers. The internal control regulations require a separation of duties between employees which, in the case of most small companies, requires a larger workforce. Also, Sarbanes-Oxley places limits on the non-audit services that auditors can perform for their clients. This requires companies to seek council from outside consulting firms which inevitably increases their expenses (D'Aquila, 2004).

Additional Auditing Services Affect Costs of Complying With SOX

While additional auditing services may initially be required in order to get companies in compliance with the regulations, these costs will diminish over time. As stated in the Financial Executive magazine, “Most audit firms will tell you that there was a huge, one-time cost to get companies up to speed to meet SOX requirements, but going forward, things won’t be so costly. There is already some evidence that audit fees are going down” (Marshall & Heffes, 2006, p. 8). Audit fees were so high in the beginning because companies did not have proper controls and procedures set up and auditors were required to spend a lot more time helping clients get these procedures implemented into company policy. Once set up, these procedures merely have to be evaluated on a yearly basis which is much less time consuming. As auditors and companies become more accustomed to Sarbanes-Oxley procedures their costs will decrease as a reflection of that knowledge.

Costs of Implementing Internal Control Procedures

The costs associated with meeting Section 404 requirements have been the most controversial. Companies feel that the regulations themselves are too excessive. However, the PCAOB is focused on enhancing audit quality and many of the critics of Section 404 are scared of the weaknesses auditors might find in their company’s structure if they look as closely as SOX demands: “The SEC Final Rules about implementing section 404 also require that a registrant disclose all ‘significant control deficiencies’ to its audit committee as well as its external auditors and disclose all ‘material control weaknesses’ in its Internal Control of Financial Reporting to the public via its periodic

filings with the SEC” (Gupta, 2006). Thus, one factor in the costs associated with Section 404 is management’s fear of failure.

Prior studies have documented not only a decline in share price of companies that report material weaknesses, but also a negative impact of the careers of the executives responsible. Accordingly, it is in management’s best interest to ensure that internal controls meet the rigorous standards of SOX before the external auditors begin their evaluation (Blaskovich, 2007, p. 31).

Therefore, these executives hire consultants to aid them in this compliance which increases their compliance costs. However, the benefits reaped from ensuring adequate internal controls can outweigh the potential costs of uncovering material weaknesses and ruining the company’s reputation. As a survey of auditors from Big Four firms confirms, “external auditors perceive the involvement of the external consultant as a positive reflection on management that may result in some reduction of the audit risk for external auditors” (Blaskovich, 2007, p. 33). This shows that hiring outside consultants to aid in the compliance efforts is advantageous.

If companies have been properly handling their finances they should have a lot of the controls already in place. A partner of a Big Four firm stated,

“The costs of complying with SOX are being blown out of proportion as an excuse to get rid of unwanted oversight. The large majority of internal controls should be in place, regardless of public reporting requirements, to answer that the company is safeguarding its assets properly and that the larger organization is functioning in accordance with senior management’s and the board’s intent” (Hill, 2007).

Just because a company is not bringing in billions of dollars in revenue annually does not mean it does not have a responsibility to safeguard the assets of its shareholders.

Often forgotten in this debate is the significant number of smaller businesses that fail, often because they do not have good business plans or do not identify and control risks. For example, “Research shows that a strong commitment to internal control is a matter of company priority, not a matter of resources” (Rittenberg, 2007). Smaller companies have the ability to install adequate internal controls if they make it a priority. Research shows “companies that haven’t dedicated sufficient resources to maintain their internal controls and don’t make it a priority to fix control weaknesses as they arise are most susceptible to control failures” (Chan, 2006). It is much more cost effective for these companies to implement internal controls rather than pay for the repercussions of control failure later on down the road.

Evidence proves that the cost of Section 404 compliance is lessening. The CPA Journal affirms, “Financial Executives International (FEI) recently studied section 404’s financial impact on 200 large companies (average annual revenues of \$6.8 billion). The study found that in 2006, these companies spent an average of \$2.9 million to comply with SOX section 404. This figure is 23% lower than in 2005 and on average less than 1% of revenues” (Grumet). These costs are going down every year due to standardization of control procedures and auditors and companies have become more efficient at implementing the controls.

Section 404 costs for smaller companies.

Since the passing of Sarbanes-Oxley, smaller public companies have complained that the costs associated with Section 404 compliance are too extreme. The SEC was

considerate of the increased financial burden on these companies and has extended the deadline for smaller public companies to comply with Sarbanes-Oxley multiple times. The most recent extension is to fiscal years ending after July 2007 (Campbell, 2006). However, the companies have still not been satisfied. In response, the Committee of Sponsoring Organizations issued an exposure draft in October 2005. This draft addressed the concerns of the smaller companies and provided guidance as to how they could best assess the effectiveness of their internal controls over financial reporting.

Smaller public companies must realize that, although the steps to compliance can be time-consuming, the benefits will outweigh any initial costs. A company's ability to have a strong commitment to internal control is based on their priorities, not their resources (Rittenberg, 2007). If proper controls are set in place, they will build a strong financial and ethical foundation for the company to grow on. There are many guidelines and tips smaller companies can follow in order to make the internal control implementation process easier and more cost-friendly. For example, procrastination in establishing good internal control will only incur more cost. The risks and deficiencies must be immediately acknowledged and corrected. Another piece of advice is that smaller companies do not have to invent a new system. They can learn from what they have tried in the past and continually work toward improvement. Also, as with all companies, the controls must start at the top. Management must show a commitment to ethical practice and a responsibility in establishing effective company policies and procedures to ensure accurate financial reporting. Once management is on board with maintaining ethical practices and standards, the mindset of the rest of the company will conform to the same ideal. If these actions are taken, smaller public companies will be

thankful for the strong foundation they set for their company and will recognize the necessity of the compliance cost.

Information Small Companies Can Utilize to Aid in Implementing Section 404

When Section 404 was created, it was a new concept that many found difficult to understand. Small companies particularly complained because they did not have the resources to hire extra big-name audit firms to advise them on compliance. In an effort to aid smaller companies in better understanding the expectations of the PCAOB and SEC in regards to internal control over financial reporting, Auditing Standard No. 2 was issued and the Committee of Sponsoring Organizations Framework was declared an acceptable guideline for creating and assessing internal control.

Auditing Standard No. 2

On June 17, 2004, the Securities and Exchange Commission approved the standard set by the Public Company Accounting Oversight Board known as Auditing Standard No. 2. This standard is effective for internal control over financial reporting as required by Section 404 of Sarbanes-Oxley (Public Company Accounting Oversight Board, 2004). It offers guidelines on the requirements of management and auditors when dealing with assessing internal control over financial reporting.

The purpose of developing internal control is to prevent and mitigate material financial misstatements. Included in the standard is an explanation that while internal control is highly effective, it is not absolute assurance that financial misstatements will be eradicated. This is due to the understanding that humans make errors. It asserts, “Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human

failures. Internal control over financial reporting also can be circumvented by collusion or improper management override” (Public Company Accounting Oversight Board, 2004). While these limitations are inevitable, a strong system of internal control will reduce this risk.

Committee of Sponsoring Organizations

Issued in 1992, the Committee of Sponsoring Organizations (COSO) framework was developed to assess the effectiveness of controls. The COSO framework is a “process designed to provide reasonable assurance of effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations” (Callaghan, 2007, p. 59). With the passing of Sarbanes-Oxley, the COSO framework has been declared an acceptable framework for evaluating internal controls over financial reporting by the SEC. It is specifically noted in Auditing Standard No. 2 as an acceptable framework to set and assess internal control. As noted earlier, COSO also issued an exposure draft after Sarbanes-Oxley was passed that was specific for smaller companies and aiding them in implementing this framework in their businesses.

The framework is compiled of five components of internal control. The first component is the control environment. The evaluation of this control is critical because it affects every aspect of the business. This is a reflection of management’s knowledge and dedication to setting and maintaining accurate controls and ethics throughout the company. This is called the “tone at the top” approach. The idea is that top executives should set an ethical standard that will permeate the rest of the company (Callaghan, 2007). According to research by the Institute of Internal Auditors, “companies perform better and last longer when top management makes a commitment to strong internal

control and clearly conveys this through their actions” (Institute of Internal Auditors, 2005, p. 2). If a company teaches their employees the importance of controls they will have a much easier time implementing and evaluating their internal control system.

The second component of the COSO framework is risk assessment. Management must identify and evaluate the risks that have the potential to keep the company from achieving corporate goals. Next, control activities must be established in order to ensure the company is taking the necessary steps to mitigate risk and reach objectives. These control activities can include but are not limited to segregation of duties, management oversight, and proper documentation of policies and procedures. Information and communication systems are the next component which enables the company to collect and manage the information needed to conduct its control activities. Finally, the company must monitor the effectiveness of its internal control system (Rittenberg, 2007).

Management’s Report on Internal Control

Once a company has implemented a framework for internal control procedures (ICOFR), management and the internal auditor must report on the effectiveness of internal control over financial reporting. The SEC requires management to disclose four statements in its report on internal control.

1. A statement of management’s responsibility for establishing and maintaining adequate ICOFR.
2. A statement identifying the framework used by management to evaluate the effectiveness of ICOFR.
3. Management’s assessment of the effectiveness of the company’s ICOFR as of the end of its most recent fiscal year, including an explicit statement as to

whether that control is effective, and disclosure of any material weaknesses identified.

4. A statement that the registered public accounting firm that audited the financial statements has also issued an attestation report on management's internal control assessment (Agami, 2006).

Similarly, the auditor must report on "management's assessment of the effectiveness of ICOFR; and the auditor's independent assessment of the effectiveness of the company's ICOFR" (Agami, 2006). If the auditor does not find any material weaknesses in the company's ICOFR or the auditor and management both report a material weakness and are taking the steps to correct it, the auditor can give an unqualified opinion. However, if the auditor found a material weakness and management did not; the auditor must then issue an adverse opinion. As stated earlier, management may determine that a significant deficiency or a material weakness is present in its internal control procedures. If a material weakness exists, management and the auditor must report that the company's system of internal control is not effective (Agami, 2006).

Ways to Create Value from Sarbanes-Oxley Regulations

With all the debate surrounding the Sarbanes-Oxley regulations many companies are simply trying to get by without going bankrupt or getting into trouble with the SEC. If companies keep this mindset they will never see the benefits that can be derived from these regulations. However, if companies view implementing and complying with Sarbanes-Oxley regulations as more than a "let's do the least amount of work we can that will allow us to say we followed the rules" attitude, they will recognize lasting benefits.

The CPA Journal came out with five keys to create value from Sarbanes-Oxley. The first is to appreciate the goal behind Sarbanes-Oxley. The second is to understand the fraud disease. Thirdly, aggressively address ethical attitudes and the potential for rationalizing fraud. Fourth, consciously decide to go beyond simple compliance to improve governance and controls. Lastly, investigate and implement enterprise risk management (Beasley, 2004). If small companies follow these steps to creating value from Sarbanes-Oxley, they will have no need for exemption. They will be thankful they have the regulations in place as their corporate structure and public reputation will be stronger.

Appreciate the Goal Behind Sarbanes-Oxley

The first way companies can recognize value from Sarbanes-Oxley is to appreciate the overriding purpose behind its creation. Executives must realize that while they themselves may be conducting business with the utmost integrity, others are not. They must realize that when viewed from an all-inclusive perspective, the regulations will foster a much stronger market for the American economy in general. It is important that top management make this a priority. Otherwise, employees will not recognize it as being a necessity.

Understand the Fraud Disease

In order to see benefits from an Act made to decrease the occurrence of fraud, management must understand how and why fraud happens. As stated in Auditing: A Journal of Practice & Theory, the recipe for fraud has three components: incentive, opportunity, and attitude/rationalization (Beasley, 2004).

Incentive.

For anyone to commit fraud, he or she must first have some type of motivation or incentive. This can come from a number of factors. It could be from a desire for greater compensation whether it is to steal money directly or distort figures in order to meet sales figures that trigger a bonus. Another factor would be a motivation to perform to a certain level or to meet expectations placed on the company. Executives must realize these incentives if they want to eliminate them.

Opportunity.

Executives must realize that perpetrators of fraud cannot complete their mission if they never have an opportunity to do so because “the main deterrent to opportunity is strong internal controls, the focus of Section 404 of the Sarbanes-Oxley Act” (Beasley, 2004). Good internal controls will eliminate opportunity to get away with fraud. Internal controls should be designed so that fraud will be automatically detected.

Attitude/Rationalization.

This component asks whether a person who has incentive and opportunity to commit fraud will somehow give an excuse for his or her actions. Some excuses include saving jobs or that it will only happen once and will be corrected in the future. This is the hardest component to combat because it is an unobservable mind-set.

Aggressively Address Ethical Attitudes and the Potential for Rationalizing Fraud

The best way to aid in eliminating the possibility of rationalization is to instill a solid ethical attitude within the company. This again should start with top management (Callaghan, 2007). If employees see that executives are aggressive at maintaining ethical standards, they will be compelled to follow suit.

The CPA Journal offers four questions that companies need to address when considering their ethical attitude: Does the company have clearly defined ethical boundaries that are communicated to employees? How would others describe the company's ethical boundaries relative to the gray zone and the black zone? What types of accountabilities are present for those who suffer an ethical lapse? Does top management's day-to-day behavior support or undermine the stated ethical attitude and boundaries? (Beasley, 2004). If companies consider their responses to these questions, they will get a better understanding of the ethical attitude and potential for fraud within their company.

Beyond Compliance: Improving Governance and Controls

If companies will do more than just the bare minimum necessary for Sarbanes-Oxley compliance, they will realize a much greater benefit. Companies must not view the regulations as a burdensome task but rather an opportunity to improve their corporate structure and build a stronger financial future. Companies wanting to gain the greatest benefit from Sarbanes-Oxley should take two important steps. The first is instead of just making the required structural changes to their executive boards and committees; they should explore governance best practices to enhance their own governance processes. The second step is to use the work done for Section 404 internal controls to actually improve their controls. They should examine and question every detail of their controls and procedures to see what is necessary, what is not working, and what could be added that would be more beneficial (Beasley, 2004).

Investigate and Implement Enterprise Risk Management

Enterprise Risk Management is defined by the Committee of Sponsoring Organizations exposure draft as “a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives” (Beasley, 2004, p. 13). This framework was designed to aid companies in discovering what activities are prohibiting objectives from being reached. Using this framework will aid companies in getting the most out of their Section 404 compliance work.

Making Section 404 Compliance Cost-Effective

Not only is it possible to create value out of Section 404 compliance, it can be done in a cost-effective manner. The CPA Journal listed nine tips on implementing effective internal control while working with a budget. The first tip is to not procrastinate. If issues are addressed promptly, they will be less of a hassle later on. The second tip is to not try and reinvent your entire control procedures. Build a plan based on things you learned from initial compliance efforts. Next, allocate the right resources to the project. Create a compliance team with the right talents and skills needed to accomplish the job.

The fourth tip is to make sure top management shows their support. This will inspire others to get on board. Next, use a risk-based approach. This helps to properly plan the compliance activities. Another tip is to make a plan. Draw a timeline of your

projects with reasonable due dates and goals. Next, provide adequate training to your staff to make them knowledgeable of the needs and expectations.

The next tip is to remedy control issues as soon as they arise. Waiting only makes them more costly and potentially damaging. Lastly, ensure timely evaluation and discussion of challenges faced along the way and how to resolve them (Chan, 2006). All of these tips will aid companies, small ones in particular, in developing and implementing proper internal controls without going bankrupt.

Evidence That Sarbanes-Oxley Is Effective

It has been five years since the passing of the Sarbanes-Oxley Act, and we are now able to more adequately determine its effectiveness in fulfilling its intended purpose. In assessing the Act's performance, its positive effects must be weighed against the costs incurred to create those results. Sarbanes-Oxley is only effective if its benefits outweigh its costs.

Transparency of Financial Reports

One unmistakable benefit is the transparency of financial reports created by the increase in independence of auditors from company management. Auditors have realized their duty is to provide investors with a clear depiction of a company's financial position rather than to please executives. By demanding auditor independence, investors can be confident that the financial reports they are given are based on accurate measures of company performance. They no longer have to worry as much that the numbers they see on paper are skewed so that the executives and auditors can make their profit projections which are linked to their bonus package. A survey was taken to question auditors on whether they believed Sarbanes-Oxley would increase investor confidence. The survey

showed that “nearly seven out of ten auditors agree that investors and creditors should have greater confidence in financial statements because of SOX” (Hill, 2007). This helps to show that one of Sarbanes-Oxley’s main goals is being accomplished.

Weaknesses in Corporate Structure

Sarbanes-Oxley regulations have also opened the eyes of corporations to weaknesses in their corporate structure and encouraged them to make positive company changes. Former Securities and Exchange Commission Chairman William H. Donaldson affirmed that 200 out of 2,500 companies who filed internal control reports found material weaknesses in those controls. Many of those weaknesses caused errors in their financial statements as a result (Swartz, 2005, p. 23). As management recognizes these weaknesses, it can take the necessary steps to correct them thereby improving and strengthening the external view of the company. This information gathered for compliance purposes can be utilized in other areas of the business to ultimately affect overall performance.

Public Market Performance

There is little room for doubt that Sarbanes-Oxley has strengthened our public market and restored confidence in investors. As noted in the CPA Journal, “While SOX may have negatively affected the earnings of certain corporations, the best argument in favor of the law comes from simply looking at the performance of our financial markets. Between July 30, 2002, and June 30, 2007, the Standard & Poor’s 500 has increased 67%, representing about \$4.2 trillion in market value” (Grumet, 2007). These numbers are staggering and give evidence that Sarbanes-Oxley is accomplishing its goals.

Material Internal Control Weaknesses

Another surprising number is the percentage of companies reporting material weaknesses of internal control from the first year of compliance compared to the second. In 2005, 15.4% of companies reported internal control weaknesses. In 2006, that percentage dropped to 5.6% (Rittenberg, 2007). This again proves that the arguments that Sarbanes-Oxley is costly and ineffective are unsupported.

Many companies fail because they do not have solid business plans or they do not identify and manage risks. Establishing good internal control over financial reporting will strengthen companies and diminish the chance of financial failure. The difficulty companies have with setting strong internal controls is not in the expense but rather in the necessity to make it a priority (Rittenberg, 2007). Executives do not want to spend their time setting up a policy on ethical procedures. They often feel it is unnecessary and that it's not an issue top management must deal with. Also, many of them do not have any ethical standards set for themselves so it would seem worthless to them to set ethical standards for their business. However, as stated earlier ethical and responsible behavior must start at the top with the executives. Management must realize that the benefits of establishing good internal control procedures greatly outweigh any costs incurred to develop and implement them in the long run.

Restatements by Small Capital Firms

Another benefit is that the small capital firms are now being looked at by the PCAOB. AuditAnalytics, a company that analyzes audit problems, reported that in 2005 the number of companies filing restatements was up 72% from the previous year. However, clients of the most well known, large audit firms were filing 31% fewer

restatements during this time period. How could these two percentages coexist? The increased percentage in audit restatements came from the small capital companies, whose number of restatements more than doubled during this time period (Norris, 2006). Before Sarbanes-Oxley, these companies were regulated by the Securities and Exchange Commission which was very limited in authority and staff. The SEC did not have enough time or resources to look over every large audit firm much less review the audits of tiny public firms. Now, under Sarbanes-Oxley regulations, the PCAOB inspects every firm that audits public companies at least once every three years. This regulation is causing these firms to look more closely at the details and provide investors with quality audit reports for every public company regardless of size.

Conclusion

The Sarbanes-Oxley Act of 2002 was installed in an attempt to protect investors by better regulating financial reporting. While this purpose is being fulfilled on a slow but consistent basis, small and foreign companies are seeking exemption from the regulations due to increased compliance costs, effects on the public market, and the effects on risk taking of public companies. While compliance costs have been considerable, the benefits cannot be overlooked. Investor confidence in management, auditors, and financial reporting has been restored. It has encouraged investors to continue trusting the U.S. public market with its finances. Allowing these select companies to be exempt from the Act would ultimately contradict its purpose. These companies must realize their costs of compliance are miniscule compared to the risk of losing their entire capital when investors no longer trust their financial reports.

Companies must recognize the potential value in Sarbanes-Oxley in order to reap the benefits. Companies that view the regulations as a burden and as one more test they must pass, will see little payback. However, if companies view Sarbanes-Oxley as an opportunity to strengthen their corporate structure and solidify their reputation in the public market they will see long-lasting results. They will also be above the curve at mitigating fraud and financial reporting discrepancies. This is true regardless of the size of the company.

Sarbanes-Oxley has now been in place for five years and its initial critics are running out of arguments against it. Small companies were given multiple extensions for meeting the SOX regulations and were also given lots of detailed instructions and aids on how to meet compliance standards without having to pay high-priced audit firms to teach them. Any regulation of its size is inevitably going to have an initial cost burden and need continuous evaluation. However, the Sarbanes-Oxley Act is proving its value as it matures.

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