

The Effects of Sarbanes Oxley on Current Financial Reporting Standards

Kiersten N. Clark

A Senior Thesis submitted in partial fulfillment  
of the requirements for graduation  
in the Honors Program  
Liberty University  
Spring 2012

Acceptance of Senior Honors Thesis

This Senior Honors Thesis is accepted in partial fulfillment of the requirements for graduation from the Honors Program of Liberty University.

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Gene Sullivan, Ph.D.  
Thesis Chair

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Melanie Hicks, D.B.A.  
Committee Member

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Donald Fowler, Th.D.  
Committee Member

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Brenda Ayres, Ph.D.  
Honors Director

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Date

### Abstract

Many changes have taken place over the past eight years in almost every sphere of the business world. The first topic discussed within this paper will be the origin and background of Sarbanes-Oxley, why it was necessary, and what the primary causes of such regulation were. There are many new regulations that are required of companies, primarily publicly-traded companies, which will be covered in the next section. Finally, the last discussion will involve the impact of SOX and the Public Company Accounting Oversight Board on financial reporting and the changes that have taken place within companies. The impact of this legislation, according to President Bush, was “the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt” (President Bush, 2002, para. 4).

## The Effects of Sarbanes Oxley on Current Financial Reporting Standards

### **Introduction**

Financial reporting has changed a great deal over the past ten years. There have been many companies that have come and gone, some with little fanfare, and some with the explosion akin to the Macy's Fourth of July fireworks display. There have been various reasons why these companies have left the operating sphere: the inability to make a profit, poor business decisions, and low marketability. However, one of the most notable reasons why certain companies go under is unethical behavior in the workplace (Pitt, 2009). When exposed, the lack of ethics scandalized the corporate, as well as the public, world. In order "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes," Congress published the Sarbanes Oxley Act of 2002 (SOX 2002, para. 1). The Securities and Exchange Commission, or SEC, enforces the application of the regulations contained within Sarbanes Oxley. This Act dealt with intensifying financial reporting regulations and the punishments for non-cooperation (Berman, Knight, & Case 2008). Throughout this paper, the effects of Sarbanes Oxley, otherwise known as SOX, will be dealt with and discussed concerning various different aspects of financial reporting.

### **Background of Sarbanes Oxley**

Prior to 2002, the regulations on financial reporting were much more lax than they are currently. Companies were more apt to be under the radar if they desired to engage in fraudulent financial practices. Since the enactment of the Sarbanes Oxley Act in 2002, all publicly-traded companies have been required to comply with regulatory policies. Many of these policies had been in existence before SOX, but they were not enforced. This Act

was intended to prevent potential scandals and to re-establish investor assurance (Miller, & Pashkoff, 2002). Following high-profile cases such as Enron, which obliterated any confidence investors may have had, SOX was a crucial piece of legislation. SOX was also meant to reinforce corporate responsibility, strengthen disclosure, and fight against fraud (Hoyle, Schaefer, & Doupnik, 2011). There were many corporate scandals that occurred during the past century, but none received the amount of publicity that Enron and its auditor, Arthur Anderson did.

### **The Enron Scandal**

Enron scandalized the business world in 2001 and 2002 when the internal fraud of the company was uncovered. Since its inception, Enron sustained burdensome debt. At times the financial state of the company promised success. However, Enron never fully recovered from the debt with which it was created. The laxity of internal control within Enron ultimately led to the company's demise (Thomas, 2002).

**Formation of the company.** Enron was created in 1985 as a result of a merger between two companies, Houston Natural Gas and InterNorth (Thomas, 2002). The merger saddled Enron with an enormous amount of debt which proved to be the beginning of the end (Fusaro, & Miller, 2002). When a company begins its life on a shaky foundation, it is safe to assume that the company will not last long without very drastic changes. The CEO of Enron in 1985 was Kenneth Lay, who hired a consultant named Jeffrey Skilling of McKinsey & Co. to help formulate Enron's business plan (Thomas). A portion of Skilling's business plan proposed inventing a gas bank where gas would be purchased from a system of merchants which would in turn be sold to a system of clients, resulting in constant cash flows throughout the process (Fusaro, et al.).

Skilling's plan pleased Mr. Lay, and he hired Skilling to be in charge of Enron Finance Corp., which was created in 1990 (Thomas). Over the ensuing eleven years, Skilling led the company through a period of exponential growth. However, he was not alone during this growth process. In 1990, following the creation of Enron Finance Corporation, Skilling hired Andrew Fastow to be his protégé (Thomas). Fastow became the chief financial officer in 1998, and controlled Enron's investing and funding while Skilling directed the enhancement of Enron's trading operation (Thomas). One of the primary reasons for Enron's rapid growth was the extensiveness of the U.S. economy's bull market (Thomas). Unfortunately, this growth was only temporary.

**The destruction of Enron.** In 1996, Enron named Jeffrey Skilling as the chief operating officer, or COO (Thomas, 2002). This position of power engendered more greed and the temptation to pursue unethical decisions in the business policies. In October of 1999, Enron Online, or EOL, was born (Fusaro, & Miller, 2002). EOL was a trading website in which electronic commodities were being sold (Thomas). This program enabled Enron to witness every business deal that occurred, and also permitted the company to enhance Enron's credit due to the confidence generated in a safe purchasing environment (Thomas). Unfortunately, Enron took advantage of the growing stock bubble by investing hundreds of millions of dollars into Internet broadband but with minor profit. This investment did increase the stock price, which increased investor confidence because after all, if the stock price is high, should not the company be doing well? Sadly, the increased stock price and investor confidence masked the true condition of Enron. As the Internet age blossomed and grew, other companies copied Enron's strategies, thus causing Enron to lose the edge it had held for several years (Thomas).

With the previously set high standard, the profitability of financing deals did not concern executives at Enron, rather they focused on keeping the numbers from appearing low (Thomas). Enron became more of a hedge fund company rather than a trading company (Fusaro, et al.). Eventually, Enron's poor risk management came back to haunt the company. Toward the end of 2001, Enron was forced to file for bankruptcy protection (Bottiglieri, Reville, & Grunewald, 2009). The events that followed this filing proved to be the company's undoing. While they received the desired protection, they also were forced to disclose faulty accounting practices, both with Enron and also with their accounting firm, Arthur Anderson (Bottiglieri, Reville, & Grunewald). In a period of less than a year, Enron was dissolved, and legislation, SOX, was passed in an attempt to prevent the falsification of data and lessen the probability for insider trading to occur in the future.

### **Increase in Regulations after Sarbanes Oxley**

The Sarbanes-Oxley Act initiated stringent regulations. The Act was composed of sixty-six sections, some long and others short. Each section dealt with a different part of the reporting cycle (Schaeffer, 2006). These sections are contained within eleven titles, primarily dealing with the issue of internal control. The eleven titles of SOX are as follows: Public Company Accounting Oversight Board, auditor independence, corporate responsibility, enhanced financial disclosures, analyst conflicts of interest, commission resources and authority, studies and reports, corporate and criminal fraud accountability, white-collar crime penalty enhancements, corporate tax returns, corporate fraud and accountability (SOX, 2002). Each of these titles has its own specific impact on different areas of financial reporting, but only a few will be discussed in detail within this paper.

**Important Accommodations**

While it is important for companies to follow every section of SOX, there have been several sections that received more attention than others. A common section of the Sarbanes-Oxley Act is Title III, Corporate Responsibility. This portion of the legislation contains many important guidelines regarding the duties of management, including certain audit committee requirements as seen in Section 301 (SOX, 2002). A few other notable common sections are Section 401 (b), conditions for use of non-US GAAP or pro forma financial information, and Section 404, internal control over financial reporting (Rulemaking, 2009). Another very important section is covered by Title XI, Corporate Fraud and Accountability (SOX). Title XI deals with the penalties and regulations companies must comply with to avoid fraudulent practices. The last portion of Sox that will be discussed is Title I, creation of the Public Company Accounting Oversight Board, or PCAOB (Rulemaking).

**Corporate Responsibility**

Title III of the Sarbanes-Oxley Act contains several important sections dealing with corporate responsibility. While only a few will be gone into depth in this paper, every section is incredibly vital. Each section contains a particular amount of pertinent information for all forms of companies that comply. The eight sections of Title III are as follows: section 301, public company audit committees (expanded below), (302) corporate responsibility for financial reports, (303) improper influence on conduct of audits, (304) forfeiture of certain bonuses and profits, (305) officer and director bars and penalties, (306) insider trades during pension fund blackout periods, (307) rules of professional responsibility for attorneys, and (308) fair funds for investors (SOX, 2002).



**Sections 302-308.** Each of these sections involves a portion of corporate responsibility. Within Title III, the entire spectrum of financial reporting is covered, which gives credence to the importance of proper reporting. Section 302, corporate responsibility for financial reports, deals with the specific requirements for managers and chief executives of companies to comply with (SOX, 2002). One of these requirements is to ensure that the financial 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” (Kranacher, 2011, para. 4). When a company’s financial statements are in order and correctly represented, investors are able to make wiser investing decisions. In addition, individuals are more likely to have confidence in the company (Kranacher). The next section, improper influence on conduct of audits, is very similar to section 404 (internal control). The legislation states actions that are prohibited:

It shall be unlawful...for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading. (SOX, 2002, p. 33)

Section 304, forfeiture of certain bonuses and profits, explains that if a company is required to restate its financial statements on account of misconduct, the CEO and CFO are responsible for compensating the company (Kleckner, & Jackson, 2004). The items they would be accountable for in the event of misstated financial statements would be (a) bonus or other compensation received during the 12-month time span after the issuance

of financial statements or (b) any profits realized from the sale of securities during the same 12-month period (Kleckner, et al., 2004). The next section under Title III covers the penalties that apply to officers and directors when they are deemed unsuitable (SOX, 2002). These penalties also include providing “equitable relief” when necessary in order to benefit investors (SOX). Section 306, insider trades during pension fund blackout periods, mandates prior notice be communicated to individuals who are prohibited from making investment changes, procuring loans, or receiving a distribution from tax-qualified plans during a blackout period (Pett, Stevens, & Mao, 2003). A blackout period is defined as the following: “periods during which participants cannot direct the investment of their plan account balances or request loans or distributions” (Pett, et al., para. 1). The Sarbanes-Oxley Act expands upon this definition by specifying the time period as “three or more consecutive business days” (Pett, et al., para. 13). Whenever a firm decides to implement a blackout period, they are required to provide notice to the proper individuals. This notice must include the following information: (a) the reason for the blackout; (b) details of which transactions are affected by the blackout period; (c) the start and end dates of the period; (d) the contact information of who can be questioned about the blackout period (Pett, et al.). The next section, rules of professional responsibility for attorneys, covers items that attorneys are required to report when they are working in conjunction with an audit committee (SOX, 2002). The last section under Title III, fair funds for investors, provides additional assistance to investors who have been subject to the effects of fraudulent practices.

**Audit committee requirements.** An effectively operating audit committee is one of the most essential elements of internal control over financial reporting (Gramling,

Hermanson, & Hermanson, 2009). Section 301 in the Sarbanes Oxley Act of 2002 contains six components dealing with different requirements that are necessary for audit committees to have (SOX, 2002). These sections are as follows: commission rules, responsibilities relating to registered public accounting firms, independence, complaints, authority to engage advisors, and funding (SOX). Along with complying with these requirements, auditors are responsible to rotate their audits with another registered auditor (Miller & Pashkoff, 2002). This rotation is meant to aid in independence and objectivity. The SOX legislation defines an audit committee as follows:

A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer. (SOX, p. 2)

According to research conducted in 2009, since the execution of SOX, audit committee effectiveness has improved (Gramling, et al., 2009). In order to be effective, these committees should comply with the requirements provided in Section 301. The purpose of those requirements is to aid in effectiveness (Gramling, et al.). A strategic weakness of the requirement to have an audit committee is with small companies. Many small companies are unable to provide a separate audit committee because they have an extremely limited staff (Gramling, et al.). However, SOX section 205 has a potential loophole for this dilemma. This section gives the provision that if a separate audit committee is not available or in existence, the full board may act as the audit committee (Gramling, et al.). In order to remain in compliance with independence and objectivity

requirements, it is vital that those members of the committee are not part of management (Gramling, et al., 2009). It can be difficult for any audit committee to remain unbiased in every aspect of the word, but it is also important for the committee to remove any bias from the management of the firm (Caskey, Nagar, & Petacchi, 2010). The manager has a vested interest in the company, and rightly so, however that interest has the potential to cause them to make poor business decisions. This is one reason why SOX was published and then implemented: to detract from non-objective individuals in management (Caskey, et al.).

### **Use of Non-U.S. GAAP or Pro Forma Financial Information**

When speaking of foreign companies, most do not follow U.S. Generally Accepted Accounting Principles, hereafter referred to as GAAP. Many foreign companies follow the International Financial Reporting Standards, or IFRS, rather than GAAP. However, for a company that does not prepare their statements according to IFRS, the SEC requires their financial statements to be in accordance with GAAP (Parrino, & Sung, 2009). Section 401(b) of SOX discusses the rules and regulations that concern how a company can present figures from their financial statements and remain in compliance with SOX (SOX, 2002). For those companies that are registered in the US, with the SEC or PCAOB, section 401(b) requires two disclosures: (a) “a presentation of the most comparable financial measure calculated in accordance with GAAP”; (b) “a reconciliation of the differences between that measure and the non-GAAP measure” (Rulemaking, 2009, para. 31). These disclosures come as a result of the SEC’s Regulation G, adopted in January 2003 (Rulemaking). While this regulation was adopted in January, it was put into effect until March 28, 2003 (Marques, 2006). Regulation G is

believed by some to imply that the SEC considers more transparency and consistency in filing and providing information to be more beneficial to investors (Marques). Prior to the Sarbanes-Oxley Act, the SEC came to the realization that investors desiring to put capital into firms who did not comply with GAAP might be misled if the firms masked GAAP results (Marques, 2006). Because of this realization, and as a provision to SOX, the SEC proposed Regulation G and additional changes to the filing and furnishing rules, with the intent “to ensure that investors and others are not misled by the use of non-GAAP financial measures” (Marques, p. 550). The information that is now required to be disclosed to the investors may aid them in their investing decisions. This information will permit the investors the ability to choose if they concur with the adjustments seen in the firm or if they prefer to reverse these adjustments (Marques). According to one researcher, “the frequency of reporting non-GAAP earnings and other financial measures in quarterly earnings press releases did not change with the SEC interventions” (Marques, p. 554). This research appears to show that those firms which originally reported with pro-forma financial statements continued to do so, and firms which did report in accordance with GAAP continued their reporting as well. However, it is important to point out that firms registered with the SEC in the United States must comply with GAAP in their published financial statements, even if their own company statements continue to be in pro-forma format.

### **Internal Control**

Although internal control was one of the major issues being addressed in the Sarbanes Oxley Act of 2002, certain rules were not established until nearly a year after the publication of SOX. One of the most important provisions of SOX is the necessity to

employ internal controls in an attempt to prevent, detect, and deter fraud (Moffett, & Grant, 2011). The two sections of the legislation that affected internal control the most are Sections 302 and 404 (Thevenot, & Hall, 2011). Section 302, corporate responsibility for financial reports, is more of a practical application of the internal controls. This particular section requires the management of a company to (a) establish and maintain internal controls; (b) design internal controls to guarantee that material information which relates to the issuer and its subsidiaries is communicated to the officers with the entities; (c) evaluate the internal controls' efficiency within ninety days prior to the report; (d) present their conclusions in the report concerning the effectiveness of the internal controls based on the evaluation (SOX, 2002). Section 404, or management assessment of internal controls, requires each annual report to contain a report on internal controls and their effectiveness within the company (SOX). These vital sections changed the previous reporting standards and now require management to present an analysis of the design and efficiency of firms' internal controls (Thevenot, et al.). Efficient internal controls aid a business or firm with financial reporting, compliance, and operations (Moffett, et al., 2011). However, it should be stressed that internal controls are not an assurance that companies will be able to function with perfection. Controls may fail for various reasons, such as poor human judgment, negligence, or simple input errors (Moffett, et al.). However, in a report published in 2008 by the ACFE, or Association of Certified Fraud Examiners, internal controls were able to uncover fraud in 23.3 percent of cases analyzed (Moffett, et al.).

**Section 404.** The reporting requirements of SOX section 404 first became applicable to accelerated filers in 2004. This particular section of the Sarbanes-Oxley Act

mandates that company management and their external auditors testify concerning the efficiency of internal controls over financial reporting (Moffett, et al., 2011). Section 404 also requires the firms to file their report on internal controls with the SEC in order to divulge any noteworthy control deficiencies and material control weaknesses (Moffett, et al., 2011). It is necessary to specify that only material weaknesses need be divulged. Those that are not considered material are assumed to have little importance (Thevenot, et al., 2011).

**Fraud prevention.** Because of all the uncertainty Enron's meltdown caused, many employees of companies in the United States were afraid to come forward to reveal fraudulent practices because they feared losing their jobs. In April of 2003, the U.S. Securities and Exchange Commission published an addition to Section 301 of SOX (Rulemaking, 2009). This addition provided protection to employees who would come forward and disclose pertinent information. One of the primary purposes of a company having internal controls in place is to prevent fraud. Without the presence of effective and strong internal controls, companies are extremely susceptible to fraudulent activities (Moffett, et al., 2011).

**Weaknesses.** A major weakness of internal control systems surprisingly comes from the management of the company. Management has the ability to damage or reinforce these systems by the way they interact with the company and the employees (Moffett, et al., 2011). According to an article published in *Internal Auditing* by Ryan Moffett and Gerry Grant, management override and collusion with the other individuals employed at the firm have proven to be the largest danger (2011). In research conducted by Maya Thevenot and Linda Hall, certain deficiencies in internal controls have been

linked to poor accrual quality, poor board and audit committee quality, firm risk, and the cost of equity capital (2011). Furthermore, many firms with serious control flaws have a tendency to be smaller, less monetarily sound, have more involved operations and smaller amounts of resources (Thevenot, et al., 2011). These firms are unable to invest the proper funding into creating a secure system of internal controls, which causes them to be less confident. There are two types of weaknesses: account-specific and entity-level deficiencies. Those that are considered account-specific are regarded as less severe because they are linked to specific financial statement accounts, such as inventory, receivables, and intangibles (Thevenot, et al.). On the other hand, entity-level weaknesses have a far-reaching impact on the firm. They affect larger areas, such as “recognition and segregation of duties” and tend to be a sign of company-wide weak control environment (Thevenot, et al., para. 14).

### **Corporate Fraud and Accountability**

Many companies that experience fraud on any level are typically searching for ways to lessen the potential for fraud. Title XI of the Sarbanes-Oxley Act, Corporate Fraud and Accountability, seeks to alleviate the longevity of the search (SOX, 2002). This particular section contains severe consequences for both individuals and companies alike who engage in fraudulent practices. One such consequence applies to any individual who attempts to tamper with documents or official proceeding. These individuals would be subject to a fine or placed in prison for up to twenty years (SOX). Title XI contains six applicable sections with penalties and regulations: tampering with a record or otherwise impeding an official proceeding (1102), temporary freeze authority for the SEC (1103), amendment to the federal sentencing guidelines (1104), authority of the commission to



prohibit persons from serving as officers or directors (1105), increased criminal penalties under Securities Exchange Act of 1934 (1106), and retaliation against informants (1107) (SOX, 2002). Each of these sections was meant to instill a particular emotion so as to decrease the desire to commit such practices. Section 1107 specifically states what actions would be taken against informants:

Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than ten years, or both. (SOX, p. 65)

Recent research provides evidence of the specific types of individuals who would take the chance to inform the authorities of fraudulent practices. Such individuals have been identified as (a) employees of the company, (b) industry regulators, (c) press journalists, (d) equity holders and their analysts, (e) securities regulators, and (f) auditors (Bolt-Lee, Farber, & Moehrle, 2011). As is evident by the variety of individuals who have been categorized as informants, one need not be an employee of a company to discover fraudulent information.

### **Public Company Accounting Oversight Board**

The Public Company Accounting Oversight Board, or PCAOB, was created as a result of SOX. However, the PCAOB is not an entity of the United States government, but rather is a nonprofit corporation under the jurisdiction of the District of Columbia (Spillane, 2004). This board is run by five members from various backgrounds. Members

have a five-year term, with the option to serve an additional five years (Kranacher, 2008). The primary purpose of the PCAOB is to “protect investors by improving the accuracy and reliability of financial reports” (Kranacher, p. 1). Compliance with four key responsibilities is required when considering the administration procedures for the accounting-related portions of Sarbanes-Oxley: registration, standards, inspections, and enforcement (Lauriello, Leaby, Welsh 2010).

The main purpose of the PCAOB is to ensure that registered public accounting firms are following SOX, PCAOB regulations, SEC regulations, professional values and also the firm’s quality control policies (Lauriello, et al., 2010). The PCAOB has not been the easiest nor the cheapest regulation with which to comply. However, nearly a decade after the publication of Sarbanes-Oxley, many companies are beginning to appreciate the benefits of compliance.

### **Registration**

Registration with the PCAOB is required by SOX. This registration period takes a minimum of forty-five days, and could take longer if the correct information is not sent (Berger, 2010). There are three potential actions that may occur after the initial application is submitted: “approval, issuance of a notice of a hearing, or request for additional information” (Berger, para. 4). The two items that would require a lengthier registration period would be the issuance of a notice, or the request for additional information. Once these items have been sent out, a new forty-five day period begins (Berger). As of 2008, there were approximately 1,800 firms that had completed registration with the PCAOB (Kranacher, 2008). The Sarbanes-Oxley legislation mandates the PCAOB to gather a preliminary registration fee and also an annual fee from

those firms which have registered (Berger). These fees help offset some of the PCAOB's expenses, since it is a nonprofit organization (Berger). The due date for the annual fee is July 31 of every year the firm is registered (Berger). Along with the registration, firms must also file an annual report that releases selected client information (Lauriello, et al. 2010). The annual report is not to be filed past June 30 of every year, and is to encompass a 12-month period starting April 1 of the former calendar year concluding with March 31 of the calendar year in progress (Berger, 2010). This annual report is to be made available to the public on the PCAOB's website, excepting that information that is considered confidential (Berger). In order to receive confidentiality, a firm must request this treatment on their registration application (PCAOB, 2012).

### **Standards**

Firms that have completed the registration process with the PCAOB must then comply with the standards that the PCAOB has deemed acceptable for both auditing and the related verification for issuers (Lauriello, et al. 2010). According to the PCAOB website, there are four categories from which all standards are derived: auditing, ethics and independence, quality control, and attestation (PCAOB, 2012). Under each of these categories, there are certain standards which existed prior to the formation of the PCAOB, known as interim standards (PCAOB). There are also a number of new standards which either amended pre-existing standards, or were created as the result of ineffective policies.

**Auditing standards.** There are fourteen different auditing standards, or AS's, which are available to the public on the PCAOB website (PCAOB, 2012). They encompass a wide scope of the auditing process, such as report references, audit

planning, materiality considerations, audit evidence, and others (PCAOB). The most recent auditing standard, AS 15, began effectiveness on December 15, 2010 (PCAOB). AS 5, effective as of November 15, 2007, provides instructions for reporting, which is the final stage of any audit (Louwers, 2011). Many of these auditing standards are very specific, and then there are those which are more general. In the same fashion as the auditing standards, there are the interim standards. These interim standards were accepted in April 2003, and are made up of mostly generally accepted auditing standards (PCAOB, 2012). These standards are quite extensive, including a much larger range of information than the regular auditing standards. The interim standards are based on Statements on Auditing Standards, or SASs, that have not been amended by the PCAOB's Auditing Standards (Louwers).

**Ethics and independence.** Similar to the auditing portion of the PCAOB standards, the ethics and independence portion contains both new rules and interim standards. The rules range from 3501 to 3526, but only have nine rules in place (PCAOB, 2012). The other numerals that have been left out have either been superseded by a later numeral, or have become outdated. Underneath the umbrella of those nine rules, eighteen additional rules are expanded on the PCAOB website (PCAOB). Some of the ethics and independence rules that are currently in place deal with common sense items, while others provide more detail in order to prevent particular situations from occurring (PCAOB). As simply as individuals might desire for ethical decisions to be made, because of so much greed and self-preservation in the world, ethics can go out the window. These standards are an attempt to provide guidance and structure to individuals who may struggle with maintaining ethical behaviors. The interim standards that are

currently in place have been accepted as standards since April of 2003. These rules were accepted by the AICPA, American Institute of Certified Public Accountants, and are considered to be of as much importance as the rules (PCAOB).

**Quality control.** Unlike the auditing and ethics and independence sections, the quality control portion of the PCAOB contains no new rules. This particular section holds only the interim standards (PCAOB, 2012). These interim standards are in compliance with the AICPA's standards on quality control, and were accepted in April 2003 (PCAOB). Quality control only contains three interim standards specifically dealing with the topic, but there are also five requirements of membership listed as well (PCAOB). These membership requirements stem from the SEC, and involve continuing education for all professionals, meeting certain informational requirements, and following proper disclosure procedures (PCAOB).

**Attestation standards.** The final section of the PCAOB website that has current application to auditors is attestation (PCAOB, 2012). Attestation provides credible information to the management of a company (Louwers, 2011). There are six major interim standards for the attestation portion of the PCAOB: attest engagements, agreed-upon procedures engagements, financial forecasts and projections, reporting on pro forma financial information, compliance attestation, and managements' discussions and analysis (PCAOB). Each of these standards has its own specific use within the attestation portion. An attest engagement occurs when an auditor publishes a report on the financial statements that are the responsibility of management (Louwers). In practice, the attestation process involves the publication of the auditors' opinion of the financial statements (PCAOB).

**Inspections**

Another important responsibility of the PCAOB is to perform inspections of those audit firms which are registered (Lauriello, et al. 2010). These inspections occur annually for firms which issue audit reports for more than 100 companies (Lenard, Meonske, & Alam, 2009). According to the PCAOB website, this list includes ten firms which are inspected annually. They are BDO USA, Crowe Horwath, Deloitte & Touche, Ernst & Young, Grant Thornton, KPMG, MaloneBailey, McGladrey & Pullen, ParenteBeard, and PricewaterhouseCoopers (PCAOB, 2012). Those firms which deal with less than 100 companies are inspected once every three years (Lenard, et al.). Since the first inspection reports were released in August of 2004, roughly 1,600 inspections have been completed (Herron, & Gilbertson, 2011). These inspections included companies in the United States and also around the world. The first inspections of those public firms that registered with the PCAOB began in 2004 (Lauriello, Leauby, Welsh, 2010). During the course of these inspections, essentially all documentation and communications dealing with particular audits are exposed to review and evaluation (Lauriello, et al.). If during the performance of one of the inspections, an erroneous report is discovered, the PCAOB is authorized to take corrective action against the firm (Berger, 2010). There are three different reports that may be issued after an inspection: an unqualified, qualified or an adverse inspection report (Lenard, et al.). An unqualified report is the best report to receive. This report means that no deficiencies are found during the course of the audit inspection (Lenard, et al.). The other two types of reports are considered to be negative to receive. A qualified report is where one deficiency is found and an adverse report is where two or more deficiencies have been found (Lenard, et al.).

**Enforcement**

The fourth and final responsibility with which the Public Company Accounting Oversight Board has been tasked is enforcement. The PCAOB's Department of Enforcement and Investigations carries out the enforcement program. The program can be merely informational or antagonistic in nature (Herron, & Gilbertson, 2009). A significant part of the enforcement process is the task of inspection. In addition to inspection, there are two other important components: investigations and disciplinary actions (Lauriello, et al. 2010). Once the disciplinary actions have been decided, a company or individual will either be subject to either a hearing or adjudication. These three components will be discussed in the following paragraphs.

**Investigations.** Prior to having disciplinary actions take place, the PCAOB conducts investigations. These investigations can be either informal inquiries or formal investigations (Herron, et al., 2009). The informal inquiry is conventionally used when the PCAOB receives a potential violation complaint with minimal additional information (Spillane, 2004). A formal investigation is necessary only when adequate information has been acquired which provides evidence of a violation (Spillane). Any evidence that is obtained through the formal investigation process is considered to be confidential and the property of the PCAOB (Herron, et al.). However, the PCAOB has the ability to provide said information to the SEC, the U.S. Attorney General, other federal regulators, state attorneys general, and appropriate state regulatory authorities (PCAOB, 2012). Once the investigation has been completed, then the PCAOB makes the decision to conduct disciplinary action.

**Disciplinary actions.** According to Rule 5200 of the PCAOB, disciplinary action will only be taken if the alleged individual or company has breached the following: “any provision of Sarbanes-Oxley Act, any PCAOB rule, any professional standard, or the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto” (Spillane, 2004, para. 8). The PCAOB has disciplined sixty-three CPAs or firms since May 2005 (Herron, et al., 2011). The primary reason for disciplinary action to be taken on a firm or an individual is an act of omission (Herron, et al., 2011). It has been argued by certain scholars that the PCAOB is not being as harsh as they could be on certain companies in order to protect the limited competition there is in the market today (Lauriello, et al. 2010). While there are a significant amount of small audit firms in the United States currently, there are only four major players: Deloitte Touche Tohmatsu, Ernst&Young, KPMG, and PricewaterhouseCoopers (Albu, Albu, Fekete Pali-Pista, & Cuzdriorean Vladu, 2011). If one of these firms was to be eliminated, the level of competition would be significantly decreased. According to a study performed by David Gilbertson and Terri Herron, disciplined firms are more likely to have fewer partners, perform more audits on SEC issuers, and have a smaller, less financially sound clientele (Herron, et al.). A significant portion of the disciplinary process deals with hearings and adjudication. Each firm that has been charged with breaching any of the aforementioned items has the option to settle the case outside of court or undergoing litigation (Modesti, 2010). For each litigation case, the PCAOB assigns a hearing officer to be in control of the proceedings and to issue the initial decision (Spillane, 2004). This initial decision will be final excepting the respondent filing a “petition for review” or the board wishing to



review said decision (Spillane). The disciplinary actions that could be taken include suspension or removal of a firm's registration, prohibition of an individual to be affiliated with a registered firm, or a monetary penalty (PCAOB, 2012). These would only occur if the initial decision made by the hearing officer, and ultimately the PCAOB, was considered final. At that point only would these disciplinary actions come into play.

### **Impact of Sarbanes-Oxley**

Many studies have been conducted since the passing of the Sarbanes-Oxley Act concerning the impact of this Act. Some have shown the Act in a negative light due to the high costs of compliance (Jain, & Rezaee, 2006). In a study conducted by Jain and Rezaee, the costs of meeting the standards imposed by SOX can range from \$1 million to over \$10 million (2006). However, the same study stated that the overall effect of the Act was an increase in the wealth of those companies that took the time and effort to comply with the requirements (Jain, & Rezaee). Conversely, other studies have shown the Sarbanes-Oxley Act as a picture of success when considering the advantages of compliance (Verleun, Georgakopoulos, Sotiropoulos, & Vasileiou, 2011). During the course of the study conducted by Verleun, et al., they realized that the disadvantages of the Act must be considered in equal portion to the advantages (2011). Unless this tactic was taken, valuable information would be considered immaterial and lost to consideration. The conclusion of the study stated that SOX has had an overall positive effect on the quality of accounting (Verleun, et al.). Despite many critics who believe that such positivity cannot be sustained, the study states that this increase in quality is sustainable, based on a five year sample period (Verleun, et al.). In answer to the critique that the requirements of SOX are too expensive, some studies have shown that while the

initial costs to comply can seem daunting, an average of time to cost balances it out (Verleun, et al.). This average is calculated by dividing the amount of costs incurred by a particular firm in order to meet the compliance requirements set by SOX by the total amount of years that company is believed to survive (Verleun, et al.). While this theory is evidenced by only one study in this paper, there are multiple others that could be considered. One such study deals with the impact of SOX on “off-balance sheet supply chain activities” (Kros & Nadler, 2010, p. 1). The result of this particular study showed that the higher the level of compliance with SOX, the greater positivity of the effect on the supply chain activities (Kros & Nadler).

### **Conclusion**

The Sarbanes-Oxley Act has caused many companies to reconfigure their financial reporting methods completely. These changes have not come without costs, but the benefits have many times outweighed the costs. Many companies have benefited from the changes, but others have been unable to comply. However, those who have made the sacrifices necessary to implement these changes have seen exceptional results. The reporting standards as a whole have become more stringent since the implementation of SOX, yet the lack of flexibility provides a certain level of structure for companies. This structure is incredibly important in a world where nearly anything is permissible. While these changes have required intentional adjustment, throughout this past decade the U.S. economy has been able to avoid many meltdowns like that of Enron. Many companies that have followed the new reporting standards have been able to adapt to the evolution of legislation. Those that either could not or would not adapt are no longer in the market. There is no perfect fix for any problem or difficulty that will come in the economy. Every

instance of illegal activity or poor decision-making often stems from one simple mistake. That mistake compounds into something that can never be undone. While legislation is not a cure-all for these problems and mistakes, they do provide guidelines. In this writer's opinion, Sarbanes-Oxley was the catalyst for many more pieces of legislation to be passed. The long-reaching effects of SOX remain to be seen, yet the evidence from the past decade is overwhelmingly positive. Only time will tell what changes will come to be in the future of financial reporting.

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