

The sarbanes-oxley act of 2002

Law



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In the wake of the financial scandals that struck major corporations such as Enron, WorldCom and Tyco International, the Sarbanes-Oxley Act of 2002 was enacted “ to protect investors by improving the accuracy and reliability of corporate disclosures , made pursuant to the securities laws. ” (P. L. 107-204, 116 Stat. 45) It aims to create new and enhance previously existing standards and practices for the boards of all publicly held companies as well as management and public accounting firms in the United States, delineating and clarifying rights and responsibilities with regards to auditing and accountability and emphasizing such points as auditor independence, corporate governance and responsibility and assessment of internal controls. Specifically, the Act stresses upon a more exhaustive disclosure of financial transactions as reporting requirements of companies based in the United States now need to be more thorough and more critical, and therefore more costly to implement. As such, this comes as a heavy burden to smaller companies who have to contend with the high costs imposed on them to complete their assessments, effectively forcing many of these small businesses to do away with public ownership, which in turn reduces valuable entrepreneurial activity. Ribstein & Butler, 2006, p. 101) The Sarbanes-Oxley Act, known in full as the Public Company Accounting Reform and Investor Protection Act, was enacted June 30, 2002 through the sponsorships of Maryland Senator Paul Sarbanes and Ohio 4th District Representative Michael Oxley.

The Act has 11 titles dealing with auditor independence, individual responsibility of senior executives for the accuracy and completeness of corporate financial reports, and enhanced reporting requirements for

financial transactions. (P. L. 107-204, 116 Stat. 45, Titles II, III, IV) It also includes measures and practices designed to help restore investor confidence in securities analysts, as well as indicating violations and specific criminal penalties for fraud by manipulation of financial records or other interference with investigations. (P. L. 107-204, 116 Stat. 745, Titles VIII, IX, XI) In its establishment, the Act created the Public Company Accounting Oversight Board (PCAOB) to regulate and discipline accounting firms as auditors of public companies. It also mandates the Securities and Exchange Commission (SEC) to implement rulings on requirements in compliance with the Act. P. L. 107-204, 116 Stat. 745, Titles I, VI, VII) In his signing statement, President George W. Bush claims the Sarbanes-Oxley Act “ the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. ”

He stressed that it ushers in a new era of integrity and responsibility in corporate America where dishonest leaders will be caught and penalized accordingly, a reference to the major corporate and accounting scandals that affected many large corporations during the '90s and well into the new millenium, shattering public confidence in the nation's securities markets. Office of the Press Secretary, 2002) Particularly enraging accounts that led to the creation of the Act are the scandals that involved Enron, WorldCom and Tyco International, where conflicts of interest, unusual and unreasonably justified banking practices, and problems in incentive compensation activities revealed massive fraud on the part of both the companies and their accounting firms, resulting in massive market downturns. (Patsuris, 2002)

The Act combats such unscrupulous activities by emphasizing corporate controls and enhanced financial reporting to maintain credibility. Details of off-balance sheet transactions, pro-forma figures and stock transactions of corporate officers must be reported. To assure the accuracy of financial reports and disclosures, management assessment of internal controls must be thoroughly performed. Timely periodic reporting of material changes in financial condition is required, as well as specified enhanced reviews by the SEC of such corporate reports. (P. L. 107-204, 116 Stat. 745, Title IV) A specific part of the Act, Section 404, requires management and external auditor to report on the adequacy of the company's control over financial reports.

This, however, is considered by many the aspect that costs most to implement as enormous effort is needed to document and test important financial controls. Since it requires both management and external auditor to perform assessment in the context of a top-down risk assessment, it must cover all aspects of compliance and thus needs much time, labor and cost. Ribstein & Butler, 2006, p. 100) Compliance with Section 404 of the Act has a much greater impact on smaller companies as there is a significant cost involved in completing their assessments. Ribstein and Butler (2006) contend that this necessitates many small businesses to spend much more than what they actually earn, driving a huge percentage of their expenditure on compliance alone. This eventually forces them to forgo with public ownership.

As an example, during 2004, U. S. companies with revenues exceeding \$5 billion spent .06% of revenue on compliance, while companies with less than <https://assignbuster.com/the-sarbanes-oxley-act-of-2002/>

\$100 million in revenue spent 2. 55%. (U. S. Securities and Exchange Commission, 2006) It is quite unfair that small companies should bear the brunt when they do not earn as much as their bigger counterparts, and the government must take steps and act on what can be seen as a drawback on such a well-intended regulation.

In conclusion, while much of the Sarbanes-Oxley Act of 2002 was created and implemented to help put public trust back into corporations through recognizing and rewarding honest corporate leaders while disciplining and fining unaccountable ones, much must be done to help alleviate the apparent burden on small companies who have to spend much on compliance, so that they may flourish and be able to compete without being compelled to spend too much on something that is beyond their capacity. And we should look forward in continuing the good work that the Act itself represents in defending the public from fraudulent and malicious corporate activities.