

# Sarbanes-Oxley at Two

by Itzhak Sharav

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It has been two years since the Sarbanes-Oxley Act was passed in the aftermath of financial reporting scandals and corporate failures, for which Enron Corp. has become a notorious symbol the world over.

Certain provisions of Sarbanes-Oxley and Securities and Exchange Commission (SEC) rules are clearly meant to prevent a repetition of the wrongdoings that came to light as various corporate fiascoes unfolded in rapid succession, beginning in 2001. Unprecedented in this regard is Sarbanes-Oxley's Section 302 requirement that the chief executive officers and the chief financial officers of public companies personally certify quarterly and annual reports. In addition, Section 404 of the act requires an annual assessment and documentation by management of the internal control over financial reporting — such assessment to be attested to by the outside auditors.

Estimates of the extra costs incurred by companies that have enacted tighter internal control systems and followed other compliance rules, vary. It appears, according to a recent study conducted by Financial Executives International, an association of senior-level executives, that costs in the first year amounted to less than \$2 million for companies whose revenues were under \$5 billion, and \$4.6 million for companies whose revenues exceeded \$5 billion.

It should not come as a surprise that several corporate executives and lobbyists have begun to argue that Sarbanes-Oxley and the regulators went too far in imposing costs on companies, which do not result in a commensurate return. Thus, General Motors Corporation's chief accounting officer, Peter Bible, was quoted in *The Wall Street Journal* as saying that while "Everybody feels they have to do something to react to corporate scandals, you really have to scratch your head and say: How is this really benefiting our shareholders?"

Mr. Bible was not the only one to cast doubts on the usefulness of Sarbanes-Oxley by couching criticism in terms of cost benefit analysis. Complaints of this sort are likely to be voiced with growing frequency, now that the fully operative Public Company Accounting Oversight Board (PCAOB), a Sarbanes-Oxley creation, has emerged from infancy and is poised to expand its activities by promulgating additional rules, and moving on to audit the work done by the accounting firms.

Sarbanes-Oxley, if vigorously applied, should result in a significant decline in the scandal rate of recent years. The benefits for corporations and stockholders are likely to outweigh

the costs of compliance with Sarbanes-Oxley. HealthSouth Corporation and its former CEO Richard M. Scrushy are a case in point:

Among the SEC's numerous allegations against Mr. Scrushy is the claim that in 2001 he received a bonus of at least \$6.5 million, which was based on inflated earnings. That figure alone exceeds the estimated \$2 million figure, mentioned earlier, that it cost companies the size of HealthSouth to put in place tighter internal control systems.

That said, there is no denying that any unreasonable escalation in the costs of compliance with Sarbanes-Oxley should be of concern to the SEC and the PCAOB, because such a trend would likely result in a backlash, and provide ammunition to those, who, having objected from the beginning to the scope of reforms that Sarbanes-Oxley entails, may enjoy a measure of congressional sympathy and support in their attempts to curtail those reforms.

It is important, therefore, to closely analyze cost increases in order to establish their legitimacy. The much talked about Section 404, for example, is bound to increase annual costs, because it mandates that management's year-end assessment of internal controls be attested to by outside auditors.

But the question that ought to be asked is: by how much should overall audit costs increase as a result of the auditor's attestation? It is true that tighter controls are expected now, but the auditors are not totally new to the task, having attested to their audit clients' internal controls in the pre-Sarbanes-Oxley era, and having based those attestations on an examination that included a review of the internal control structure, and meetings with the audit committee of the board.

Thus, a two paragraph statement in International Business Machines Corporation's 2001 annual report, well before the enactment of Sarbanes-Oxley in mid-2002, states the following:

"PricewaterhouseCoopers LLP, independent accountants, is retained to examine IBM's financial statements. Its accompanying report is based on an examination conducted in accordance with generally accepted auditing standards, including a review of the internal control structure and tests of accounting procedures and records.

The Audit Committee of the Board of Directors is composed solely of outside directors, and is responsible for recommending to the board the independent accounting firm to be retained for the coming year, subject to stockholder approval. The Audit Committee meets periodically and privately with the independent accountants, with the company's internal auditors, as well as with IBM management, to review accounting, auditing, internal control structure and financial reporting matters."

(Similar statements appear in the annual reports for that period of other companies.)

Eyebrows should be raised in cases where auditors have been portrayed as conducting robust reviews of internal controls all along, yet a subsequent audit by the same auditors, only one year later, following the enactment of Sarbanes-Oxley, carries a much higher price tag.

The increase may indeed be legitimate, in which case the failure to contest it amounts to a tacit admission that past reviews of internal controls by the auditors were, after all, not as thorough as the costlier latest review that adhered to the specifications of Section 404.

It is also possible that the auditors have performed some unnecessary extra work (so-called “Gold Plating”) in order to increase their revenues. And then again, the increase may amount to the good old fashioned opportunistic “price gouging” that PCAOB member, Ms. Kayla J. Gillan, warned against in a recent speech, in which she called for disciplinary action against such perpetrators, having foreseen the temptation faced especially by the big CPA firms, whose number has shrunk with the demise of Arthur Andersen at the same time that overall demand for their audit services has increased.

While many costs can be measured with relative ease, including those attributable to Sarbanes-Oxley, benefits expected to accrue in the future are not given to precise measurement. To the extent that Sarbanes-Oxley, by wielding a stick, discourages misbehavior, common sense suggests that compliant companies will spare themselves reputational loss, lawsuits and legal expenses, business interruptions, fines and financial collapse, and thus reap a benefit that exceeds the costs triggered by the two-year old legislation.

Sarbanes-Oxley should be given a chance to prove its effectiveness.

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