

THE LAW OF UNINTENDED CONSEQUENCES? ASSESSING THE COSTS, BENEFITS AND OUTCOMES OF THE SARBANES/OXLEY ACT

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The Sarbanes/Oxley Act fundamentally impacted financial reporting, auditing, internal control, standard setting and corporate governance. Its' unstated, but fairly transparent goal was to ensure that there would be no more Enron's, WorldCom's and Tyco's. But will that be the actual outcome of the legislation, or will the act eventually turn out to be more a case of choosing appearance over substance in response to public outrage? In this paper we discuss the myriad implications of the Sarbanes/Oxley Act, both intended and unintended, and their cost and benefits.

Introduction

The Sarbanes/Oxley Act is not just a major piece of securities legislation; it is also a prime example of the "law of unintended consequences". When the act was passed amidst the meltdown of Arthur Andersen, few would have thought that it would lead to substantive increase in the profits of the remaining audit firms, the cancellation of many software efforts due to the lack of resources, arguably to the emergence of scandals at the NYSE, Freddie Mac and Mutual Funds due to the increased emphasis on transparency, and a major rebalancing of the roles and players in the consulting field. Once the act was seen as imposing additional regulation on the accounting profession as punishment for its ethical

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lapses; now it is derided as a full employment act for those same accountants, as firms complain about the burden that Section 404 of the act imposes upon them.

It is not surprising that the Sarbanes/Oxley Act, like any complicated law, will have unforeseen results that will have to played out in practice. But the way in which the legislation was passed, not after a considered review process, but as a grab bag of provisions reacting to the latest corporate scandal (Tyco gave its CEO absurd loans, so ban all loans) makes it particularly vulnerable in this regard. The legislation had been in the mind of Senator Sarbanes of Maryland for some time, prompted by the failure at Enron. But it languished in the face of strong opposition from the GOP, led, ironically, by Representative Oxley, until the WorldCom debacle made it politically imperative for Congress and the Bush Administration to be seen to be acting. The very name of the act, bringing together the law's chief sponsor with the most vocal and adamant opponent of government regulation is perhaps a warning that its tortured birth may well have resulted in awkward compromises and not-well thought out formulations in its content.

Initially, the most publicity was drawn to the requirements of Section 302 of the Act, requiring the CEO and CFO to personally sign off on the appropriateness of the firm's financial statement. It was pointed out, of course, that the CEO has long been required to effectively do this, but perhaps the provisions of Title IX greatly increasing the penalties for white collar corporate crime (making it equivalent in some cases to the jail time for murder, albeit without the death penalty!) served to focus the executives mind more on what that certification entails. Similarly, the requirements (in Section 407) that at least one member of the audit committee be a "financial expert" caused many firms to scramble to find new directors at the same time that they were facing a crisis in the market for directors insurance (oddly, the most infamous director at the time of the passage of the act was the chairman of the audit committee at Enron, who is an accounting professor and former business school dean, and so, surely, a financial expert too). And, to put it mildly, the unfortunate way in which the then SEC Chairman Harvey Pitt attempted to pick the chair of the newly formed Public Company Accounting Oversight Board (PCAOB) was also a source of much angst in

the media.

But today, most observers would agree that it is Section 404 of the Act, on the attestation of financial reporting controls, that is its most momentous provision, at least at present—as we argue later in this paper, Section 409, on more frequent reporting, may prove to have an even greater impact on business in the long run. But first, to Section 404. It is so short in relation to its impact that it is worth quoting in full:

Section 404
Management Assessment of Internal Controls

(a) RULES REQUIRED- The Commission shall prescribe rules requiring each annual report required by section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) to contain an internal control report, which shall--

(1) State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING- With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

The genesis of this provision was the concern that, there was a lack of sufficient controls at such scandal-ridden firms as WorldCom and Tyco to ensure that assets were safeguarded and that the firm's financial statements were accurate. Thus the act required managers to implement controls over the financial reporting process and state whether they were effective. And, by the way, the auditor, in the course of the regular annual audit, should

check whether that statement by management was well based. Confusingly, another provision of the act, Section 302, also discussed internal controls, and in fact, does so in much greater length and detail than Section 404.

But it is Section 404 that has captured the imagination of the accounting profession, caused fear and loathing in corporate America and generates approximately 1.5 million hits (and counting) on Google. It is best described as the first new mandated audit product since the passage of the original securities acts in the 1930s. Not so long ago it was argued that audit firms had to transform themselves into management consultants because the mandated audit was such a backwater—an uninteresting loss leader and a ever shrinking source of work, with only 10% of CPAs engaged in auditing even though the very definition of a CPA is an individual who can sign off on an audit statement. Today, as 404 has been interpreted as a mandate to document controls there is an exploding demand for auditing, even as controversy continues as to whether auditors can attest to controls that they have themselves helped put in place.

Costs and Benefits of 404

Even as the SEC has released its final rules on the implementation of Section 404¹ and the PCAOB issues its preliminary 404 auditing standards², there is considerable uncertainty in the profession as to what exactly it will take to do a 404 attestation. Meanwhile many firms feel overwhelmed by what the strict interpretation of the act seems to require of them in terms of imposing new controls and documenting existing ones. In response the SEC has postponed the implementation date of 404 to 2004, but that has done little to quell the controversy.

¹ SEC. 2003b. Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports. <http://www.sec.gov/rules/final/33-8238.htm>.

² PCAOB (2003). Proposed Auditing Standard: An Audit of Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. http://www.pcaobus.org/rules/2003-10-07_Proposal_Brief-Proposed_Auditing_Standard.pdf

One of the key concerns of the business community with 404 is the cost of implementation, especially given the widely circulated story that at the time the Sarbanes/Oxley Act was passed, the SEC assumed that compliance would take the average firm only a few extra hours of work. While that story may eventually turn out to be an urban myth, it reflects the frustration felt by many executives that Congress had little idea what the consequences would be on the economy of 404.

In its article “Sticker Shock: the true Cost of Sarbanes-Oxley Compliance”³ CFO magazine reports the results of a survey in which many managers vehemently argues that the cost of compliance is excessive. Business Week, in its recent report “Honesty is a Pricey Policy”⁴ puts forward an estimate of 404 compliance of \$7 billion in the first year, with continuing costs as the attestation has to be renewed each year, and in the case of Section 302, each quarter.

There is little doubt that the cost of compliance will be very high. But the question is what that cost buys the economy in terms of more credible financial reporting and perhaps, better run firms. While it is too early to quantify the cost and benefits of 404, we can make several points that will put the problem into better perspective. First, internal control evaluation and responsibilities are not a new mandate on business. The Foreign Corrupt Practices Act of 1977 imposed strict internal control requirements to ensure that firms don’t pay bribes, and at the time had its own large cadre of detractors. One serious attempt to reduce its scope was defeated in Congress and overall the act has not been the basis for much legal action, and nor is there much complaint today about the cost of compliance. Also, it is worth noting that bank and thrift holding firms are already subject to controls very similar to Section 404 under the 1991 Federal Deposit Insurance Corporation Improvement Act.

Furthermore, all audits include substantial element of internal controls, in which if controls are weak there is substantive increase in detail testing and consequent reporting in

³ Alix Nyberg, “Sticker Shock: the true Cost of Sarbanes-Oxley Compliance,” CFO Magazine, September 2003, pp. 51-62.

⁴ October 27th, 2003, page 100.

the management letter. The audit committee of the board of directors typically reviews this letter and management has to respond to its recommendations.

Secondly, there is some evidence that even prior to the malfeasance crisis many firms, in response to market pressure, were becoming increasingly concerned about corporate controls and corporate guidance. The 1997 report of the AICPA's Special Committee on Assurance Services⁵ (The "Elliot Committee") recommended a system reliability assurance service (SysTrust) that been met with good acceptance by management over the last three years. The SysTrust service, while more limited in scope than 404, also relies heavily on auditor consideration and review of internal corporate processes and controls. The emergence of this service, prior to Sarbanes Oxley, and its increasing acceptance by firms can be interpreted as market demand for additional assurance on systems and their controls. The substantial corporate investment in enterprise resource planning systems (ERPS) such as SAPTM, which incorporate best industry practices, while prompted somewhat by the Y2K phenomenon, can also be interpreted as the recognition that new technologies and disjoint IT systems were dangerous for corporate integrity.

Finally and perhaps most important of all, the argument that implementing 404 will impose more costs than benefits assumes that few firms will benefit from the imposition of tighter controls. But the benefits of improved corporate controls are not only expected to be found in decreased malfeasance but perhaps even more so on a substantial increase in corporate data quality, the decrease of instances of data rework and erroneous intra and extra corporate transactions. The main domain of benefits from lower level corporate controls is better operations and improved matching between corporate needs and its expenses.

However, we should also mention the important criticism of Section 404 recently made by Boston College law professor Lawrence Cunningham.⁶ One of his arguments is that

⁵ AICPA. 1997. *Report of the Special Committee on Assurance Services*, Systems Reliability Assurance segment. <<http://www.aicpa.org/assurance/scas/newsvs/reliab/index.htm>>

⁶The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills. Research paper #18, Boston College Law School. September 12, 2003.

the Sarbanes/Oxley Act is an instance of the cycle by which controls are mandated in response to some crisis, and when those controls eventually prove ineffective; auditing is required of the implementation of those controls. The problem with this knee-jerk reaction is that controls are written to be auditable rather than to address the underlying problem they were originally intended to address. That is certainly a concern with the Section 404, for note that while most of the attention today is on how auditors are making money imposing controls, the act itself puts the emphasis on the role of **management** in assessing the effectiveness of reporting controls, not on the role of the auditor in attesting to that certification. To the extent that the intent of the act has been reversed, with managers simply passing the buck (literally...) to the auditor the cost and benefits of the legislation will certainly differ from what was intended.

Continuous Assurance as a Facilitator of 404 Implementation

In the 1980s firms came to recognize that the full benefits of technology come about only when processes are first reengineered to take advantage of the new capabilities that the technology makes possible, rather than using the technology to simply automate existing manual processes. A similar argument applies to 404 implementation: if the existence of the act is taken as given, firms can move on and ask themselves whether their control systems are up to date and whether they can be improved, not just to improve financial reporting, but the way the firm is run in general. That is a more productive approach than complaining about the Act (which is not likely to be changed any time soon, given the current political climate) and grudgingly documenting every existing control, without asking whether they are optimal or not. It is worth considering that the COSO framework that will underlie 404 controls has been available to firms for over a decade, but few firms had shown any interest in it. Some may argue that this shows that COSO is not wanted by firms, but a far more likely explanation is that during the boom years of the 1990s few firms really paid any attention to the quality of their control infrastructure. Implementing 404 can force firms to

think about how they are run in much the same way as budgeting forces planning on busy managers.

In particular, the most lasting impact of 404 implementation will come about when the new financial reporting controls are integrated with the rapidly emerging technology of continuous assurance, reporting and monitoring.⁷ Indeed, in its article on the cost of 404 compliance, CFO magazine (September 2003) states that *“at this point, many companies are still performing low-tech risk-mapping processes to gauge the impact of Sarbanes-Oxley. But the technology sector has high hopes that soon that will give way to a need for new tools.”*

Control mapping, in particular of manual processes that existed for a long time is a low return procedure. Corporate systems are evolving to real-time monitoring and control systems⁸ whereby managers monitor processes in real time and take corrective actions at progressively shorter and shorter time intervals. Many of these adjustments will be performed by automatic processes or by managers using hi-tech dashboards with alarming and alerting functions. The tools for automatic control mapping, evaluating online-real time control functioning and selecting alarms for auditor review will greatly facilitate 404 compliance.

On the other hand, the unintended consequence of the act in this area has been the slowing of the above mentioned trend towards real-time management phenomena in order to perform small benefit manual control mapping and documentation on controls that are rapidly disappearing. Hopefully, after the initial panic over 404 subsides, a more long term view about controls will prevail aimed at systemically improving data quality and control process integrity. This will lead to new emphasis on integrative software, continuous monitoring systems and continuous audit.

⁷ Alles et al (Black Box Logging and Tertiary Monitoring of Continuous Assurance Systems, ISACA Journal, Vol. 1, pp. 37-39, 2003) discuss forms of corporate monitoring and audit logging that may evolve. The ISACA journal has in fact had two special issues on continuous assurance over the last five years.

⁸ The Economist, The real time economy, January 31, 2002.

Section 409: Real Time Disclosure

As continuous assurance becomes prevalent, the most important long term provision of the Sarbanes/Oxley Act may well turn out to be Section 409 on real time reporting:

SEC. 409. REAL TIME ISSUER DISCLOSURES.

“(I) REAL TIME ISSUER DISCLOSURES.—Each issuer reporting under section 13(a) or 15(d) shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.”

This rule has been currently interpreted as a mandate for the SEC to force faster reporting on several of its forms. The Enron episode showed that insider stock sales could legally be disclosed nearly a year after the trades, and special noteworthy events were at the discretion of management for disclosure. But moving up the filing deadline for 10-Q's from 45 dates from the end of the quarter to 35 is a far cry from the disclosure on the a “rapid and current basis” specified in Section 409.

Computer technology, such as ERP systems and the emergence of XML, especially the XBRL and XBRL-GL derivatives, increasingly provides firms with the possibility of cost-efficient online real-time systems. This could include financial statements published on the Web that that are complete up to the last recorded corporate transactions, contracts and commitments in process, even prior to their realization in traditional accounting. These fulfill the Section 409 requirements much better than preliminary steps taken by the SEC

thus far, which are much more along the lines of taking processes as given rather than rethinking and reengineering them.

Inevitably, the needs of the modern information marketplace will see the use of this provision as the lever to finally bring about real time reporting and disclosure. The assumption is that corporations with real-time monitoring and control systems will have lesser latency (delay) in their processes and consequently gain competitive advantage over the other players in their industry. Consequently, internal reporting processes regardless of how Section 409 is officially interpreted will progressively be real-time. Therefore the incremental cost of using real-time controls for external reporting will be small, especially when all accounting systems are XBRL enabled. The unintended consequence question that arises is whether litigation fears relative to optional disclosure will forbid the above technologically facilitated capabilities.

Calibrating Expectations about Sarbanes/Oxley

A recent study¹¹ examined 100 recent events of malfeasance and observed that about two-thirds of these were related to the income recognition practices of the firms, many of which did not have specific guidance in GAAP. On the other hand, the number of explicit violations of bright-line rules in GAAP was small and the instances of direct theft from companies were negligible. The analysis seems to indicate that corporate malfeasants were reluctant (with the notable exception of WorldCom) to directly violate GAAP and securities laws but relied on a highly paid army of investment bankers, management consultants and lawyers to take advantage of legal omissions and misapplications of GAAP interpretations.

Examining the malfeasance, three possible scenarios arise:

1. Endogenous fraud where company assets are misappropriated.
2. Endogenous fraud where earnings are managed in order to boost incentive compensation.

¹¹ Arnold, L. W. and Vasarhelyi, M. A. Assertions about the Malfeasance crisis; implications for a new business reporting model, Working Paper, Rutgers Accounting Research Center, 2003.

3. Exogenous fraud where certain management activities by executives render them personal benefits outside the measures of the firm (e.g. executives receive generous personal allocations of rights to IPO stocks in exchange of giving investment banking business to the IPO underwriter).

While all these types of malfeasance cause major losses to corporate stakeholders Section 404 focuses on controls over earnings. The Sarbanes/Oxley Act in general does little if anything for scenarios 1 and three. Concerning scenario 2, if a firm correctly reports earnings the act does nothing about the outsized levels of compensation eagerly awarded by compliant compensation committees. By not touching the drivers of the malfeasance crisis (as it could have done, for example, by requiring the expensing of options) the act is rather more limited in its scope than it may at first appear.

The Sarbanes/Oxley Act did greatly increase penalties for miscreant executives, making such activities criminal and increasing their statutory supervisory obligations. However the jury is still out on whether corporate governance rules have been sufficiently improved to take advantage of a tighter control environment in the organization. The study also showed that the loss in market value resulting from the revelation of this malfeasance was more than twenty times the amount of the direct loss to the firm. One interpretation of this seemingly disproportionate stock price reaction is that the revealed malfeasance makes the market reassess its prior expectations about the quality of the firms reporting controls. This provides a metric for the benefits of the tighter controls on financial reporting that Section 404 mandates.

The passage of the Sarbanes/Oxley Act, with its emphasis on greater transparency and better corporate governance has indirectly led to a second wave of scandals of a different sort than malfeasance. Controversy about outlandish executive compensation at the NYSE and elsewhere, emerging concern about the misbehavior of individuals in the financial sector (preferential trading at mutual funds, opportunistic and inappropriate trading by managers of financial institutions taking advantage of their trade volumes and financial

might against small investors) are all issues that are being energetically pursued by previously complaisant regulators and state attorney generals that traditionally had little appetite for this form of litigation. As an unforeseen consequence we see substantial settlements being reached in the above litigation and a second wave of regulation being drawn up—indeed, many market participants are already talking about Sarbanes/Oxley II.

Conclusion

While a piece of legislation as complex as the Sarbanes/Oxley Act will inevitably result in unintended consequence, that is not to say that all those outcomes will be contrary to the intent of the act. There are valid concerns about the cost of Section 404, and it is probably true that not enough thought was given to those costs when the legislation was passed—partly because the momentous nature of that provision was not even realized in advance. But the way that the interpretation of that section has organically grown and taken a life of its own, spawning an entire new industry of financial reporting controls, is also indicative that it touched upon an important unmet need in business. Firms today are far more complex and technologically dependent than they were even in the recent past, and that suggests both that the way in which they are controlled needs to be reengineered and that making use of such new technologies as continuous assurance will allow that to happen cost effectively and with far greater capability.