The History and Consequences of the Sarbanes-Oxley Act of 2002

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THE HISTORY AND CONSEQUENCES OF
THE SARBANES-OXLEY ACT OF 2002

by
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A thesis submitted to the faculty of The University of Mississippi in partial
fulfillment of the requirements of the Sally McDonnell Barksdale Honors
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ABSTRACT

GERALD WALTMAN III: The History and Consequences of the Sarbanes-Oxley Act of 2002
(Under the direction of John Czarnetzky)

The purpose of this research and thesis is to explore the intended and unintended consequences of the Sarbanes-Oxley Act of 2002. The Act arose from a series of financial scandals including those that happened at Enron and WorldCom. The Act is one of the most wide-sweeping pieces of financial legislation in the country's history, and it has drastically changed the way that publicly traded companies and their auditors conduct their business. A significant challenge to the Act was heard by the United States Supreme Court, and the Court held a portion of the Act to be in violation of the United States Constitution but allowed the remainder to stand.
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INTRODUCTION

The purpose of this thesis is to explore the consequences, intended and otherwise, of the Sarbanes-Oxley Act of 2002, and provide information about the history of financial regulation in the United States, the financial environment that lead to the passage of the Act, specifically the Enron and WorldCom scandals, and the role of accountants throughout this and other cases. Understanding the history of regulation and the financial environment at the turn of the millennium is essential to understanding why Sarbanes-Oxley was passed, and an understanding of the "why" of Sarbanes-Oxley is vital to understanding if it has had the effects its authors desired. It could be that Sarbanes-Oxley increases the value of companies' financial information and auditors' services, or it could be that it simply adds layers of red tape that will do little to curb corruption that pervades our corporate culture.¹

These effects have drastically altered how publicly traded companies structure their internal controls and how they communicate relevant and reliable financial information to users of that financial information. As greatly as publicly traded companies have been affected, the auditors of those companies have been affected equally if not more. This work will also detail the changes that companies and auditors have had to make to be compliant with Sarbanes-Oxley.

HYPOTHESIS

The author believes that Sarbanes-Oxley has curtailed accounting fraud to some degree by increasing the oversight that the federal government has over publicly traded companies and their auditors. The author expects that the field of auditing publicly traded companies will have been more greatly affected than any individual company or industry, and the author expect that costs for companies and auditors will be greater than before Sarbanes-Oxley was enacted.

It is difficult to say what crimes Sarbanes-Oxley has prevented, but the author believe that by highlighting the differences between pre-SOX and post-SOX regulations and practices the author can make reasonable conjecture about how SOX has affected the prosecution and detection of financial crimes. While the author may find that Sarbanes-Oxley has had a beneficial effect on publicly traded companies, their auditors, and ultimately the users of financial information, the author does not believe that any amount of legislation or regulation can drive corruption from the hearts of men.

SOURCES AND METHODOLOGIES

After the celebration of the tenth anniversary of the passage of Sarbanes-Oxley, there is a wealth of information available about the Act and its consequences. This work draws on the author's experience in studying financial accounting and auditing and research done through financial and legal periodicals, academic and professional websites, court cases and opinions, and the text of and commentary about federal statutes. The author draws the relevant information from these sources and arranges it in this work in an effort to
LITERATURE REVIEWS

This document touches briefly on the history of financial regulation, the environment that lead to Sarbanes-Oxley, basic tenets of the statute itself, and the opinion of the U.S. Supreme Court in Free Enterprise Fund v. PCAOB. This thesis incorporates these reviews with commentary and discussion from the author.
CHAPTER I
A BRIEF HISTORY OF FINANCIAL REGULATION IN THE UNITED STATES

The Securities Acts of 1933 and 1934 require that companies who issue securities to file financial statements that come with the opinion of an independent auditor to be filed as part of the company's registration and following reports. The only person who can issue such an opinion to accompany said financial statements is a Certified Public Accountant (CPA), which is a state-licensed accounting practitioner.²

Before the passage of Sarbanes-Oxley in 2002, the American Institute of Certified Public Accountants (AICPA) was the highest authority for its members. Sarbanes-Oxley established the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of publicly traded companies by CPAs, but that will be discussed in greater detail later in this work. Despite the presence of the PCAOB, the AICPA still wields considerable influence, and its Statements on Auditing Standards (SASs) continue to be used by the PCAOB and CPAs. Such standards include the Generally Accepted Auditing Standards (GAAS) for general qualifications and conduct, field work audit performance, and results reporting.³

Perhaps the greatest asset an auditor can bring to society is an independent and unbiased opinion. While doctors and lawyers are primarily

responsible for looking after the best interests of their clients and patients, auditors are also valuable because they look after the best interest of the users of the financial information provided by the auditor's clients. It must follow then that for auditors to be able to adequately and fairly evaluate their client's information that the auditor must be independent. For over a century auditors were able to govern themselves, but, as a new millennium dawned, a series of financial scandals rocked the confidence and trust that are essential to the successful course of an audit. Therefore, legislation was enacted to protect the independence of auditors.\(^4\)

The largest two scandals that contributed to the environment of corruption are the ones that occurred at Enron and WorldCom, and the events surrounding them are described below. These are two of the largest scandals, financial or otherwise, that have rocked the American people in the last century, and one hopes they do not set the tone for this new century to be one of corruption and bad business. However, with the passage of Sarbanes-Oxley, it would seem we are taking steps to increase accountability and good business practices.

\(^4\) Id.
CHAPTER II
THE ENVIRONMENT THAT LEAD TO SARBANES-OXLEY

ENRON

While there were some smaller financial scandals that rocked the public's faith in accounting, the scandal of Enron Corporation was the beginning of a new era of financial regulation.\(^5\)

Enron Corporation, an energy company that expanded into commodities and services, was at one time the seventh largest company in the United States and commanded a $70 billion market value. At the time of its fall, Enron was the largest scandal in the history of the United States.\(^6\) As a giant of the American economic landscape, Enron was expected to meet certain earnings targets for its shareholders. When it became likely that those expectations would not be met, Enron's management used a complex financial structure and numerous off-balance sheet transactions to hide its less than ideal performance.\(^7\)

Perhaps the three most notorious names related to Enron are Ken Lay, the former chairman, Jeff Skilling, the former chief executive officer, and Andrew Fastow, the former chief financial officer. Lay and Skilling were charged with lying to investors and employees about the health of the company, and Fastow was charged with self-dealing, which means that Enron would enter into deals with special purpose entities that Fastow controlled.\(^8\)

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Despite widespread corruption among Enron's leadership, there were cries of concern. Sherron Watkins, a vice-president at the time, brought her concerns before the company's audit committee through a memo in October of 2001. Ms. Watkins wrote, "I am incredibly nervous that we will implode in a wave of accounting scandals."9 This memo was discussed by the audit committee, but her concerns and suggestions were rejected. Despite these limited internal cries for reform, Enron's top management continued to tout the company's financial stability, and they continued to rely on the work of the company's auditor: Arthur Andersen.10

Arthur Andersen's memory will linger in infamy in the minds of accountants across the world. The firm was charged with obstruction of justice for destroying and falsifying documents related to their audits of Enron. After its fall, foreign accounting firms that once partnered with Andersen paid $40 million to pursuant to suits by Enron investors.11

In the wake of the fall of Enron and Andersen, the public trust in the integrity of accountants, which is what gives the accounting profession its value, was shaken. The trust that the users of financial information have in the integrity of the services that accountants provide is the very foundation upon which the profession of accounting is built. However, while Enron was the largest scandal to date, it was merely setting the stage for an even greater tragedy. The events that surrounded the fall of telecommunications giant WorldCom would hasten the

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passage of what would be one of the most drastic financial reform laws in United
States history.\textsuperscript{12}

\begin{center}
\textbf{WORLDCOM}
\end{center}

WorldCom, at its peak, was the second largest long-distance carrier in the
nation, served over twenty million customers, and provided telecom services to
some of the largest companies in the world.\textsuperscript{13} Like Enron before it, WorldCom
was a giant in its industry, and the drive to continue to meet stockholders’
expectation would prove to be just as much of a stumbling block for WorldCom
as it had been for Enron. WorldCom had taken the telecommunications industry
by storm, and its success was due in large part to its charismatic and business-
savvy leader, Bernie Ebbers.

Ebbers, a native Canadian, relocated to Mississippi to play basketball for
Mississippi College in Clinton, Mississippi. After college, Ebbers invested in a
number of hotels, and his successful investments brought him to the attention of
a group of men who were interested in basing a telecommunications company in
Mississippi. The men drew up the plans for what would become Long-Distance
Discount Services (LDDS), and with Ebbers at the helm the company grew
rapidly by buying other telecommunications companies and expanding its
influence. By the mid-1990s, LDDS was renamed WorldCom and took its place
as a leader among the world’s telecom companies.\textsuperscript{14}

\begin{footnotesize}
\begin{enumerate}
\item Andrew Backover et al, \textit{WorldCom Finds Accounting Fraud}, \textit{USA Today}, Jun. 26, 2002, at 1
\item Tim Padgett and Alice Jackson Baughn, \textit{The Rise and Fall of Bernie Ebbers}, \textit{Time Europe}, May 13, 2002, at 54.
\end{enumerate}
\end{footnotesize}
However, Ebbers became enamored with making deals rather than running his company. He began borrowing money from WorldCom, and at the time of his resignation he still owed the company $366 million. Making such large loans to the CEO was not a healthy decision for WorldCom, especially as the demand for telecom services shrunk during 2000. The numerous expansions and acquisitions further hindered the company’s success. The individual acquisitions continued to function almost as they had before being acquired, and the resulting lack of efficiency lead to a complicated corporate reporting structure that further harmed a reeling company. WorldCom, which was struggling with a stock price below $1 and over $25 million in debt, was desperate, and desperate times will drive men and women to desperate measures.\textsuperscript{15}

Throughout 2001 and the first quarter of 2002, WorldCom engaged in financial fraud that rivaled and possibly surpassed what had happened at Enron. Through the manipulation of ordinary expenses and capital expenditures, WorldCom accountants were able to generate extra cash flow of $3.9 billion over the five quarters. Arthur Andersen, infamous due to its involvement with the Enron scandal, audited WorldCom’s 2001 financial statements and failed to detect the fraud.\textsuperscript{16} Over the course of the investigation and trial, several WorldCom employees, including the former Controller, Chief Financial Officer, and Chief Executive Officer would be sentenced to serve time in prison for intentionally falsifying financial information and misleading the users of that information.

\textsuperscript{15} Tim Padgett and Alice Jackson Baughn, \textit{The Rise and Fall of Bernie Ebbers}, \textit{Time Europe}, May 13, 2002, at 54.
\textsuperscript{16} Andrew Backover et al, WorldCom Finds Accounting Fraud, USA Today, Jun. 26, 2002, at 1
Another titanic scandal shattered the public's trust and spurred Congress to enact sweeping financial reform legislation. The fact that the same accounting firm had audited both Enron and WorldCom and could be seen as complicit in the first fraud and incompetent for not detecting the second was a terrible blow to the perception of accountants as trustworthy professionals, and the terms of the Public Company Accounting Reform and Investor Protection Act are set forth to increase accountability for management and auditors alike.
CHAPTER III

THE SARBANES-OXLEY ACT OF 2002

The Sarbanes-Oxley Act as we know it today is the product of accounting
reform bills proposed by Senator Paul Sarbanes and Representative Michael
Oxley in 2002. The Act was passed on July 25, 2002 and was signed into law on
July 30, 2002. The Act is considered to be the most significant piece of financial
legislation since the Securities Act of 1933 and the Securities Act of 1934. When
President George W. Bush signed the Act into law he said it was one of
the “most far-reaching reforms of American business practices since Franklin
Roosevelt was president.”

A SUMMARY OF THE SARBANES-OXLEY ACT OF 2002

The Act contains eleven Titles that deal with the (1) Public Company
Accounting Oversight Board, (2) auditor independence, (3) corporate
responsibility, (4) enhanced disclosure, (5) analyst conflicts of interest,
(6) commission resources and authority, (7) studies and reports, (8) corporate and
criminal fraud accountability, (9) enhancements of white collar crime penalties,
(10) corporate tax returns, and (11) corporate fraud accountability.

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dissertation, University of Rochester) (on file with author).
Perhaps the two hardest Titles to swallow for auditors and companies are the first and fourth respectively, but all the Titles are summarized below. In the interest of time and space, not all Sections of every Title are summarized.

TITLE I

From 1887 until 2002, the accounting profession enjoyed a large degree of autonomy in ordering its affairs and enforcing its standards for the good of its professional members and the users of financial information. However, in 2002, Sarbanes-Oxley gave the American Institute of Certified Public Accountants a government boss in the form of the Public Companies Accounting Oversight Board (PCAOB). Title I of Sarbanes-Oxley created the PCAOB, which is under the authority of the SEC, to register audit-performing public accounting firms, create standards for the preparation and issuance of audit reports, and investigate accounting firms and issue penalties where warranted. The PCAOB also conduct inspections to verify that CPAs are in compliance with professional standards and firm policies. The PCAOB is composed of five members, and two of the members are CPAs.\(^2\)

It seems odd that only two members of the PCAOB can be CPAs when the entity is the overseer of the accounting profession. It is possible the authors of the law intend this to give the board two members who are familiar with the discipline while limiting the number of conflicts of interest between the CPA

members and the CPAs in the field. It could also serve the function of checking the power that the profession might exert over their regulators.

TITLE II

The most valuable thing that an auditor brings to the table when he or she issues an audit report on the financial statements or internal controls of a company is his or her independence. This can be even more important than the knowledge, training, and experience of the auditor, which would all be worthless to users of financial statements if the auditor they are relying upon is not independent of his or her client. Therefore, it is no surprise that Sarbanes-Oxley contains an Title that deals with strengthening the requirements for an auditor to be independent.

Section 201 of Title II amends Section 10A of the Securities Exchange Act of 1934 to include an extended list of services that firms are prohibited to offer to their audit clients. By restricting the services that accounting firms can offer their audit clients, the firm’s independence cannot be compromised by the possibility of income or threat of income being withheld. The following services are prohibited from being offered by accounting firms to their audit clients.

1. Bookkeeping or other services related to the audit client’s accounting records or financial statements
2. Financial information systems design and implementation services
3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
4. Actuarial Services
5. Internal audit outsourcing services
6. Management functions or human resources
7. Broker or dealer, investment adviser, or investment banking services
8. Legal services and expert services unrelated to the audit
9. Any other services that the Board determines, by regulation, is impermissible

Section 202 requires that the Audit Committee of an audit client's Board of Directors must approve the work of independent auditors. Section 203 requires that the lead partner on an audit engagement must be rotated every five years. Section 204 requires the independent auditors to give their reports to the audit committee rather than the management of the client. Section 206 forbids an accounting firm from performing and audits for a company whose chief executive officer, chief financial officer, chief accounting officer, controller, or a person in any equivalent position was employed by the auditing firm in for the one year period before the audit of said client company. A conflict of interest also exists under Section 206 if a former lead partner, concurring partner, or audit team member from the auditing firm joins the client company in a role that has responsibility for financial reporting within a year preceding the current audit's initiation. Section 209 instructs State regulatory authorities to make their own judgments about the applicable standards for nonregistered-firms of medium or small size.

Establishing the audit committee as the primary receiver of an auditor's report increases independence by reducing the possibility that management will exert inappropriate influence over the findings of an audit and lead to the
proliferation of inaccurate information that will mislead investors and regulators. The year-long "cooling off period" promotes independence by reducing the likelihood of a conflict of interest arising from a partner being able to join a company whose audit he oversees while he might still exert influence over the outcome of the audit. For example, the partner might be enticed by the chance of employment and allow his professional judgment to be impaired by the offer.

TITLE III

Title III establishes the responsibilities that issuers of financial statements have for insuring the validity of said financial statements. One of the major issues in the Enron and WorldCom cases was that "higher-ups" in the companies were either complicit in or ignorant of the issuance of false or misleading financial statements27, and Title III sets standards that are aimed at preventing or limiting executive ignorance or encouragement to enable fraudulent accounting practices.

Section 301 of Title III adds several lines of text to Section 10A of the Securities Exchange Act of 1934 that change the nature of an issuer's audit committee. Those paragraphs are summarized in Table 1 below.

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<table>
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<th>Paragraph Number</th>
<th>Requirements</th>
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| 1                | • The national securities exchanges will not permit the listing of companies that are not in compliance with paragraphs (2) through (6)  
                   • The SEC shall provide the issuer with an opportunity to correct any defects that keep the issuer from being in compliance with paragraphs (2) through (6) |
| 2                | • Each issuer's audit committee will be responsible for appointing, compensating, and overseeing the work of the issuer's independent auditors  
                   • The audit committee will be responsible for resolving all conflicts and disagreements between the issuer's management and the independent auditors regarding financial reporting |
| 3                | • Each member of the audit committee will be a member of the issuer's board of directors, and each member will maintain his or her independence in all other regards  
                   • To be independent, the member of the audit committee will not receive any fees other than those he or she is due as a member of the board of directors or be an affiliated with the issuer in any capacity other than as a member of the board of directors  
                   • An issuer may be granted an exemption with regard to relationships of the audit committee at the discretion of the SEC |
| 4                | • The audit committee will establish procedures for receiving, retaining, and treating complaints received regarding accounting, internal controls, and auditing procedures  
                   • The audit committee will establish procedures for receiving confidential or anonymous information from the issuer's employees |
| 5                | • The audit committee has the right to engage independent counsel and other advisers as it sees fit to the execution of its duties |
| 6                | • The issuer will make funds available for the payment of the independent auditors  
                   • The issuer will make funds available for the payment of independent counselors and advisers retained under paragraph (5) |
These paragraphs summarized in Table 1 empower the audit committee of an issuing company's board of directors to retain and compensate independent auditors for the company and counselors and advisors for the audit committee. It also establishes the audit committee as the arbitrator of disputes between independent auditors and the company's management and as the primary receiver of the findings of the independent auditors.28

This power and autonomy allow the audit committee to more effectively protect the integrity of audits performed by independent auditors, and the provisions allowing the audit committee to have their own counselors and advisors gives them the tools to better detect possible wrongdoings of company management and protect themselves, the company, and its shareholders from said wrongdoings. Mandating that independent auditors report directly to the audit committee prevents the possibility that management will alter the findings of an audit before it reaches the audit committee, and giving the audit committee the authority to resolve disputes between the independent auditors and the management prevents the management from inhibiting the work of the auditors. For example, if a company accountant refuses to comply with an auditor's request and the company's controller was the sole arbiter of disputes then the controller might not compel the accountant to comply with the request if he was complicit with what the accountant was trying to hide. As it stands, the audit committee can order the accountant to provide with auditors with whatever information they might need.

Section 302 dictates that the chief executive and chief financial officers, or persons who fulfill similar functions, for companies filing periodic reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 must certify in the annual or quarterly reports of the company that they have reviewed the report, that the report, to the best of their knowledge, does not contain any false statements of material facts or omissions of material facts, and that the report, to the best of their knowledge, is an accurate statement of the financial condition and results of operation of the company. By signing the report the officers indicate that they are responsible for establishing and maintaining internal controls, that internal controls are designed to ensure that material information is made known to the officers, that the internal controls have been evaluated within ninety days prior to the issuance of the report, and that their report on the effectiveness of the controls is based on that evaluation. The signing officers also certify that they have brought all deficiencies and fraud, regardless of materiality, to the attention of the audit committee of the board of directors. They also indicate whether or not significant changes were made to internal controls.

Some may see requiring senior officers of a company to certify the financial reports of their companies as a rubber-stamp measure, but it is more than that. Requiring senior officers to certify that they have reviewed the reports before they are issued adds a layer of accountability to financial reporting that was not there before. If nothing else, it makes the responsibility for the accuracy of financial statements a personal issue for the chief executive officer, whereas

his or her focus in the past might have simply been to maximize the profits of the company. Now he or she must put his or her assets, reputation, and possibly freedom on the line to verify that his or her company presents itself fairly and honestly to the users of its financial statements.

Section 304 makes it a criminal act for an officer of director of an issuer to fraudulently influence, coerce, or manipulate a CPA who is auditing the financial statements of the company for the purpose of making said financial statements materially misleading.\(^3\)

**TITLE IV**

Title IV primarily deals with increasing the disclosures that are required in periodic reports. Section 401 outlines that all adjustments to financial statements be included in periodic reports, that all material off-balance sheet transactions be disclosed, that pro forma (estimated) figures must be truthful and reconciled with the financial condition of the results of the issuer’s operations. Section 401 also requires that the SEC investigate special purpose entities that might be used for off-balance sheet transactions.\(^4\)

Section 402 deals primarily with restricting the possibility for the existence of conflicts of interest. Specifically, companies are forbidden from making loans or extending lines of credit to their officers or directors.\(^5\) Section 404 requires that a report on the internal controls in place in a company must be included in its

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financial reports, and the management of the company is responsible for implementing adequate internal controls. Section 405 specifies that companies must disclose their codes of ethics, and it establishes that such codes must promote honest and ethical conduct of employees, management, and directors of each issuer.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ordered the SEC to conduct a study on the costs of complying with Section 404(b) and how those costs might be reduced while still providing adequate protection for investors. There was concern that the high costs of compliance with Section 404(b) might keep new companies from listing themselves on United States exchanges. However, the study showed the SEC that the costs of compliance had declined since the implementation of SOX, and that the costs of compliance were not major factors for companies when they chose to list on exchanges. The study also determined that financial statements are more reliable when an auditor assesses a company’s internal controls on financial reporting, and the study determined that the investing public generally found the auditor’s reports on internal controls to be beneficial. While the SEC recommended that the existing requirements under Section 404(b) be left alone, the Dodd-Frank Act added Section 404(c), which exempts large accelerated filers and accelerated filers from Section 404(b).

TITLE V

The lack of objectivity among financial analysts was one of the key factors in the downfall of WorldCom and other scandals. Financial analysts who were employed by investment banks, and they would sing the praises of companies whose money was handled by the same investment banks. The information provided by these analysts was of little legitimate use to the investing public, and Title V addresses the issue of analyst conflicts of interest so that they might provide information free from more reliable information.

Section 501 prohibits research reports to be issued by employees of a broker or dealer that is also engaged in investment banking, and it stipulates that analysts cannot be compensated by anyone engaged in investment banking. It also limits the time periods in which research reports can be issued and establishes safeguards to maintain a financial analyst's functions separate from any investment banking activities of his or her firm. Also, any debt or equity that would tie an analyst to an issuing firm must be disclosed to the SEC.36

TITLE VI

Section 601 of Title VI provides an initial $776,000,000 to carry out the added functions, powers, and duties of the SEC established by Sarbanes-Oxley, and it provided for the addition of at least 200 additional professionals to better oversee, investigate, and discipline auditors. Section 602 gives the SEC authority to prohibit a practitioner from representing a client before the SEC if the practitioner is found to not have the necessary qualifications, to have engaged in unethical conduct, to have intentionally violated or abetted another in the violation of any provision of securities laws.

TITLE VII

Title VII requires that the Comptroller General of the United States to investigate the effects of the diminished number of public accounting firms might have had on the quality of audit services offered by said firms. Specifically, the investigation should reveal what factors lead to the many consolidations of firms, if the consolidations have impacted the domestic and international capital markets, and if there can be any solutions to any problems that might be identified. This is primarily to determine if a lack of competition has led to higher costs for audit services, lower qualities of audit services, a lack of independence among auditors, and a lack of choice of auditors for companies.

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TITLE VIII

Title VIII of Sarbanes-Oxley is the teeth of the Act. Section 802 imposes severe criminal penalties on anyone who knowingly “alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title XI, or in relation to or contemplation of any such matter or case, shall be fined under this Title, imprisoned not more than 20 years, or both.” The Title also requires that auditors of issuing companies must maintain their work papers relating to the audit for up to 5 years after the end of the fiscal period in which the audit was concluded. Anyone who willfully destroys said working papers will be fined, imprisoned for up to 10 years, or both. The punishment for destroying evidence can be evaluated by the amount of evidence, the degree to which the evidence is essential to the investigation, the planning involved in the destruction, and if the destruction involved abusing a person’s special skill or position of trust.40

Title VIII also establishes the statute of limitations for private actions claiming that an auditor committed fraud as either 2 years after the discovery of the violation or 5 years after the violation.41 Section 807 also criminalizes anyone who knowingly defrauds or attempts to defraud any person in connection with

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These actions may seem harsh, but the preparation and audit of financial statements is not something to be taken lightly. Even unintentional misstatements may have disastrous effects on a company’s shareholders, and the effects can be several magnitudes greater if the misstatements are intentional. Title VIII shows that actions like those that occurred during Arthur Andersen’s audit of Enron will not be tolerated.\footnote{Jaret Seibert, Enron’s Long Shadow, Daily Deal, Jul. 18, 2003.}

Section 806 provides protection for a group of people who are essential to the discovery of most instances of financial fraud: whistleblowers. In short, company management and directors are forbidden from discriminating against an employee who lawfully provides any person with supervisory authority in the company, Federal regulatory or law enforcement agency, or any Member or committee of Congress with information or assists in an investigation regarding what the employee reasonably believes to be a violation of any Federal law regarding defrauding shareholders or SEC rule or regulation. This protection is also extended to employees who file or participate in proceedings filed with regard to any alleged violation of any provision of Federal law or SEC rule or regulation. If such an employee is subjected to discriminatory treatment or
harassment by his or her employer or fellow employees, he or she may file a complaint with the Secretary of Labor.\textsuperscript{44}

It is essential to provide protections for “whistleblowers”, because it is their brave deeds that reveal most cases of fraud. The men and women who put their careers and livelihoods on the line for the sake of truth and honesty deserve to be protected for speaking up for what is right. Including protections for whistleblowers shows the government’s commitment to providing avenues for individuals to speak up when they know they should.

\textbf{TITLE IX}

Title IX continues in the vein of increasing the government’s crackdown on violations of federal laws by increasing the penalties associated with various acts of “white-collar crime”. For example, the penalty for committing mail and/or wire fraud before the passage of Sarbanes-Oxley was up to 5 years in prison, but now the penalty is up to 20 years in prison.\textsuperscript{45} Violations of the Employee Retirement Income Security Act of 1974 now warrant between $100,000 and $500,000 in fines and up to 10 years in jail, whereas the penalties were between $5,000 and $100,000 in fines and up to one year in jail.\textsuperscript{46}

Again, it is important to emphasize the seriousness of financial crimes. One would hope that companies that issue financial statements and the auditors who audit them would conduct all of their affairs legally and ethically out of a

sincere desire to uphold the integrity of their firms. However, it may be that fear
of penalties is the only way to produce relevant and reliable financial information
across the board if we cannot rely on the consistent ethical actions of the
financial officers of corporations.

TITLE X

Title X, the shortest Title of the Act, mandates that the chief executive
officer of a corporation sign the Federal income tax return of said corporation.
This is similar to the signing requirements imposed by Title III in that the purpose
is for the upper management of the company to be involved and concerned with
the accurate presentation of the company's financial position.47

It is not surprising that Sarbanes-Oxley contains a provision that deals
with Federal tax returns. If one thinks the government is protective of what a
company says in regard to what it owes a shareholder, one should know the
government is especially concerned with what a company says in regard to what
it owes the government.

TITLE XI

Title XI also deals with the consequences of tampering with records,
documents, or other objects that could be used in official proceedings and
impeding an investigation.48 It also deals with toughening the sentencing
guidelines for persons convicted of accounting fraud, securities fraud, or related

offenses.49 Section 1103 prevents companies from making “extraordinary” payments to persons who are the subjects of a lawful investigation50, and Section 1105 gives the SEC the authority to prohibit a person who has committed a violation of SEC rules or regulations.51 Section 1107 returns to the issue of retaliating against whistleblowers, and it outlines stiff penalties for anyone who takes action to harm a whistleblower.52

It would seem that Title XI is mostly housekeeping for items not directly addressed in the preceding Titles.
In 2004, the Public Companies Accounting Oversight Board cited a small Nevada audit firm, Beckstead and Watts (the Firm), for deficiencies in the audits inspected by the PCAOB. In 2006, along with the Free Enterprise Fund (the Fund), the firm filed suit against the Board, claiming that it was an unconstitutional entity. The plaintiff’s claim of unconstitutionality was based on an argument that the selection of PCAOB members and the limitations on their removal violated the separation of powers doctrine. In 2004, Beckstead and Watts was one of the first small auditing firms to be inspected by the PCAOB. According to Brad Beckstead, the firm’s managing partner, “The inspection was akin to the New York Giants playing the local high school in a game of football.”

The Board released a report citing deficiencies in eight audits conducted by Beckstead and Watts, and a formal investigation was launched into the firm’s audit practices.

However, in response to the launch of the formal investigation, Beckstead and Watts sought out an ally to join them in a suit against the PCAOB, the Free Enterprise Fund. The Free Enterprise Fund, which was founded by economist and political analyst Stephen Moore, is an organization that existed to oppose the

The firm and the Fund challenged the constitutionality of the PCAOB’s appointment and removal, and they believed that if these portions of the Act were unconstitutional then the Board would be removed from power. The plaintiffs argued that the Board members were unduly and unconstitutionally insulated from the President’s right and duty to effectively hold members of the executive branch accountable for executing the laws and policies of the United States.\footnote{Court Rules PCAOB Constitutional, Accounting Today, Sept. 22, 2008, at 3.}

Under Title I of the Sarbanes-Oxley act as passed in 2002, members of the Public Companies Accounting Oversight Board are to be selected by the Securities and Exchange Commission, and members of the PCAOB can only be removed from their positions “for good cause shown in accordance with specified procedures”.\footnote{Public Company Accounting Reform and Investor Protection Act of 2002, 15 U.S.C. §§ 107-204 (2012) 1 USC §101 (2012).} This affords members of the PCAOB the same protections offered to members of the Securities and Exchange Commission, who can also only be removed “for inefficiency, neglect of duty, or malfeasance in office”.\footnote{Court Rules PCAOB Constitutional, Accounting Today, Sept. 22, 2008, at 3.} By stipulating that members of the PCAOB can only be removed “for cause”, Congress added a layer of insulation to the members of the PCAOB, and the plaintiffs argued that this second layer of “for cause” removal was unconstitutional. If one follows the reasoning of the plaintiffs, if the President cannot use the threat of termination at will to hold members of his branch of the
government accountable, then there is a violation of his Constitutional authority as the head of the executive branch. The firm and the Fund also argued that allowing the Securities and Exchange Commission to appoint members of the PCAOB violated the Appointments Clause. The Appointments Clause stipulates that the President may appoint officers with the advice and affirmation of the Senate, and that the President, the Courts, or Department Heads can appoint inferior officers. The petitioners argued that the Securities and Exchange Commission was not a department head and therefore could not appoint inferior officers.

Beckstead and Watts and the Free Enterprise Fund filed suit with the United States District Court which held that Sarbanes-Oxley was constitutional, and the firm and Fund appealed to the U.S. Court of Appeals in Washington D.C. However, while the petitioners believed that they had a case that could cripple or fatally wound the PCAOB and Sarbanes-Oxley, they did not have the full support of the accounting industry. “I didn’t see the Big Four jump in behind it. I don’t think it was a largely held opinion in the profession. I’ve never heard anybody else in the industry speak out against how the PCAOB was formed and structured,” said Peter Iannone, a director at the consulting firm CBiz/Mayer Hoffman McCann. The Court of Appeals seemed to agree that “how the PCAOB was formed and structured” was not an issue, and it upheld the ruling of the District Court. This decision was met with numerous statements of support from the accounting industry and the federal government. Christopher Cox, the

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Chairman of the Securities and Exchange Commission, hailed the decision as "welcome news for the commission, investors, and U.S. capital markets." The executive director of the Center for Audit Quality, Cindy Fornelli, holds that the decision "will benefit the stability of our capital markets." The petitioners sought a writ of certiorari from the Supreme Court of the United States.

THE SUPREME COURT

The Supreme Court of the United States is endowed by Article III of the Constitution of the United States of America and created by the Judiciary Act of 1789, is the highest court in the United States. The Supreme Court of the United States is the final court that may be appealed to, and since Marbury v. Madison, it has been the final arbiter and interpreter of the United States Constitution. In Marbury v. Madison, the Court created for itself the power of judicial review, and that has been the primary avenue by which the Court has expressed its interpretations of the Constitution since. While a longer discussion of the powers of the federal judiciary could be had, it might not be appropriate in this venue. Let it suffice to say that if the Supreme Court of the United States deems that an act of the United States government or State government is not allowed by the Constitution of the United States, then it is not allowed. The only recourse one would have if he or she disagrees with the ruling of the Supreme Court would be to change the Constitution itself. However, it is the concept of judicial

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review on which the fate of the Public Companies Accounting Oversight Board and the Sarbanes-Oxley Act hinge.

THE OPINION

The Court granted a writ of certiorari to the case of Free Enterprise Fund v. PCAOB and heard arguments on December 7, 2009. In a 5-4 decision the Court held that: 1) the lower courts had appropriate jurisdiction and authority to hear and rule on the case, 2) that the removal limitations placed on PCAOB members are unconstitutional, 3) that the unconstitutional portions of Sarbanes-Oxley are severable from the remainder of the statute, 4) and that the method for appointing members to the Board is not a violation of the Appointments Clause of Article II of the Constitution. Chief Justice John Roberts delivered the opinion of the Court, and he was joined in the majority by Justices Alito, Kagan, Kennedy, and Scalia. Justice Breyer wrote the dissenting opinion, and he was joined in his dissent by Justices Ginsburg, Sotomayor, and Stevens. However, the majority and dissenting Justices all agree that this is a question of “first impression” for the Court.

The Court’s first holding in affirming the jurisdiction of the District Court is an important point. Sarbanes-Oxley allows petitioning firms to appeal decisions of the PCAOB to the Securities and Exchange Commission, and theoretically firms could approach the courts for an appeal after the SEC rules. However, the question is not one of the procedures of the Sarbanes-Oxley; it is a question of

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the constitutionality of the law. Therefore, since the Securities and Exchange Commission does not have special knowledge or training in answering questions of constitutionality, or any authority to decide such questions, the Federal Judiciary is the appropriate arbiter of the question. The District Court decided that it had jurisdiction over the matter, the Court of Appeals affirmed its decision, and the Supreme Court reaffirmed it.65

The second point that the Court decided was to reverse the decisions of the lower courts that held Sarbanes-Oxley as completely Constitutional. While in other cases, such as Myers v. United States, the Court has held that Congress may limit the President’s removal power in the interest of officers being able to perform their duties without being afraid of being removed without cause, the Court held that by making the members of the PCAOB removable only “for cause” by the Securities and Exchange Commissioners, who are also removable only “for cause,” did indeed violate Article II of the Constitution.66 The issue for the Court was not that there were officers who could not be removed at will. The issue was that there were two layers of officers who could not be removed at will. They held that this double layer of protection could inhibit the President from adequately holding his subordinates in the Executive branch accountable.

The respondents and dissenting Justices hold that such an arrangement is not unconstitutional, and that it is conducive to a “workable” government67. From an accounting standpoint, one might say that it is more useful to have PCAOB

members who are insulated from removal by the President at will. From an auditing standpoint, the added insulation would promote the independence of the board members, which would increase the reliability of the PCAOB’s findings.

For example, suppose the PCAOB finds an auditing firm to be deficient in some areas, launches an investigation, and holds the firm and its officers criminally liable under Sarbanes-Oxley. Now suppose that the President decides that he disagrees with the PCAOB’s for no legitimate reason. If there were not a provision that prevented him from doing so, he could remove any member, or all members, of the PCAOB for no other reason than that he wishes to. Since the PCAOB, which is basically a government body that audits auditors, could potentially be intimidated by the threat of termination there would be a breach of the auditor’s apparent independence, which is more important than the actual independence of the auditors.68

In the opinion of the Court, Chief Justice Roberts writes, “The people do not vote for “Officers of the United States. They instead look to the President to guide the assistants or deputies subject to his superintendence.” With a double layer of “for good cause” protection, the President cannot adequately guide his inferior officers because he has no direct control over them. Roberts also describes how by creating an executive agency without executive accountability Congress increases its own power by diminishing the President’s. If there is no check on the PCAOB by the President, then the only check on them is on their budget, and since Congress holds the purse strings the PCAOB is an executive agency.

agency that is only answerable to Congress. The dissenting justices argue that the PCAOB is an agency that requires very technical abilities that it is acceptable for it to have such a degree of independence. However, while it may be useful to have an independent organization like the PCAOB, it is not in keeping with the ideals of the Constitution of the United States.

However, despite reversing the rulings of two lower courts, the fact that the Court held that the unconstitutional portions of the law are severable from the remainder of the statute is perhaps the most important holding. Since the removal limitations issue is severable from the law as a whole, the PCAOB can continue functioning to insure that auditors are auditing correctly. This severability allows the Board to continue to exist and function; however it operates without the dual layers of protection of removal that were written into the original law.

THE DISSENT

While the Court did rule that the majority of Sarbanes-Oxley was constitutional, the decision to sever a portion of the Act and declare it unconstitutional did cause a split in the Court. Justice Breyer writes that the legal issue arises from the “intersection of two general constitutional principles.” The dissenting Justices hold that the conflict is between the Constitution’s vesting of each branch of government with its own powers and responsibilities and

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Congress's power to create "necessary and proper" statutes\textsuperscript{72}. The dissenting Justices believe that the power of Congress to create "necessary and proper" statutes trumps the separation of powers principle. According to the dissent, the Court should not look to "bright-line rules" but rather the "function and context" of a statute and its provisions when deciding if Congress can limit the power of the President over his inferior officers\textsuperscript{73}.

While it is the purview of the Court to decide which portions of the Constitution are more applicable in deciding the constitutionality of a piece of legislation, the "necessary and proper" clause should not trump the overarching theme of checks and balances that permeates our Constitution.

\textsuperscript{72} Free Enterprise Fund v. PCAOB, 561 U.S. ___, ___ 130 S.Ct. 3138 (2010).
\textsuperscript{73} Free Enterprise Fund v. PCAOB, 561 U.S. ___, ___ 130 S.Ct. 3138 (2010).
CONCLUSION

The purpose of this writing was to explore the causes and effects of The Sarbanes-Oxley Act of 2002. The causes of the Act were the series of financial scandals that rocked the American financial landscape in the early years of the new millennium. The scandals involving Enron and WorldCom were two of the largest financial scandals in American history, and these two scandals gravely injured the public's perception of accountants as trustworthy stewards of financial information. The corrupt practices at Enron not only brought down an enormous energy and commodities company, but it brought down Arthur Andersen, which was once one of America's most well respected accounting firms. WorldCom executives and accountants engaged in fraud that possibly eclipsed the acts committed at Enron and sent the company and many of its employees into bankruptcy. As a Mississippian, I am especially sensitive to the effects that WorldCom had on my home state and its citizens.

The cause of these scandals can be cited as falsifying information to meet earnings expectations, but the most basic reasons are much more simple and primal than that: greed and fear. I will not presume to say which force motivated which people, but it is clear to me that these were motivating forces. The men and women involved in these events were ordinary men and women no matter how much money was in their bank accounts or what letters came after their names. They were vulnerable to greed and fear like every other human. Does that make them any better or any worse than any other people? That is not for
me to judge. I do know that these people were trusted with a fiduciary duty to their employees and shareholders and that they failed in fulfilling their duty.

However, in Enron and WorldCom we see another side of human nature brought forth in the face of adversity: that of the whistleblower. In each case, employees of the company risked their careers and reputations to bring these scandals to light. These individuals displayed courage and commitment to the truth, which are essential in anyone who is to be trusted with the money of another. That means that these are essential characteristics of those who would be called accountants and auditors of companies.

If accountants and auditors cannot be trusted to courageously pursue the truth, then they cannot be trusted to fulfill their obligations to those who rely on the financial information they provide. If an accountant or auditor cannot be trusted, then he or she is useless in those positions. For that reason, I contend that the extra requirements that Sarbanes-Oxley created for companies and audit firms promote the accountability of public companies and the auditors of public companies, and that extra accountability provides a benefit to the users of financial information presented by public companies and their auditors.

For 115 years the AICPA governed the accounting profession, but Sarbanes-Oxley created the PCAOB as a government entity to enforce accounting standards. While the PCAOB adopted the standards of the AICPA almost verbatim, it gave those standards the force of law. The restrictions that the Act created above the existing regulations also increased the amount of accountability that the government required for companies to have when they
filed their annual reports with the Securities and Exchange Commission. By holding public companies and their auditors criminally liable for failing to uphold accounting standards the government increases the amount of accountability among companies and firms.

However, while increased accountability is beneficial to the investing public, at what cost does it come? When Sarbanes-Oxley was passed, the double “for cause” limitations on the PCAOB members’ removals should have raised a major red flag. I agree with Chief Justice Roberts, if Congress can create an executive agency that is not answerable to the Chief Executive, then why would it not create others? To me, it is a clear violation of “Separation of Powers”, and it should have been recognized as such before nearly a decade had passed. An executive agency that has the ability to create policies and enforce them without Executive oversight has no accountability, and it is especially hypocritical since Sarbanes-Oxley purportedly seeks to increase accountability.

However, after the United States Supreme Court ruled to amend the law to reflect the adequate level of accountability, I believe that Sarbanes-Oxley and the PCAOB will continue to be powerful agents of accountability in the United States economy.
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