

**Can Legislation Restore Public Trust? An Analysis of the
Sarbanes-Oxley Act 2002**

By

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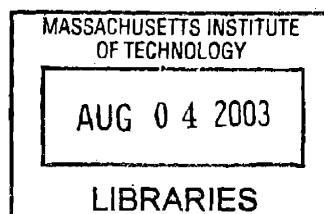
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Abstract

Financial statement requirements, the Board of Directors, and the audit committee all represent methods of controlling the business decision of management in an effort to protect the investments of investors and creditors. At times, management and auditors have incentives to misrepresent the financial statements, or to exploit the accounting and reporting model, or the attest and assurance standards even though there are compelling moral and economic reasons to act ethically. Despite the high levels of legal liability, potential public embarrassment, and possible bankruptcy, some management and auditors fail to act ethically or to follow even basic professional standards. The consequences of even just a few individuals' misdeeds can have a dramatic impact on investors' confidence in financial reporting and the capital markets.

This thesis probes the question of what role can legislation play in restoring public trust when it appears that all institutions that provide protection against large-scale fraud have failed to varying degrees.

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 Society of Sloan Fellows Professor of International Management

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Chapter 1

Introduction

The handful of spectacular failures of large corporations that took place at the beginning of the twenty-first century shook the dust off the highly political and morally charged issue of corporate scandal in America. It was only a few short years ago, after the Asian financial crisis in 1997-1998, that the American system of corporate governance and financial disclosure was seen as a model to be emulated by the rest of the world. Economist John Kenneth Galbraith once wrote, “[t]he man who is admired for the ingenuity of his larceny is almost always rediscovering some earlier form of fraud. The basic forms..have all been practiced.”¹

Today’s corporate scandals are not new to business. In fact, much of the same behavior, such as greed and loose lending practices coupled with rampant speculation, plagued American business and markets for decades. However, the twenty-first century corporate scandal crisis, most notoriously exemplified by the financial collapse of Enron and WorldCom, seem to have distinguishing characteristics that are different from the past. Where the economic forces of market self-correction would prove sufficient in the past, they are insufficient for today’s crisis environment. What distinguishes recent corporate scandals is that nearly all of the market institutions that provide protection against large-scale fraud, including investment bankers, buy and sell analysts, lawyers, rating agencies, auditors, officers and directors, fail to varying degrees.² These failures are largely attributed to perverse incentives and conflicts of interest that, from the beginning, should not have been tolerated.

The effects of today’s scandals have far-reaching economic, political, and social consequences. Consider the equity investor: during 2001, more than 51% of American

¹ Galbraith, John Kenneth, *The Age of Uncertainty*. 1977. Chapter 2.

² Glassman, Cynthia A. Speech by SEC Commissioner: Sarbanes-Oxley and the Idea of “Good” Governance. American Society of Corporate Securities, Washington D.C., September 27, 2002.

households invested in stocks directly, or through mutual funds, up from 32% in 1989.³ It is, in fact, for the equity investor that the current system of financial disclosure is defined by law and by practice. The equity investor relies on company provided financial information to project future cash flows. A large part of the future determination of value is based on accounting information. While accounting information is backward looking by definition, it is nonetheless a critical input in the attempt to project future performance of companies. To the extent the market deems accounting information unreliable, investors confront information risk in making investment decisions.⁴ The higher the information risks, the less attractive are stocks in comparison with alternative investments.⁵ The higher information risk results in lower stock prices, and is an overall negative effect on the economy.

Speculations are already being made of how much the corporate disclosure crisis will cost the American economy. Using the same parameters that are incorporated in the macro-economic model developed by the staff at the Federal Reserve board, and assuming that roughly 2/3 of the stock-price drop can be attributed to the series of highly visible accounting scandals, the Brookings Institution estimates that the current crisis will likely reduce GDP by about \$US40 billion, or 0.4 percent, over the next year.⁶ This estimate is based on an assumption that stocks remain at or near when the Dow Jones Industrial Average was about 8,000. To provide a context of how much is \$US40 billion in the American economy, consider that it is about the same amount of money that the United States Federal Government is now spending on homeland security.⁷

It was Congressman Michael Oxley (4th District, OH), Chairman of the House Committee on Financial Services, and Senator Paul Sarbanes (D-MD), Chairman of the Banking,

³ Data derived from Benston, George et al. Following the Money. The Enron Failure and the State of Corporate Disclosure. 2003. Page 5.

⁴ Ibid., p. 7

⁵ Ibid.

⁶ Graham, Carol, and Litan, Robert E. "Shares Crash Has a Silver Lining." Australian Financial Review, July 25, 2002.

⁷ Ibid.

Housing, and Urban Affairs Committee, who took action to deal with this crisis. They recognized the recent proliferation of earning restatements and other financial data issued by publicly traded companies would cause the public to be increasingly wary of corporate financial reports, and that investors' confidence in the capital markets would be undermined. They stated that without a solid foundation of trust and confidence in corporate disclosure from the public, the American capital markets would not operate efficiently and would inevitably have serious adverse implications for the American economy.

Shattered investor confidence and the continued wave of accounting irregularities pushed the United States Congress to design quickly a comprehensive package of measures to reform more broadly both corporate accounting and corporate governance standards.

My thesis probes the question: what is the role legislation can play in restoring public trust? This topic supports my broader research interest of how those in business and government work together to contribute to the well-being of American democratic society. By using the Sarbanes-Oxley Act 2002 as the basis for my research, I will analyze, at a fundamental level, the interaction of the relevant interest groups in business and government who are tasked with resolving the corporate disclosure crisis. I will look at how their responses may have been influenced by public opinion and the media, and I provide the background for how legislation has become a mechanism to respond to crisis. I conclude by stating that it is my belief that relevant members of business and government need to create more efficient mechanisms to work together to solve today's complex problems. I provide recommendations for moving members of business and government toward more efficient interaction for the betterment of society.

Chapter 2

Why Corporate Disclosure Matters

To restore the vitality of America's capital markets requires improving the quality of information that investors receive; nothing is more important.⁸ In general, America's publicly traded securities markets are extremely efficient at pricing and allocating capital based on all available information. However, when critical information is absent, or when disparities exist in the quality of information available to different users of the information, the power of markets is misdirected and the allocation of resources becomes skewed.

One way to view the recent corporate scandals is that they grew out of a corporate disclosure information gap between management insiders and their advisors, and investors. The American system of corporate disclosure is the combination of accounting and auditing standards, the professionalism of auditors, and the rules and practices of corporate governance, and is designed to ensure timely dissemination of relevant and accurate financial information.⁹ In 2001, government regulators and the public called the entire system question when Enron collapsed financially and its independent auditor, Arthur Andersen, was accused of professional misconduct.

The Enron-Andersen debacle was the first of a series of situations to generate widespread public and government concern over the usefulness of corporations' financial disclosures, but it was not the last. What is unique about the Enron-Andersen situation is not only the magnitude of the accounting irregularities at Enron, but also that Arthur Andersen is alleged to have known about the company's problems, but also did nothing to have Enron reveal the issues. There is speculation that Andersen may have helped Enron deceive the public.

⁸ Under Secretary of the Treasury Peter R. Fisher. "Restoring Investor Confidence: The Key is Disclosure" Speech to the Securities Industry Association, Boca Raton, Florida.

⁹ Benston, Op. Cit., p. 1

Thousands of employees who once worked for and had their pensions tied to Enron's capital suffered serious economic setbacks. Enron equity investors lost billions collectively in capital appreciation as the stock market steadily and sharply declined, losing nearly 30% in just three months. This drop was strong signal that investor confidence was severely shaken, if not shattered, at least temporarily. At this time, criminal charges and civil lawsuits are pending against Enron, Andersen, and several top executives in both firms.

At the end of August 2002, high-profile lawsuits and government investigations involving fifteen major companies have been launched against five leading accounting firms for auditing failures:¹⁰

<u>Company</u>	<u>Auditor</u>
Adelphia	Deloitte & Touche
AOL/Time Warner	Ernst & Young
Bristol-Meyers-Squibb	PricewaterhouseCoopers
Computer Associates	Ernst & Young
Enron	Arthur Andersen
Global Crossing	Arthur Andersen
Merck	Arthur Andersen
MicroStrategy	PricewaterhouseCoopers
PeopleSoft	Ernst & Young
PNC Financial Services	Ernst & Young
Qwest	Arthur Andersen
Tyco	PricewaterhouseCoopers
Waste Management	Arthur Andersen
WorldCom	Arthur Andersen
Xerox	KPMG

¹⁰ Ibid., p. 2

Senator Paul S. Sarbanes (D-MD), Chairman of the Banking, Housing, and Urban Affairs Committee, requested the General Accounting Office (GAO) to probe into the proliferation of restatements of earnings and other financial data recently released by publicly traded companies. Sarbanes wrote to the GAO: "Frequent restatements of earnings go directly to the heart of our financial system, because by raising questions about the reliability of published financial statements they threaten to undermine investors' confidence in the way our securities markets operate."¹¹ The key questions Sarbanes wanted answered¹² 1.) the principle reasons why companies are restating earnings and other financial data; 2.) the immediate and intermediate impacts of the restatements on the value of company stock; 3.) the effects of the restatements on shareholders' confidence in the capital markets, and; 4.) the existing regulatory structures whose purpose it is to prevent restatements.

2.1 Defining the Problem

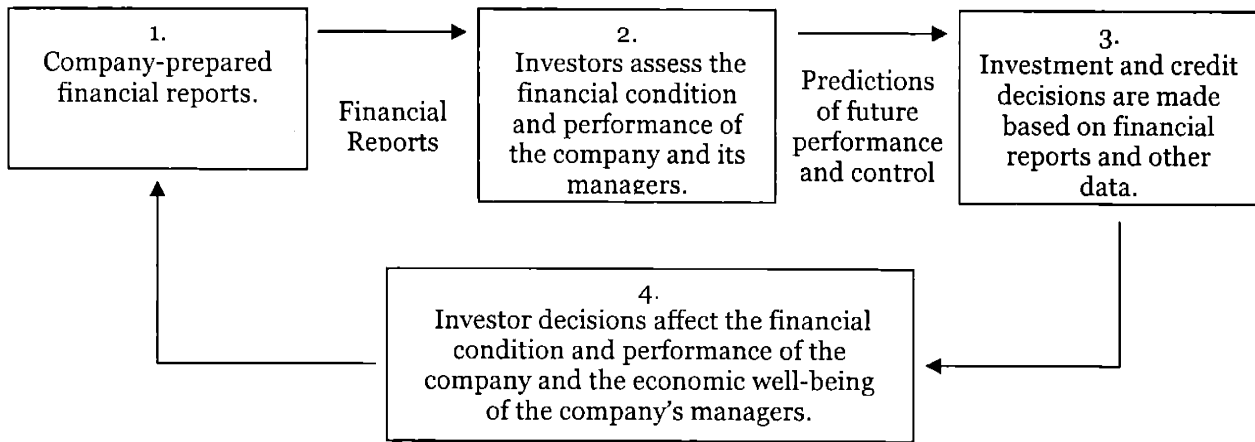
Financial reporting plays an important role in investment decisions. Investors and creditors demand that management provide financial accounting information for two fundamental economic reasons:¹³ first, they need financial numbers to monitor and enforce the debt and compensation contracts written with management; second, they need financial information to decide where to invest their funds. Figure 2-1 depicts how financial reporting relates to investment decision making. Note that the relationship is dynamic in its nature.

¹¹ U.S. Senate Committee on Banking, Housing, and Urban Affairs News Release from Paul S. Sarbanes, Chairman. January 23, 2002

¹² Ibid.

¹³ Pratt, Jamie. Financial Accounting. Fifth Edition. 2003. Page 28.

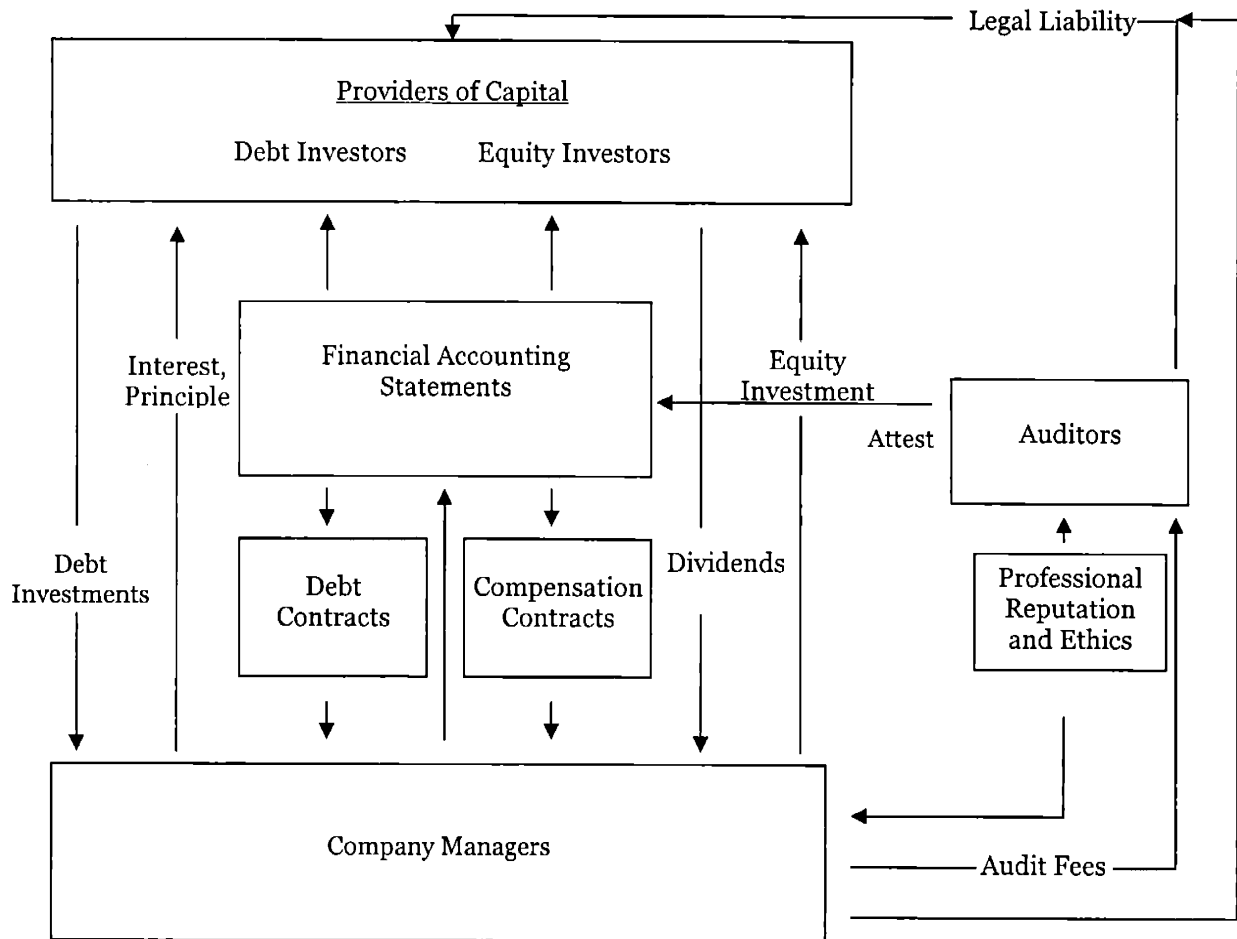
Figure 2-1: Basic Relationship between Financial Reporting and Investment Decisions



The entire environment of financial accounting shows a more detailed representation of the relationship between financial reporting and investors. Figure 2-2, below, depicts this environment. The figure¹⁴ shows that providers of capital (either in the form of debt or equity) invest in companies and expect in return to receive interest, principal, and dividend payments. As a condition of these investments, the capital providers require that company managers provide audited financial information and enter into debt and/or compensation contracts. The financial accounting information helps investors and creditors evaluate and predict the ability of managers to generate investment returns.

¹⁴ Ibid., p. 15

Figure 2-2: The Environment of Financial Accounting



In this environment, independent auditors are in an ironic position. They have a reporting responsibility to the capital providers, while their fees are paid by the company whose financial statements are being audited.

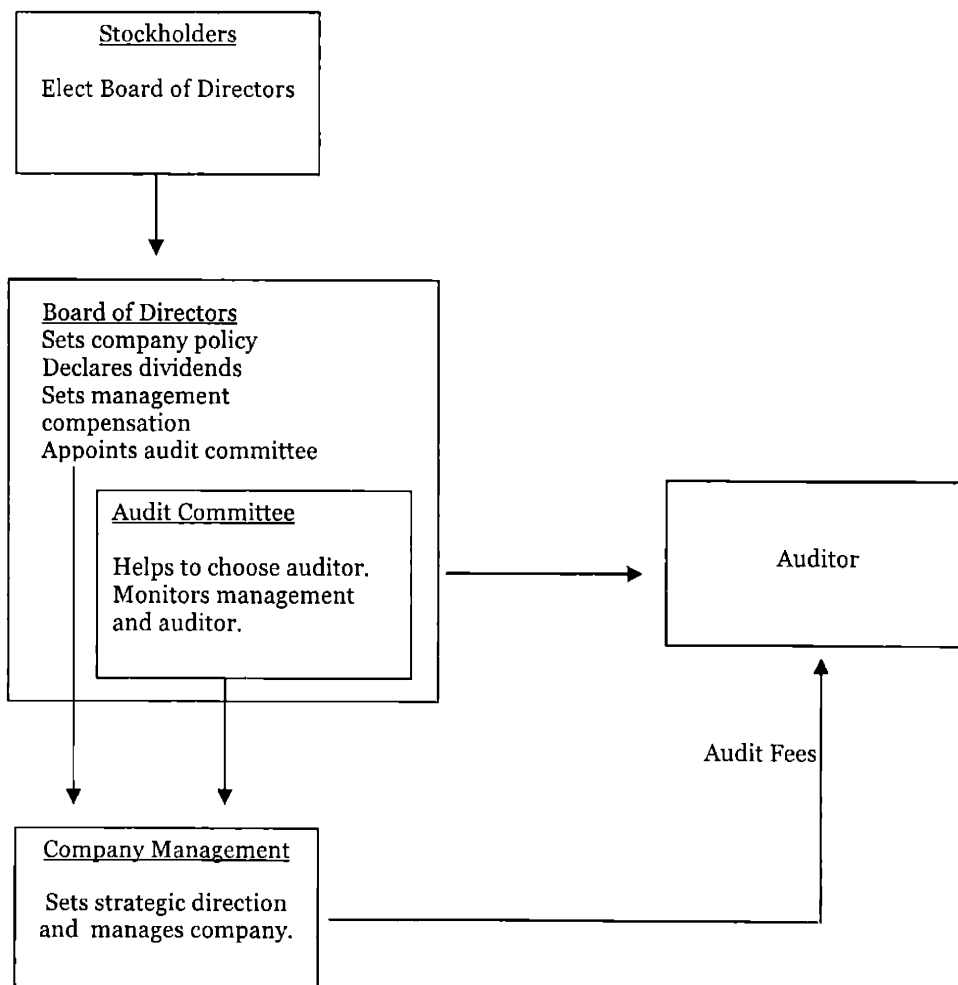
It is generally accepted that the root causes contributing to the decline in investor confidence in the capital markets are complex, and involve at least four general interrelated areas of the overall American accountability system designed to protect the public interest. The four areas are: 1.) corporate governance; 2.) financial reporting; 3.) the accounting profession, and; 4.) regulation and enforcement.

2.1.1 Corporate Governance

The overall governance model for public companies in America is not adequate to protect the interests of shareholders and other key stakeholders. Top corporate management and Boards of Directors (Boards) have varying degrees of responsibility for the recent scandals, not just accounting firms.

There is an intricate relationship between those individuals that manage, own (stockholders who provide capital), and monitor a publicly traded company. The relationships are shown in Figure 2-3,¹⁵ below.

Figure 2-3: Relationship among Capital Providers, Management, and Auditor



¹⁵ Ibid., p. 19

In publicly traded companies in America, the stockholders elect the Board of Directors, which appoints a subcommittee of outside directors called the audit committee. The audit committee represents the interests of the stockholders as it is part of the Board of Directors, and works with company management to choose an auditor. The audit committee monitors the audit to make sure that it is thorough, objective, and independent.

Board members have a fiduciary responsibility to the shareholders that they represent, and they must not breach this responsibility through either commission or omission of their actions. Modern governance theory tells us that Boards have at least three roles they need to play:¹⁶ 1.) Boards should provide strategic advice to management to help maximize shareholder value; 2.) Boards should help manage company risk, including risks related to maximizing current value at the expense of future returns, and; 3.) Boards have a clear responsibility to hold management accountable for company results.

The qualifications of board members need to be more than education and experience; there is also the matter of personal attributes, of which integrity is the most important. With the high occurrence of interlocking boards (executives sitting on each other's Boards), the independence of Boards may be more a matter of form than substance.

An issue related to corporate governance is the nature and reasonableness of compensation and incentives to executive management. The role of company management and its Board is to add shareholder value and to manage shareholder risk over time. This is a team effort. It is well known that behavior of individuals is affected by the nature of their compensation arrangements. Some management may be tempted to accelerate income or expense recognition that will help them to maximize their bonus compensation. Boards need to be vigilant to ensure that any inappropriate actions are avoided.

¹⁶ Walker, David M. "Integrity: Restoring Trust in American Business and the Accounting Profession." Speech given at the AICPA leadership conference, November 26, 2002.

There is both a need and an opportunity for corporate governance reform to forge a realignment of interests between Boards and auditors in ways that enhance value and manage risk for shareholders. Corporate governance reforms are also needed to enhance the independence and the capacity of the Board.

2.1.2 Financial Reporting: Accounting and Reporting Model, Attest and Assurance Standards

The corporate disclosure scandals indicate strongly that the current accounting and reporting requirements are inadequate. There are at least four categories of concern over the current model: 1.) the rules are too complex; 2.) inadequate at tracking value; 3.) heavy reliance on historical data, and; 4.) lack of global standards.

The current financial reporting model comprised of complex rules that are difficult to understand and may entice users to look for loopholes or to create complicated transactions based on their own interpretation of the rule. In the twenty-first century, economies are increasingly knowledge-based, and the current model is not able to account accurately for this change. Previously, tangible assets were of great value. Today, intellectual capital more often defines a company's value, making people the most valuable asset. However, in the current model, people are treated primarily as a cost and a liability. Additionally, historical financial statements are less relevant today. It is more important to know what something is worth than what it costs. Finally, markets today are increasingly inter-dependent, yet no global accounting and reporting standards exist to reflect the globalization of economies and enterprises.

The attest and assurance model is equally out of date. The current model relies heavily on an expression of an auditor's opinion of historical cost-based financial statements after year-end. There is a continuing expectations gap between what an audit opinion actually means (assurance that the financial statements are a true and fair view of the company's financial performance) and what some believe or hope it means (validation of the health and soundness of the company).

It is interesting, but perhaps it is even more troubling, that Sarbanes-Oxley Act does not specifically address the broader concerns about current accounting standards, such as whether the standards are too slow in the making or too heavily influenced by narrow interests.

2.1.3 The Accounting Profession

The accounting profession is a self-regulated industry and raises concern over auditor independence. A professional licensed industry, such as accounting, by its nature is self-regulated. The generic model for licensed industries, including medicine and law, is to establish and enforce standards for its members to follow that result in the highest conduct of integrity. In reality, the accounting industry has been heading toward a major reform for many years. The corporate disclosure crisis finally made the issue come to a head as the effectiveness of the self-regulated industry weakened under auditor independence issues and conflicts of interest.

The overarching principles of auditor independence are that auditors should not perform management functions or make management decisions, and that auditors should not audit their own work or provide non-audit services in situations where the amount or services involved are significant/material to the subject matter of the audit. When distinguishing audit and non-audit services, audit services are financial audits, attestation engagements, and performance audits. Non-audit services are requested by management and directly support entity operations. Generally, non-audit services are performed only for the use and benefit of the requesting entity, and data are provided without verification, analysis, conclusions, recommendations, or opinions. Because of the fee-for-service nature of the accounting industry, there is a temptation to co-mingle services to get a bigger piece of any one client's service fees.

2.1.4 Regulation and Enforcement

Nearly all of the market institutions that provide protection against large-scale fraud failed to varying degrees. Criticism of accounting regulations is not new, though. Strident

complaints about dishonest and deceptive accounting in the 1920s and the distress of the Great Depression led to the creation of the Securities and Exchange Commission (SEC) in 1933. The SEC was given the authority to prescribe, monitor, and enforce accounting rules that would presumably help investors make informed decisions. The SEC delegated its rulemaking function, first to the American Institute of Certified Public Accountants (AICPA) in 1936, and then to the Financial Accounting Standards Board (FASB) in 1973.

Although there are several institutions set up to ensure proper financial disclosure, the recent accounting scandals show that the mechanisms can fail to effectively monitor and timely enforce the fiduciary responsibility of management, directors, and auditors of publicly traded corporations. Misstatement of financial figures does not provide investors with trustworthy information on which to base their investment decisions. Investors need a broad range of information to make sound financial decisions. This means to instill and maintain investor confidence, financial reports must be trustworthy.

From a user's perspective, there are at least three characteristics of financial reports that help to define trustworthiness: ¹⁷ 1.) data are reported in accordance with the well-accepted convention of generally accepted accounting principles, or GAAP; 2.) data are reliable in that they are verified by an independent accounting expert, and are from relevant market transactions in accordance with the well-accepted convention of generally accepted auditing standards, or GAAS, and; 3.) the reporting and auditing conventions (GAAP, GAAS) are effectively enforced by market forces or an appropriate government or industry agency. Even though financial statements do not, nor can they, provide all of the information investors may want to make informed decisions, the statements have great value as reports of management's stewardship of the resources entrusted to them by the shareholders when the numbers reported are trustworthy.¹⁸

¹⁷ Benson. Op.Cit., p. 19

¹⁸ Ibid., p. 93

2.2 Setting the Problem in Context: What Went Wrong at Enron?

Enron's bankruptcy in 2001 is a dramatic example of the consequences of financial disclosure misconduct. Although Enron is far from being alone in financial statement reporting abuses, it is unique in how quickly the corporation and its independent auditor, Arthur Andersen, collapsed. Outlined below are the major events that lead to the fall of Enron,¹⁹ defined in broad classifications, to illustrate the root causes of the decline of investor confidence in the capital markets.

Tracing the recent changes in Enron's stock price provides a dramatic bird's eye view of the brief amount of time and the significant events that lead Enron to file for bankruptcy. Consider the following information:

Enron's stock price increased from a low of about \$7 a share in the early 1990s to a high of \$90 a share in mid-2000. On October 16, 2001, Enron announced it was reducing its third-quarter, after-tax net income by \$1.0 billion, and reducing shareholder's equity by \$1.2 billion. On November 8, 2001, Enron announced, that because of accounting errors, it was restating its previously reported net income for the years 1997 through 2000, cutting stockholder's equity by another \$508 million. On December 2, 2001, Enron filed for bankruptcy, one month after reporting a stockholder's equity drop of \$1.7 billion (nearly 20% of reported value on September 30, 2001). By the end of 2001, Enron stock was selling for less than \$1 per share.

Time, investigations, and lawsuits will provide us with a more detailed picture of the events leading to Enron's fall, but public reports already available identify five types of failures at Enron that are most noteworthy²⁰:

- 1.) Enron failed to account properly for, and to disclose investments in, special purpose entities (SPEs).

¹⁹ Ibid., pp. 23-48

²⁰ Ibid., p. 24

- 2.) Enron incorrectly recognized revenue that increased Enron's reported net income.
- 3.) Enron restated merchant investments using fair-value accounting based on unreliable information that overstated both assets and net income of merchant investments.
- 4.) Enron incorrectly accounted for its own stock that was issued to and held by special purpose entities (SPEs).
- 5.) Enron inadequately disclosed of and accounted for related-party transactions, conflicts of interest, and their cost to shareholders.

The failures generated great concern about the inadequacies of generally accepted accounting standards (GAAS) and generally accepted accounting principles (GAAP). There was also concern around the apparent complexity of Enron's accounting methods.

It is worthwhile to examine each of these failures more closely:

2.2.1 Special Purpose Entities

Many of Enron's accounting misstatements were related to or associated with their use of special purpose entities (SPEs). A SPE is an independently owned enterprise created for a limited purpose, with a limited life and limited activities.²¹ Corporations have used SPEs for many years, and they are not considered unusual. The issue surrounding Enron's use of SPEs is whether, and under what circumstances, the SPE's assets and liabilities should be consolidated with Enron's (considered here to be the "sponsor"). Under GAAP, a sponsoring company is required to consolidate only if they own a majority of the SPE shares, or if the equity put up by outside investors amounts to less than 3 percent of the SPE's assets.²²

There were at least six accounting problems associated with Enron's use of SPEs. First, the minimum 3 percent rule was violated, but the associated SPEs were not consolidated. This problem would require Enron to restate its financial statements. Second, Enron failed to

²¹ Ibid., p. 25

²² Ibid.

comply with the Federal Standards Accounting Board (FASB) rule to report clearly in a footnote the amount of financial contingencies for which it was liable because of the guarantee of the SPE's debt. If Enron provided this information, users of Enron's financial statements would have been warned that the corporation could be (and eventually was) liable for a very large amount of debt. Third, Enron did not consolidate the assets and liabilities of the SPEs that were controlled by Enron. Enron's chief financial officer, Andrew Fastow, managed some of the SPEs. Fourth, even though Fastow controlled some of the SPEs, the associated transactions were treated as independent from Enron. As a result, the net profits from these transactions were improperly recorded in Enron's financials. Fifth, Enron funded some of the SPEs with stock or certain stock options and took notes receivable in return. Here, Enron violated the basic accounting procedure where companies cannot record an increase in stockholders' equity unless the stock issued was paid for in cash or cash equivalent. The financial restatement associated with correcting this violation resulted in the US\$1.2 billion reduction in stockholders' equity in October 2001. Finally, Enron used a put option written by an SPE to avoid recording a loss in value of previously appreciated stock when its market price declined. When Enron's investment in the stock declined, the SPE could not pay Enron as they should because the SPE's assets also declined in value as Enron's stock price declined. The SPE could not pay its bank loans, so it transferred the liability to Enron. In short, Enron violated current accounting rules and accepted accounting principles, and its auditor failed to identify and stop the abuses.

2.2.2 Income Recognition

Several SPEs paid Enron fees for guarantees on loans made by a SPE. Although GAAP allow for a number of different and acceptable methods to account for revenue on financial statements, revenue recognition must be matched with the period in which the benefit from the revenue is recognized. Enron should have recognized revenue over the period of the guarantees.

Enron, however, recorded millions of dollars of up-front payments as current revenue, which sizably and erroneously increased the value of Enron's stock.

2.2.3 Fair Value Restatements

Generally accepted accounting principles (GAAP) requires companies to revalue marketable securities to fair values that are not held to maturity, even when these values are not determined from arm's length market transactions. Fair market value is determined by independent appraisals and by models using discounted expected cash flows. Using such models, however, allow company managers to manipulate net income by making assumptions that will yield more gains.

Enron had problems with its energy contracts and merchant investments. The worst of Enron's actions in this category were in their broadband investment and joint venture with Blockbuster, Inc., Braveheart.²³ Enron invested more than US\$1 billion in broadband and reported revenue of US\$408 million in 2000. Much of this revenue came from the SPEs CFO Fastow controlled. In 2000, Enron assigned a fair value of US\$125 million to the Braveheart investment and a profit of US\$53 million when the venture was only two weeks old and had not yet generated any profit. Enron then recorded US\$53 million additional revenue in the first quarter 2001 even though Blockbuster did not record any income from the venture and dissolved the partnership in March 2001. In October 2001, Enron reversed profit it claimed earlier, plus additional losses, for a total of US\$180 million. This action contributed to Enron's loss of public trust and subsequent bankruptcy.²⁴

2.2.4 Stock Issued to and Held by SPEs

Generally accepted accounting principles (GAAP) prohibits companies from recording stock as issued unless it paid for the stock in cash or in cash equivalents. Enron did, however,

²³ Benson. Op. Cit., p. 28

²⁴ Ibid.

record US\$1 billion worth of stock as issued. GAAP also prohibits companies from recording increases in the value of their own stock. Enron worked around this prohibition by transferring its stock and contracts with investment banks to purchase its stock to SPEs in exchange for equity in the SPEs. When the market price of Enron stock increased, and the SPEs increased their assets, Enron recognized the gains as an increase in its equity investment in the SPEs.

2.2.5 Inadequate Disclosure of Related-Party Transactions and Conflicts of Interest

While Enron disclosed that it had engaged in transactions with a related party, identified in its proxy statements as Andrew Fastow (Enron's CFO), it did not report Fastow as the related party in its annual 10K report required by the SEC. Instead, in a footnote in the 10K report filed in 2000, Enron wrote that the terms of the transactions with the related party (i.e., Fastow) were reasonable compared to those that could have been negotiated with unrelated parties. It is highly unlikely that unrelated third parties would be offered the same terms as Fastow. Fastow personally received more than US\$30 million for his management of the SPEs that did business with Enron. These Fastow-managed SPEs provided Enron with a vehicle to misreport income and to delay reporting losses that violated both FASB disclosure requirements and the SEC requirement to disclose transactions exceeding US\$60,000 in which an executive officer of a corporation has a material interest.

Chapter 3

Restoring Public Trust through Legislation

To understand how legislation may be used to restore public trust requires an appreciation of two components. First, the intricate relationship between the public and the private sectors; specifically why and how government intervenes in the economy, and how businesses respond. Second, how does the public define trust, and what are some of the indicators that can signal a change in this perspective.

3.1 Business and Government Interaction

Government agencies and business enterprises are two of the most powerful institutions in modern society. The shifting and complicated relationship between them exerts great influence on the changing performance of the economy and on the lives of its citizens.²⁵

Scholars write about the idea of historical path-dependence,²⁶ meaning how something is likely to be handled is based on where it has been. Hard residues²⁷ of government's historical path-dependence behavior can be seen in crisis-spawned institutions,²⁸ such as government agencies and legal precedents that tend to be irreversible. Human behavioral structures also change, and do not revert to their prior condition because the events of the crisis create new understandings of, and new attitudes toward, government action. In short, an ideological relationship between government and those it protects is established.

Relations between politico-economic and ideological changes are extraordinarily difficult and complex – but are fundamental²⁹ to understanding government's response to crisis. Accordingly, my research will focus narrowly on the nature of modern government-business

²⁵ Weidenbaum, Murray L. *Business and Government in the Global Marketplace*. 1995. Page 4.

²⁶ Higgs, Robert. *Crisis and Leviathan: Critical Episodes in the Growth of American Government*. Page 59.

²⁷ *Ibid.*, p. 58

²⁸ *Ibid.*

²⁹ Weidenbaum. *Op. Cit.*, p. xi

relations to understand the impact of government's regulatory power on business, and to evaluate the responses of business.

3.2 The Fundamentals of the Business and Government Relationship

It is generally understood that business is a fundamental mechanism for achieving human progress.³⁰ Americans have a strong belief in the role of the private markets and competition, and that the independent business firm ultimately limits the ability of government to dominate the economy. Thus, successful economies have decentralized power and a large degree of individual liberty, two essential factors for capitalism to prosper. The fundamental goal of the United States Constitution, the document that is the basis of the American representative system of government, is to divide and limit power, thereby eliminating the danger of control by a few.³¹ Therefore, the high degree of economic freedom enjoyed by business, and the rules that define the nature of those freedoms, are founded on the principles of the Constitution.

However, business-government relations range from cooperative to competitive, from friendly to hostile.³² At the core, it is an uneasy relationship because each side has powers, and yet both sides have an important need for the other. There needs to be reconciliation between, and careful balance among, the pressures of the private market economy and the preservation of a democratic political system. In virtually every modern industrialized society, the result is a mixed economy in which the public and the private sectors interact in many ways.³³ Today, there is an increasing influence of government in business decision-making, putting more pressure on the delicate balance of America's private markets and political system. The growing public sentiment that government officials are motivated more by incentives that often may be

³⁰ Ibid., p. xi

³¹ Fritschler, Lee. A. Executive's Guide to Government. How Washington Works. 1980. Page 15.

³² Weidenbaum. Op. Cit., p. 4

³³ Ibid.

closer to their own needs and desires than to the broader principles of public interest,³⁴ exacerbate the already tense business-government relations.

3.3 The Rationale for Government Rules and Regulations

A basic way that the government exerts its power over business is to issue regulations that stipulate, or constrain, certain behaviors of business. Government intervention of this type is rationalized when private markets fail to work effectively. The major departures from effective market operation that may prompt government intervention are³⁵: 1.) false or insufficient information that results in fraudulent market exchanges; 2.) force and persuasion that inhibits voluntary exchange market transactions; 3.) lack of competition that impedes free and fair exchange and interferes with market forces that determine price, and; 4.) effects external to the market that impacts the market's voluntary exchange mechanism (can be positive or negative).

False or insufficient information results in a market failure when institutions or individuals do not have sufficient information to make sensible decisions in the market. For purposes of my research, this is the most relevant case of market failure and government intervention. Because of inadequate financial data disclosure from publicly traded corporations, investors do not have sufficient information on which to base their investment decisions. When the problem of imperfect knowledge is not solved by providing more information, then it may be necessary for the government to establish and enforce standards. This becomes the rationale for government intervention.

This type of regulation is called protective regulatory policy,³⁶ and it is intended to protect the public at large from the negative effects of private activity, such as fraudulent

³⁴ Ibid., p. 9

³⁵ MacRae, Duncan and Wilde James. Policy Analysis for Public Decisions. 1979. Page 171

³⁶ A chosen course of action significantly affecting large numbers of people is a *policy*. If the government directs the action, then it is a *public policy*.

business transactions.³⁷ Even though business leaders understand their responsibility to the public at large, they are motivated by profits and may resist regulation on cost grounds. Protective regulatory policy tends to be highly contentious when business resists regulation while regulatory agencies insist that they are acting in the public interest.³⁸

3.4 Defining Public Trust

The core idea of trust is based on a fiduciary relationship; one person acts on behalf of another, or holds and manages property for another. Public trust is a notion based on common law; some things cannot be privately owned so they are held by a sovereign for the benefit of all. Over a long period, rules for trust management have been defined through federal and state statutes and are based on an accretion of case law and managed by various market institutions. There are mechanisms in place to enforce the rules. The recent corporate scandals, however, indicate that nearly all of the market institutions that the public trusts to provide protection (specifically against large-scale fraud) failed to varying degrees.

The Voice of the People survey of 36,000 people conducted by Gallup International reveals that "trust" will be one of the major issues in 2003. These results disclose a dramatic lack of trust in democratic institutions and global and large national companies around the world.³⁹ The graph below shows a change in the trust level of leaders in the past year for 15 countries.⁴⁰ Notably, Americans were most likely to report decreased trust in executives of domestic companies and in executives of multinational companies.

³⁷ Birkland, Thomas A. *An Introduction to the Policy Process: Theories, Concepts, and Models of Public Policy Making*. 2001. Page 139.

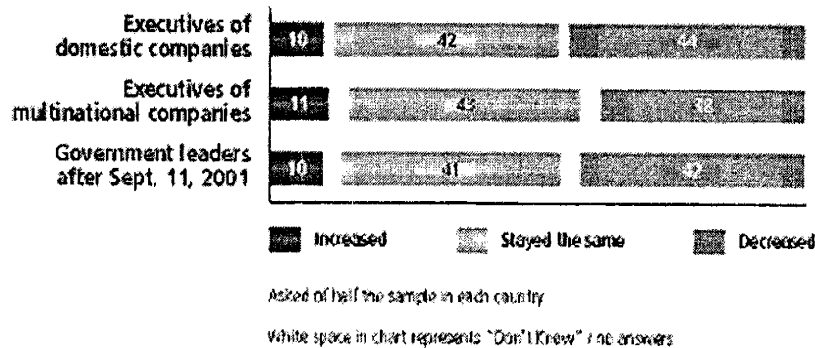
³⁸ *Ibid.*, p. 140

³⁹ World Economic Forum, *Results of the Survey on Trust*. November 2, 2002.

⁴⁰ The World Economic Forum Poll was conducted on a survey that involved a total of 15,000 in-person or telephone interviews across mainly "Group of 20" countries (n = 1,000 per country). It was conducted between November and December 2002 by respected research institutes in each participating country under the leadership of Environics International Ltd of Toronto, Canada.

Change in Trust Levels of Leaders in Past Year

Self-Reported Changes (Average Across All 15 Countries)

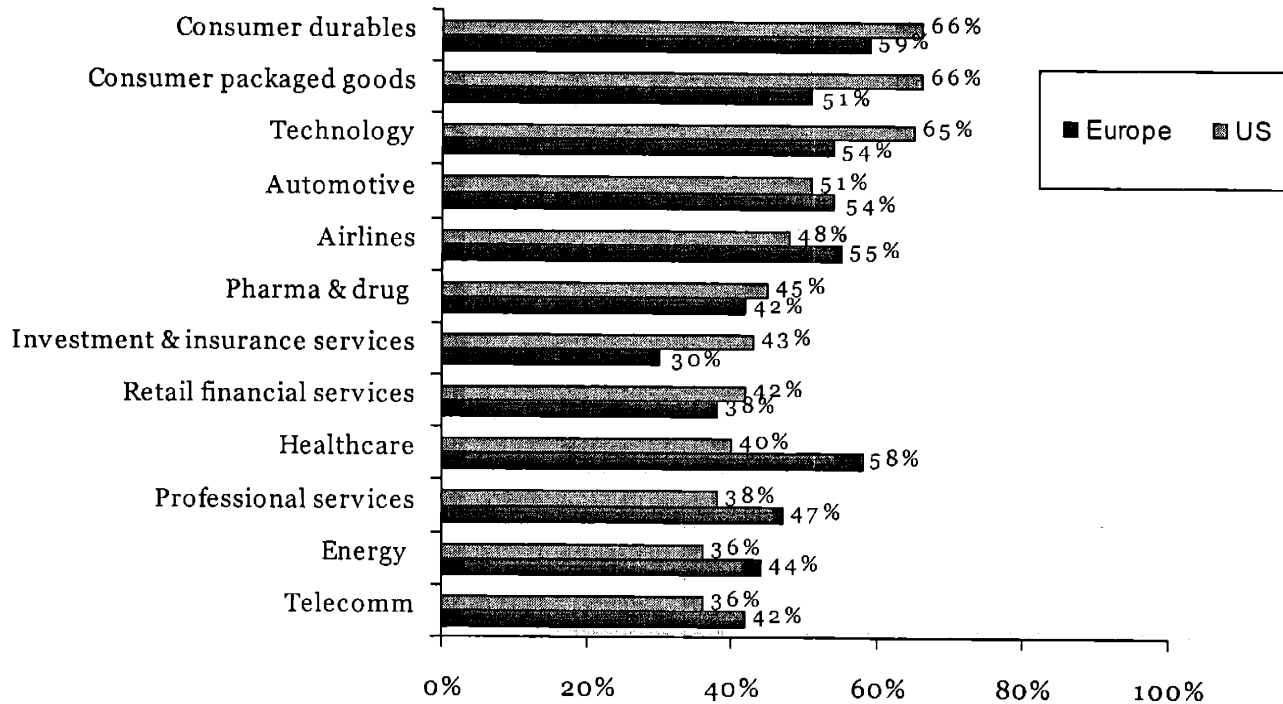


Another source, Richard Edelman's fourth semi-annual trust and credibility survey of opinion leaders,⁴¹ states that a corporation's reputation plays a large role in forming public opinion about its goods and services. Not surprisingly, Edelman's survey results highlight that the American corporate scandals have contributed to making the professional services industry (of which accounting is included) one of the least trusted industries based on research that was fielded between December 14, 2002 and January 10, 2003 of 400 American opinion leaders. These data is shown in Figure 3-1, below.

⁴¹ Edelman is global public relations firm, ranked 6th in its industry. Opinion leaders are defined as being between 35-64 years, college educated with a household income of more than \$75,000 in the U.S. and are business and media attentive. The interviews were conducted via telephone and averaged 25 minutes in duration.

Figure 3-1: Benchmark of Trust in U.S. Business Sectors

Question asked: How much do you TRUST each to do what is right. Please use a 9-point scale where 1 means do not trust them at all and 9 means that you trust them a great deal.



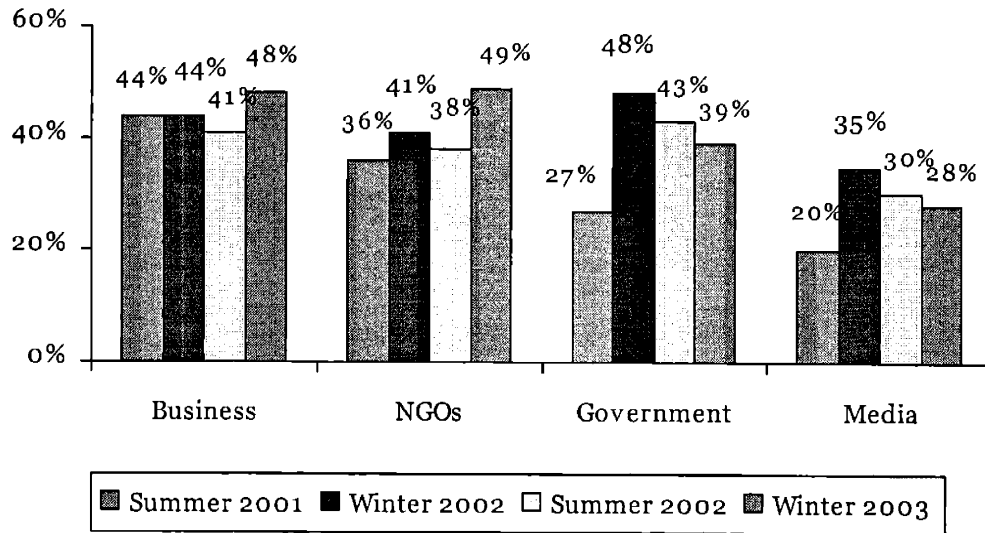
However, during this same period, Edelman's survey revealed that trust in American business, *in general*, (emphasis added) improved despite the unprecedented corporate scandals, and that companies have a window of opportunity⁴² to address public concerns by demonstrating changes in corporate behavior.⁴³ Forty-eight percent of United States opinion leaders expressed trust in business, an increase from the 41% recorded in Edelman's June 2002 survey. Edelman's data shows that trust in the United States government, however, has fallen from a post-September 11 high of 48% in January 2002 to a current rate of 39%. These data is shown in Figure 3-2, below.

⁴² The timing frame was undefined by Edelman.

⁴³ Edelman, Richard. "Building Trust. A Special Report." Presented at the World Economic Forum Annual Meeting, January 23, 2003, Davos Switzerland.

Figure 3-2: U.S. Trust in Institutions

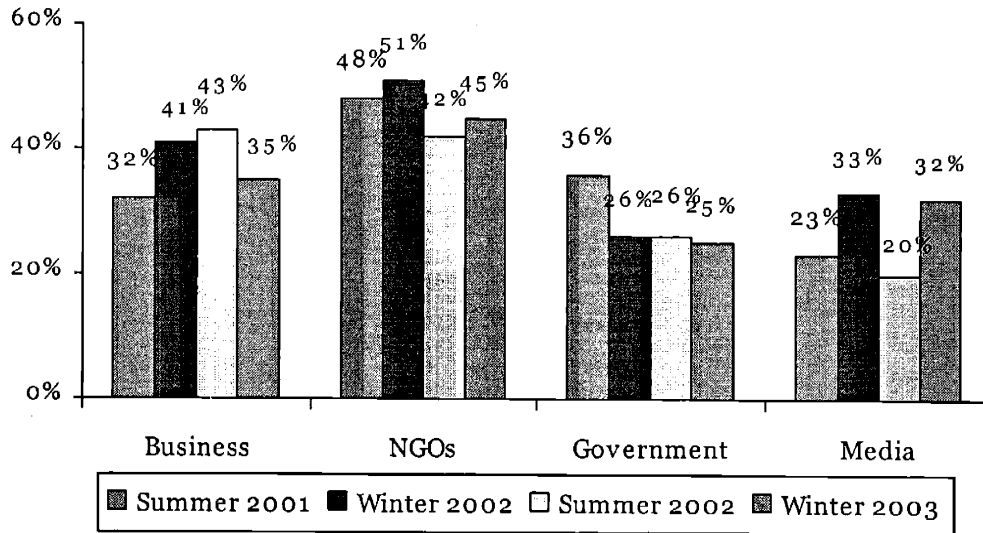
Question asked: How much do you TRUST each to do what is right. Please use a 9-point scale where 1 means do not trust them at all and 9 means that you trust them a great deal.



Also interesting is that Edelman's data for the current state of trust in the United States toward business and government is higher than that in Europe despite the number of American corporate scandals, a prolonged recession, and sizable layoffs in many industries. Europeans' trust in business declined from 43% in June 2002 to a current 35% rate. Over the same period, trust in government in Europe remained low at 25%, down from a peak of 36% in June 2001. These data is shown in Figure 3-3, below.

Figure 3-3: European Trust in Institutions

Question asked: How much do you TRUST each to do what is right. Please use a 9-point scale where 1 means do not trust them at all and 9 means that you trust them a great deal.



When Edelman writes about the impact of scandals in an industry, he states that quality, trust, and ethical standards must be the central themes for firms in industries that people mistrust, and that American's have faith in the system to restore trust. He goes on to say that, "Trust in U.S. business is improving because corporations have been taking steps to restore confidence, and there is new legislation like Sarbanes-Oxley."⁴⁴

⁴⁴ Ibid.

Chapter 4

Analysis of the Sarbanes-Oxley Act 2002

On February 14, 2002, Congressman Michael G. Oxley (4th District, OH) introduced H.R.3763, originally entitled the Corporate and Auditing, Responsibility, and Transparency Act of 2002, to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.⁴⁵ Oxley is the Chairman of the House Committee on Financial Services. This Committee oversees the entire financial services industry and also oversees the work of the Federal Reserve, the Treasury, the SEC, and other financial services regulators.

On June 25, 2002, Senator Paul Sarbanes introduced S.2673. The bill was originally entitled as a summary of its purpose: An original bill to improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes.⁴⁶

Together, the House and Senate bills became Public Law No: 107-204 on July 30, 2002, less than 24 weeks after Congressman Oxley first introduced his bill to the House of Representatives. Ratified as an Act known as Sarbanes-Oxley, the House approved the measure, 423-3, and the Senate soon followed with a unanimous vote, 99-0.

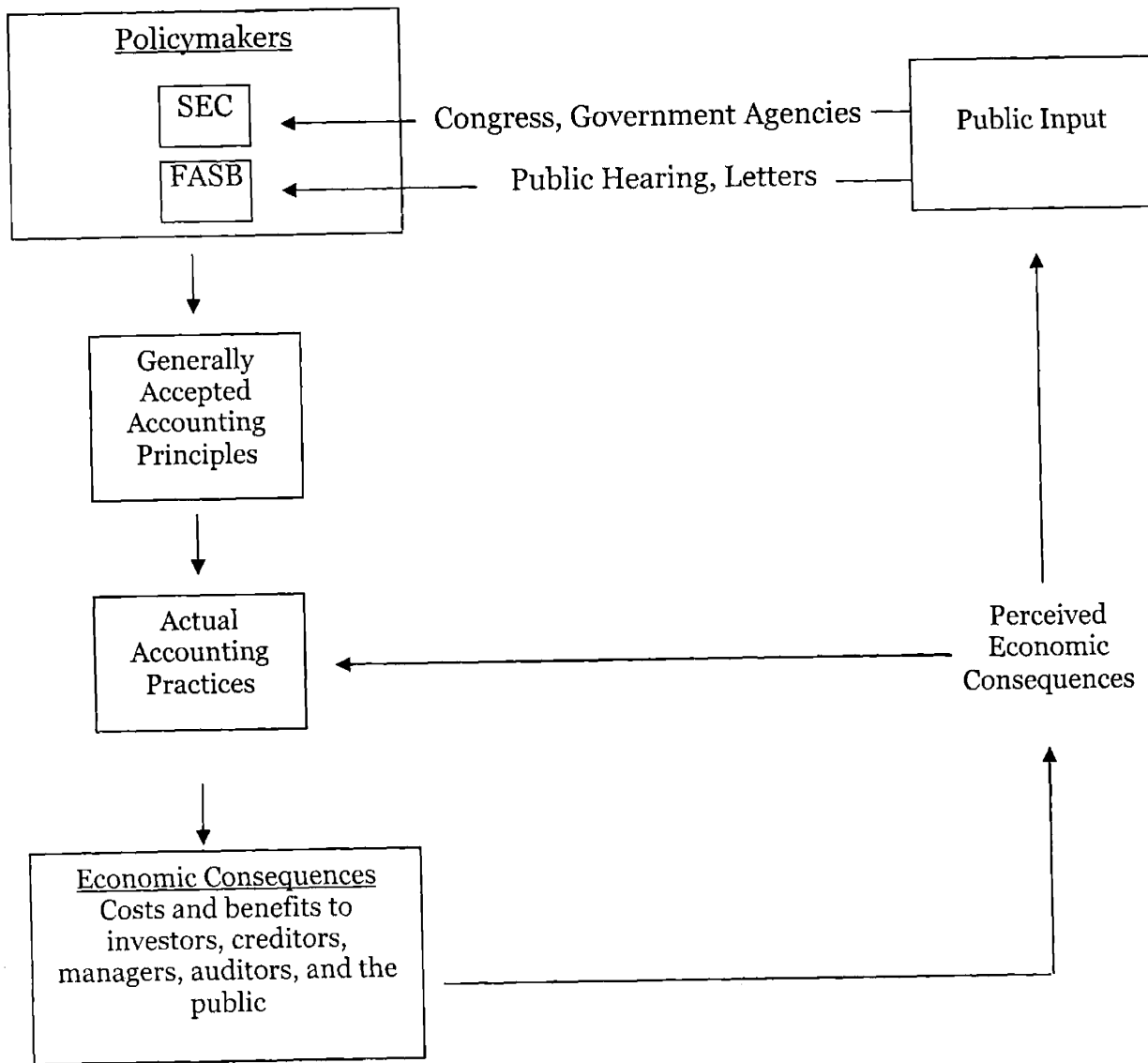
⁴⁵ Bill Summary and Status of the 107th Congress. H.R. 3763, Thomas Information Service, Library of Congress. February 14, 2002

⁴⁶ Bill Summary and Status of the 107th Congress. S. 2673, Thomas Information Service, Library of Congress. June 25, 2002.

Figure 4-1, below, shows the accounting policymaking process.⁴⁷ Policymakers, represented by the SEC and the FASB, are influenced in their deliberations by public input from Congress, government agencies, public hearings, and letters from interested parties. The result is generally accepted accounting principles, which, in turn, lead to actual accounting practices – the methods used by companies to account for their business activities. In turn, these methods bring about economic consequences – the costs and benefits to investors, creditors, managers, and the general public associated with reporting financial accounting information. Such costs and benefits play a critical role in the political process because they create incentives for interested parties to provide public input to policymakers.

⁴⁷ Pratt. Op. Cit., pp. 22-24

Figure 4-1: The Accounting Policymaking Process



I defined the corporate disclosure crisis in Chapter 2 by showing the root causes contributing to the decline in investor confidence in the capital markets involve four general interrelated areas of the overall American accountability system, and can be categorized as: 1) corporate governance; 2) financial reporting; 3) the accounting profession, and; 4) regulation and enforcement. The Sarbanes-Oxley Act uses 11 titles and 56 sections to address the failures in the overall system. Instead of traditional title-by-title analysis, my analysis is organized

around the major topics of the Act, which I then associate with the areas of the accountability system, as listed above. Appendix A includes the index of the titles and sections of the Sarbanes-Oxley Act, and its summary as prepared by the Congressional Research Service (CRS) of the Library of Congress.

4.1 Directors and Senior Executives of Public Companies (Corporate Governance)

The Act imposes new obligations and restrictions on directors and senior executives of public companies. Specifically, the Act requires that CEOs and CFOs must certify in each report containing financial statements that it fully complies with the reporting requirements of the federal securities law, and that the information fairly presents, in all material aspects, the financial condition, and results of operations of the issuer. A CEO or CFO who knows a certification is wrong may be subject to a fine of up to US\$5,000,000 and imprisonment of up to 20 years.

The purpose of the provisions related to executive certification is to pre-empt fraudulent financial data from reaching investors and other potential users of a company's financial statements. Auditors are heavily criticized for not detecting fraud. This is known as the expectations gap between what an audit opinion actually means (assurance that the financial statements are a true and fair view of the company's financial performance) and what some believe or hope it means (validation of the health and soundness of the company). The responsibility to detect and prevent fraud lies with executive management, not external auditors.

4.2 Audit Process and Oversight (Accounting Profession, Regulation and Enforcement)

The Act establishes the Public Company Accounting Oversight Board (PCAOB) to oversee independent auditing firms of public companies. A five-member oversight board will be

established as a non-profit entity to create a more uniform, comprehensive, and detailed oversight regime for the process of auditing public companies. Fees from accounting firms and public companies will fund the PCAOB. A significant independence provision restricts accounting firms from engaging in the following non-audit services: bookkeeping related to the accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services or fairness opinions; actuarial services; internal audit outsourcing services; management or human resource functions; broker, dealer investment advisor, or investment banking services; and legal services and expert services unrelated to the audit.

4.3 Public Company Disclosures (Financial Reporting)

The Act contains numerous provisions regarding SEC review of and rules for disclosure of financial information from public companies. Most significantly, the Act authorizes the SEC to require public companies to disclose material changes in financial condition or operations on a rapid and current basis. The Act also requires companies to disclose all material off balance sheet transactions that may have a current or future material affect on the company's financial condition.

Additionally, the Act requires public companies to disclose whether its audit committee includes at least one financial expert, and if not, why. What is most striking about this provision is that the Act only introduces the concept of a financial expert, but does not mandate that such a person sit on the audit committee.

4.4 Enforcement and Penalties (Regulation and Enforcement)

New criminal penalties are aimed at individual wrongdoers and errors in corporate disclosures. As noted above, CEOs and CFOs, who must now certify the annual and interim

reports of their companies may face severe fines and imprisonment for up to 20 years if they fail to comply with such provisions. Additionally, the Act imposes fines and imprisonment for up to 20 years for auditors who alter or destroy records that impede an official investigation.

New civil provisions are designed to assist securities plaintiffs with an extended statute of limitations for fraud. The Act designated a “Fair Funds” to collect illegal gains and fines paid by violators to benefit injured investors. A company will no longer be permitted to discharge in bankruptcy any order or settlement arising from a securities-related action.

Chapter 5

Conclusion

The days when Board of Directors rubber stamped management's decisions, collected fees, and adjourned for lunch, are over. Also gone are the days when auditors rubber stamped a clean opinion on a public company's financials. A company's financial results are the cornerstone of communication with the capital markets; the annual and interim financial statements are key signals to the public of the company's performance.

Generally speaking, optimists are hoping that the Sarbanes-Oxley Act will quickly form tougher corporate governance rules, and designate more money for the Securities and Exchange Commission to investigate corporate records through a new oversight board for the auditing profession. From a pragmatic perspective, the Act is designed to enforce tough restrictions on non-audit work by auditors, and very tough new criminal penalties for corporate fraud. In the end, this combination should more than clean up the corporate governance mess, and perhaps even come to be viewed as overkill. Nevertheless, in the short run, more investigations are likely to turn up more wrongdoing, and thus add to investors' nervousness about the reliability of corporate information generally. Only time and vigilance of the various interest groups will settle these short run-long run fluctuations.

The Sarbanes-Oxley Act 2002 makes a significant effort to address the major areas perceived to be the root cause of the corporate disclosure crisis. However, I perceive there to be many gaps in the provisions that may result in unintended consequences for the investors, publicly traded companies, or those institutions that monitor and regulate publicly traded companies. Listed below are the most significant gaps in the provisions that I perceive:

- 1.) The SEC identifies that the material changes in financial condition must be reported correctly as is useful for the protection of investors and the public interest, but the Act does not indicate how a company should satisfy this requirement.
- 2.) Technical compliance with GAAP is not in and of itself sufficient to ensure that an investor has all of the information that he needs to understand the financial condition of a company.
- 3.) Federal courts will have to clarify what misconduct constitutes a willful violation of CEO and CFO certification states about financial reports.
- 4.) The Act introduces the concept of “financial expert,” but does not require any member of the audit committee to be a financial expert.
- 5.) Exceptions exist throughout the Act, but guidance is vague and subject to interpretation.
- 6.) The Act is unclear whether this means that the financial statements themselves must be modified to reflect the adjustments even if the company disagrees with the auditor, or whether the company is merely required to make a separate disclosure regarding the adjustments.
- 7.) Rules will be needed to clarify a blackout period and security exemptions.
- 8.) Exemptions may be provided for certain extenuating circumstances throughout the Act, but the circumstances are not yet defined.
- 9.) An appropriate reason for not adopting a code may be impossible to establish or extremely implausible.
- 10.) Off balance sheet transactions are already complex to understand and interpret. Provisions in the Act relating to off balance sheet transactions do not provide a remedy to this major problem.

Legislative reform involves predicting the consequences of policies and relating them to general ethical principles. This reasoning seems sound and complete. Because there are many ways to think about how to solve a problem, there are dilemmas of legislative reform. It is worthwhile to ask yourself whether the decisions that are being made could be made better. However, think carefully about what you mean by "better." Theorists really do not have an opinion about what a better policy is; a rationalist would argue that the best policy is the policy that is most likely to solve a problem. Opinion holders might have different goals and values that would make defining the "best" policy as much an analytical problem as it is a political one.

Appendix A: (Appendix to Chapter 4)

- 1.) Index of Sarbanes-Oxley Act 2002
- 2.) Summary of the major provisions of the Sarbanes-Oxley Act 2002 categorized by the four areas of the American corporate accountability system.
- 3.) Summary of the Sarbanes-Oxley Act 2002 as prepared by the Congressional Research Service (CRS) of the Library of Congress

1.) Index of Sarbanes-Oxley Act 2002

TITLE I -- PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

- Sec. 101. Establishment; administrative provisions.
- Sec. 102. Registration with the Board.
- Sec. 103. Auditing, quality control, and independence standards and rules.
- Sec. 104. Inspections of registered public accounting firms.
- Sec. 105. Investigations and disciplinary proceedings.
- Sec. 106. Foreign public accounting firms.
- Sec. 107. Commission oversight of the Board.
- Sec. 108. Accounting standards.
- Sec. 109. Funding.

TITLE II -- AUDITOR INDEPENDENCE

- Sec. 201. Services outside the scope of practice of auditors.
- Sec. 202. Pre-approval requirements.
- Sec. 203. Audit partner rotation.
- Sec. 204. Auditor reports to audit committees.
- Sec. 205. Conforming amendments.
- Sec. 206. Conflicts of interest.
- Sec. 207. Study of mandatory rotation of registered public accounting firms.
- Sec. 208. Commission authority.
- Sec. 209. Considerations by appropriate State regulatory authorities.

TITLE III -- CORPORATE RESPONSIBILITY

- Sec. 301. Public company audit committees.
- Sec. 302. Corporate responsibility for financial reports.
- Sec. 303. Improper influence on conduct of audits.
- Sec. 304. Forfeiture of certain bonuses and profits.
- Sec. 305. Officer and director bars and penalties.
- Sec. 306. Insider trades during pension fund blackout periods.

Sec. 307. Rules of professional responsibility for attorneys.

Sec. 308. Fair funds for investors.

TITLE IV -- ENHANCED FINANCIAL DISCLOSURES

Sec. 401. Disclosures in periodic reports.

Sec. 402. Enhanced conflict of interest provisions.

Sec. 403. Disclosures of transactions involving management and principal stockholders.

Sec. 404. Management assessment of internal controls.

Sec. 405. Exemption.

Sec. 406. Code of ethics for senior financial officers.

Sec. 407. Disclosure of audit committee financial expert.

Sec. 408. Enhanced review of periodic disclosures by issuers.

Sec. 409. Real time issuer disclosures.

TITLE V -- ANALYST CONFLICTS OF INTEREST

Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.

TITLE VI -- COMMISSION RESOURCES AND AUTHORITY

Sec. 601. Authorization of appropriations.

Sec. 602. Appearance and practice before the Commission.

Sec. 603. Federal court authority to impose penny stock bars.

Sec. 604. Qualifications of associated persons of brokers and dealers.

TITLE VII -- STUDIES AND REPORTS

Sec. 701. GAO study and report regarding consolidation of public accounting firms.

Sec. 702. Commission study and report regarding credit rating agencies.

Sec. 703. Study and report on violators and violations

Sec. 704. Study of enforcement actions.

Sec. 705. Study of investment banks.

TITLE VIII -- CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY

Sec. 801. Short title.

Sec. 802. Criminal penalties for altering documents.

Sec. 803. Debts non-dischargeable if incurred in violation of securities fraud laws.

Sec. 804. Statute of limitations for securities fraud.

Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.

Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.

Sec. 807. Criminal penalties for defrauding shareholders of publicly traded companies.

TITLE IX -- WHITE-COLLAR CRIME PENALTY ENHANCEMENTS

Sec. 901. Short title.

Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.

Sec. 903. Criminal penalties for mail and wire fraud.

Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.

Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.

Sec. 906. Corporate responsibility for financial reports.

TITLE X -- CORPORATE TAX RETURNS

Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.

TITLE XI -- CORPORATE FRAUD AND ACCOUNTABILITY

Sec. 1101. Short title.

Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.

Sec. 1103. Temporary freeze authority for the Securities and Exchange Commission.

Sec. 1104. Amendment to the Federal Sentencing Guidelines.

Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.

Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.

Sec. 1107. Retaliation against informants.

2.) Summary of the major provisions of the Sarbanes-Oxley Act 2002 categorized by the four areas of the American corporate accountability system.

Corporate Governance

Most Significant Provisions	Purpose of the Provision
CEO/CFO certification	CEOs and CFOs must certify in each report containing financial statements that it fully complies with the reporting requirements of the federal securities law, and that the information fairly presents, in all material aspects, the financial condition and results of operations of the issuer.
No loans to directors and officers	Prohibits a public company from making personal loans or extensions of credit to any of its directors and officers.
Insider Trading Rules: Section 16 Reporting	Amendment to Section 16 of the Securities Exchange Act requiring persons to report sock transactions within 2 business days.
Insider Trading Rules: Employee Benefit Plan Blackout Dates	Directors and executive officers cannot buy or sell the company's securities during a blackout period if the securities were acquired in connection with his service or employment.
CEO or CFO Disgorgement Penalty for Financial Statement Restatements	Without requirement for being personally connected with the misconduct, the CEO and CFO must reimburse an issuer for any bonus or equity-based compensation and profits realized from the sale of the company's stock during the 12 months after the publication of the original financials.
Code of Ethics	Requires public companies to disclose in their periodic reports whether or not they have adopted a code of ethics for senior financial officers, and if not, state why.

Inclusion of Financial Expert in Audit Committee	Requires public companies to disclose whether its audit committee includes at least one "financial expert," and if not, why.
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Financial Reporting

Most Significant Provisions	Purpose of the Provision
Adjustments Identified by Auditors	Each report that contains financial statements must reflect all material correcting adjustments that have been identified by the company's auditor in accordance with GAAP and the rules and regulations of the SEC.
Off Balance Sheet Transactions	Requires companies to disclose all material off balance sheet transactions that may have a current or future material effect on the company's financial condition.
Reporting Material Changes in Financial Condition	Requires companies to disclose on a "rapid and current basis," and in "plain English," such additional information concerning material changes in the financial condition or operations of the issuer.

The Accounting Profession

Most Significant Provisions	Purpose of the Provision
Non-Audit Services	<p>Registered accounting firms may not provide any of the following non-audit services to audit clients:</p> <ul style="list-style-type: none">- Bookkeeping related to the accounting records or financial statements.- Financial information systems design and implementation.- Appraisal or valuation services or fairness opinions.- Actuarial services.- Internal audit outsourcing services.- Management functions or human resources.- Broker, dealer, investment advisor, or investment banking services.- Legal services and expert services unrelated to the audit.- Any other service that the Oversight Board determines by regulation is impermissible.
Report to Audit Committee	<p>Registered accounting firms providing audit services to a company must timely report to the audit committee:</p> <ul style="list-style-type: none">- All critical accounting policies and practices to be used.- Alternative treatments that were discussed with management, the ramifications of the use, and which treatments the auditors prefer.- Other material written communications with management.

Conflicts of Interest	Registered accounting firms may not audit a public company if the CEO, CFO, controller, or chief accounting officer of the company was employed by the auditor and participated in the audit of that company during the previous year.
Audit Partner Rotation	The lead audit partner for an account must rotate every five years.

Regulation and Enforcement

Most Significant Provisions	Purpose of the Provision
Public Company Accounting Oversight Board	A new board created to register and inspect all accounting firms and to establish rules and quality controls related to the preparation of audit reports.
Frequent Review	The SEC will review disclosures by NYSE, AMEX, and Nasdaq companies on a regular and systematic basis for the protection of investors.
New Criminal Statute	A new statute provides for imprisonment of up to 25 years for any person who knowingly executes or attempts to execute a scheme to defraud securities of a public company.
Prohibitions Against Destruction of Documents	It is a crime, punishable by a fine and imprisonment, to knowingly and willfully violate record retention provisions, or to "corruptly" alter, destroy or conceal any records or documents with the intent to obstruct a federal government investigation.
Protections for Whistleblowers: No Retaliation	It is a crime, punishable by a fine and imprisonment, to retaliate, take any action harmful to any person for providing law enforcement officers any truthful information relating to the commission or possible commission of any federal offense.

<p>Protections for Whistleblowers: No Discrimination Against Employees</p>	<p>The Act prohibits companies from discharging, demoting, suspending, threatening, harassing, or discriminating against any employee who undertakes a lawful act to provide information, or to participate in a proceeding relating to an alleged violation of law or regulations.</p>
<p>Enhanced SEC Powers</p>	<p>The Act grants the SEC enhanced powers to police corporate fraud.</p>
<p>Statute of Limitations</p>	<p>The statute of limitations for private securities fraud litigation is expanded to now 2 years after the discovery of facts constituting the violation, and no more than 5 years after the violation.</p>

3.) Summary of the Sarbanes-Oxley Act 2002 as prepared by the Congressional Research Service (CRS) of the Library of Congress

TITLE I -- PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Establishes the Public Company Accounting Oversight Board (Board) to: (1) oversee the audit of public companies that are subject to the securities laws; (2) establish audit report standards and rules; and (3) inspect, investigate, and enforce compliance on the part of registered public accounting firms, their associated persons, and certified public accountants.

(Sec. 101) Prohibits Board membership from including more than two certified public accountants.

(Sec. 102) Requires a public accounting firm that performs or participates in any audit report with respect to any issuer to register with the Board.

(Sec. 103) Directs the Board to establish (or modify) the auditing and related attestation standards, quality control, and the ethics standards used by registered public accounting firms to prepare and issue audit reports.

Requires auditing standards to include: (1) a seven-year retention period for audit work papers; (2) concurring or second partner review and approval by a Board-prescribed qualified person; (3) an evaluation of whether internal control structure and procedures include records that accurately reflect transactions and dispositions of assets; (4) assurance that transactions are recorded to permit preparation of financial statements in accordance with generally accepted accounting principles (GAAP), and that receipts and expenditures are made only with authorization of senior management and directors; and (5) a description of both material weaknesses in internal controls and of material noncompliance.

(Sec. 104) Mandates that a program of continuing inspections to ensure compliance is conducted: (1) annually for firms that regularly provide audit reports for more than 100 issuers; and (2) at least every three years for firms that regularly provide audit reports for 100 or fewer issuers.

(Sec. 105) Empowers the Board to impose disciplinary or remedial sanctions upon registered public accounting firms, associated persons, and accountants.

Restricts sanctions and penalties to intentional conduct or to repeated instances of negligent conduct.

Authorizes the Board to impose sanctions upon a registered accounting firm or its supervisory personnel for failure to supervise.

(Sec. 106) Places within the purview of this Act foreign public accounting firms that prepare or furnish an audit report for an issuer, including audit workpapers.

(Sec. 107) Grants the Securities and Exchange Commission (SEC) general oversight and enforcement authority over the Board, including prior approval of Board rules; review of disciplinary action taken by the Board; and general modification and rescission of Board authority.

(Sec. 108) Directs the SEC to report to Congress on adoption of a principles-based accounting system by the U.S. financial reporting system.

(Sec. 109) Directs the Board to establish annual accounting support fees which shall be collected from issuers.

Title II -- AUDITOR INDEPENDENCE

Amends the Securities Exchange Act of 1934 to prohibit an auditor from performing specified non-audit services contemporaneously with an audit (auditor independence). Requires pre-approval by the audit committee of the issuer for those non-audit services that are not expressly forbidden by this Act.

(Sec. 202) Mandates: (1) pre-approval by the audit committee of the issuer of all auditing and non-auditing services provided by an auditor; and (2) disclosure of such pre-approval in periodic reports to investors.

(Sec. 203) Mandates: (1) audit partner rotation on a five-year basis; and (2) auditor reports to audit committees of the issuer.

(Sec. 204) Requires an auditor to report timely to the audit committee: (1) critical accounting policies and practices used in the audit; (2) alternative treatments and their ramifications within generally accepted accounting principles that have been discussed with management officials; (3) the treatment preferred by the auditor; and (4) material written communications between the auditor and senior management.

(Sec. 206) Prohibits an auditor from performing audit services if the issuer's senior executives had been employed by such auditor and had participated in the audit of the issuer during the one-year period preceding the audit initiation date (conflict of interests).

(Sec. 207) Directs the Comptroller General (GAO) to report to Congress on the potential effects of mandatory rotation of registered public accounting firms (limiting the number of years such firms may remain auditor of record for a particular issuer).

(Sec. 209) Declares that State regulatory authorities should determine independently the standards for supervising non-registered public accounting firms and consider the size and nature of their clients' businesses audit.

Title III -- CORPORATE RESPONSIBILITY

Confers responsibility upon audit committees of public companies for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. Requires an audit committee member to be a member of the board of directors of the issuer, and to be otherwise independent.

(Sec. 302) Instructs the SEC to promulgate requirements that the principal executive officer and principal financial officer certify the following in periodic financial reports: (1) the report does not contain untrue statements or material omissions; (2) the financial statements fairly present, in all material respects, the financial condition and results of operations; and (3) such officers are responsible for internal controls designed to ensure that they receive material information regarding the issuer and consolidated subsidiaries.

Requires such senior corporate officers additionally to certify that they have disclosed to the auditors and audit committee of the board of directors; (1) significant internal control deficiencies; and (2) any fraud that involves staff who have a significant role in the issuer's internal controls.

States that the rules governing corporate responsibility apply to issuers even if they have reincorporated or transferred their corporate domicile or offices from inside the United States to outside the United States.

(Sec. 303) Deems unlawful efforts by corporate personnel to exert improper influence upon an audit for the purpose of rendering financial statements materially misleading.

(Sec. 304) Requires the chief executive officer and chief financial officer to forfeit certain bonuses and compensation received following an accounting restatement that has been triggered by a violation of securities laws.

(Sec. 305) Amends the Securities Exchange Act of 1934 and the Securities Act of 1933 to authorize a Federal court to bar a violator of certain SEC rules from serving as an officer or director of an issuer if the person's conduct demonstrates unfitness to serve (the current standard is "substantial unfitness").

(Sec. 306) Prohibits insider trades during pension fund blackout periods if the equity security was acquired in connection with services as either a director, or employment as an executive officer. States that profits realized from such trades shall inure to and be recoverable by the issuer irrespective of the intent of the parties to the transaction.

Limits actions to recover profits to two years after the date on which such profits were realized.

Amends the Employee Retirement Income Security Act of 1974 (ERISA) to require a plan administrator to notify the following parties of an impending blackout period: (1) participants and beneficiaries in individual account plans; and (2) the issuer of any employer securities subject to such blackout period. Subjects a plan administrator to civil penalties for failure to notify.

(Sec. 307) Directs the SEC to issue rules of professional responsibility for attorneys who practice before the Commission, including a rule requiring an attorney to report a material violation or breach of fiduciary duty to: (1) the chief legal counsel or chief executive officer of the company; and (2) the audit committee of the board of directors if such legal counsel or officer does not respond appropriately.

(Sec. 308) Allows civil penalties to be added to a disgorgement fund for the benefit of victims of securities violations if such penalties were obtained by the SEC in addition to an order for disgorgement.

Instructs the SEC to report to Congress on previous procedural actions taken to obtain civil penalties or disgorgement in order to identify where such procedures may be used to provide restitution efficiently for injured investors.

Title IV -- ENHANCED FINANCIAL DISCLOSURES

Requires financial reports filed with the SEC to reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with SEC rules and generally accepted accounting principles (GAAP).

Instructs the SEC to require by rule: (1) disclosure of all material off-balance sheet transactions and relationships that may have a material effect upon the financial status of an issuer and (2) the presentation of pro forma financial information in a manner that is not misleading and that is reconcilable with the financial condition of the issuer under GAAP.

(Sec. 401) Directs the SEC to report to Congress on: (1) the extent of off-balance sheet transactions and the use of special purpose entities; and (2) whether GAAP clearly conveys to investors the economics of off-balance sheet transactions; and (3) the extent to which special purpose entities are used to facilitate off-balance sheet transactions.

(Sec. 402) Prohibits personal loans extended by a corporation to its executives and directors.

Permits certain loans if: (1) made in the ordinary course of the consumer credit business of the issuer; (2) of a type generally made available by the corporation to the public; and (3) made on market terms, or on terms that are no more favorable than those offered to the public.

Permits loans for: (1) home improvement and manufactured homes; (2) consumer credit; (3) an open end credit plan or a charge card; (4) credit extended by a broker or dealer for employee securities trades; and (5) made by an insured depository institution if they are subject to the insider lending restrictions of the Federal Reserve Act.

(Sec. 403) Requires senior management, directors, and principal stockholders to disclose changes in securities ownership or security-based swap agreements within two business days

after such transactions were executed (currently ten days after the close of the calendar month). Mandates electronic filing and availability of such disclosures one year after the date of enactment of this Act.

(Sec. 404) Directs the SEC to require by rule that annual reports include an internal control report which: (1) avers management responsibility for maintaining adequate internal control mechanisms for financial reporting; and (2) evaluates the efficacy of such mechanisms. Requires the public accounting firm responsible for the audit report to attest to and report on the assessment made by the issuer.

(Sec. 406) Directs the SEC to issue rules requiring an issuer to disclose whether it has adopted a code of ethics for its senior financial officers, including its principal financial officer or principal accounting officer.

(Sec. 407) Sets a deadline for the SEC to promulgate rules requiring an issuer to disclose whether its audit committee consists of at least one member who is a financial expert.

(Sec. 408) Mandates regular, systematic SEC review of periodic disclosures by issuers, including review of an issuer's financial statement.

Title V -- ANALYST CONFLICTS of INTEREST

Requires the SEC to adopt rules governing securities analysts' potential conflicts of interest, including: (1) restricting the prepublication clearance or approval of research reports by persons either engaged in investment banking activities, or not directly responsible for investment research; (2) limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities; (3) prohibiting a broker or dealer involved with investment banking activities from retaliating against a securities analyst as a result of an unfavorable research report that may adversely affect the investment banking relationship of the broker or dealer with the subject of the research report; and (4) establishing safeguards to assure that securities analysts are separated within the investment firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.

Directs the SEC to adopt rules requiring securities analysts and broker/dealers to disclose specified conflicts of interest.

Title VI -- COMMISSION RESOURCES and AUTHORITY

Authorizes appropriations for FY 2003 to the SEC for: (1) additional staff compensation; (2) enhanced oversight of auditors and audit services; and (3) additional professional staff for fraud prevention, risk management, market regulation, and investment management.

(Sec. 602) Authorizes the SEC to censure persons who appear and practice before the Commission if it finds: (1) the person has engaged in unethical or improper professional conduct; or (2) has willfully violated, or willfully aided and abetted violation of securities laws.

Deems a registered public accounting firm to be engaged in "improper professional conduct" if the SEC finds "intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards."

(Sec. 603) Amends the Securities Exchange Act of 1934 and the Securities Act of 1933 to authorize a Federal court to prohibit specified brokers, dealers, or issuers from participating in offerings of penny stock .

(Sec. 604) Amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to authorize SEC censure or restriction of associated persons of brokers and dealers who are subject to a final order of State regulatory bodies that bars them from engaging in the business of securities, banking or insurance.

Title VII -- STUDIES and REPORTS

Mandates a GAO report to Congress on: (1) the factors leading to the consolidation of public accounting firms and the subsequent reduction in the number of firms providing audit services to businesses subject to the securities laws; and (2) the impact of such consolidation upon the capital formation and securities markets.

(Sec. 702) Directs the SEC to report to Congress on the role of credit rating agencies in the securities market, including: (1) their role in securities evaluation; (2) impediments to accurate appraisal by credit rating agencies of the resources and risks of issuers of securities; and (3) conflicts of interest in the operation of credit rating agencies and measures to prevent or ameliorate the consequences of such conflicts.

(Sec. 703) Sets a deadline for the SEC to report to Congress on: (1) the number of securities professionals practicing before the Commission who have aided and abetted Federal securities violations but have not been penalized as a primary violator; (2) the occurrence of multiple violations by the same party; (3) whether disciplinary sanctions have been imposed upon each violator, including censure, suspension, temporary or permanent bar to practice before the Commission; and (4) the amount of disgorgement, restitution, or other fines collected from violators.

(Sec. 704) Instructs the SEC to report to Congress on: (1) enforcement actions it has taken regarding violations of reporting requirements and restatements of financial statements; and (2) areas that are most susceptible to fraud, manipulation, or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities.

(Sec. 705) Directs GAO to report to Congress on whether investment banks and financial advisers assisted public companies in earnings manipulation and obfuscation of financial condition, with particular attention to: (1) the collapse of the Enron Corporation, (including derivatives transactions, special purpose vehicles, and other financial arrangements); (2) the failure of Global Crossing, (including swaps of fiberoptic cable capacity and transactions designed to obscure the company's true financial status); and (3) the creation and marketing of transactions designed solely to manipulate revenue, obtain loans, or move liabilities off balance sheets without altering the business risks faced by the companies.

Title VIII -- CORPORATE and CRIMINAL FRAUD ACCOUNTABILITY

Corporate and Criminal Fraud Accountability Act of 2002 - Amends Federal criminal law to impose criminal penalties for: (1) knowingly destroying, altering, concealing, or falsifying records with intent to obstruct or influence either a Federal investigation or a matter in bankruptcy; and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities.

(Sec. 802) Directs the SEC to promulgate regulations governing the retention of documents relating to an audit or review. Establishes criminal penalties for knowing and willful violation of such promulgations.

(Sec. 803) Amends Federal bankruptcy law to make non-dischargeable in bankruptcy certain debts incurred in violation of securities fraud laws.

(Sec. 804) Amends the Federal judicial code to permit a private right of action for a securities-fraud violation to be brought not later than: (1) two years after its discovery; or (2) five years after the date of the violation, whichever is earlier.

(Sec. 805) Directs the United States Sentencing Commission to review the Federal Sentencing Guidelines governing obstruction of justice and extensive criminal fraud to ensure that they are sufficient to deter and punish: (1) activities proscribed by this Act; (2) fraud that endangers the financial security of a substantial number of victims; and (3) organizational criminal misconduct.

(Sec. 806) Amends Federal criminal law to prohibit a publicly traded company from retaliating against an employee because of any lawful act by the employee to: (1) assist in an investigation of fraud or other conduct by Federal regulators, Congress, or supervisors; or (2) file or participate in a proceeding relating to fraud against shareholders.

Sets a 90-day statute of limitations for filing a civil action for retaliation.

Cites remedies for such aggrieved employee, including reinstatement, back pay, and compensatory damages.

(Sec. 807) Subjects to a fine and imprisonment any person who knowingly defrauds shareholders of publicly traded companies.

Title IX -- WHITE-COLLAR CRIME PENALTY ENHANCEMENTS

White-Collar Crime Penalty Enhancement Act of 2002 - Amends Federal criminal law to: (1) establish criminal penalties for attempt and conspiracy to commit criminal fraud offenses; and (2) increase criminal penalties for mail and wire fraud.

(Sec. 904) Amends the ERISA to increase the criminal penalties for violations of such Act.

(Sec. 905) Directs the United States Sentencing Commission to review Federal Sentencing Guidelines to: (1) ensure that they reflect the serious nature of the offenses and penalties set forth in this Act, the growing incidence of serious fraud offenses, and the need to deter and

punish such offenses; and (2) consider whether a specific offense characteristic should be added in order to provide stronger penalties for fraud committed by a corporate officer or director.

(Sec. 906) Amends Federal criminal law to require senior corporate officers to certify in writing that financial statements and attendant disclosures comply with SEC disclosure requirements and fairly present in all material aspects the operations and financial condition of the issuer (corporate responsibility for financial reports).

Establishes a criminal liability for failure of corporate officers to certify financial reports, including maximum imprisonment of: (1) ten years for certifying while knowing that the periodic report does not comport with this Act; and (2) twenty years for willfully certifying a statement knowing it does not comport with this Act.

Title X -- CORPORATE TAX RETURNS

Expresses the sense of the Senate that the Federal income tax return of a corporation should be signed by its chief executive officer.

Title XI -- CORPORATE FRAUD ACCOUNTABILITY

Corporate Fraud Accountability Act of 2002 - Amends Federal criminal law to establish a maximum 20-year prison term for tampering with a record or otherwise impeding an official proceeding.

(Sec. 1103) Amends the Securities Exchange Act of 1934 to authorize the SEC to seek a temporary injunction to freeze extraordinary payments earmarked for designated persons or corporate staff under investigation for possible violations of Federal securities laws.

(Sec. 1104) Requests the United States Sentencing Commission to: (1) promptly review sentencing guidelines for securities and accounting fraud; and (2) expeditiously consider promulgation of new sentencing guidelines to provide an enhancement for senior corporate officers who commit fraud and related offenses. Prescribes guidelines for Commission consideration, including a request that it ensure that the sentencing guidelines and policy statements reflect the serious nature of securities, pension, and accounting fraud and the need for aggressive law enforcement action to prevent such offenses. Sets a deadline for promulgation of such guidelines.

(Sec. 1105) Amends the Securities Exchange Act of 1934 and the Securities Act of 1933 to authorize the SEC to prohibit a violator of rules governing manipulative, deceptive devices, and fraudulent interstate transactions, respectively, from serving as officer or director of a publicly traded corporation if the person's conduct demonstrates unfitness to serve.

(Sec. 1106) Amends the Securities Exchange Act of 1934 to increase criminal penalties for violations of the Act.

(Sec. 1107) Amends the Federal criminal law to establish criminal penalties for intentional retaliation against individuals who provide information to law enforcement officers relating to a Federal offense.

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