Sarbanes-Oxley Act of 2002 –a brief analysis from an accounting perspective

Against a backdrop of numerous corporate accounting scandals and many subsequent bankruptcies, Congress and the President have put into effect significant financial reform by way of the Sarbanes-Oxley Act of 2002 ("Act"). The purpose of this paper is to briefly explore the circumstances leading to this legislation, explain the nature of the Act, and analyze some of the ramifications for the accounting profession.

The prevalence and magnitude of financial wrongdoing in publicly traded firms has become apparent in recent months, resulting in widespread economic loss and a decline in investor confidence. The hiding of debt from regulators and stockholders by Enron executives and the conscious misclassification of expenses as assets by WorldCom are but two examples. Unfortunately, in at least one case (Enron) there has been evidence of auditor complicity in the wrongdoing (Arthur Andersen). This legislation was an attempt by elected officials to combat these negative forces, which have been seen as having the potential to undermine the capital markets.

This paper will address the following primary foci of the Act:

1) establishment of a Public Company Accounting Oversight Board ("Board") charged with the responsibility of establishing or adopting accounting and auditing standards, inspecting accounting firms and enforcing compliance with the Act
2) elimination of the real or perceived conflict of interest that arises when an accounting firm does both consulting work and auditing work for the same client by prohibiting the provision by registered firms of numerous non-auditing services to audit clients
3) arrangement of new funding arrangements for the Financial Accounting Standards Board (FASB)
4) clarification of certain responsibilities of the audit committee members and requirement of closer communication between the audit committee and the auditors
5) enhancement of deterrents to fraud

The most noteworthy effect of the Act on the accounting profession is the elimination of the largely self-regulated environment that the Securities and Exchange Commission (SEC) has allowed to exist for years. In place of a peer review process of oversight and a standard setting body that was closely aligned with the accounting profession, the SEC-appointed Board will now take over these functions. The Board, which will be setting and/or adopting financial accounting and auditing standards, will consist of five (5) financially literate, full-time members, only two of whom are allowed to be Certified Public Accountants (CPAs). The intent is to have a wider representation of viewpoints in the process, but the fact that the majority of the Board members will not have accounting expertise is apt to lead to resentment on the part of accounting practitioners, and may interfere with the efficiency and effectiveness of the Board's activities. However, the change from a peer review process to a Board investigative process for accounting firms is a positive step for the profession as there is evidence to suggest that the peer review process was not achieving the desired results. A shift of onus from peer accountants to a neutral Board will elicit more public trust that firms are adhering to proper standards.

The actual functioning and profitability of the larger accounting firms will clearly be affected by the act. Prohibition of non-audit services to audit clients will be detrimental to the profitability of a firm, and the increased costs of compliance with the new regulation are hard to estimate. Certainly, the cost of audit services will be increased to make up this lost profit on non-auditing services. This may be compounded by a decreased availability of services as some firms decide to abandon their audit practices. Although the Board will likely tend to adopt existing auditing standards, the fact that the potential exists for a non-CPA dominated Board to enact new standards introduces a heightened level of risk for auditing firms.

Currently, the FASB is funded in part through voluntary contributions from CPA firms. The potential conflict of interest has been a source of criticism for the accounting profession. With the new legislation, funding for the FASB will come from assessments on issuers, calculated by a formula that is based on market capitalization. This change will deflect some criticism away from the accounting profession, and eliminate any influence peddling that existed.

The Act will assist auditors by clarifying the role and strengthening the expectations of the audit committees, and by dictating the practice of some auditing standards that were generally shunned by management. Although technically the audit committee has always had the responsibility of hiring and firing the outside auditors, in actuality this has not always been the case, and management has often intervened between the audit committee and the auditors. The Act requires companies to give the audit committee exclusive control over the hiring, firing and spending decisions with respect to the auditors. Even though the audit committee is designed to be an oversight body, oftentimes this has been compromised by the lack of independent status. The Act addresses this by increasing the independence requirements of members. These two factors combined should allow auditors to perform a more effective audit.

By requiring that the financial statements reflect all material correcting entries identified by the auditors, the Act removes auditors from the compromising position of knowing that entries should be made, but weighing this against the need to keep the client happy. Additionally, the law dictates that the auditors discuss with the audit committee any critical accounting policies or alternative accounting treatments and their ramifications. Finally, the SEC will issue rules prohibiting a company's officers from influencing or coercing auditors for the purpose of producing misleading financial statements. Together, these mandates will put the auditors in a much firmer position from which to perform the audit without interference.

Numerous provisions of the Act should function as a deterrent to the commission of fraud including required certification, under penalty of criminal law, by top executive officers of the quarterly filings to the SEC. Penalties for financial and securities fraud were increased substantially. The Act also requires the audit committee to establish a system for anonymous reporting by employees of any suspected fraud, and the employees of issuers and accounting firms are given "whistle-blower protection". These measures should act to decrease the amount of fraud being committed, which will be a benefit to the accounting profession and the capital markets, in general.

There are provisions in the Act for two studies, the outcome of which could have far-reaching effects on accounting practice. The first is a study to be conducted by the General Accounting Office into the effects of mandatory rotation of audit firms. If this were to come to pass, the costs of compliance would be extraordinary because of the loss of efficiencies gained from prior audits. The second is a study to be conducted by the SEC on the replacement of the current rules-based accounting system with a principles-based system. This degree of change is hard to fathom, but would clearly result in a system more reliant on the accountant's judgement, which might lead to more meaningful financial reporting.

The Sarbanes-Oxley Act of 2002 represents landmark legislation for the country's financial markets and the accounting profession. Although some of the positive and negative ramifications for the accounting profession are immediately apparent, to the extent that the legislation is vague and calls for further study, predicting the overall impact on accounting practice is difficult. The final outcome will most likely be determined largely by the philosophies of the Board members who are appointed and even the manner in which the accounting profession responds to the new playing field.