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A Comparison of Corporate Practices in Compliance Before and After Sarbanes-Oxley

by

Johnathan Dale Kovarna

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Honors Capstone Director: Dr. Tobias Mendelson
Clinical Assistant Professor of Accounting

Johnathan Kovarna **4/19/2021**

Student (signature) Date

4/19/2021

Director (signature) Date

Department Chair (signature) Date

Honors College Dean (signature) Date

Honors College
Frank Franz Hall
+1 (256) 824-6450 (voice)
+1 (256) 824-7339 (fax)
honors@uah.edu

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Johnathan Kovarna
Student Name (printed)

Johnathan Kovarna
Student Signature

4/19/2021
Date

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Abstract

The Sarbanes-Oxley Act drastically affected the way that public businesses conduct themselves in the United States. Any student who has taken an accounting class could tell you as much. However, for as much as we are taught about what we are now required to do due to Sarbanes-Oxley, we are told precious little about why it was passed or how it has affected business outside of the regulations themselves. This paper attempts to give a rudimentary understanding of why the Act was passed, what it does (for those who need a refresher), how it has been used since, and gauging the effectiveness of the Act with the costs of compliance. In order to do this, I have looked into the biggest events that lead to the passing of the Sarbanes-Oxley Act, looked into the law itself, examined several litigations from the SEC that involve the Act, and finally look into the studies concerning the costs of compliance with the Act.

In essence, the Sarbanes-Oxley Act is about ensuring accountability in the financial statements that publicly traded companies release. It was created after several massive scandals involving companies committing fraud against its investors for years, and attempts to reach its goal by holding the executive officers of companies liable for the damages caused by the company's fraudulent activities, incentivizing them to look into and ensure that their companies are behaving ethically. Most litigations that I could find that even mention Sarbanes-Oxley have to do with Title III, the area that covers the executive officers' responsibilities and penalties for (mis)handling corporate fraud. My findings show that the Act does do what it claims to do, but at great cost both to companies that comply with it, as well as to the economy as a whole by causing many companies to either stay private or to go public in foreign stock exchanges rather than comply with Sarbanes-Oxley's regulations.

Introduction

Sarbanes-Oxley is one of the most important pieces of legislation concerning how public businesses run in the United States, and while business students will hear of the Act, they are only taught how to comply with it. This is fine, but it is my belief that people will better comply with the regulations that come with Sarbanes-Oxley and the Public Company Accounting Oversight Board if they understand why such regulations were created in the first place. This paper attempts to explain the history behind the Act and how it affects publicly traded businesses in the United States. To accomplish this, I will look at three memorable examples of fraud before Sarbanes-Oxley was signed into law, include some information as to what the law does, then talk about three cases that were affected by the regulations in Sarbanes-Oxley and will talk about some of the costs of complying with the legislation.

Chapter 1: Fraud Before Sarbanes-Oxley

To understand why the Sarbanes-Oxley Act was passed, it is important to look into the scandals that caused people to gain a new distrust of the auditing industry. In the late 1990s and early 2000s, major scandals broke out with Enron, WorldCom, Tyco, and many other companies, usually concerning massive fraud within the company to increase public perceptions of their stock value. In this section, I will be going over the scandals of Enron, WorldCom, and Tyco International in order to explain why the Sarbanes-Oxley Act was drafted and passed.

Enron is possibly the most well-known of these companies. According to William Thomas' article, "The Rise and Fall of Enron," Enron was formed in 1985 in a merger between Houston Natural Gas and InterNorth. From the start, the company struggled to survive, but managed to do so due to the work of a consultant named Jeffrey Skilling. Skilling later hired Andrew Fastow in 1990, and the two eventually became Enron's Chief Executive Officer and Chief Financial Officer, respectively. It was Fastow's leadership that led Enron into scandal and bankruptcy. With Fastow's guidance, the company used Special Purpose Entities (SPE) to hold their failing assets, while giving just enough ownership to outside investors that the SPEs did not need to be included on Enron's financial statements as subsidiaries. An SPE is, according to Dr. Peggy Crawford and Edward Fredericks Jr., is a legal structure created by a firm whose purpose is to provide liquidity or obtain favorable funding from outside sources. Assets (in Enron's case, usually failing assets) would belong to the SPE, and securities issued by those entities would be backed by those same assets as collateral. Until 2003, firms were allowed to own as much as 97% of an SPE without having to list their assets and liabilities on the firm's balance sheet (Crawford & Fredericks, 2003). While these assets were owned by the SPE, Enron still needed to have enough outside investors to be able to avoid having to list the SPEs on their financial

statements. Fastow accomplished this by pairing these SPEs with promises of being issued additional shares of Enron stock, eventually reaching the point where Fastow managed thousands of SPEs (Thomas, 2002). However, Enron's stock value fell quickly, falling over $50 between February and October 2001. On October 16, 2001, Enron announced its first quarterly loss in over four years, and shortly after announced a change in their 401(k) plan (preventing employees from selling Enron stock for 30 days, as Enron stock made up part of their 401(k)). On October 24th, Fastow was fired from his position in the company, and at the end of the month the SEC subpoenaed Fastow to appear before the SEC for a testimony and to provide them with certain Enron documents, but he neither appeared for testimony nor produced any of the new documents that the SEC had requested. At the start of November, Enron released a restatement of their financial statements all the way back to 1997 to reflect the thousands of SPEs that the company had never included in those statements. This was the final nail in the coffin for Enron, as the stock value plummeted to a quarter per share, and the company declared bankruptcy on December 2nd that same year (Thomas, 2002). In less than two weeks, the SEC filed an enforcement action against Fastow, requiring that he presents all of the documents that the SEC had originally requested as well as once more calling on him to testify to the SEC. Once again, on December 12th, Fastow neglected his duties and did not appear for testimony. Over the next few years, various current and former employees of Enron were charged with committing or aiding in fraudulent activities.

Similar to Enron, WorldCom and Tyco were both caught on fraud charges. WorldCom had thrived by acquiring other companies and using their resources to increase the value of WorldCom stock. When that strategy began to falter, WorldCom's CEO, CFO, and Controller conspired to create false accounting entries to give the illusion that WorldCom was continuing to

grow and meet its expected double-digit growth margins. According to the SEC's findings, such illegal practices were easily accomplished due it seemingly being an acceptable practice in the company to record entries upwards of hundreds of millions of dollars with little more documentation than a verbal directive from high-ranking employees. Reportedly, this fraud was well-known throughout the financial and accounting groups in the company, who for the most part just went along with the orders from the top to create these fraudulent entries. The SEC were only made aware of this fraud after the resignation of WorldCom's CEO, when the company's audit committee reviewed their capital expenditures and found that there was no support for the entries. They immediately asked for the resignation of the CFO and Controller before disclosing this information to the SEC. The SEC filed several multiple complaints against WorldCom after this. In its first amended complaint, the SEC details what fraudulent actions WorldCom performed over the last few years, including the extents to which these actions were performed. For example, WorldCom hid the true extent of one of its major operating expenses (their "line costs") by reducing reserves held against them and transferring certain costs to their capital assets accounts. While doing this, WorldCom also continued to sell their securities, using their fraudulent statements to persuade would-be investors. Overall, WorldCom violated several fraud, reporting, record-keeping, and internal control provisions of the United States federal securities laws and overstated their income by several billion dollars between 1999 and 2002. Ebbers, WorldCom's CEO at the time of the fraud, was put on trial for several years following the scandal. According to a WMC article about Ebbers' sentencing, he testified that he was unfamiliar with the accounting practices taking place at WorldCom and that, above all, he had no idea of the fraud that was taking place under him. However, the CFO, Scott Sullivan, testified against Ebbers, claiming that he had ordered Sullivan to "hit our numbers" several times over the

years, a command that he went on to claim meant to falsify financial information. Sullivan himself had pleaded guilty to fraud and admitted to being the brains behind the scheme, but that he only did it on orders from Ebbers. In March of 2005, Ebbers was found guilty of one count of conspiracy, one count of securities fraud, and seven counts of false regulatory findings, crimes which, according to the article, carried up to 85 years in prison.

Like WorldCom, the SEC found that Tyco also created blatantly false accounting entries to present an inaccurate image of the company's value. Tyco's CEO was even found to be using company money to purchase personal assets, including apartments and homes internationally, and bribing Tyco board members and employees to stay silent about the fraud and these purchases, a crime referred to as "enterprise corruption." SEC further filed litigations against Tyco executives for violating federal securities laws, specifically their failure to disclose that they had taken several multi-million-dollar loans at little to no interest from the company for personal use. To make matters worse, they would even forgive their own loans, again without disclosure to investors.

Chapter 2: What is Sarbanes-Oxley?

To understand the impact of the Sarbanes-Oxley Act, it is necessary to understand what the Act does. The opening statement of the Act claims that it is "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." It is divided into eleven titles that each work to enhance accountability and corporate responsibility in the auditing process. Several of these titles, such as Title I and Title III, are more well-known than others, either due to how often they come up or what they have done. Due to this, I will not be detailing every Title of the Act, but instead will talk about Title I and Title III, as they will be mentioned later in the paper.

Title I of the Sarbanes-Oxley Act is responsible for the creation of the Public Company Accounting Oversight Board (PCAOB), which is an independent agency that oversees the audits of all companies that are subject to the various securities laws passed in the United States. PCAOB membership is comprised of only five members, of which exactly two members are allowed to be current or former certified public accountants. If one of these two members is the chairperson of the Board, they must have been out of practice for at least the five years prior to them serving the Board. The purpose of the Board is to register all public accounting firms that prepare audit reports, establish standards relating to quality control, auditing rules, company ethics, and other standards, as well as conduct inspections and investigations to ensure that these standards are being followed. In order to do this, the Board is given the ability to exercise all of the powers and rights mentioned throughout the Sarbanes-Oxley Act. Title I alone gives the PCAOB the ability to enter into contracts, sue, complain, and defend with the approval of the Securities and Exchange Commission, and to conduct their operations in all states without regards to the licenses or other provisions of the states in question. The goal of Title I, then, is to

set up the PCAOB to investigate public companies for fraudulent financial activities to protect shareholders and investors in those companies, and it does it by giving ample power to the PCAOB so that they can follow through with their objectives.

Title III, meanwhile, defines corporate responsibility for auditing procedures. One of the most important things that Title III does is require that the principal executive and financial officers of the company review their financial reports, sign off on the reports and claim that, to their knowledge, the reports do not falsify or exclude material facts of the company's financial information or financial controls, and assigns the signing officers responsibility for the establishment of internal controls and maintaining them. They are also responsible for ensuring that other officers are aware of the internal controls, especially during the production of financial reports. Additionally, the signing officers are required to report to the audit committee about all "significant deficiencies" about the design and operation of internal controls and any fraud, no matter the materiality, that was committed by managers or other employees with a significant role in the issuer's internal controls. Title III also details penalties for the CEO and CFO of companies if their company is required to submit an accounting restatement. If the company has to issue a financial restatement for any noncompliance or other misconduct, the CEO and CFO of the issuer company shall reimburse the company for any bonuses received for each year a restatement was necessary, as well as any profits they have realized in that same time period for any company stock they have sold. Following what happened with Enron when they modified their pension plans, section 306 of Title III prohibits directors and executive officers from trading company securities during the pension fund "blackout period," which refers to any time when, for a minimum of three days, at least half of the participants and beneficiaries of a pension plan are unable to sell, acquire, or transfer their interests in the pension plan. The goal of Title

III, then, is to give a company's executive officers responsibility for the financial statements and controls and prevent them from profiting off of any fraudulent activity, hopefully leading these executives to take action to ensure that there are adequate controls and no fraudulent activity occurs.

Chapter 3: Fraud After Sarbanes-Oxley

One of the easiest ways to see how Sarbanes-Oxley has impacted the world of accounting is to see how fraud is being committed under SOX and how people are being punished for the fraud. Of course, with almost 20 years of litigations and scandals to look through, it would be difficult to get an accurate depiction of how things have changed from only a handful of filings. Nevertheless, it is important to look at some examples so that we can form an idea of how the world has changed since then. It is worth noting that, unlike with Enron, WorldCom, and Tyco, the cases I present in this section are not all about fraud, even if fraud is mentioned in the case.

The first case I am going to talk about was filed in 2014. Former CEO Marc Sherman and former CFO Edward Cummings of QSGI Inc., were charged with misrepresenting the state of their internal controls with both external auditors and the investing public. The charges state that Sherman lied about his participation in management's assessment of internal controls, and that Sherman and Cummings withheld knowledge of inadequate inventory controls from external auditors. Additionally, neither party disclosed that they were working jointly to accelerate the recognition of select accounts and inventories in QSGI's books in order to increase the amount of money that the company could borrow from creditors. Altogether, Sherman and Cummings were found in violation of several sections of the Securities Exchange Act of 1934 as well as Section 302 of the Sarbanes-Oxley Act. Section 302 dictates that any signing officer must have reviewed the reports which they are signing, that, to the best of their knowledge, the report contains no falsehoods of material facts, does not omit any material fact that would make the statements misleading, and that all information included in the reports fairly presents all material respects the financial state of the company. Sherman and Cummings violated Section 302 several times over through their withholding of information and falsehoods.

Another case of a company committing fraud by accelerating revenues comes from a Californian company known as Super Micro Computer Inc.. According to an SEC order filed in August of 2020, Charles Liang and Howard Hideshima, the CEO and CFO of the company, pushed their employees to maximize revenues and minimize expenses by ignoring several key internal controls between 2015 and 2017. Of the litany of offenses committed by Super Micro, most were meant to recognize revenues that they were going to earn anyway, but several stand out. One offense, for example, included recognizing revenues from transactions built upon customer acceptance terms before the customer had even accepted the products, in one case doing so even when the customer didn't want the product due to not having storage capacity for it. Another offense included purposefully sending incomplete or mis-assembled goods to customers at the end of the quarter in order to earn the revenues in that quarter, and on more than one occasion the company would recognize revenues from goods shipped overseas while still holding the bill of lading for those goods, preventing their overseas customers from taking possession of the goods even though Super Micro had already recognized the revenues. Additionally, the CEO and CFO insisted on under-reporting expenses, which was accomplished through the misuse of their cooperative marketing programs to pay for many unrelated expenses and over-valuing inventory by refusing to reduce recorded inventory even when the company did not hold the inventory anymore. Both Hideshima and Liang were required to cease and desist from causing any additional violations of SEC laws, pursuant to Section 21C of the Exchange Act. Additionally, they were both required to pay penalties for their roles in the fraud. Hideshima, according to the SEC Order specifically against him, was required to pay just over $350,000 in penalties, with a Fair Fund set up for Hideshima to pay these penalties via Section 308(a) of Sarbanes-Oxley. Charles Liang, as he had made profits off of the sale of Super Micro

stock while the company was committing fraud, was ordered to reimburse the company and issuer a total of $2.1 million pursuant to Section 304 of Sarbanes-Oxley. After failing to do so quickly, the SEC filed a litigation against Liang for this failure, ordering him to pay these penalties within 10 days and, due to his previous failure, to deliver proof of paying these penalties to the SEC Division of Enforcement.

Of course, not every violation of the Sarbanes-Oxley Act is going to be from actions committed over the course of business. In May of 2009, the SEC filed a complaint against former CEO Maynard L. Jenkins for violating Section 304 of the Sarbanes-Oxley Act, which requires that the CEO and CFO reimburse their issuer the value of any bonus or profits realized within the 12-month period following every violation when the issuer is required to prepare an accounting restatement. This is done regardless of whether or not the CEO and CFO were responsible for the issues that led to the restatement being necessary, although the SEC may grant an exception under special circumstances. In Jenkin's case, his company, CSK Auto Corporation, had committed accounting fraud between 2002 and 2004 by recognizing tens of millions of dollars in vendor allowances that it could not collect and using several methods of fraud to hide the fact that they were uncollectable. Furthermore, the four managers that were responsible for the fraud hid their misconduct by lying to the company's independent auditors and providing false documentation that supported their practices. They would later release a restatement of their financial statements in 2005 that corrected some of these fraudulent activities, but still attempted to hide parts of it and even tried to make up an extra $15 million of vendor allowances that the company was not owed in order to collect the money and conceal their previous fraud. Jenkins, despite his only part in the scheme being that he signed off on the financial statements without knowing of the fraud, was required by Section 304 of the Sarbanes-Oxley Act to reimburse

issuers with the bonuses and profits that he had made between 2002 and 2004. According to an SEC news release from July of 2009, Jenkins had failed to reimburse a total of $4 million of bonuses and stock sale profits.

Chapter 4: The Effectiveness & Costs of Sarbanes-Oxley

With the above cases in mind, how do we judge the effectiveness of the Sarbanes-Oxley Act? To start, all of the cases from the previous sections were detailing Title III violations, specifically in Section 302 and 304. Additionally, the Super Micro case was only discovered due to an independent auditor (required by the PCAOB) found that the company's financial statements were unreliable, leading to the discovery of fraudulent activity. When looking just at those facts, the Act appears to be successful in what it does: preventing or otherwise finding (usually finding) fraudulent activity and punishing those who serve to gain from it. However, I had extreme difficulty in finding companies who violated specifically the Sarbanes-Oxley Act. Most companies instead violated other SEC regulations and were simply punished through Section 304 of Sarbanes-Oxley. The only parts of Sarbanes-Oxley that seem to be necessary to the goal of the Act are Titles I and II, which create the PCAOB and establish independent auditor requirements for publicly traded companies. The Act still does what it sets out to do but creates a mass of regulations that only add costs to the companies that are forced to comply or stay private.

Even if the Act does what it was meant to do, are the costs worth the effort? A 2007 paper authored by Yousef Jahmani and William Dowling lists some of the direct and indirect costs of the Act being passed. One of the first direct costs was the cost of complying with the Act. According to Jahmani and Dowling, the SEC originally concluded that compliance with Sarbanes-Oxley would require an additional five hundred-man hours per company but looked at their estimates again when faced with criticism (2007). Their final estimates included an additional three hundred- and eighty-man hours with an estimated cost of $91,000 per company, excluding auditing fees for each company every year. In 2007, Ivy Zhang, an academic

researcher, found that even this was an underestimation. He concluded that the Sarbanes-Oxley Act resulted in a cumulative market value loss of $1.4 billion, and that Section 404 of Sarbanes-Oxley (which requires annual control tests for companies) created significant real costs on the public companies. However, Jahmani and Dowling (2007) state that his study was limited due to the absence of a comparable firms that were not affected by Sarbanes-Oxley, so the real result of how much of that cost was from Sarbanes-Oxley alone is unknown. The indirect costs of the Act are mostly determinable by looking at how many companies decided to stay or go private after the passage of the Act. Not only do these companies list Sarbanes-Oxley as one of their reasons for this decision, but a significant number of them chose to list themselves on the London Stock Exchange, which at the time had far fewer regulations and associated costs than the US Stock Exchange. Another paper by William Carney states that over 38% of Schedule 13E-1 filings for going private cited the costs of complying with Sarbanes-Oxley as their primary reason for doing so. Clearly, although Sarbanes-Oxley helps to ensure publicly traded companies aren't committing fraud, it also comes with heavy costs to companies that comply with it, to the point that many companies would rather stay private or move to other stock exchanges than go public in the United States.

Conclusion

For better or worse, Sarbanes-Oxley has had a profound effect on how public businesses operate in the United States. It was created due to concerns over the fraud schemes of Enron, WorldCom, and many other companies, and though the legislation itself doesn't do much to stop fraud, the agency created through the legislature, the PCAOB, has created the standards that we use to prevent and detect it. There are still some doubts, however, as to the costs Sarbanes-Oxley imposes on businesses in the United States, but I would say the costs are warranted. Though the cost of complying with the legislation is prohibitively expensive for a number of companies, most still prefer going public and paying that cost to staying private or moving to foreign stock exchanges. This can be seen as a victory for the legislation, as it accomplishes its goal of helping ensure that public companies aren't committing fraud against their shareholders without discouraging too many companies from going public. Overall, I would say that the legislation was a success, in spite of the issues that some people have with it.

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