SarbOx Controversial, But Seen Doing The Job

J. BONASIA

Investor's Business Daily, August 17th, 2007

Since it was signed into law five years ago in the wake of scandals at Enron and WorldCom, the Sarbanes-Oxley Act has had mixed results fighting corporate corruption.

But despite criticism from many U.S. executives who call the requirements too costly and cumbersome, recent studies suggest the law has done more good than harm. Now other countries are following the U.S. with similar measures to shore up corporate accounting.

The Sarbanes-Oxley Act, often shortened to SarbOx or SOX, requires companies to set up stronger internal audit controls. The goal is for top executives to certify the accuracy of their financial results. In addition, the law expands the independence of board audit committees.

Audit controls can include systems that scan for duplicate payments to suppliers, or impose limits on purchase orders. Other controls segregate duties so that one person can't approve payments and then write checks.

Oversight Improved

One clear benefit of SarbOx has been to improve the oversight of auditors, says Daniel Goelzer of the Public Companies Accounting Oversight Board, a private nonprofit group created by the SarbOx legislation. For instance, auditors can't provide consulting services to the companies they audit.

Before SarbOx, such conflicts of interest hurt the public's trust, says Goelzer, a former general counsel for the Securities and Exchange Commission. "The markets depend on reliable financial information," he said. "There has been a refocus on auditing for its own sake and for the need to engender the confidence of investors."

The European Union passed regulations similar to SarbOx in 2005. Canada approved a set of measures last year nicknamed C-SOX. Japan has proposed its own auditing rules, known as J-SOX. that are set to take effect in April. London, Australia, India and Singapore have passed similar rules as well.

Corporate governance standards are clearly going up worldwide as a result of SarbOx, says Sanjay Anand, chairman of the SOX Institute, which provides SarbOx training for executives. "I'm a believer that SOX has had more overall benefits than costs," he said.

Critics in the U.S. contend that Sarbanes-Oxley has created an undue financial strain, especially for smaller companies. In addition to buying new software systems, firms must spend more on audits and legal fees. The smallest of the public companies, known as microcaps, are exempt from the law for now.

$2.8 Million A Year

On average, companies with less than $1 billion in annual revenue spent $2.8 million to comply with SarbOx in fiscal 2006. That's down from a peak of $3.4 million in the prior year, according to a survey by law firm Foley & Lardner.

The high price tag has caused 23% of companies to mull going private. An additional 16% have considered selling the company. And 14% have brought up the notion of a merger.

The SEC is trying to address complaints about the regulations. In July, it relaxed auditing standards to simplify Sarbanes-Oxley compliance and cut costs, especially for smaller companies. The new standards give auditors more discretion to focus on clients' biggest areas of potential accounting fraud rather than follow rigid controls.

All the effort to comply with SarbOx has improved auditing standards, thus boosting investor confidence, according to a new survey from the Center for Audit Quality, an audit trade group.

More than three-fourths of investors say that requiring companies to validate their internal controls and have them attested by external auditors has been a positive step.

Also, 74% of investors say having financial reports certified by CEOs and CFOs has had a positive effect. And 79% think new independent audit committees are helpful.

At the same time, SarbOx has served to improve the accuracy of financial statements, according to new research from Glass Lewis, an investment advisory firm.

In 2006, restatements by large public companies that have to comply with SarbOx fell by 14% over the prior year. Restatements by smaller firms exempt from SarbOx rules rose by 40% in that same period.

Last year was the first time such restatements by larger companies have declined, notes Mark Grothe, a research analyst with Glass Lewis. He says it shows that big companies are cleaning up their books.

Prison Terms Possible

"Now that more large companies have effective controls in place, fewer errors are making their way into these companies' financial statements," Grothe wrote.

Sarbanes-Oxley threatens executives with prison terms and fines for failure to certify the accuracy of their financial controls and reports. Most financial executives say the cost of complying with the law is too high. That finding is based on a poll by Financial Executives International, an advocacy group for chief financial offers and controllers.

Section 404 requires management to document its company's processes for ensuring effective financial controls. It is the most complex and costly part of the law, according to Michael Cangemi, president and chief executive of FEI.

"Financial executives agree that compliance with Section 404 raises investor confidence, but does so at a significant price, with three-quarters saying the costs still exceed the benefits," Cangemi said in a statement after the FEI survey's release.

Managers have overstated the burden of complying with Section 404, says Grothe of Glass Lewis. He notes that audit fees are small vs. executive compensation.

"Judging by the surge in restatements," he wrote, "we suspect that some management teams just want less outside scrutiny."

Nearly half of all financial executives agree that Section 404 has made their financial reports more accurate and reliable. Five years into the SarbOx process, that should be the real gauge of success, says Bill Lyons, the head of AXS-One **AXO**, a compliance software firm.

"Accountability makes everybody sign on the dotted line and renew their vows each quarter," Lyons said. "Ultimately, that's better for corporations and investors."