

Sarbanes-Oxley Act of 2002

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Introduction

The Sarbanes-Oxley Act, also known as SOX was introduced on 30th July 2002. Also referred to as the Public Company Accounting Reform and Investor Protection Act, it was introduced in response to many corporate and accounting controversies preceding it. Huge corporations, such as Enron, WorldCom, Peregrine Systems, and Tyco International, caused numerous investors and stakeholders to lose millions of dollars. These unfortunate people had no legal regulation or law to secure their investments. Moreover, in addition to massive financial losses, these cases also resulted in a loss of public confidence in the market security of the United States.

It was proposed by U.S. Representative Michael G. Oxley and Senator Paul Sarbanes, hence its name. Approved by U.S. President George W. Bush, the law is rightfully regarded as a remarkable achievement over the last decades. The Act has eleven articles that act as the guidelines and framework for financial reporting. These articles are further divided into several titles. Some of the important titles include corporate responsibility, enhanced financial disclosures, public company accounting, and auditor independence.

Background

The lack of adequate laws regarding financial fraud and reporting led to a large number of corporate financial frauds during the period from 2000 to 2002. Some scams, especially the Enron and WorldCom cases, created massive publicity. These cases highlighted the ineffectiveness of the financial system and policies of the United States. These circumstances contributed to the political interest in improving the situation, as the fall elections were approaching. Therefore, the White House and Congress deemed it necessary to introduce legislation that focused on protecting investors from financial fraud. Hence, the Sarbanes-Oxley Act was introduced in 2002. (U.S. Congress, 2002)

Before its introduction, the United States was mired in a vast number of cases involving auditors' conflicts of interest. The financial supervisors of the investors worked in the absence of governmental regulation. In addition to performing audits for their client firms, they also acted as financial consultants. Their contracts with the firms were highly favorable to the auditors, hence the creation of conflicts of interest.

Another major area of concern was the audit committees and the board of directors. They were responsible for the formulation of approaches of oversight for financial reporting. Most of the scandals during the period were attributed to the board members not adequately performing their duties.

Moreover, most of them lacked the appropriate expertise to comprehend the complexities of the business. The audit committees relied on the managerial staff instead of deciding on financial matters independently. Another important aspect was the role of the stock market analysts, who were the ones recommending the selling or buying of the stock or bonds of companies.

The stock market decline of 2000 further worsened the problematic business atmosphere for the investors. Some mutual funds managers who favored purchasing specific technology stocks were merely interested in selling them. Therefore, the fall of these technology stocks further outraged investors already facing financial difficulties due to continuous losses.

Finally, the issue of compensation played a crucial role in the development of the Act. The practice of incentives and bonuses and the accompanying unstable stock prices led to a need to manage earnings. Therefore, elected government officials introduced the Sarbanes-Oxley Act to regulate the financial processes of corporations and mitigate the widespread practices.

Significant Characteristics of the Act

The Act was much needed at the moment and was regarded as playing a vital role in restoring the public's confidence in the stock market and the United States economy. Moreover, it strengthened the government's control over the accounting principles of corporations. (U.S. Securities and Exchange Commission, n.d.)

Specific provisions of the Act have been imperative in improving the economy of the United States. Section 302 of the Act deals with the certification of internal control. The law has defined two types of certifications, the criminal and the civil. The primary purpose of this section is to ensure that the financial information is reported correctly. Under this Act, the signing officers are made to certify that they are responsible for the formulation and maintenance of the internal controls. Moreover, they are mandated to report the financial information within the specified time. These officers have to evaluate the internal controls within ninety days before submitting the reports to the commission.

Another section of the Act, Section 404, is very significant. Known as the internal control assessment, it has been controversial. According to this section, the management and the external auditor must formulate internal control reports for financial reporting. It is a very complicated process, and implementing it has proven very costly for organizations. Furthermore, the process requires hectic documentation and tests of the financial manual. The section mandates that management establish a report on internal control as a part of the yearly report of the Exchange Act. Also, the report should include data on the effectiveness of the structure of control.

Moreover, the Sarbanes-Oxley Act also states the consequences of its violations. In fact, the portion dealing with the punishments is deemed to be very strict. According to the Act, the sentence for financial fraud or obstruction of justice can be incarceration for up to 25 years. Also, several existing punishments for federal crimes were either extended or made stricter. The previous penalty for mail

and wire fraud was drastically increased from five to twenty years. The same was the case with the violations of certain securities laws, with the punishment rising from ten to twenty years. The monetary penalty was also increased from the previous amount of 2.5 million U.S. dollars to 25 million.

Conclusion

In conclusion, the Sarbanes-Oxley Act of 2002 was implemented in response to the dire economic and financial environment of the United States. The Act's main purpose was to maximize transparency in the processes of financial reporting and ensure that investors and stockholders are provided with correct information. The investors have greatly benefitted from the law as they are now presented with full disclosure of financial information, and hence they can make responsible financial decisions. Moreover, the law has been instrumental in mitigating corporate financial fraud, as the law has made the management accountable for maintaining internal controls. (Public Company Accounting Oversight Board, n.d.)

References

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