

# Ethics and Security under the Sarbanes–Oxley Act

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## INTRODUCTION

The objective of this article is to review the Sarbanes-Oxley Act and assess the difficulty in maintaining ethical standards, strong internal controls, and acceptable levels of security in a technologically advanced economy such as the United States. According to Arthur Levitt, the chair of the Securities and Exchange Commission (SEC) in 1999:

*The dynamic nature of today's capital markets creates issues that increasingly move beyond the bright line of black and white. New industries, spurred by new services and new technologies, are creating new questions and challenges that must be addressed. Today, we are witnessing a broad shift from an industrial economy to a more service based one; a shift from bricks and mortar to technology and knowledge. (Levitt, 1999)*

The role of government, the impact of legislation, and the interaction of public policy with capital markets in the United States will be addressed in this article. In addition, we will review the ethical issues that were encountered by large accounting firms such as Arthur Andersen in their efforts to audit the financial information of clients such as Enron and Global Crossing.

## BACKGROUND

The Internet boom and bust that occurred from 1996 to 2002 was one of the most significant business events of the past several decades. In the wake of this historic period, accountants, investors, analysts, and business managers have an unprecedented opportunity to learn from past mistakes and successes. The dot.com bear market may have indicated the end of the gold rush stage for technology firms. Down 39.3% in 2000, the

NASDAQ (National Association of Securities Dealers Automated Quotations) suffered the largest one-year loss in its 30-year history. In 2001, the NASDAQ continued its downward trend with a 21.1% loss. The statistics in Table 1, compiled by Webmergers.com, reports the shutdowns and bankruptcies of substantial Internet companies that have received significant funding from public capital markets.

Inexperienced stockholders had unrealistic expectations, and disgruntled investors who relied on financial statements lost money during the Internet shakeout and took legal actions against Wall Street investment and large accounting firms. Major bankruptcy cases such as Enron, WorldCom, Adelphia Communications, and Global Crossing disclosed misleading financial statements. The resulting lawsuits have damaged the reputation of the accounting profession (Tribunella & Tribunella, 2003).

The financial statements of a company should provide information to a variety of users so that they can make investment and credit decisions. According to the Efficient Market Hypothesis, stock market

*Table 1. Dot.com shutdowns of Net companies by quarter (Webmergers, 2002)*

Month and Year	Number
March 2000	5
June 2000	31
September 2000	52
December 2000	135
March 2001	164
June 2001	181
September 2001	119
December 2001	80
March 2002	54
June 2002	39

prices should reflect all publicly available information relevant to the traded companies. In addition, market prices should react quickly to new information such as freshly issued financial statements (Wolk, Tearney, & Dodd, 2001).

Financial statements include a balance sheet, income statement, statement of changes in stockholders' equity, statement of cash flows, and footnotes. Certified public accountants (CPAs) who serve as auditors have the responsibility of examining the financial statements and certifying their conformity with Generally Accepted Accounting Principles (GAAPs). A CPA is an individual that has completed education, examination, and work experience requirements. A CPA is professionally licensed in the state where he or she practices (Arens, Elder, & Beasley, 2006).

As a result of these major bankruptcies, the U.S. government has started to regulate the accounting industry. President Bush signed into law the Sarbanes-Oxley Act of 2002. The act includes far-reaching changes in federal regulation that represents the most significant overhaul since the enactment of the Securities Exchange Act of 1934. For example, Section 404 of the Sarbanes-Oxley Act requires management to assess and issue a report on the company's internal controls. Furthermore, auditors must now express an opinion on the effectiveness of internal controls over the financial reporting of an organization (Ramos, 2004).

### **MAINTAINING ETHICS AND SECURITY FOR FINANCIAL INFORMATION UNDER THE SARBANES-OXLEY ACT**

As a result of several conspicuous accounting frauds, the U.S. government has started to regulate the accounting industry through the Sarbanes-Oxley Act. The act prescribes a system of federal oversight of auditors (Paul, 2005) through the Public Company Accounting Oversight Board (PCAOB). In addition, a new set of auditor independence rules, new disclosure requirements applicable to public companies, and new penalties for persons who are responsible for accounting or reporting violations have been promulgated by the act (Cary, 2002). A summary of the act is listed below (AICPA, 2002):

- increases criminal penalties for corporate crimes up to 20-year prison terms and fines of \$1 to \$5 million
- creates the Public Company Accounting Oversight Board to police the accounting industry
- prevents CPAs from auditing and consulting with the same corporation
- requires top executives to certify their firm's financial statements
- allocates \$300 million which will go to the SEC to hire 200 investigators and auditors
- bans personal loans from companies to their officers and directors
- gives the SEC authority to ban corporate wrongdoers from serving as company officers in the future
- prohibits officers from filing bankruptcy to avoid paying financial judgments

In addition, members of the board of directors should be independent; in other words, they should not be corporate officers and they should not do business with the corporation. The audit committee of the board of directors that chooses the auditors must be knowledgeable, independent, and have a long tenure. Finally, the chief executive officer (CEO) or chief financial officer (CFO) should not chair the board of directors, and board members should not sit on numerous other boards (Persons, 2005). These issues fall under the category of corporate governance.

Corporate governance refers to all structures, policies, and procedures that are issued from the board of directors and put in place to govern the corporation in an ethical manner. It includes strategic planning, corporate values and ethics, as well as internal control (Yakhou & Dorweiler, 2005). The following high-level internal controls should be maintained by the members of the board of directors who are ultimately responsible for the actions and financial stability of the organization they direct:

- The board of directors should be elected by the shareholders or other outside parties (e.g., major donors of a not-for-profit organization) and not appointed by the officers
- The outside auditing firm should be hired by and report directly to the audit committee of the board of directors

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