By Paul Sweeney

Remember the stock options backdating scandal? Reaching its apex in 2006, the scandal ensnared senior executives at more than 150 companies who engaged in the manipulation of stock-option grants. Taking advantage of lax reporting rules, grantees cherry-picked the lowest stock price during the previous 90 days before cashing out at higher stock prices and maximizing their take.

Using such methods, hundreds of top corporate officials at leading American companies were able to increase their income, in some cases by many millions of dollars. Several went to jail, including chief executives at Brocade Communications Systems Inc. and Comverse Technology Inc., and dozens more resigned or were sent packing.

But one little-noted feature of the scandal, notes Peter Henning, a Wayne State University law professor and an expert on white-collar crime, was what actually put an end to the practice.

The death blow to this particular activity, Henning reports, was dealt by reporting requirements contained in the Sarbanes-Oxley Act of 2002. Under Section 403 of the law, senior executives must notify the U.S. Securities and Exchange Commission within three days of receiving, buying or selling stock, including stock options.

"If you look at the cases of stock-option backdating," Henning says, "they all occurred before 2002. It's likely the practice would have continued had not Sarbanes-Oxley stopped it dead in the water."

This important yet largely unheralded achievement of Sarbanes-Oxley is only one of many striking effects of the law described in interviews with a diverse array of sources, including financial executives, representatives of the Big Four accounting firms, former government regulators, forensic accountants, attorneys, academic experts and investor advocates, as well as one noted whistleblower. All were asked to comment on the major impact of the legislation as it turns 10 years old.

Despite criticism from free-market advocates and politicians of the conservative stripe that Sarbanes-Oxley has been costly to business and a poster child for regulatory overreach, a much-stated opinion of business and professional sources — including defense lawyers tasked with pleading the cases of alleged violators of Sarbanes-Oxley — is that the law has had a salutary effect on business, commerce, finance, the accounting profession and the United States economy.

"Regardless of which partner you talk to at our firm and probably at all the largest ones as well, most would say that Sarbanes-Oxley has been incredibly beneficial," says Laura Cox-Kaplan, principal in charge of government and regulatory affairs at PwC and a former deputy assistant secretary for banking and finance at the U.S. Treasury Department.

Paul Regan, president of accountancy Hemming Morse in San Francisco and a pioneer forensic accountant, notes that "there's still plenty of fraud. But if we didn't have Sarbanes-Oxley, the misstatements would be significantly worse."

Barbara Roper, director of investor protection at the Consumer Federation of America, expresses reservations about the law's efficacy but only because of continued congressional tampering and persistent legal assaults from disgruntled parties.

"Sarbanes-Oxley has clearly enhanced the integrity of the financial markets and the quality of financial reporting," she says. "My criticism is that the reforms are being eroded. It's chugging along but still facing challenges."

At the time of its enactment — in the wake of corporate accounting scandals — the Sarbanes-Oxley Act of 2002 was the most sweeping financial regulation since the Securities Act of 1934. In hindsight, has the law achieved what was intended?

Signed into law a decade ago on July 30, 2002 by President George W. Bush, the Sarbanes-Oxley Act was enacted by spectacularly lopsided votes in both chambers of Congress: 423-3 in the House and 99-0 in the 100-member Senate. The 78-page document was designed to shore up the integrity of financial statements after accounting fraud and deceit at several brand-name companies had become public.

"Starting in the 1990s, there was a spate of corporate fraud and fraudulent accounting statements at Sunbeam, Waste Management, Rite-Aid and some others even before you got to the gargantuan cases in the early 2000s involving Enron, WorldCom, Adelphia, Qwest and Global Crossing," recalls Lynn Turner, former chief accountant at the SEC.

To accomplish massive fraud, corporate schemers invented fictitious sales and bogus revenue streams, concealed losses, inflated inventories and manufactured phony profits.

Sarbanes-Oxley makes it far more difficult for such deceit to occur, especially at large public companies, says April Klein, an accounting professor at the Stern School of Business at New York University. "We don't want another Enron or WorldCom and the law has been very successful at preventing that," she says.

The act created the Public Company Accounting Oversight Board to police the accounting profession and set auditing standards. It shored up the role of the audit committee, making it independent and responsible for hiring, firing and overseeing external auditors, removing that authority from management.

Under Section 404, companies were required to establish internal controls and procedures for financial reporting. Another section mandated that both the chief executive and chief

Photography by Pete Byron

financial officer personally attest that they have reviewed the auditors' report and that it "does not contain any material untrue statements or material omission" or anything that could be "considered misleading."

Sarbanes-Oxley also instituted "clawback" provisions requiring CEOs and CFOs to return ill-gotten gains to their employer. In one notable case, Ian McCarthy, former CEO at Atlanta-based Beazer Homes USA Inc., and former CFO James O'Leary both agreed to return all of their cash bonuses, incentive and equity-based compensation for 2006. McCarthy had to relinquish more than $5.7 million in cash plus $772,232 in stock sale profits along with some 120,000 in restricted stock shares; O'Leary returned $1.4 million.

One wrinkle in the case: neither McCarthy nor O'Leary was directly to blame for the fraudulent financial reporting. The chief accounting officer, Michael Rand, was. He engineered the fraud and was eventually convicted of seven criminal counts.

Deborah Meshulam, a law partner at DLA Piper in Washington, D.C., and former SEC enforcement attorney, says, "Generally I think Sarbanes-Oxley has met its goals. But to me the concept that the SEC can claw back money from CEOs and CFOs who may not have been at fault for misstatements is troubling."

The message has been sent. No longer can corporate chieftains plead ignorance, or say "I'm not an accountant," as Enron's former (and now-imprisoned) CEO Jeffrey Skilling claimed in congressional testimony. Says Les Brorsen, vice-chair for Public Policy at Ernst & Young: "The law was spawned by massive inaccuracies and massive restatements. So all the changes in the law were designed to improve — and have improved — the accuracy of financial reporting."

Strengthening Financial Reporting

Toby Bishop, director of the Chicago-based forensic center at Deloitte, says: "From the perspective of someone who enjoys a nice big juicy fraud, life has become a little boring. What I am seeing, though, is that small- and medium-sized companies that have not been through the Sarbanes-Oxley process have weaknesses in their internal controls that can be exploited."

Section 404 of Sarbanes-Oxley, which requires management to assess and disclose the adequacy of internal controls over financial reporting, has been the whipping boy of the legislation. So much so that it has twice been modified by regulators, most recently in 2007, and targeted for changes by Congress.

An in-depth examination commissioned by the SEC sought to determine whether Section 404 "imposed large out-of-pocket and opportunity costs without commensurate benefits" and "adds layers of financial reporting procedures to no avail." After questioning 3,138 "corporate insiders" at 2,907 companies, the four-person research team concluded that this "common view" was "overstated."

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Gary Kabureck, vice president and chief accounting officer at Xerox Corp., an FEI member and a member of FEI's Committee on Corporate Reporting, says of the changes wrought by Section 404: "It's been good for us. We've got a robust set of internal control procedures and my closes go smoother, audits go easier and there are very few surprises that weren't already observed."

At Corning Inc., the costs of complying with Section 404 shot up by as much as 60 percent in the first year and persisted for another two years before returning to prior levels, reports Tony Tripeny, corporate controller and principal accounting officer.

"It took some additional spending but we took advantage of the law to look at our internal controls process and make it stronger," he says. "We made the decision to get something positive out of it." Tripeny, an FEI member, serves on FEI's Committee on Corporate Reporting.

Meanwhile, many other public companies were forced to reckon with — and disclose — inadequacies, notes Turner.

A March 2006 report by corporate-governance research firm Glass Lewis disclosed that the number of restatements of financial reports by publicly traded companies ballooned to 1,295 in 2005, or roughly one in 12 U.S. companies. That record number was more than triple the total in 2002, the year Sarbanes-Oxley was enacted.

Sarbanes-Oxley Limitations

Sarbanes-Oxley is sometimes faulted for not preventing the financial crisis and the great recession of 2008-09, from which the U.S. economy has yet to recover. But defenders argue that it wasn't designed to do more than insure that accounting rules were followed.

"If you've got employees who are stealing stuff out the back door of the warehouse, Sarbanes-Oxley would tell you whether you have inventory controls in place, not whether the door is locked," Kabureck says.

Turner faults lax law enforcement as "the number one reason we had a financial crisis. We've got lots of laws saying, 'You can't rob a bank,' " he says. "But if people realize the cops won't do anything, they'll do it anyway." At mortgage lenders and financial companies where shady lending practices proliferated, Turner notes, "we really didn't see much in the way of prosecution."

That also rankles Sherron Watkins, the whistleblower at Enron who was named one of three "Persons of the Year" by *Time* magazine in 2002. She questions, for example, why charges weren't brought under Sarbanes-Oxley against top executives at the banks, mortgage lenders and Wall Street firms playing fast and loose with the law.

"Dick Fuld of Lehman Brothers Holdings Inc. was signing off on the financial statements," she notes. "I fear that the Department of Justice was politicized."

One consolation, says Turner, is that Sarbanes-Oxley no doubt mitigated the force of the financial crisis, which could have been worse. "We didn't see the huge rash of fraudulent reporting like we saw in the 1996-2002 time period," he says. "So that would tell you, 'Yes, the legislation did accomplish its goal.' "

Ernst & Young's Brorsen sees creation of the PCAOB to police the auditing profession — coupled with corporate governance rules' putting a public company's board-level audit committee, rather than company management, in charge of the auditing process — as "the top two fundamental changes" brought about by the act. "It's fair to say that the largest single impact of Sarbanes-Oxley was to end 100 years of self-regulation," he says.

Related to that, Brorsen adds, "Improved corporate governance is one of the hallmarks of the legislation."

For several years, PCAOB operated under a cloud as it fended off a lawsuit challenging its existence. Filed in 2006 by the Free Enterprise Fund and a Henderson, Nev., accountancy, the plaintiffs challenged the panel's right to exist under the U.S. Constitution's separation-of-powers doctrine. Finally, in 2010 the board largely prevailed before the Supreme Court.

PCAOB has taken 47 enforcement actions arising from faulty audits and conflicts of interest, including several against Big Four firms, according to a report by a PCAOB advisory body. But it does not "name and shame" violators. PCAOB's chairman, James R. Doty, told Congress in 2011 testimony that "inspectors have found deficiencies (in audits of public companies) to be on the rise and persist."

And PCAOB member Jeanette M. Franzel recently declared in a speech, "I am troubled by the serious audit deficiencies that are found too frequently during the PCAOB inspections." Franzel also said that "clearly improvements are needed in the audit process and audit model."

But Congress has been moving in the opposite direction. Two recent laws — the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and this year's Jumpstart Our Business Startups Act (the JOBS Act) — have largely served to weaken Sarbanes-Oxley.

Dodd-Frank exempted public companies with a "public float" below $75 million, thereby removing 42 percent of public companies, according to figures cited by the Council of Institutional Investors and Center for Audit Quality in a joint letter last November. The letter implored both the chairman and ranking member of the House Financial Services Committee to not further reduce safeguards, to no avail.

Similarly, a broad range of investor-protection groups and regulators have expressed alarm that the JOBS Act, signed into law by President Barack Obama in early April, "guts" Sarbanes-Oxley. Among other things, it exempts newly public "emerging growth companies" from meeting Section 404 obligations for five years following an initial public offering.

On balance, financial executives say that while law didn't do everything it set out to do, the industry benefit overall has been substantial. "Sarbanes-Oxley didn't achieve 100 percent perfection, which is impossible," Kabureck says. "But it has made a big and positive difference."

Paul Sweeney (easyswee@aol.com) is a freelance writer in Austin, Texas.

Reaction to Sarbanes-Oxley ... Then and Now

Denny Beresford, former Financial Accounting Standards Board chairman, who was named to the board of directors of WorldCom Inc. following its first major restatement (and who was an inductee in the first FEI Hall of Fame in 2006), comments.

What was your first reaction to the passage of Sarbanes-Oxley?

Having been named to the WorldCom board of directors immediately after announcement of its first major restatement, it was obvious that Congress would have to act quickly to restore confidence in financial reporting and auditing of public companies. I had earlier been asked to testify at one of Sen. Sarbanes's hearings leading to the legislation (in response to the Enron matter) and my major concern at that time was whether a new PCAOB would be qualified to set auditing standards or whether that should be left to the AICPA Auditing Standards Board with PCAOB oversight.

I favored the latter but with hindsight it's obvious that there needed to be more independence in the process and the right decision was made.

So, my first reaction was that the law was pretty much what had been expected when earlier discussions had taken place. Enron set the stage for the legislation but WorldCom was the "straw that broke the camel's back" and caused Congress to act within only a month or so.

What was the general response at the company boards you served on?

I was on three public company boards at the time, one of which was WorldCom. While all three complained about the more rigorous and detailed auditing by our CPA firm at the time, I kept remind-