services use the same letter grades, but use various combinations of upper- and lowercase letters to differentiate themselves.

As early as 2003, financial analysts and the three global rating firms suspected that there were some major problems with the way their models were assessing risk. In 2005, Standard & Poor's realized that its algorithm for estimating the risks associated with debt packages was flawed. As a result, it asked for comments on improving its equations. In 2006–2007 many governmental regulators and others started to realize what the rating agencies had known for years: Their ratings were not very accurate. One report stated that the high ratings given to debt were based on inadequate historical data and companies were ratings shopping between companies so as to obtain the best rating possible. It was found that investment banks were among some of the worst offenders, paying for ratings and therefore causing conflicts of interest. The amount of revenue these three companies annually receive is approximately $5 billion.

Further investigations uncovered many disturbing problems. First, Moody's, S&P's, and Fitch had all violated a code of conduct that required analysts to consider only credit factors, not "'the potential impact on Moody's, or an issuer, an investor or other market participant.'" Also, these companies had become overwhelmed by an increase in the volume and sophistication of the securities they were asked to review. Finally, analysts, faced with less time to perform the due diligence expected of them, began to cut corners.

SEC Chairman Mary Schapiro believes that the SEC must take more drastic measures to implement oversight for credit-rating firms—a group that was largely blamed for not catching risky activity in the financial sector sooner. Part of the problem, as Schapiro sees it, is that credit rating firms are paid by the securities that they rank. This creates a conflict of interest problem, and can affect the reliability of the ratings.[23] No organization is exempt from criticism over how transparent it is. While large financial firms have received most of the fury over risk taking and executive pay, even nonprofits are now being scrutinized more carefully.[24]

THE SARBANES–OXLEY ACT

In 2002, largely in response to widespread corporate accounting scandals, Congress passed the Sarbanes–Oxley Act to establish a system of federal oversight of corporate accounting practices. In addition to making fraudulent financial reporting a criminal offense and strengthening penalties for corporate fraud, the law requires corporations to establish codes of ethics for financial reporting and to develop greater transparency in financial reporting to investors and other stakeholders.

Supported by both Republicans and Democrats, the Sarbanes–Oxley Act was enacted to restore stakeholder confidence after accounting fraud at Enron, WorldCom, and hundreds of other companies resulted in investors and employees losing much of their savings. During the resulting investigations, the public learned that hundreds of corporations had not reported their financial results accurately. Many stakeholders came to believe that accounting firms, lawyers, top executives, and boards of directors had developed a culture of deception to ensure investor approval and gain competitive advantage. Many boards failed to provide appropriate oversight of the decisions of their companies' top officers. At Adelphia Communications, for example, the Rigas family amassed $3.1 billion in off-balance-sheet loans backed by the company. Dennis Kozlowski, CEO of Tyco, was accused of improperly using corporate funds for personal use as well as fraudulent accounting practices.[25] At Kmart, CEO Charles Conaway allegedly hired unqualified executives and consultants for excessive fees. Kmart's board also approved $24 million in loans to various executives, just a month before the retailer filed for Chapter 11 bankruptcy protection. Conaway and the other executives have since left the company or were fired. Loans of this type are now illegal under the Sarbanes–Oxley Act.[26]

As a result of public outrage over the accounting scandals, the Sarbanes–Oxley Act garnered nearly unanimous support not only in Congress but also by government regulatory agencies, the president, and the general public. When President George W. Bush signed the Sarbanes–Oxley Act into law, he emphasized the need for new standards of ethical behavior in business, particularly among the top managers and boards of directors responsible for overseeing business decisions and activities.

At the heart of the Sarbanes–Oxley Act is the **Public Company Accounting Oversight Board,** which monitors accounting firms that audit public corporations and establishes standards and rules for auditors in accounting firms. The law gave the board investigatory and disciplinary power over auditors and securities analysts who issue reports about corporate performance and health. The law attempts to eliminate conflicts of interest by prohibiting accounting firms from providing both auditing and consulting services to the same client companies without special permission from the client firm's audit committee; it also places limits on the length of time lead auditors can serve a particular client.Table 4–6 summarizes the significant provisions of the law.

TABLE 4–6 Major Provisions of the Sarbanes–Oxley Act

1.	Requires the establishment of a Public Company Accounting Oversight Board in charge of regulations administered by the SEC.
2.	Requires CEOs and CFOs to certify that their companies' financial statements are true and without misleading statements.
3.	Requires that corporate board of directors' audit committees consist of independent members who have no material interests in the company.
4.	Prohibits corporations from making or offering loans to officers and board members.
5.	Requires codes of ethics for senior financial officers; code must be registered with the SEC.
6.	Prohibits accounting firms from providing both auditing and consulting services to the same client without the approval of the client firm's audit committee.
7.	Requires company attorneys to report wrongdoing to top managers and, if necessary, to the board of directors; if managers and directors fail to respond to reports of wrongdoing, the attorney should stop representing the company.
8.	Mandates "whistle-blower protection" for persons who disclose wrongdoing to authorities.
9.	Requires financial securities analysts to certify that their recommendations are based on objective reports.
10.	Requires mutual fund managers to disclose how they vote shareholder proxies, giving investors information about how their shares influence decisions.
11.	Establishes a ten-year penalty for mail/wire fraud.
12.	Prohibits the two senior auditors from working on a corporation's account for more than five years; other auditors are prohibited from working on an account for more than seven years. In other words, accounting firms must rotate individual auditors from one account to another from time to time.

TABLE 4–7 Benefits of the Sarbanes–Oxley Act

1.	Greater accountability of top managers and boards of directors to employees, investors, communities, and society
2.	Renewed investor confidence
3.	Clear explanations by CEOs as to why their compensation package is in the best interest of the company; the loss of some traditional senior-management perks such as company loans; greater disclosures by executives about their own stock trades
4.	Greater protection of employee retirement plans
5.	Improved information from stock analysts and rating agencies
6.	Greater penalties for and accountability of senior managers, auditors, and board members

The Sarbanes–Oxley Act requires corporations to take greater responsibility for their decisions and to provide leadership based on ethical principles. For instance, the law requires top managers to certify that their firms' financial reports are complete and accurate, making CEOs and CFOs personally accountable for the credibility and accuracy of their companies' financial statements. Similar provisions are required of corporate boards of directors, especially audit committees, and senior financial officers are now subject to a code of ethics that addresses their specific areas of risk. Additionally, the law modifies the attorney–client relationship to require lawyers to report wrongdoing to top managers and/or the board of directors. It also provides protection for "whistle-blowing" employees who might report illegal activity to authorities. These provisions provide internal controls to make managers aware of and responsible for legal and ethical problems. Table 4–7 summarizes the benefits of the legislation.

On the other hand, the Sarbanes–Oxley Act has raised a number of concerns. The complex law may impose burdensome requirements on executives; the rules and regulations already run to thousands of pages. Some people also believe that the law will not be sufficient to stop those executives who want to lie, steal, manipulate, or deceive. They believe that a deep commitment to managerial integrity, rather than additional rules and regulations, are the key to solving the current crisis in business.[27] Additionally, the new act has caused many firms to restate their financial reports to avoid penalties. Big public companies spent thousands of hours and an average of $4.4 million each annually to make sure that someone was looking over the shoulder of key accounting personnel at every step of every business process, according to Financial Executives International. Section 404 is a core provision of the 2002 corporate reform law. The number of companies that disclosed serious chinks in their internal accounting controls jumped to more than 586 in 2005 compared to 313 in 2004.[28]

Public Company Accounting Oversight Board

The Sarbanes–Oxley Act establishes an oversight board to oversee the audit of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies. Their duties include (1) registration of public accounting firms; (2) establishment of auditing, quality control, ethics, independence, and other standards relating to preparation of audit reports; (3) inspection of accounting firms; (4) investigations, disciplinary proceedings, and imposition of sanctions; and (5) enforcement of compliance with accounting rules of the board, professional standards, and securities laws relating to the preparation and issuance of audit reports and obligations and liabilities of accountants.

The board reports to the SEC on an annual basis that includes any new established rules and any final disciplinary rulings. The board works with designated professional groups of accountants and other standard-setting advisory groups in establishing auditing, quality control, ethics, and independence rules.

Auditor and Analyst Independence

The Sarbanes–Oxley Act also seeks to eliminate conflicts of interest among auditors, security analysts, brokers, and dealers and the public companies they serve in order to ensure enhanced financial disclosures of public companies' true condition. To accomplish auditor independence, Section 201 of the act no longer allows registered public accounting firms to provide both non-audit and audit services to a public company. National securities exchanges and registered securities associations have already adopted similar conflict-of-interest rules for security analysts, brokers, and dealers, who recommend equities in research reports. The face of Wall Street is experiencing major changes. In early 2003, 10 of the nation's largest securities firms agreed to pay a record \$1.4 billion to settle government charges involving abuse of investors during the stock market bubble of the late 1990s. Wall Street firms routinely issued overly optimistic stock research to investors in order to gain favor with corporate clients and win their lucrative investment-banking business.

Enhanced Financial Disclosures

With independence, the Sarbanes–Oxley Act is better able to ensure compliance with the enhanced financial disclosures of public companies' true condition. For example, registered public accounting firms are now required to identify all material correcting adjustments to reflect accurate financial statements. Also, all material off-balance-sheet transactions and other relationships with unconsolidated entities that affect current or future financial conditions of a public company must be disclosed in each annual and quarterly financial report. In addition, public companies must also report "on a rapid and current basis" material changes in the financial condition or operations.

Whistle-Blower Protection

Employees of public companies and accounting firms, in general, are also accountable to report unethical behavior. The Sarbanes–Oxley Act intends to motivate employees through whistle-blower protection that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle-blowers are also granted a remedy of special damages and attorneys' fees. Two years after the act, the SEC received approximately 40,000 whistle-blowing reports per month, compared with 6,400 per month in 2001.[29] With only 11,000 publicly-traded companies in the United States, it seems that even though 75 percent of the whistle-blowing reports have no validity, there are still more whistle-blowing reports every month than the number of companies listed.[30]

Also, any act of retaliation that harms informants, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense, will be fined and/or imprisoned for 10 years.

Corporate and Criminal Fraud Accountability

Title VIII of the Sarbanes–Oxley Act, Corporate and Criminal Fraud Accountability, makes the knowing destruction or creation of documents to "impede, obstruct or influence" any existing or contemplated federal investigation a felony. The White-Collar Crime Penalty Enhancements Act of 2002 increased the maximum penalty for mail and wire fraud from 5 to 10 years in prison. It also makes record tampering or otherwise impeding an official a crime. If necessary, the SEC could freeze extraordinary payments to directors, officers, partners, controlling persons, and agents of employees. The U.S. Sentencing Commission reviews sentencing guidelines for securities and accounting fraud.

The act may not prevent future Enron-type businesses from occurring. However, the act's uniqueness from past legislation is its perspective to mandate accountability from the many players in the "game of business," creating more explicit rules in playing fair. The act creates a foundation to strongly discourage wrongdoing and sets ethical standards of what's expected of American business.

Cost of Compliance

The national cost of compliance of the Sarbanes–Oxley Act is estimated at $1 million per $1.7 billion in revenues.[31] These costs come from internal costs, external costs, and auditor fees. In a survey by Financial Executives International, nearly all the respondents (94 percent) said that the costs of compliance exceeded the benefits.[32] This act has increased external auditing costs for mid- to large-size companies between 52 and 81 percent. The section that has caused the most cost for companies has been compliance with Section 404. Section 404 has three central issues: It requires that (1) management create reliable internal financial controls, (2) that management attest to the reliability of those controls and the accuracy of financial statements that result from those controls, and (3) that an independent auditor further attests to the statements made by management. Section 404 requires companies to document both the results of financial transactions and the processes they have used to generate them. A company may have thousands of processes that may work, but they have never been written down. Writing down the processes is time consuming and costly.[33] Also, because the cost of compliance is so high for many small companies, some publicly-traded companies are even considering delisting themselves from the U.S. Stock Exchange. Companies based outside the United States have also been weighing the costs of compliance versus the savings of deregistration. Sweden-based Electrolux was among the first to delist from NASDAQ after the Sarbanes–Oxley Act was passed. Many new non-U.S. companies may be avoiding the U.S. market altogether. New listings with the SEC from companies outside the United States have dropped to almost zero since the act passed in 2002.[34] After years of complaints from firms, in spring 2009 the Supreme Court agreed to hear arguments over the constitutionality of

"The national cost of compliance of the Sarbanes–Oxley Act is estimated at $1 million per $1.7 billion in revenues."

Sarbanes–Oxley, which has gained new critics as it failed to detect wrongdoing that led to the subprime mortgage crisis and the meltdown on Wall Street in 2008–2009.[35]

However, there are some cases where companies are benefiting from the act's implementation. Apart from the obvious increase in books and materials to help people comply with the act, there is also a growing business for people teaching and implementing ethics programs and hotlines for organizations. Companies such as Global Compliance and EthicsPoint have grown rapidly as companies seek to learn ethics, and a vast new industry of consultants and suppliers has emerged.[36] Other benefits and savings have come in the form of increased efficiency as companies such as Pitney Bowes Inc. find that they can meld various units such as combining four accounts receivable offices into one, saving more than $500,000 a year. At Genentech Inc., simply having detailed reports on financial controls sped up installation, by several months, of a new computer system that consolidates financial data, which meant that it was running months ahead of schedule. The new system allows managers to analyze data from customers rather than just collecting it. Cisco spent $50 million and 240,000 hours on its first-year audit of internal controls. The mind-numbing effort revealed opportunities to streamline steps for ordering products and services, making it easier for customers to do business with Cisco. It forced them to make sure that sales and support were integrated when a customer called, resulting in one-stop shopping for its customers. Other companies have been able to streamline steps for ordering products and services, making it easier for customers to do business with them.[37]

LAWS THAT ENCOURAGE ETHICAL CONDUCT

Violations of the law usually begin when businesspeople stretch the limits of ethical standards, as defined by company or industry codes of conduct, and then choose to engage in schemes that knowingly or unwittingly violate the law. In recent years, new laws and regulations have been passed to discourage such decisions—and to foster programs designed to improve business ethics and social responsibility (Table 4–8). The most important of these are the Federal Sentencing Guidelines for Organizations (FSGO) and the Sarbanes–Oxley Act. One of the goals of both acts is to require employees to

TABLE 4–8 Institutionalization of Ethics through the U.S. Sentencing Guidelines for Organizations

1991	*Law:* U.S. Sentencing Guidelines for Organizations created for federal prosecutions of organizations. These guidelines provide for just punishment, adequate deterrence, and incentives for organizations to prevent, detect, and report misconduct. Organizations need to have an effective ethics and compliance program to receive incentives in the case of misconduct.
2004	*Amendments:* The definition of an effective ethics program now includes the development of an ethical organizational culture. Executives and board members must assume the responsibility of identifying areas of risk, provide ethics training, create reporting mechanisms, and designate an individual to oversee ethics programs.
2007–2008	*Additional definition of a compliance and ethics program:* Firms should focus on due diligence to detect and prevent misconduct and to promote an organizational culture that encourages ethical conduct. More details are provided encouraging the assessment of risk and appropriate steps to design, implement, and modify ethics programs and training to include all employees, top management, and the board or governing authority. These modifications continue to reinforce the importance of an ethical culture in preventing misconduct.