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## **Assessing the Success of Sarbanes-Oxley**

July 9, 2012



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### **Abstract**

This paper evaluates the success that the Sarbanes-Oxley Act has had in the market place. It initially assesses improvements the act has made to restore public confidence in the auditing process, and their effectiveness. It then assesses provisions made to improve the ability of boards of directors to monitor and correct abuses of power by corporate executives. Having concluded the quality of auditing processes and the boards monitoring function is still inadequate despite the enactment of Sarbanes-Oxley; it then analyzes published data on the incidents of fraud. The results of the analysis indicate that, in general, Sarbanes-Oxley has done little to stop the tidal wave of fraud occurrences, nor does it limit their consequences. This paper concludes, therefore, that Sarbanes-Oxley has not been successful.

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## **Introduction**

This paper describes some corporate governance best practices and then uses them to establish a framework for evaluating the impact that the enactment of the Sarbanes-Oxley Act of 2002 (PL 107-204, 116 Stat. 745) has had in the market place. After a brief discussion of the history of Sarbanes-Oxley, and the market conditions that motivated its enactment, some best practices are discussed in terms that show how the act could have had a more significant impact on deterring and detecting fraud.

A key concept in today's corporate finance and governance is the need to improve the reliability of the auditing process. When auditors certify the contents of a firm's balance sheet, investors must be able to trust the published data. Has Sarbanes-Oxley increased consumer confidence in financial data published in balance sheets in accordance with the best industry accounting procedures? This issue must be assessed as well. Also, the relationship between Chief Executive Officers (CEOs) and members of the Boards of Directors (BoDs) need to be monitored to ensure no undue influence is used to manipulate the directors into authorizing CEOs to receive windfalls. The integrity of the BoDs' monitoring function must be maintained and leveraged. Self-serving collaborations between CEOs and the directors need to be eliminated. How has Sarbanes-Oxley performed on this front? Finally, this paper addresses the need to have some objective evidence on how progress in corporate governance could be monitored and compared to success criteria. Only then would improvements resulting from the act be clear, and researchers would not have to write papers like this one and debate whether the act has been a success or not.

## Objectives

The objective of this paper is to assess whether the 2002 enactment of Sarbanes-Oxley improved corporate finance and good governance behavior.

## Background

Corporate finance and governance provide the fundamental principles that capital markets depend on to establish consumer trust and, as such, facilitate participating in the marketplace via obtainment of investor financing. There are several methods for implementing governance that should be considered, such as:

- Enacting legislation defining disclosure requirements and the actions participants can and cannot take
- Creating organizations tasked with regulatory oversight to ensure good governance behavior of the executives running the businesses
- Anticipating that the consumer protections implicit in open market business transactions will suffice, eliminating the need for government intervention
- Providing a governance code and directing businesses to comply with the code.

Notice that these techniques all have associated costs and benefits. Nordberg (2011) questions the use of legislation due to its limited scope, the long lead time needed to enact it, and fact that it is typically appropriate for the last crises, but never applicable to the current one. Regulatory organizations are tasked to augment existing laws to compensate for their shortcomings, but regulators are prone to sensationalism and tend to intervene in trivial matters such as Martha Stewart's insider trading case, and yet consistently fail to detect indications of major frauds and crimes (Nordberg, 2011). Manne (2003) contends that law and regulation do not prevent executive abuses, but that the capital market should be responsible for providing a trustworthy

marketplace for investors. An unregulated system, however, offers no governance protections, and violates the fundamental principle of informed consent between buyers and sellers (De George, 2005). Recent scandals in unregulated market areas have shown that when public trust and confidence is damaged by self-serving business dealings, legislation usually follows anyway. Thus, the open market approach seems inappropriate. Perhaps the best option would be providing a governance code that would allow market participants to tailor their compliance to their business operations, and rely on market pressure by investors seeking governance mechanisms to motivate companies to comply with the code. By enacting the Sarbanes-Oxley act, the U.S. chose the legislative approach, and became subject to its limitations.

### **History of Sarbanes-Oxley**

Historically, the American corporate governance system has been highly legalistic with the threat of lawsuits from shareholders, and involved compliance with rules established by the U.S. Securities and Exchange Commission (SEC). Influenced by an accounting profession worried about its reputation, U.S. corporate governance was driven by lawyers worried about helping clients avoid fees, fines, and jail time (Nordberg, 2011). It protected investors to a greater extent than other capital markets through disclosure regulations ensuring communications of pertinent information to the investing public. With the collapse of Enron, WorldCom, and others in the early 2000s, the public lost confidence in the U.S. corporate governance system. Enron demonstrated that the risks of malfeasance was not just limited to shareholders, but also encapsulated employees, pensioners, suppliers, customers, and lending institutions (Nordberg, 2011). WorldCom magnified the problem as a result of the apparent willingness of its auditing firm, Arthur Andersen, to collude in the corruption (Nordberg, 2011). In an attempt to gain back consumer confidence and encourage investment, the SEC began adopting new international

financial reporting standards, and the U.S. enacted Sarbanes-Oxley to insert federal law in areas that had previously been the purview of the states. Instead of adopting a governance code, the U.S. took the legislative approach. The act had some new and unique features:

- CEOs and Chief Financial Officers (CFOs) are now required to personally certify the accuracy of the firm's financial statements in annual and quarterly statements to shareholders
- CEOs and CFOs now face criminal sanctions including prison time if financial data reported on balance sheets is proved to be inaccurate
- The Public Company Accounting Oversight Board (PCAOB) was created to monitor the accounting profession by regulating the accounting and auditing firms (i.e., monitor the books of the bookkeepers) of any company that had securities trading on U.S. markets
- Corporations are now required to pay strict attention to risk management
- Annual reports must now state the management responsibility for establishing and maintaining adequate internal control procedures for financial reporting
- Annual reports must now contain an assessment of the effectiveness of their internal control procedures and make them transparent to potential investors
- Auditors are required to 'attest to' statements from the executive management (Nordberg, 2011, p. 108).

As a direct consequence of Sarbanes-Oxley many corporate and investor organizations in Europe, worried about the stringent reporting requirements and the administrative burden, petitioned the SEC to be delisted from U.S. stock exchanges to avoid having to comply with Sarbanes-Oxley. MacAvoy and Millstein (2003) contend we continue to explore symptoms of a larger problem that solutions like Sarbanes-Oxley have so far failed to address. The structures



and mechanisms currently in place are not enough to solve the agency problem in corporate governance. How much additional governance is required before CEOs can be prohibited from expropriating the resources that make a company viable? Would that optimum level of governance actually interfere with a CEOs ability to manage business operations? Peter Brabeck-Letmathe, former CEO of the Swiss corporation Nestle, faced regular criticism for refusing to give up the chairmanship to an independent outsider (Nordberg, 2011). While debating the boundaries of oversight, he cautioned against “*group-think*,” and remained focus on the need for managing board renewal (Korn-Ferry Institute, 2011). Concerned about the legal structures of Sarbanes-Oxley which call for even greater accountability, Brabeck-Letmathe asserted they create a different problem in corporate governance: they get in the way of creating value. So it appears there are two sides to the debate which must be balanced.

## **Presentation of the Facts**

### **Fact thread #1 – The auditing function has been compromised and needs to be repaired.**

Financial services regulation protects trading investors on financial markets by disclosing relevant financial data so they can make informed investment decisions. The protection received from regulators is essentially giving them a fair market for conducting financial transactions like buying and selling shares. Auditors provide an independent check on the accuracy of the financial data and statements a company makes on its operational performance. Auditors can present another, potentially critical view, independent of the executive management and the board, that rounds out the information investors have access to (Nordberg, 2011). Auditing is a monitoring function offered as a potential solution to the agency problem. External firms of accounting professionals skilled in the processes for dissecting accounts examine, in detail, corporate transactions in accordance with governing accounting principles. External audits are

one of the concessions corporations make when they invite outside investors to provide capital to support business operations (Nordberg, 2011). External auditing professionals are said to operate under an oath of honesty and integrity, but recent scandals have brought to light the fallacy of merely relying on oaths. Having participated in the corruption with several of their major clients, like Enron and WorldCom, the auditing firm of Arthur Andersen collapsed in 2002. The WorldCom case is particularly enlightening as a method of illustrating the auditing crises that has evolved. In December of 2001 WorldCom was one of the largest businesses in the U.S. by market capitalization. Less than 6 months later it filed for bankruptcy protection. \$11 billion had to be written off the books since it had billed as capital expenditures items that should have been accounted for as costs, and inflated the assets and profits on their balance sheets. Arthur Andersen participated in the corruption and cover up. No longer being able to count on the integrity and honesty of auditing professionals, corporate governance mechanisms need to be updated to ensure the reliability of the auditing function to the investing public.

**Fact thread #2 – Boards of Directors have been failing the monitoring function and CEOs are expropriating excessive compensation from the companies they manage.**

As a result of recent scandals like Enron, WorldCom, Parmalat, Merrill Lynch, the near failure of the entire banking industry after the subprime mortgage crises, and the implosion of the world's economy, it has become evident that some CEOs are running companies unchecked with the sole purpose of expropriating resources to increase their own personal wealth. An essential corporate governance task, that being to ensure the monitoring function of the Boards of Directors is achieved across the market place, has been a dismal failure. This failure at all levels of monitoring results in frauds conducted against the businesses, the hiding of risks and losses from balance sheets, and a lack of investor confidence (Ribstein, 2002).

**Fact thread #3 – Objective evidence that the provisions espoused in Sarbanes-Oxley improved the state of the market is required to support a finding the act has been successful.**

The Association of Certified Fraud Examiners (ACFE) and other researchers are using reported data on occupational fraud to draw sweeping conclusions about the effectiveness of Sarbanes-Oxley. If Sarbanes-Oxley were to be shown a success, then there should be some objective evidence that the marketplace has improved enterprise-wide as a result of its enactment. By its very nature, corporate governance should be collecting data to prove the positive impact governance is having on the marketplace, and to support status reporting on the progress being made. This should have been a critical component of the act. The inquiry as to whether Sarbanes-Oxley has been a success must incorporate an analysis of reported fraud statistics to see, if in fact, fraud in the marketplace has been improving since its enactment. This fact thread is dedicated to finding objective data in the form of fraud statistics and analyzing it to see if it shows improvements in the marketplace.

Data limited to mere cases of fraud may be insufficient. There are many questionable acts where CEOs expropriate resources from companies, but in ways that may not constitute fraud. Shareholders accused Stanley O’Neal of destroying Merrill Lynch, but he was determined to be protected from shareholder actions by Delaware’s common law business judgment rule, and even received a generous bonus by the board of directors as he departed (Craft, 2008). While this was technically not a case of fraud, shareholders and investors were harmed by incompetent and self-serving actions, and it does fall into an area that corporate governance should prohibit. If executive management and board negligence, incompetence, or self-serving actions result in harm to others, then those harmed have a right to seek compensation (Narveson, 2002).

## Discussion of the Facts

### **Fact thread #1 – Implementing critical auditing best practices could restore the integrity of the auditing function, improve consumer confidence, and encourage investment.**

One lesson learned from the WorldCom debacle is that regulators are subject to *regulatory capture*. That is auditors become deeply involved and sympathetic to the businesses they regulate. After their shady Enron dealings were finally disclosed, Arthur Andersen pointed an accusing finger on the accounting rules (Bratton, 2002). Sympathetic regulators often go on to take lucrative positions in the companies they once supervised (Nordberg, 2011). These situations represent conflicts of interests where shareholder interests are sacrificed for individual gains (Imhoff, 2003). This problem could be eliminated by adopting some corporate governance best practices, such as:

- Requiring that audit firms be rotated periodically, say every 4 years or so (Bratton, 2002)
- Improving the PCAOB monitoring capability so it can fully enforce the monitoring function (i.e., monitor the books of the bookkeepers)
- Standardizing financial reports and data formats to make it harder to hide questionable outlays and business transactions
- Mandatory disclosure of all CEO compensation.

The impetus for corporate governance to repair the reputation of the auditing function stems from the need to mitigate its negative reputational damage and attract investors (Fisher, 2007).

### **Fact thread #2 – A key requirement of future corporate governance mechanisms is to ensure that corporate executives honor their duty of loyalty and act in the best interest of the corporation.**

Although ensuring the loyalty of corporate executives is not an easy task, it is not to be taken lightly, and must be the primary focus of future corporate governance mechanisms.

Sarbanes-Oxley does provide some useful guidance in this area, such as requiring CEOs and CFOs to attest to information on balance sheets, but more needs to be done. To reduce the temptations of greedy CEOs, some potentially new best practices recently identified by researchers must be incorporated into the governance scheme. The following list represents an initial starting point for ensuring better performance from our boards of directors while monitoring CEOs:

- There should be a provision demanding no dual role executives and insisting that the role of the CEO and Chairman of the Board of Directors be separate. This will ensure a separation of power and make it less likely that a single powerful individual can conduct a fraud against the company they serve (Adams, Hermalin, & Wisbach, 2010).
- Each board of directors should ensure director independence by appointing outside directors not affiliated with the company (Klein, 2006).
- Each board of directors should designate an audit committee tasked with ensuring a fair, transparent auditing process that results in the reporting of accurate financial data. An external and objective opinion should be acquired concerning the quality of the financial reports (Klein, 2006).
- Each board of directors should appoint an executive compensation committee to determine the total compensation package a CEO is entitled to, and then disclose the information to shareholders.
- Each board of directors should appoint a representative from the company's workforce to sit on the board to ensure better communication between the board and employees (Denis & McConnell, 2003).

- Each board of directors should amend their bylaws to require the corporation to disclose the ownership shares and voting rights of preferred shareholders (Denis & McConnell, 2003).
- Board evaluations of sitting directors should occur on a routine basis to identify director conflict of interests (Denis & McConnell, 2003).

**Fact thread #3 – The data reported by the ACFE over the last decade does not support a finding that Sarbanes Oxley has been a success.**

During the first reporting period after Sarbanes-Oxley required public companies to implement anti-fraud controls, the Association of Certified Fraud Examiners (ACFE) reported that “[p]ublicly traded organizations with SOX-related controls in place incurred median losses 70% to 96% lower than the corporations that had not yet implemented these controls” (ACFE, 2008, p. 38). Referencing the data in Table 1, duplicated herein, ACFE placed great significance on the reduced values of median loss per incident of fraud for companies that had implemented the anti-fraud controls indicated.

*Table 1. ACFE Median Loss Reduction Data for Public Companies with Anti-Fraud Controls.*

Sox-Related Internal Controls in Public Companies (256 cases)										
Control	Control in Place?				Median Loss			Months to Detection		
	Yes		No		Yes	No	% Reduction	Yes	No	% Reduction
Independent Audit Committee	228	89.1%	13	5.1%	\$139,000	\$463,000	70.0%	18	24	25.0%
Management Certification of F/S	226	88.3%	8	3.1%	\$135,000	\$3,725,000	96.4%	18	15	-20.0%
External Audit of ICQFR	212	82.8%	16	6.3%	\$125,000	\$1,150,000	89.1%	18	27	33.3%
Hotline	197	77.0%	28	10.9%	\$100,000	\$784,000	87.2%	16	24	33.3%
Management Review of IC	188	73.4%	36	14.1%	\$110,000	\$425,000	74.1%	14	18	22.2%

The table provides data on a reduction in the median loss due to incidents of fraud when the victim organization has implemented the anti-fraud controls indicated. The table is taken from ACFE (2008, p. 39) in its entirety.

Looking at the data in Table 1, there is a clear propensity to initially conclude that Sarbanes-Oxley has been successful and results in a reduction in the median loss per incident of fraud if a company is willing to expend the resources and costs to implement the recommended anti-fraud controls. Looking more closely at the table, however, it becomes evident that when incidents of fraud are detected earlier as a result of anti-fraud control mechanisms, the fraudsters have less time to plunder the company, and get away with less in their pockets. This data merely supports the unremarkable deduction that when detected earlier, the dollar value of the fraud is reduced since the fraudsters did not get the opportunity to finish their crime. The primary question that really needs discussion, however, is whether Sarbanes-Oxley has had any kind of enterprise wide impact (in the form of deterrence) on fraud in the marketplace.

The data in Table 1 is only relevant for cases where frauds were successfully detected, but the majority of fraud cases go undetected, and the data relevant to the undetected cases of fraud would be more pertinent to the inquiry about whether Sarbanes-Oxley has been a success. To ascertain the successfulness of Sarbanes-Oxley requires evaluation of all data on fraud, not a tiny subset. By basing their conclusions on a very limited set of data, which only includes the limited number of cases where a fraud was successfully detected, ACFE introduced a fundamental flaw into their analysis. To be meaningful, the supporting data would need to reflect the other half of the equation, all the cases where frauds have not been detected. The data set should also include questionable acts that do not necessarily constitute a fraud. The totality of the data would be required to support the kind of sweeping conclusions espoused by ACFE.

Even with an understanding it may be impossible to collect data on incidents of fraud that have not been detected or identified, we can still recognize the calamity that results if we limit our data to only those cases where we have successfully detected fraud, and then draw sweeping

conclusions based on the resulting analysis. Our corporate governance perspective is obviously more interested in the frauds that current control mechanisms were unable to detect. A useful inquiry may be to assess how much of the fraud is being categorized by the ACFE data, and how much is going undetected. The data in the top section of Table 2 represents the actual fraud metrics reported out by ACFE from 1985 through 2012. It has been organized by the year it was reported and normalized so only equivalent annual amounts are shown. There are some interesting trends in the top section of the table.

*Table 2. Reported fraud and median loss data from 1985 through 2012.*

Metric	Prior to 1996 <sup>1</sup>	1996 to 2002 <sup>2,5</sup>	2004	2006	2008	2010	2012
# of Reported Fraud Cases (per year)	260.0	110.5	254.0	567.0	479.5	921.5	694.0
% of Assett Misappropriation Cases	81%	86%	93%	92%	89%	86%	87%
% of Corruption Cases	15%	13%	30%	31%	27%	33%	33%
% of Financial Statement Fraud Cases	4%	5%	8%	11%	10%	5%	8%
# of Affected Countries					105	106	100
Median Loss per Fraud Case (x \$1,000)	\$ 150.8	\$ 337.8	\$ 184.5	\$ 159.0	\$ 175.0	\$ 160.0	\$ 140.0
Median Loss for Assett Misappropriation Cases (x \$1,000)	65	80	93	150	150	135	120
Median Loss for Corruption Cases (x \$1,000)	440	530		538	375	250	250
Median Loss for Financial Statement Fraud Cases (x \$1,000)	4,000	4,250	1,000	2,000	2,000	4,100	1,000
% Cases Involving more than \$1M		17%	15%	25%	25%	25%	20%
Estimate % of Revenues Firms Lose to Fraud	6%	6%	6%	5%	7%	5%	5%
% Cases where Fraudster Displayed a Behavioral Red Flag					81%	81%	81%
Average Duration Fraud Scheme went Undetected (months)		18			24	18	18
Industry Value of Detected Fraud (IVDF = [3] x [8]) in \$M	\$ 39.2	\$ 37.3	\$ 46.9	\$ 90.2	\$ 83.9	\$ 147.4	\$ 97.2
Estimated Annual Revenues Firms Lose to Fraud (in Billions of \$) <sup>3</sup>	\$ 400.0	\$ 600.0	\$ 660.0	\$ 652.0	\$ 994.0	\$ 2,900.0	\$ 3,400.0
% Value of Fraud Detected with current Governance Mechanisms	0.010%	0.006%	0.007%	0.014%	0.008%	0.005%	0.003%

1. The 1996 Association of Certified Fraud Examiners (ACFE) Report to the Nation (RTTN), unlike the subsequent years which reported biannual statistics, reported data on fraud cases collected over a ten year period. For the period from 1985 to 1995 a total of 2608 cases of occupational fraud (an average of 260 cases per year) were reported with an average cost per incident of \$150,750.

2. The second ACFE RTTN was released in 2002 and covered a six year period. Data has been converted to annual amounts.

3. Estimated loss value computed by taking the Estimated % Loss Due to Fraud (Row 13) and multiplying it by the published US Gross Domestic Product (GDP) value.

4. Since some cases involved more than one type of fraud, percentages typically sum up to more than 100 percent.

5. The median loss per fraud incident in 2002 and 2004 was not reported. The indicated value was calculated based on averaging the values reported for subcategories.

The table collects and categorizes fraud data over time from the ACFE periodic reports to the nation, for the purpose of demonstrating trends in the number of cases of fraud reported annually, and the median cost of each incident. The table also calculates the industry value of fraud that has been detected, and compares that to the estimated total amount of fraud to assess how successful legislation like the Sarbanes-Oxley Act have been. The table is based on data published in ACFE (2012), ACFE (2010), ACFE (2008), ACFE (2006), ACFE (2004), ACFE (2002), and ACFE (1996).



First, the annual number of reported cases of fraud is, in general, increasing with time after the enactment of Sarbanes-Oxley. Second, when the high profile cases that caused the 2002 data to be atypical are considered, the median loss per incident of fraud has seen only a slight reduction over time after the enactment of Sarbanes-Oxley. But the bottom section of the table demonstrates what is really at issue. By multiplying the median loss per fraud case by the equivalent number of fraud cases reported in a year, the product of the multiplication, labeled *Industry Value of Detected Fraud (IVDF)* in the table, results. By then comparing the IVDF values to the estimated lost revenues due to fraud, the percent of fraud (by dollar value) being detected with current governance controls can be computed. The results are enlightening. Since Sarbanes Oxley was enacted in 2002, the percentage of fraud detected has ranged from .003 to .014 percent. One can conclude, therefore, that very little of the ongoing fraud is being detected.

### **Analysis of the Facts**

#### **Fact thread #1 – Sarbanes-Oxley failed to restore the integrity of the auditing function by implementing auditing best practices.**

Subsequent to the enactment of Sarbanes-Oxley there has been a collapse of the world's financial markets due to real estate lending practices disclosed in the subprime mortgage crises, and the fraudulent misrepresentation that many banks made with respect to the quality of the integrated loan packages. Approximately 450 banks failed during the 2008 financial crises, and the U.S. government had to pump almost \$1 trillion into the banking industry to keep it afloat. Despite the provisions in Sarbanes-Oxley geared at requiring public disclosures and management of risks, it failed to prevent this major calamity. In a discussion of the Parmalat scandal, Ferrarini and Giudici (2005) assert that despite the fact that adequate rules were in place, more private enforcement of the rules and regulations were needed. The inquiries of external auditors in Parmalat were responded to with vague and inconsistent replies and false records made the

company look more valuable than it actually was. Auditors, it was noted, are essentially reputational intermediaries that do not want to lose their audit contracts (Ferrarini & Giudici, 2005). The implication being, that the auditors could have looked into matters with a little more vigor, but were thinking about their next auditing contract with Parmalat. Since auditing firms are operating out of a framework that puts them squarely in a conflict of interest position, it is only logical to expect more of the same behavior unless we correct the structural framework of the auditing function. To make matters worse, the paying customers contracting with the auditing firms are many times corporate executives that do not want good quality audits because that would inhibit their ability to expropriate money from the business.

Several steps need to be taken to restore the integrity of the auditing function:

- First, requiring companies to rotate their audit firms periodically, say every 4 years or so, would immediately remove the conflict of interest situation. Auditing firms could concentrate on the quality of their services, and compliance with governing regulations.
- Second, improving the PCAOB monitoring capability will ensure it can fully enforce the auditing function and have the resources to monitor auditors. This will result in accurate reporting of the financial information to investors.
- Third, standardizing financial reports and data formats will make it difficult to hide questionable outlays and unsavory business transactions as the format of financial reports and background data supporting balance sheets would be standardized across all companies and industries.
- Fourth, mandatory disclosure of all CEO compensation and the right of shareholders to vote on excessive outlays will ensure that vital resources needed to keep the

company operating will not be expropriated in secrecy.

Improving the reputation of the auditing community is a worthwhile endeavor since it results in more effective management by the CEO, increases market valuation, and investors are willing to pay a 28% premium to invest in companies with a good corporate governance process (Fisher, 2007, p. 2).

**Fact thread #2 – Sarbanes-Oxley failed to get better performance out of Boards of Directors while they monitor CEOs.**

By failing to incorporate potential best practices identified by researchers that could have improved the performance of boards of directors in monitoring executive abuses, Sarbanes-Oxley left a gaping hole in our primary corporate governance mechanism. CEO's like Stanley O'Neal of Merrill Lynch seized the opportunity and ran their company's into the ground while converting its resources into their own personal wealth. The result has been a complete loss of public confidence in the ability of our corporate governance systems to effectively govern financial transactions in capital markets. As the illustration in Figure 2 demonstrates, abuses in executive compensation levels is an importance issue in the public consciousness that has to be addressed by future corporate governance systems.



*Figure 2. Cartoon reflecting public sentiment on executive compensation.*

The figure offers evidence that misuse of compensation committees in setting executive compensation levels is an important issue the public deals with regularly, and is even the subject of cartoonists.

**Fact thread #3 – Analysis of ACFE occupational fraud data indicates Sarbanes Oxley needs to do more.**

Although it is limited to only the cases of fraud that has been successfully detected, the data published by the ACFE can be used effectively as long as we recognize the limitations associated with only having a subset of the needed data. Referring back to Table 2 reveals the following trend information:

- The annual number of reported cases of fraud is increasing with time after the enactment of Sarbanes-Oxley.
- The median loss per incident has experienced a slight reduction over time after the enactment of Sarbanes-Oxley.
- The industry value of detected fraud (IVDF) has increased slightly over time after the enactment of Sarbanes-Oxley.
- The estimated annual revenues firms lose to fraud have increased significantly over time after the enactment of Sarbanes-Oxley.
- The percent of fraud being detected with current governance mechanisms is decreasing over time after the enactment of Sarbanes-Oxley.

The graph in Figure 2 is based on the data in Table 2 and graphically depicts these trends. The figure confirms that the number of fraud cases reported annually is increasing after Sarbanes-Oxley, and the median loss per incident of fraud is relatively flat. Interestingly enough, the industry value of detected fraud (IVDF) is flat, indicating it is not changing much despite the fact that the estimated annual revenues firms lose to fraud is increasing exponentially. Since the opportunity to detect fraud is increasing rapidly, but our corporate governance mechanisms (after Sarbanes-Oxley) are not increasing the value of the frauds being detected, or the number of

frauds being detected for that matter, the only possible conclusion is that the Sarbanes-Oxley act is not the successful piece of legislation researchers have been making it out to be.

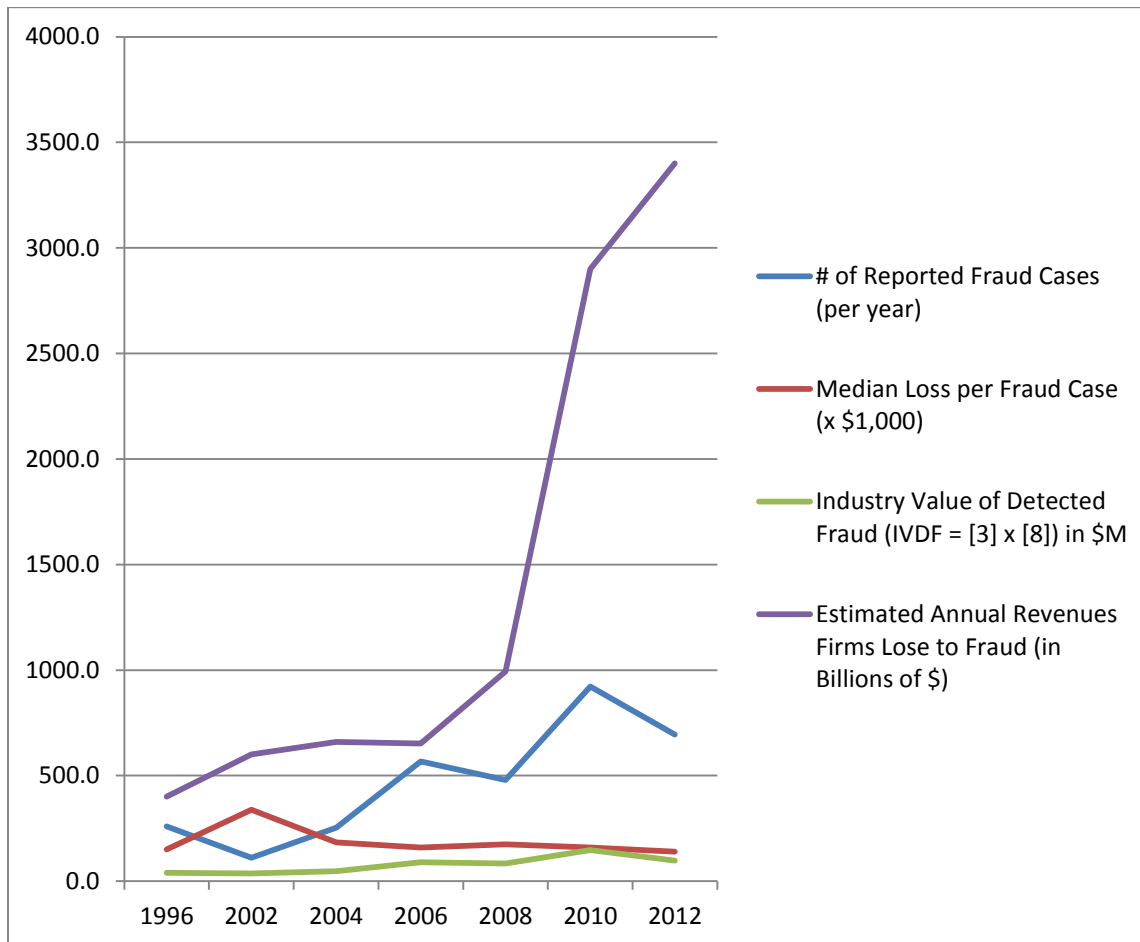


Figure 2. Performance of corporate governance over time after enactment of Sarbanes-Oxley. The picture depicts the potential impact of Sarbanes-Oxley in terms of the performance of corporate governance mechanisms over time.

Referring back to Table 2, only 0.003% of the estimated \$34 trillion annual fraud loss is being detected as of ACFE's 2012 *Report to the Nation*. Of the meager 0.003% being detected, 81% of the cases were identified because the perpetrators were exhibiting behavioral red flags like living over their means. Thus, one could argue that these cases would have been detected anyway, and that anti-fraud controls such as Sarbanes-Oxley only account for the remaining 19% of the cases being detected. This would mean that only 0.00027% ( $0.003\% \times .19$ ) of the

estimated \$3.4 trillion dollars in annual fraud loss can be attributed to identification via anti-fraud controls. These results are a catastrophe, as indicated by the volatility the marketplace has still been experiencing since enactment of Sarbanes-Oxley.

## **Conclusions**

Sarbanes-Oxley is not demonstrating a very good success record. It has not improved auditing practices and more needs to be done to restore the credibility of the auditing function. Sarbanes-Oxley has not improved the ability of BoDs to monitor and control the CEOs ability to expropriate too much of a firm's resources for self-serving pecuniary gain. But most importantly, statistical data on fraud does not show Sarbanes-Oxley in a favorable light. The data on occupational fraud published by the ACFE is, in general, alleged to support a claim that Sarbanes-Oxley has been successful. By generally noting that the median loss per fraud incident is much less for organizations that implement various anti-fraud controls, the ACFE concludes that controls specified in Sarbanes-Oxley are a success (ACFE, 2012). This analysis is flawed because of the small percentage of frauds that are actually being detected. In addition, it is fairly obvious that frauds detected earlier by implemented control mechanisms will have a reduced duration, and therefore a reduced loss value per incident. The really important issue, not being addressed by the ACFE, is how the overall marketplace is performing after Sarbanes-Oxley. The current corporate governance posture, however, is not even identifying a half of a percent of the probable fraud instances. It is hard, therefore, to rationalize the sweeping commentary many researchers (including ACFE) are making regarding the supposed positive impact of Sarbanes-Oxley. The only possible conclusion is to state the obvious, that Sarbanes-Oxley is not getting the job done. A wise professor once said, "Sarbanes-Oxley has not delivered. It does not work because we have not affected basic human nature" (Nugent, 2012).

## Recommendations

As a result of the conclusions drawn based on the foregoing presentation, discussion, and analysis of the facts, the following recommendations are made:

- Auditing firms need to be rotated so they can keep their independence.
- The PCAOB monitoring of the audit function, and the firms that perform it, should be improved to ensure published financial statements are accurate.
- Financial reporting content and formats need to be standardized to make it harder to hide the actual financial state a company is in.
- The total compensation CEOs receive, including any opportunities they may have usurped from the corporation, need to be disclosed in annual financial reports.
- Sarbanes-Oxley should be updated to address the best practices mentioned above for improving the performance of boards of directors with respect to monitoring CEOs.
- The governance code promulgated by the Organization for Economic Co-operation and Development (OECD) should be adopted worldwide as the first step at changing governance from a legislative solution, to a governing code advocated and controlled by industry (OECD, 2004). Provisions of the *OECD Principles of Corporate Governance* should then be upgraded to incorporate the best industry practices discussed above.

Implementation of these recommendations will require definition of success criteria and a plan for tracking industry performance so periodic evaluations can be made to assess how well the new governance mechanisms are working. Based on how well the success criteria is being met, the OECD code can be continually improved until complying companies limit CEOs enough through board monitoring that all companies remain viable in a perfect market place with high levels of consumer confidence.

## **Areas for Further Research**

Since the progress of any future corporate governance system needs to be tracked against pre-defined success criteria, the following areas of future research are recommended:

- Develop the success criteria to be used for assessing the success levels of future governance systems.
- Develop the standardized accounting content and formats for status reporting of financial information.
- Develop a corporate governance model of the economy to support tracking and status reporting of corporate governance good behavior initiatives.
- Clearly articulating all mandatory disclosures required under the recommended governance approach.
- Develop the standards to use for future regulation of the accounting profession and standards in relation of off-balance sheet transactions.



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