

# Impact of Sarbanes Oxley (SOX) Act on Corporate Governance Practices

## Dr. Abhishek Soni

Associate Professor  
Department of Management Studies  
JIET Group of Institutions, Jodhpur

## Ms. Sheetal Soni

Senior Research Fellow  
Department of Management Studies  
Jai Narain Vyas University, Jodhpur

### Abstract

SOX: Creating the Public Accounting Oversight Board and Increased Corporate Responsibility – The Sarbanes-Oxley Act, also known as Sarbox or SOX was passed in July 2002 in response to the rash of real and perceived failures in corporate governance and financial disclosure. Its primary emphasis was to enhance the quality and transparency of corporate disclosure and force changes in the auditing of publicly traded companies. These objectives were achieved in a number of ways by the passing of the Sarbanes-Oxley Act. The present paper highlights the role of different types of Board of Directors and their obligation towards the long run performance of an organization. It also highlights the reforms mandated by SOX Act to enhance corporate responsibility and financial disclosure and to combat corporate and accounting fraud.

**Keywords:** Accounting, Disclosure, Governance, Whistleblower

### Introduction

The term corporate governance is the set of processes, principles and systems through which a company is governed which provide the guidelines as to how the company can be controlled or directed in such a way that it can fulfill its objectives and goals in a manner which adds to the value of the company and also imparts benefits for all the stakeholders in the long run. Stakeholders here include all ranging from the board of directors to management to shareholders to customers to employees and society. Thus, the company management presumes the role of a trustee for all the others.

Corporate governance is related to maintain the balance between social goals and economic goals and also between individual and communal goals. The governance framework encourages the efficient use of resources and equally requires accountability for the stewardship of those resources. The aim is to align the interests of individuals, corporations and society. Corporate governance is based on the principles for conducting the business with all integrity, fairness, and being transparent with all the transactions, making the necessary disclosures and decisions, complying with the laws of the land, accountability and responsibility towards the stakeholders and commitment of conducting the business in an ethical manner.

## Role of Board of Directors

A corporation is a mechanism established to allow different parties to contribute capital, expertise, and labor for their mutual benefit. The investor/ shareholder participate in the profits of the enterprise without taking responsibility for the operations. Management runs the company without being responsible for personally providing the funds. To make this possible, laws have been passed that give shareholders limited liability and limited involvement in a corporation's activities. The involvement does include, however, the right to elect directors who have a legal duty to represent the shareholders and protect their interests.

The board of directors therefore has an obligation to approve all decisions that might affect the long-run performance of the corporation. This means that the corporation is fundamentally governed by the board of directors overseeing top management, with the concurrence of the shareholder. The term corporate governance refers to the relationship among these three groups in determining the direction and performance of the corporation. It is the duty of the board to select, evaluate, and approve appropriate compensation for the company's Chief Executive Officer (CEO), to evaluate the attractiveness of and pay dividends, recommend stock splits, oversee share repurchase programs, approve the company's financial statements, and recommend or strongly discourage acquisitions and mergers. They are responsible for providing stewardship of not only management functions but also operations of the institution. In India, like in other countries, the principal role of the board – as representatives of the shareholders – is to monitor the working of the organization and to protect the interests of all stakeholders. With increase in complexity in the structure of organizations, the expectations from the board of directors have increased. Indian boards in today's competitive global era must move away from the so-called rubber stamp board to being a strategic asset for the company.

However, there is a developing worldwide consensus concerning the major responsibilities of the board which falls under the order of importance as following:

Setting corporate strategy, overall direction and vision & mission of the organization

Hiring and firing of the CEO (Chief Executive Officer) and top management

Monitoring, controlling, or supervising top management

Reviewing and approving the use of all the available

resources

Caring for shareholder's interests

In Indian law, the board owes a strict judiciary duty to ensure that the company runs in the long term interest of owner with key responsibilities such as:

Determination of board functions

Setting values, mission and vision statements for the organization

Responsibility to prepare strategic plan, next year operating plan, and budget

Responsibility to ensure that the company has adequate resources to meet its objectives

Responsibility to monitor progress towards achieving the agreed objectives

Responsibility to prepare work plan for the year with monthly benchmarks and time-lines

Responsibility to mentor, monitor and evaluate the chief executive office

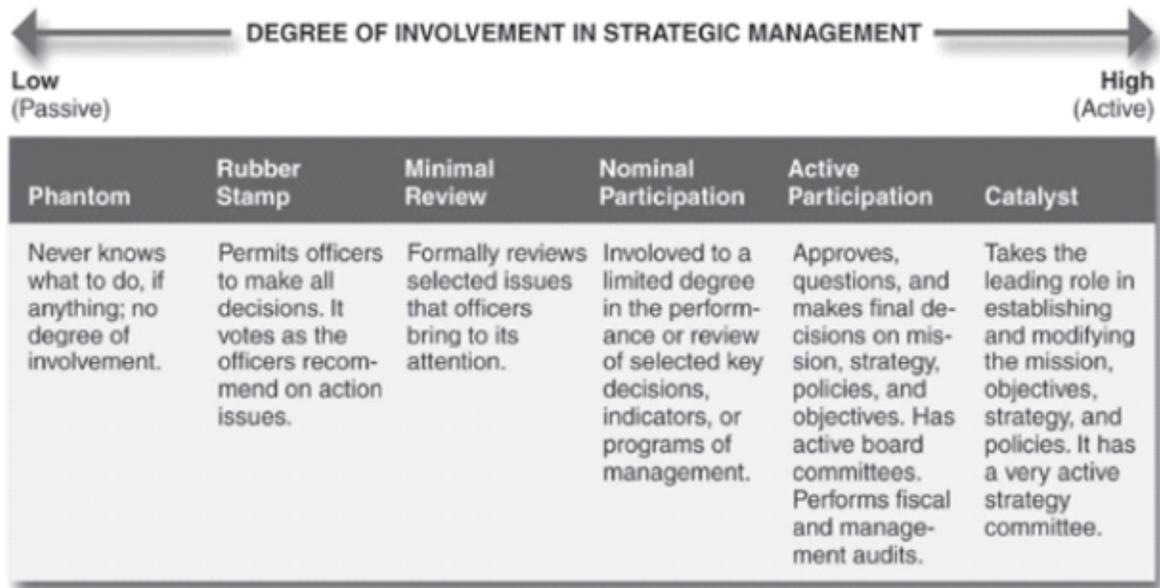
Responsibility to ensure compliance and disclosure to various acts such as Companies Act, the SEBI Act, The Income Tax, Sales Tax, other tax and labor laws

Responsibility to communicate with the stakeholders

Responsibilities which includes setting performance objectives, monitoring corporate performance, overseeing mergers and acquisitions and other capital expenditures

## Board of Director's Continuum

The boards of directors are involved in strategic management to the extent that it carries out the three tasks of monitoring, evaluating and influencing, and initiating and determining. The below listed chart Board of Director's continuum reveals the possible degree of involvement (from low to high). Board can range from Phantom Boards with no real investment to Catalyst Boards with a very high degree of involvement. Active board involvement in strategic management is positively related to a corporation's credit rating and financial performance.



Source: T.L. Wheelen and J.D. Hunger, Board of Directors Continuum

**Members of a Board of Directors**

The majority boards of the public corporations are composed of both inside and outside directors. *Inside directors* (who are also called as management directors) are those officers or executives who are employed by the corporation. Outside directors (who are also called as non-management directors) may be the executives of some other firms but are not employees of the board's corporation. In India, according to the policy of Department of Public Enterprises, the Board of Directors of Public Sector Undertakings should consist of:

- i. Full time functional directors number must not exceed 50% of the actual strength of the board;
- ii. Government directors number must not exceed one-sixth of the actual strength of the board wherein no case the number should exceed two;
- iii. Non-official part-time directors number should be at least one-third of the actual strength of the board

The board of the organization may comprise of different type of directors which may include:

a) *Executive Director* who is also known as *inside director*. They are full time employees/ executives of the company. Their power and status is derived from their respective position in the hierarchy of the company. According to the Clause 49 of SEBI's listing Agreements, every listed entity requires to reserve half the board for independent directors if the chairman is an executive director.

b) *Non Executive Directors* are outside directors who do not hold any management position in the organization. They are the people who have been chosen to sit exclusively on the board of the company. According to the Clause 49 of SEBI's listing Agreements, "independent director" means non executive director of the organization who:

- i. does not have any material relationship with the organization apart from receiving director's remuneration;
  - ii. not related to promoters or management at board level or one level below the board;
  - iii. has not been executive of the organization in the last preceding three financial years;
  - iv. is not a partner or an executive of the statutory audit firm or the internal audit firm which is associated with the organization;
  - v. is not a supplier, service provider or organization's customer; and
  - vi. is not a substantial shareholder of the organization
- c) *Nominee Director* is third party stakeholders such as government, foreign collaborators, holding companies and financial institutions or other lenders.
- d) *Representative Director* is appointed to represent the interest of a stakeholder group such as consumer, employees, suppliers etc.
- e) *Shadow Director* is also known as deemed director who is not is not named or appointed as director but

imparts instructions (not professional advice)

- f) *Associate Director* is titled to senior managers who are not on the board of the organization. This title is given as a sign of appreciation and recognition for work done.

### Indian Style of Corporate Governance

The listed companies in India are by obligations of Securities and Exchange Board of India (SEBI) has to comply with corporate governance code from January 2000 which was further reviewed in 2003 by a new committee which was headed by Mr. N R Narayana Murthy, who defined a complete and good set of corporate governance system as one which attaches "a high degree of priority towards the interests of shareholders who have placed their trust in the company to use the funds wisely and effectively". But unfortunately, the reforms of the corporate governance have been on paper only. The system is still considered to quite hollow by the fact that the "independent directors" are all nominated by the controlling group whom they are supposed to supervise.

A big majority of the listed companies of India have destroyed shareholder value. Whether proper attention to the shareholders' interest has been given by a company or not, would ordinarily get reflected in two indicators of shareholders' return, viz., dividends and capital appreciation.

### SOX (Sarbanes-Oxley) Act and Corporate Governance

The legislation came into existence in 2002 and introduced major changes to the regulations of financial practice and corporate governance. This act was named after Senator *Paul Sarbanes* and *Michael Oxley*, which sets a number of deadlines for compliance. (SOX Law, 2006)

Towards the corporate scandals, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) in June 2002. It was particularly designed to protect the shareholders from the excess and failed oversight that characterized lapses and failures at Tyco, World Com, Enron, Qwest and Global Crossing and other prominent firms. There were several key elements of SOX act which were designed to formalize greater independence on board and oversight. To quote, the act requires that all directors serving on the audit committee

should be independent of the firm and receive no fees other than that of director. The board will not grant loans to corporate officers. The act has also established formal procedures for individuals (whistleblowers) to report incidents of questionable accounting or auditing. The corporation's financial information must be certified by both the CFO and CEO. The act also bans auditors to provide both internal and external audit services to the same company.

The provisions of the Sarbanes Oxley Act state the criminal and the civil penalties for certification of internal auditing, non-compliance, and for increase in financial disclosures. It has also affected the public U.S. companies and a non-U.S. company with presence in U.S. SOX is all concerned about corporate governance and financial disclosure. (Sarbanes Oxley 101, 2005)

The SOX Act necessitate all financial reports to be comprised of with an Internal Controls Report which confirms that a financial data of the company is accurate and adequate controls are available to safeguard the financial data. Year-end financial disclosure reports are also a needed requirement. A SOX auditor is needed to review policies, controls, and procedures during audit. SOX auditing need that internal controls and procedures can be audited by via a control framework like COBIT.

Log collection and monitoring systems should provide an audit trail of all the access and activity to sensitive business information. Sarbanes-Oxley also promotes the disclosure of corporate fraud by protecting whistleblower employees of publicly traded companies or their subsidiaries who reports illegal activities. Section 806 of Sarbanes Oxley Act authorizes the U.S. Department of Labor to protect whistleblower complaints against the employers who retaliate and also authorizes the Department of Justice to criminally charge against all those who are responsible for the retaliation.

### Law Violation Consequences

To a large extent, the Act significantly increased the consequences of violations of the securities laws, actions for fraud, and other federal offenses. Law violations are subject to longer imprisonment and increased fines.

Crime	Previous Penalty	New Penalty Under the Act
Mail Fraud (903)	Up to 5 Years in Prison	Up to 20 Years in Prison
Wire Fraud (903)	Up to 5 Years in Prison	Up to 20 Years in Prison
Violation of Exchange Act (904)	Fine for Individual: 1 Million \$	Fine for Individual: 5 Million \$

(Source: corporate.findlaw.com)

An alteration, falsification, or destruction of any document with the intent to obstruct any federal investigation (whether related or not related to securities) is subject to criminal penalties. Addition to this, directors and officers, and acting persons their direction, are prohibited from manipulating, misleading, coercing, or fraudulently influencing the auditor of a public company's financial statements if that person knew or should have known that the action could cause the company's financial statements to be materially misleading.

### **Ways SOX changed Corporate Governance**

With reaction to the Enron- and WorldCom accounting scandals, the Sarbanes-Oxley Act (SOX) was passed and became law on 30 July, 2002. Although the sweeping legislation had unassailable goals preventing and deterring future accounting fraud, protecting the shareholders and increasing their confidence in public company financial reporting and, thus, in the U.S. capital markets it was disruptive. It imposed great number of new duties and costs on public companies and firms of accounting, and a decade later, people were still split about whether the money, time and focus lost to SOX are worth the benefits it has given.

**SOX reformed and re-empowered the board of directors of the corporate-** The most prominent change SOX was about to produce was a shift from a perspective that the board serves management with a view point that management is working for the board. SOX also recognized that director's independence is essential for the board to serve effectively as a check on the management which allows for the director's liability if the board fails to exercise the appropriate oversight.

**SOX encouraged the adoption of corporate codes of ethics** - SOX needed the companies to disclose whether their senior executives and financial officers followed the code of ethics. If they didn't, they had to explain why. In the same time, both the New York Stock Exchange and NASDAQ adopted the rules which require that the listed companies adopt and disclose a code of conduct.

**Public Company Accounting Oversight Board -** SOX created the independent Public Company

Accounting Oversight Board (PCAOB) in 2002 to supervise the independent auditors of public companies thereby replacing a self-regulatory scheme and mandating clear independence. The Board's inspection powers imply that the audits of companies' internal controls are subject to scrutiny.

**Role of in-house counsel** – SOX created a SEC rule which requires in-house and outside lawyers practicing before the SEC to report evidence of a material violation to the CEO of the company. Then the CEO must investigate the evidence and take rational steps to respond to the report. If the reporting attorney is not satisfied with the response, then the lawyer must report the potential misconduct to the audit or another committee.

**SOX laid the cultural roots of shareholder activism** – Shareholder activism has increased, with Dodd-Frank pushing forward shareholder proxy access and “say on pay” compensation advisory rules. Roots of such trends were there in SOX and the Enron like corporate scandals shoved the issues like executive compensation and the independence of the board into the spotlight.

**SOX made public companies more expensive to run** – SOX compliance is very costly and there's no doubt in that. Most of the organizations spend in the range of \$100,000 to \$1 million annually on compliance-related activities which doesn't include the time and focus board members and executives must spend on compliance matters.

**SOX empowered the SEC** – Among other measures, SOX extended the decree of limitations for the SEC to pursue actions and increase the penalties at their disposal. SOX changed the balance of power between companies and prosecutors, putting the prosecutors in the driver's seat.

**SOX has changed things for the private companies too** – Private companies which were not subject to SOX reforms have adopted some of its provisions as best practices, such as ensuring the director's independence and adopting audit and audit committee procedures.

### **Conclusion**

Corporate governance should begin with an

unambiguous definition of the duties, accountability and authority, for the directors of the board and management. Special emphasis must be placed on the accountability of the board of directors towards the shareholders and their independence from management. It has been very understandable that the stockholders' annual meeting and a proxy report controlled by management are not sufficient to offer shareholders with firsthand information on the performance of the corporation and the management. The alternatives are to increase the frequency and extent of information given to the shareholders, or to include several individuals directly nominated the stockholders on the board of directors. The second alternative appears to be more cost effective which allows more efficient and timely communication with the stockholders. The presence of independent directors also improves the control mechanisms on the operation and performance of the board of directors.

Though implementing best practices of the corporate governance would result in additional operating costs, it must be emphasized that the good corporate governance is not an option but an obligation, if shareholder's interest is to be protected. Compliance costs are very small fraction of the gargantuan losses which are suffered by stockholders who have invested in the companies whose shares became worthless because they did not comply with good

corporate governance practices. Stockholders of Enron and WorldCom suffered losses of more than \$100 billion, while the most aggressive estimates of Sarbanes-Oxley compliance costs amount to be less than \$5 billion.

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