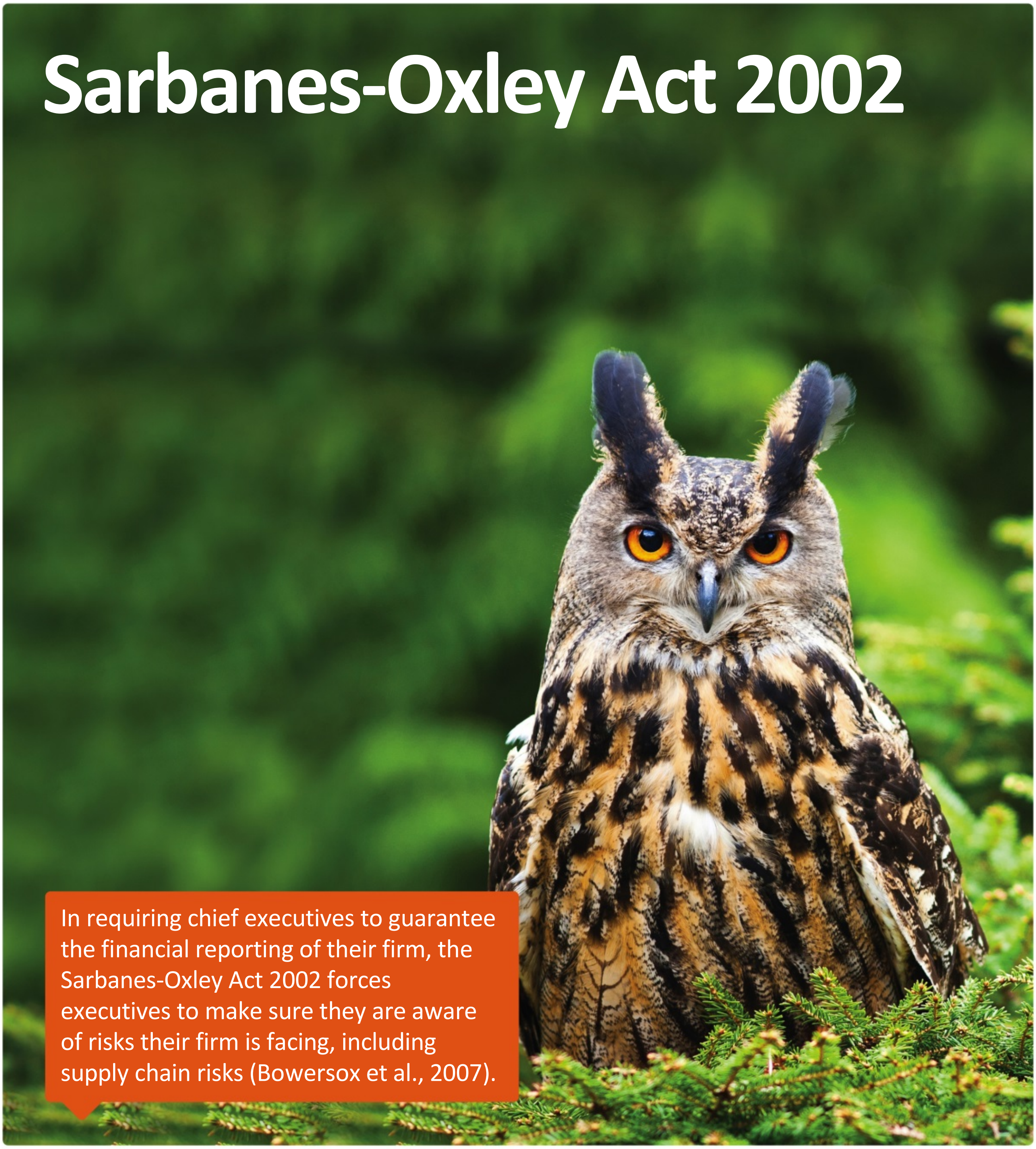
CIPS KNOWLEDGE

Sarbanes-Oxley Act 2002



In requiring chief executives to guarantee the financial reporting of their firm, the Sarbanes-Oxley Act 2002 forces executives to make sure they are aware of risks their firm is facing, including supply chain risks (Bowersox et al., 2007).

CPD HOURS 1

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Introduction

Over the last two decades of the 20th Century the business world was shaken by the a significant number of large-scale financial mismanagement scandals and corruption cases related to global corporations and large companies, some of which ceased to exist (eg. Enron, Arthur Andersen). These developments forced business organisations and regulators to pay more attention to issues of corporate governance and business continuity (CIPS: Sarbanes-Oxley Act 2002; Bowersox et al., 2007; Waters, 2007).

A focal point of these improvements was identifying and managing business risks (Bowersox et al., 2007; Waters, 2007). Governments in different countries began to publish reports and recommendations that insisted on making it obligatory for businesses to specifically address the issues of corporate governance and business risk management. One of these reports, the 1992 Cadbury Report, argued that company directors should establish and report on their formal systems for identifying significant risks, the likelihood of those risks materialising and how companies assess the consequences of those risks.

The Sarbanes-Oxley Act became the product of such concerns in the US. According to the Act, executives are obliged to disclose all significant risks to their business operations, including those that prior to the Sarbanes-Oxley Act were considered outside of their responsibility. For example, outsourcing agreements must be declared in the annual report, together with the detail on any risk management issues of third-party-providers (CIPS: Sarbanes-Oxley Act 2002; Waters, 2007). Particularly relevant for purchasing and supply management are sections of the Act that address performance measurement, monitoring and reporting, and issues of supply chain security (CIPS: Sarbanes-Oxley Act 2002; Bowersox et al., 2007).

Definition

The Sarbanes-Oxley Act, 2002, often referred to as SOX (Pub.L. 107-204, 116 Stat. 745), was enacted on 30 July 2002 in the United States to 'protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes' (The Sarbanes-Oxley Act, 2002). The Act requires Chief Executives and Financial Directors of companies to specifically address in their annual reports risks to business continuity and to the health of their business organisation (Waters, 2007).

Successful Application

Risks related to operations of an organisation should be addressed in its annual report (Waters, 2007). Section 404 of Sarbanes-Oxley Act requires that an internal control report is filed at the same time as the annual report. The Securities and Exchange Commission (SEC) evaluates the internal controls used by the firm to make sure that the financial reports are consistent and accurate (Bowersox et al. 2007).

Steps to Successful Application

- Identify significant risks.

- Consider the likelihood that the risks will materialise.
- Assess consequences if the risks materialised

Hints and Tips

- The firm must have internal measurement capabilities that comply with SEC requirements (CIPS: Sarbanes-Oxley Act 2002; Bowersox et al., 2007).
- The internal measurement systems used by companies must ensure the accuracy of financial information (Bowersox et al., 2007).
- Firms must commit resources to supply chain visibility in order to reach the required levels of accuracy of information (CIPS: Sarbanes-Oxley Act 2002; Bowersox et al., 2007).

Potential Advantages

- The Sarbanes-Oxley Act 2002 ensures that executives are aware of the risks their firm is facing, including supply chain risks (Bowersox et al., 2007).
- The Sarbanes-Oxley Act 2002 is beneficial in the practice of purchasing and supply as it acknowledges that supply chains are inherently risky, and in this way promotes and supports supply risk management (Waters, 2007).
- The Sarbanes-Oxley Act ensures that corporations take more responsibility for their actions, for example, by extending the concept of senior management responsibility. This means it eliminates their traditional defence that they did not know about the wrongdoing of people in their organisations (Waters, 2007).

Potential Disadvantages

- Although useful, the Sarbanes-Oxley Act cannot completely eliminate all the risks faced by organisations, or guarantee good corporate governance in all cases (Waters, 2007).
- Compliance with the Sarbanes-Oxley Act requires a formal and systematic approach and constant monitoring, reviewing and controlling (Waters, 2007).
- Many managers feel that the legal requirements of the Sarbanes-Oxley Act represent an additional burden on their work and on the organisation (Bowersox et al., 2007).

Case Studies

- US telecommunications giant WorldCom (today known as MCI) committed one of the biggest corporate frauds in US history. WorldCom's Chief Executive Officer Bernard Ebbers orchestrated the US$11b accounting fraud which, once discovered, led to the collapse of WorldCom in 2002 and considerable losses for shareholders and employees (CIPS: Sarbanes-Oxley Act 2002).

- In 2001 the Securities Exchange Commission (SEC) brought charges against Arthur Andersen (AA), a top accountancy firm, stemmed from audits at Waste Management Inc. which was exaggerating its profits throughout the 1990s. The audits have led to a US$1.43b restatement of earnings. AA knew about the false financial statements but still certified them every year as being in conformity with accounting principles. AA paid a penalty of US$7m. Three AA partners involved in the audit paid fines of up to US$50,000 each and were banned from auditing for up to five years (The New York Times, 2001).

- Since 2009 federal prosecutors in the US have taken on insider trading involving US firms. The most recent case reported from the US courts was in October 2011. It involved conspiracy charges and securities fraud. Drew Brownstein, a fund manager pleaded guilty in an insider-trading case in which a director of Mariner Energy Inc. tipped his son about the acquisition of the firm by a rival before its actual announcement. The son traded this information on the US$2.7b deal to Drew Brownstein (The Wall Street Journal, 2011).

Further Reading/References

Web Resources

- A guide to the Sarbanes Oxley
- Brief explanation of the Act
- Sarbanes-Oxley Act Forum
- Sarbanes-Oxley Compliance Professionals Association
- The Sarbanes-Oxley Act and implications for nonprofit organizations

Books

- How to Comply with Sarbanes-Oxley Section 404: Assessing the Effectiveness of Internal Control by Michael J. Ramos
- What is Sarbanes-Oxley? by Guy Lander

- Corporate Governance Post Sarbanes-Oxley: Regulations, Requirements, and Integrated Processes by Zabihollah Rezaee
- The Sarbanes-Oxley Section 404 Implementation Toolkit: Practice Aids for Managers and Auditors by Michael J. Ramos

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