Sarbanes-Oxley Act

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Summary Overview

The Sarbanes-Oxley Act, passed in 2002, was generally supported by liberals and advocates of financial reform at the time because it aimed to improve corporate accountability, transparency, and prevent corporate fraud after high-profile scandals like Enron and WorldCom. Liberals often viewed Sarbanes-Oxley as a necessary step to protect investors, consumers, and the public from corporate misconduct.

During the 1980s and 1990s, there was a strong push for deregulation. Claims were made that the regulations in various industries were hurting the competitiveness of American companies and costing consumers and shareholders substantial amounts of money. The philosophy behind the deregulatory push was that a combination of consumer choice, shareholder interest, and people's innate honesty would keep the companies working in a legal and efficient manner. However, by 2002, it was clear that this was not always the case. The Sarbanes-Oxley Act was one step toward insuring honesty by corporate executives and among the auditing firms that tracked their finances.

The Sarbanes-Oxley Act (sometimes abbreviated as SOX), created in response to a number of major corporate scandals, required chief executive officers (CEOs) to be personally responsible for their companies' financial statements. In addition, it increased regulations on auditing firms to reduce possible conflicts of interest. There was also a provision essentially mandating that a company's auditors be audited by another auditing firm. In addition, the law included a provision strengthening the protection of whistle-blowers, thus putting top executives on notice that any illegal or unethical acts could be called out by employees or other parties.

Defining Moment

At the time this law was passed, the current had been against increased regulation of businesses for more than two decades. However, by the early 2000s corporate scandals related to auditing practices and public statements regarding some corporations' financial health created an atmosphere for greater regulation. Shortly after one of the biggest such scandals, involving a large company named Enron, the Sarbanes-Oxley bill was introduced, passed by both chambers of Congress, and signed into law by President George W. Bush. The rapid legislative action demonstrated lawmakers' understanding that corporate crime had become a major concern for Congress and the public.

The Enron bankruptcy and related scandals had been front-page news beginning in 2001, although the practices that brought Enron down had been going on for a decade before that. Enron's accounting practices came to light when the previously successful firm filed for bankruptcy, shaking the confidence of investors and causing the general public alarm. One of the top five accounting firms, Arthur Andersen, had assisted Enron's senior executives in developing "creative" accounting practices that hid millions of dollars in liabilities. Arthur Andersen then audited Enron's books, and certified an unrealistic picture of the company's financial health. Also at the time that Sarbanes-Oxley was under consideration, information about questionable practices at firms such as Adelphia Communications, Tyco International, and WorldCom was made public. This development reinforced the need to establish an agency to oversee the major accounting firms to ensure honesty in their practices and reports.


Sen. Paul Sarbanes (D–MD) and Rep. Michael G. Oxley (R–OH-4), the co-sponsors of the Sarbanes–Oxley Act. Photos via Wikimedia Commons. [Public domain.]

Because of the frauds perpetrated by these companies, investors lost billions of dollars. Confidence in corporate executives and their business operations plummeted. In addition, tens of thousands of people lost employment when the companies employing them either declared bankruptcy or were restructured. The general effect was that Congress felt compelled to do something.

Author Biographies

Paul S. Sarbanes (born 1933), a Maryland native, represented Maryland in Congress for thirty-six years as a member of the Democratic Party. Beginning in 1971, he served six years in the House of Representatives, and then thirty years in the Senate, retiring in 2007. He had bachelor's degrees from Princeton University and Balliol College (Oxford University), and a law degree from Harvard University Law School. Prior to his service in the federal government, Sarbanes practiced law for seven years, and then served in Maryland state government for four years.

Michael G. Oxley (1944–2016), was a member of the U.S. House of Representatives from 1981 until his retirement in 2007. A Republican, Oxley was serving as the chairman of the House Financial Services Committee at the time Sarbanes-Oxley was passed. Staying within his home state of Ohio, Oxley earned his bachelor's degree from Miami University and his law degree at Ohio State University. He had been an agent in the Federal Bureau of Investigation (FBI) for three years and a member of the Ohio state government for eight years, prior to being elected to the House.

Historical Document

Sarbanes-Oxley Act

15 U.S. Code (Sarbanes-Oxley Act)

§7211 Commission Rules and Enforcement

(a) Establishment of Board

There is established the Public Company Accounting Oversight Board, to oversee the audit of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress....

(c) Duties of the Board

The Board shall, subject to action by the Commission under section 7217 of this title, and once a determination is made by the Commission under subsection (d) of this section—

(1) register public accounting firms that prepare audit reports for issuers, brokers, and dealers....

(2) establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports ....

(3) conduct inspections of registered public accounting firms....

(4) conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms....

§7241 Corporate Responsibility for Financial Reports

(a) Regulations required

The Commission shall, by rule, require, for each company filing periodic reports under section 78m(a) or 78*o*(d) of this title, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of this title that—

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation,

including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) Foreign reincorporations have no effect

Nothing in this section shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

Glossary

Commission: the Bureau of Consumer Financial Protection

"fraud, whether or not material": all known fraud must be reported by the signing officer, even if it could be argued that it has no real impact on (is not material to) a financial statement

Document Analysis

The Sarbanes-Oxley Act was an attempt to bring honesty and personal responsibility back to the governance of corporations. It sought to do so by establishing clear regulations in the conduct of accounting firms, as well as by making senior executives responsible for the content of any form they might sign, including financial statements. In addition, in sections not contained in this excerpt, Sarbanes-Oxley prohibits corporations from making personal loans to its executives. The idea that everyone should have the same, truthful information to work with lay at the center of this legislation. Cozy relationships that altered the flow of accurate information were forbidden.

The sections of the act that are the focus here begin with the establishment of the Public Company Accounting Oversight Board. Prior to this time, accounting firms were governed only by the applicable state and federal business laws. It was assumed that no firm would knowingly risk its business interests by not doing a thorough and honest job in its auditing. However, the relationship between Enron and Arthur Andersen made it clear that this was not always the case. Arthur Andersen was not only Enron's auditor, it was also a financial advisor that helped Enron executives to create artificial subsidiaries in order to hide liabilities. The Board was given the responsibility of registering accounting firms that worked with public corporations, of establishing rules/standards for accounting practices, and, from time to time, of inspecting the work of these firms. If a firm was found not to be in compliance, the Board was given the authority (in another part of the act) to impose penalties on both the firm and any individuals involved in such irregularities.

Section 7241 makes it clear that senior executives should understand, and stand by, any official documents that they sign. In previous cases of fraud, senior executives often were able to make a defense that they had not understood a document they had signed or that they had been deceived by the person creating the report. With the adoption of Sarbanes-Oxley, this was no longer a defense. By signing, a corporate officer was affirming that the information was correct and presented in a proper fashion. In the later part of the excerpt included here, corporate officers are also mandated to publicize any bad news regarding potential fraud.

A second area of responsibility for the "signing officer" is the charge to have "internal controls" over the corporation's finances and auditing procedures. This includes a clear channel of communication among the corporate executives who deal with finances. More important, it means that the officer has to make certain that a system is in place to oversee the necessary audits and that, if a problem arises, has to certify what changes are being made to address the issue.

Knowing that one of the arguments made against this type of law was that it placed American corporations at a disadvantage to foreign corporations, the authors make it clear that any American corporation trying to use that knowledge as a loophole is out of luck. The act specifically states that any American company that moves its headquarters overseas to avoid the law is still required to adhere to Sarbanes-Oxley.

Essential Themes

The adoption of Sarbanes-Oxley in the United States created the conditions for many other nations to adopt similar laws for their corporations. Thus, the uneven playing field that many predicted would hurt American companies did not come to pass. The basic need for honest and accurate accounting was not something that was only an issue in the United States; many nations recognized the problem and followed along. As in most areas of business, those producing fraudulent statements or enticing auditors to fabricate numbers were a small part of the population. However, the government desired that the general public, and especially investors and regulators, has an accurate picture of how a company is doing financially. Thus, overseeing the auditing profession was a major step in this process.

Making it clear that anyone signing a document accepted responsibility for that document has also been an important outcome of Sarbanes-Oxley. Not understanding or knowing all the details is no longer a legal defense for an executive. Corporate officers also have to affirm that a rigorous accounting system is in place, and safeguards are present to make certain that the accounting system remains rigorous.

Honesty has long been the expected norm in business dealings at the corporate level. While such honesty has not always been present, the expectation is still there. Sarbanes-Oxley was an attempt by the government to make certain that people could continue to expect honesty in business, by making it harder to cheat and making it more costly for those who do cheat. The uproar that was heard from the business community when Sarbanes-Oxley was first adopted has generally dissipated. It may take a little more of a company's resources to comply with the law, but the goodwill and trust thereby created produces benefits for businesses and the public. Some conservative critics still hope to weaken or repeal the law, but the majority of those who work with it have not found it excessively burdensome and accept the goal for which it was created.

—Donald A. Watt, PhD

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