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## The Sarbanes-Oxley Act of 2002: Setting a Baseline for the Adoption of Enterprise Ethics

THE SARBANES-OXLEY ACT OF 2002<sup>1</sup> CERTAINLY HAS HAD some positive impacts related to both the letter and the spirit of the Act—and recent data supports this. Indeed, Sarbanes-Oxley has set a baseline of rules that encourage effective corporate ethics and governance by providing for greater board independence, more stringent internal controls on financial reporting, and executive certification of financial reporting.<sup>2</sup> Corporations should embrace these regulations as a platform to encourage enterprise ethics within their organization, instead of mere compliance with the rules.<sup>3</sup>

First of all, there absolutely is greater board independence as a result of Sarbanes-Oxley. This independence is evident in the structure of boards as well as the manner in which boards operate. A 2007 Business Roundtable survey of its members—chief executive officers (CEOs) of leading U.S. companies with \$4.5 trillion in annual revenues and more than 10 million employees—indicated that 90% of its members now report that their boards are at least 80% independent.<sup>4</sup> Indeed, greater board independence was one of Sarbanes-Oxley's clearly intended effects.<sup>5</sup> Unfortunately, however, there is actually a fair amount of research suggesting that an independent board structure alone does not accomplish all of the positive impacts and effects that are projected from independence.<sup>6</sup>

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\* Executive Director, Business Roundtable Institute for Corporate Ethics. The Business Roundtable Institute for Corporate Ethics is an independent entity established in partnership with Business Roundtable and leading academics from America's best business schools. For more information, please visit [www.corporate-ethics.org](http://www.corporate-ethics.org).

1. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

2. See *infra* notes 4–23 and accompanying text.

3. See *infra* notes 27–28 and accompanying text.

4. See *infra* notes 6–12 and accompanying text; see also *Shareholder Rights and Proxy Access: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2007) (testimony of John J. Castellani, President, Business Roundtable) [hereinafter *Shareholder Rights*]; Press Release, Bus. Roundtable, Business Roundtable Corporate Governance Survey Key Findings (Oct. 22, 2007), available at <http://64.203.97.43/publications/index.aspx>.

5. See Catherine M. Daily & Dan R. Dalton, *Dollars and Sense: The Path to Board Independence*, J. BUS. STRATEGY, May/June 2003, at 42.

6. See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 235–37 (2002) (concluding that firms with greater board independence do not achieve greater financial performance); Eric M. Fogel & Andrew M. Geier, *Strangers in the House:*

## THE SARBANES-OXLEY ACT OF 2002

Where the research shows the positive effects of independence is in requiring greater focus on *good governance*. Beyond satisfying the minimum standards of regulations, good governance involves directors being committed to active dialogue, monitoring, and decision-making.<sup>7</sup> From the same Business Roundtable survey, 97% of audit committees, 92% of compensation committees, and 68% of nominating/governance committees meet in executive session each year.<sup>8</sup> An executive session is a meeting where company executives are not present and where candid independent director conversation and dialogue can occur.<sup>9</sup> These executive sessions foster active and open conversation, constructive challenge, and more thorough decision-making. The high percentage of audit committees, compensation committees, and nominating/governance committees that engage in executive sessions suggest that Sarbanes-Oxley's independence requirements have strongly encouraged corporations to engage in good governance.

In addition, independence requires a greater focus on good governance by instilling what others have termed a *duty of curiosity*, akin to the more familiar legal duties that directors have.<sup>10</sup> A duty of curiosity for a director is about seemingly simple responsibilities like asking challenging questions, finding out the core principles of the company you govern, understanding what it means to be part of the organization, making site visits to company locations, and engaging in meaningful conversations with executives whose title is not CEO.<sup>11</sup> Those are some of the actions that detail a *duty of curiosity*—a duty that gets to the very spirit of Sarbanes-Oxley. I am not sure that directors always have adhered to this “duty;” however, I believe that it should be placed along the same order as the duty of loyalty and duty of care.

Sarbanes-Oxley also has succeeded in instilling good governance by requiring more stringent internal controls on financial reporting. In June 2007, the *Journal of Accountancy* published some data on Section 404,<sup>12</sup> an oft-maligned section of the Sarbanes-Oxley regulation.<sup>13</sup> Essentially, the data suggests that Section 404 seems to

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*Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 54 (2007) (finding no evidence to suggest that a majority of independent board members guarantees a better financial return or better long term performance).

7. BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2005), available at <http://64.203.97.43/pdf/CorporateGovPrinciples.pdf>.

8. See Press Release, *supra* note 4.

9. See George Anders, *Private Time*, WALL ST. J., Oct. 9, 2006, at R4.

10. See *The Rise and Fall of Enron: Principles for Director Focus*, DM EXTRA! (Nat'l Ass'n of Corp. Dirs.), Jan. 31, 2002, at 2–3, available at [http://www.nacdonline.org/members/dmx/dmxtra\\_0202.pdf](http://www.nacdonline.org/members/dmx/dmxtra_0202.pdf).

11. Gwendolyn S. King, *Care, Loyalty, et al.*, in CORPORATE GOVERNANCE 38, 39 (Henry A. Davis ed., 2003).

12. See Kathryn E. Scarborough & Mark H. Taylor, *Two Years and Counting*, J. ACCT., June 2007, at 74–75.

13. See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 704 (2007) (noting Sarbanes-Oxley's Section 404 provision has been called “the law's most complained-of provision”); Oleg Rezy, *Sarbanes-Oxley: Progressive Punishment for Regressive Victimization*, 44 HOUS. L. REV. 95, 107 (2007) (noting that Section 404 has been referred to as the “most notorious mandate introduced” by the Sarbanes-Oxley legislation); see also Alan Levinsohn, *First-Year Verdict of SOX 404: Burden-*

be working in terms of its intended effects on internal controls on financial reporting.<sup>14</sup> In an analysis of the initial two years when companies were required to adopt the provisions of Section 404, the percentage of companies reporting material weaknesses in internal controls over financial reporting decreased from 16% to 10%.<sup>15</sup> Similarly, Glass Lewis & Co. also commented that restatements by accelerated filers have declined by 14%.<sup>16</sup> Thus, the desired structural effects of Sarbanes-Oxley are beginning to come about as companies are getting more acclimated to the regulations. Nevertheless, we must continue to be vigilant. As the author of the U.S. Department of Justice's 2003 *Thompson Memorandum* cautions, "[r]egulations expand with each ensuing scandal to encompass every possible abuse—except the next one."<sup>17</sup>

Sarbanes-Oxley's requirement that CEOs and chief financial officers certify their corporation's financial reports merely made the public's perception about the legitimacy of such financial reports a reality. Even prior to the passage of Sarbanes-Oxley, there was typically a public perception that an auditor's signature on an unqualified opinion meant that the CEO, CFO, and senior management were equally represented and responsible, regardless of whose signature appeared on the annual report.<sup>18</sup> Indeed, there has long been a public perception that the signatures of the public accounting firm and the company CEO are interlinked.<sup>19</sup> Sarbanes-Oxley made that public perception explicit. The spirit of the law requires that CEOs and CFOs spend considerably more time understanding what they are signing<sup>20</sup>—and one effect has been a significant increase in their staff's hours devoted to ensuring this understanding is as complete as possible.<sup>21</sup> The certification requirement has been positive for the legitimacy of financial reports.<sup>22</sup> It continues to be debatable, however, whether or not this detailed certification process has usurped too much time from executives' attention to other critical management demands.

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*some, Costly, and Confusing*, STRATEGIC FIN., June 2005, at 67, 68 (quoting former SEC commissioner and Stanford law professor Joseph Grundfest as calling Section 404 a "demonstrable disaster" and the "regulatory equivalent of an airplane crash").

14. See Scarborough & Taylor, *supra* note 12, at 74–78.

15. See *id.* at 74–75.

16. *Id.* at 74.

17. Larry D. Thompson, Senior Fellow, The Brookings Inst., 2003 Federalist Society Address 2 (Nov. 14, 2003).

18. See generally Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 12–14 (2002).

19. *Id.* at 11 (stating that the public blamed accounting industry and corporate management for accounting inaccuracies).

20. See J. Brent Wilkins, Comment, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 344 (2005).

21. See *id.* at 352 (discussing the additional time CEOs and CFOs will spend certifying quarterly financial records).

22. See Prentice, *supra* note 13, at 717 (noting certification requirements boost investor confidence in the credibility of information they are receiving).

## THE SARBANES-OXLEY ACT OF 2002

The ethics and governance of a corporation are important in a practical sense because they encourage a pool of stable, long-term investors. For example, an analysis of a recent *Fortune Magazine* list of the “Most Admired Companies” in the category of “Long-Term Investment” shows that these recognized companies have share turnover over 40% less than the overall New York Stock Exchange market.<sup>23</sup> The reputations of these respected companies are built upon a clear and solid vision of what these firms stand for<sup>24</sup>—and this has made them successful in the long-term. In other words, corporations are rewarded in part for their laudable corporate governance and ethics. Marriott is one great example. The Marriott brand has value because everyone knows exactly what Marriott stands for—from its hotel customers to its company employees to its property communities.<sup>25</sup> Lower share turnover actually is one reflection of a sound corporate governance program.

A further question, however, needs to be asked about what constitutes effective corporate ethics and governance. The Business Roundtable Institute for Corporate Ethics’ perspective on this is that we need to promote an understanding of ethics that is broader than compliance—where ethics is an enterprise-wide concern that informs decision-making from the C-suite to frontline employees.<sup>26</sup> Ethics needs to be embedded in both the core purpose and the culture of the firm.<sup>27</sup>

In order for a corporation to determine whether it will fully invest in and cultivate enterprise ethics, the corporation’s leadership must ask some important questions. Here are a few general questions that highlight some differences between an enterprise ethics and a compliance mindset. Are we going to operate our organization by emphasizing a rules-based mentality or are we going to operate the firm in a broader sense by assessing how we create value for stakeholders? Do we run our firm by viewing social issues as risks or do we see them as opportunities that can align with the firm’s values and strategies, make our organization a productive participant in society, and position the firm for long-term business success?

Sarbanes-Oxley sets a baseline of rules that will allow corporations to be productive members and participants in society. Sarbanes-Oxley’s intent and spirit cer-

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23. See DEAN KREHMEYER ET AL., CFA CENTRE FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORP. ETHICS, *BREAKING THE SHORT-TERM CYCLE* 11 (2006), available at [http://www.corporate-ethics.org/pdf/Short-termism\\_Report.pdf](http://www.corporate-ethics.org/pdf/Short-termism_Report.pdf).

24. See generally Sabrina Helm, *The Role of Corporate Reputation in Determining Investor Satisfaction and Loyalty*, 10 CORP. REPUTATION REV. 22, 23 (2007) (describing corporate reputation as a set of collectively held societal beliefs about how a corporation will behave in a given situation and its ability to meet stakeholder expectations).

25. See Hal B. Gregersen & J. Stewart Black, *J. W. Marriott, Jr., On Growing the Legacy*, 16 ACAD. MGMT. EXECUTIVE 33, 34 (2002) (interviewing J.W. Marriott, Jr., CEO, Marriott International, who states that Marriott is built on a foundation of service to different stakeholders groups including associates, customers, and the community).

26. See Dean Krehmeyer & Bobby Parmar, *Teaching Business Ethics*, Nov. 2006, available at [http://www.aacsb.edu/handouts/TBE06/AACSB\\_Slides\\_Day%20FINAL.ppt](http://www.aacsb.edu/handouts/TBE06/AACSB_Slides_Day%20FINAL.ppt).

27. See generally DELOITTE & TOUCHE LLP, *ETHICS AND CORPORATE COMPLIANCE* (2003), available at [http://www.deloitte.com/dtt/cda/doc/content/Ethics\\_Compliance%20final%20E.pdf](http://www.deloitte.com/dtt/cda/doc/content/Ethics_Compliance%20final%20E.pdf).

DEAN KREHMEYER

tainly causes us to look much closer at the culture of organizations, and that is the direction that we need to continue to build on. I am encouraged that many corporate leaders, however, continue to ask the above enterprise ethics questions because if we leave the bar set at just satisfying compliance, we have not set it nearly high enough.