**Regulatory and Compliance Issues**

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Regulatory and Compliance Issues

In order for one to appreciate the necessity for regulatory and compliance in financial systems, they must first understand the dynamics of the problem space. First executives and senior leadership are ethically bound to report their earnings accurately and honestly. However they are also economically incentivized to cheat. To ensure that cheating does not happen auditors are tasked with reviewing the books and validating financial statements. While this model keeps most businesses honest, it raise the question how do we know the auditing organization is fair and compliant? Even if all auditors are fair how do we protect against negligence?

These questions lite up the headlines during the early 2000s with notorious financial scandals such as Enron, WorldCom, and Lehman brothers (Mallor, Prenkert, Barnes, Langvardt, & McCrory, 2013). Due to their manipulation of the market, investors had valid reasons to stop trusting financial reporting. When investors stop trusting a market the respond by not investing into it. This reduces the value market and hurt all businesses within it.

The government needed to answer the cries of both business owners and investors, and they responsed with regulatory and compliance reform known as the Sarbanes-Oxley Act (SOX). SOX required transparency and held executives personally responsible for corruption, thus removing the incentives to cheat.

# Effect of the PCAOB

“One of the main features of the Sarbanes–Oxley Act (SOX) is the creation of an independent board that oversees the audits of public companies (Mallor, Prenkert, Barnes, Langvardt, & McCrory, 2013, p. 1236).” The Public Company Accounting Oversight Boarding (PCAOB) was incorporated as a nonprofit and maintains the America’s audit registrar listings (PCAOB US, 2015). They have the ability to create compliance rules and have the authority to investigate all public companies for fairness and accuracy of financial reporting.

The creation of a central oversight board has helped increase the independence of other financial organizations. They can confidently rely on SOX compliant reports and know that the work was done legally and ethically. If it that is not the case the oversight board will uncover and then severally fine the offenders.

# Diversity of the PCAOB

The Public Company Account Oversight Board consists of five full time members, of which exactly two must be actively working as certified public accountants (CPA). It might seem strange that all strange to limit the number of CPAs, but this is done to promote diversity of ideas. Having diversity leads to more ideas and a more complete solution (Cascio, 2013). This is not limited to diversity of culture but also of professions. Consider if the board only contained accounts, they might be more willing to hurt business at the expense of being technically more correct. Or at the other extreme with where no accountants participated, and the board made rules which could not be implemented.

# Regulatory Requirements Examples

## Banning of option backdating

Public companies typically compensate their executives with stock options, which are the right to purchase some number of shares at a given price. For example the CEO might have the right to buy up to N shares for P dollars each once during the next 5 years. Then if the CEO raises the value to S they exercise the option and make a profit of (S-P)\*N dollars.

However some businesses were not recording the purchase price P. Instead they would backdate the form with the lowest price during that season (Changa, Tangb, & Krivogorskyc, 2011). This enabled executives to cheat the system and make unfair profits, and is explicitly forbidden.

## Internal Control Report

When a business reports their financial statements, they must include an internal control report. This report outlines the steps taken to safeguard the financial data and prevent corruption (Sarbanes Oxley 101, 2015). The report is then signed by chief officers of the company, making them liable for the contents (Mallor, Prenkert, Barnes, Langvardt, & McCrory, 2013). By raising the visibility on control systems it forces the business to give them strong considerations.

Implementing these controls have been challenging especially for small businesses. This comes from not only the large overhead but also the fees associated with auditors validating the compliance status (Swartz, 2006). To reduce the stress of small businesses exceptions are being made and extensions permitted. However these extensions will eventually run out and the costs will be due.

# Conclusions

Executives were conflicted between being ethical, or cheating to receive higher pay for themselves. Because of some well publicized bad apples investor confidence was decreased and the economy suffered. To prop it back up the government created the SOX act and formed the PCAOB. The PCAOB is a diverse organization which is responsible for the oversight of public accounting. They have been a critical instrument in returning the confidence of the investors and stabilizing the economy. This has come by closing corporate loop holes and requiring strict reporting of financial information.

# References

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