



**Longbow Asset  
Management Company**

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# **Sarbanes-Oxley: A Capital Market Perspective**

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**M. Jake Dollarhide  
Chief Executive Officer**

**Phone: (918) 295-9929**

**Email: [jakedollarhide@lbamc.com](mailto:jakedollarhide@lbamc.com)**

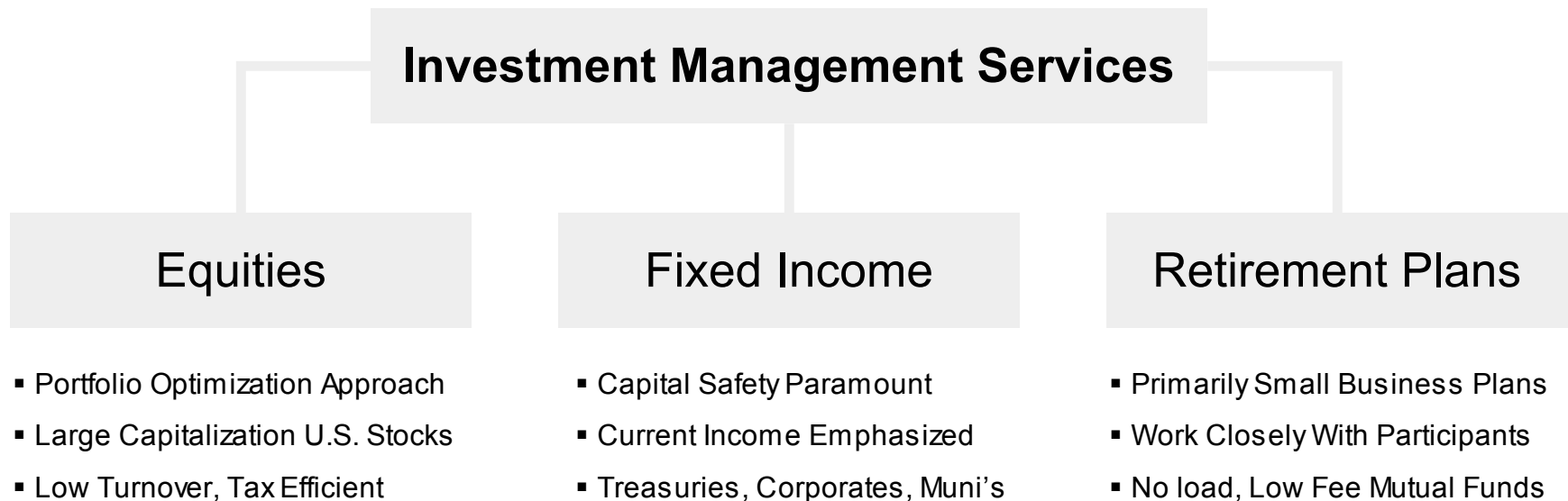
**Website: [www.lbamc.com](http://www.lbamc.com)**



## ***“Each Client Has Unique Needs. We Provide Unique Solutions”***

### **Company Description and Philosophy**

*Longbow Asset Management Company is a registered investment advisory firm based in Tulsa, Oklahoma. Our firm provides intelligent investment solutions specifically designed to achieve our clients’ definitive goal: long-term wealth accumulation.*



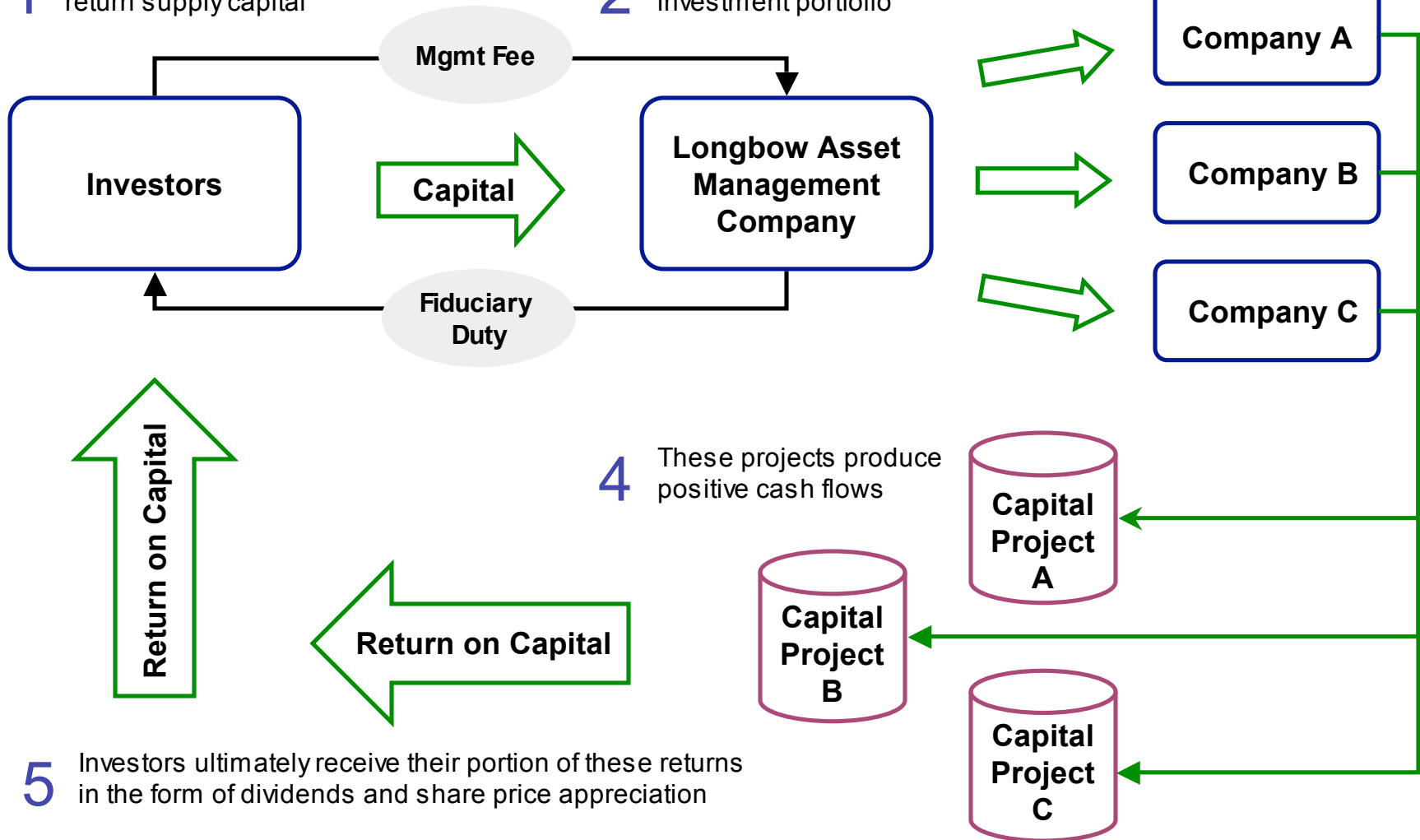


# Our Firm's Role in the Capital Market

1 Investors seeking return supply capital

2 We construct a diversified investment portfolio

3 Companies invest in +NPV capital projects



5 Investors ultimately receive their portion of these returns in the form of dividends and share price appreciation



## In 2002, it Came to Light that Fraud was Widespread

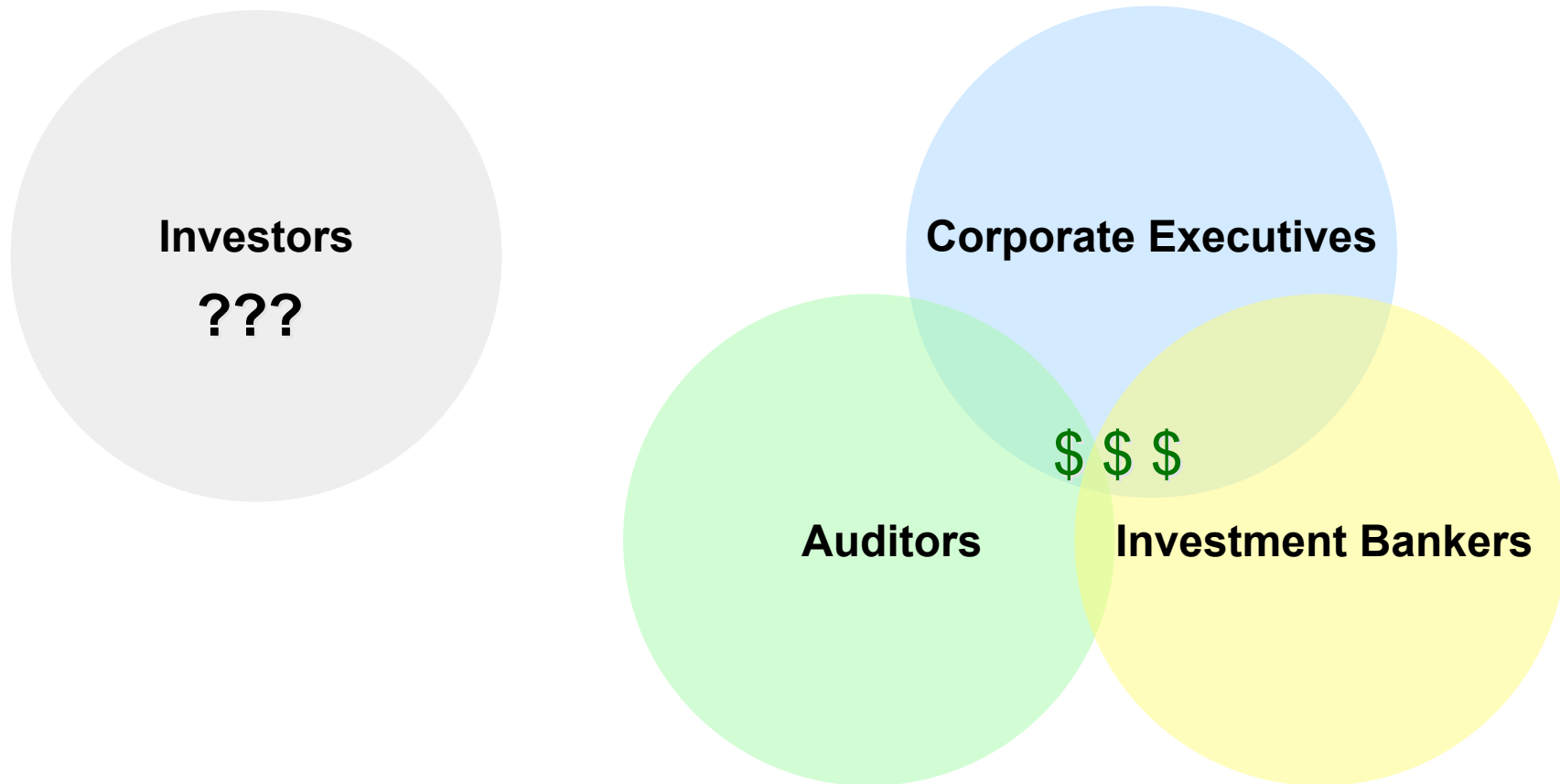


**Most highly  
publicized  
cases**

**Additional  
companies  
involved in  
scandals  
during 2002**



## The Perpetrators had Overlapping Interests – Separate and Contrary to those of Investors



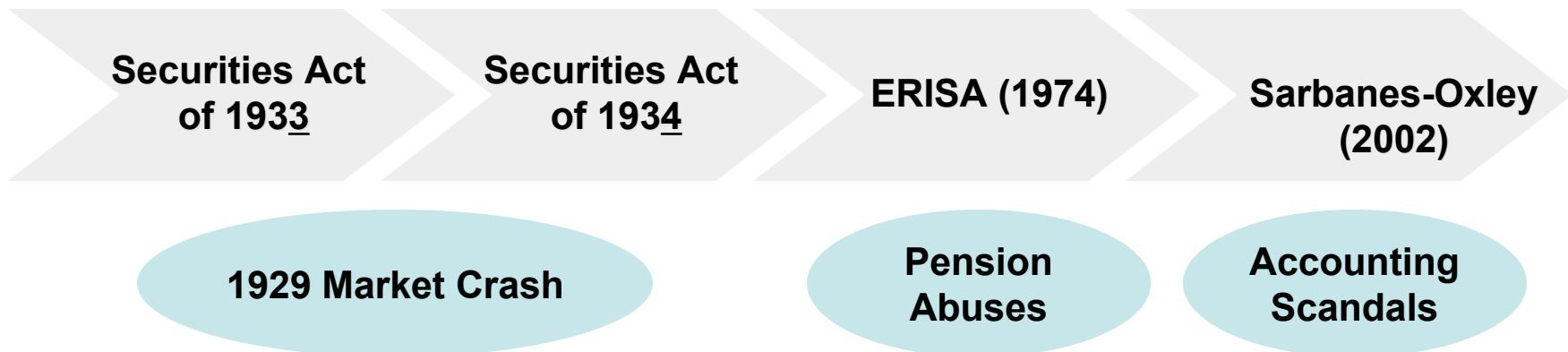


## To Restore Investor Confidence, Congress Drafted the Sarbanes-Oxley Act of 2002

Government Legislation is Often Reactive Rather than Proactive



### Historical Examples:





## **Selected Milestones in U.S. Corporate Governance**

Federal law imposes civil liability on directors for material defects in public-offering statements

1933

U.S. appeals court bars businesses from omitting governance-oriented measures from proxy statements

1947

SEC approves auditor-independence rules with stiff public disclosure provisions about consulting ties that pose potential conflict of interest

2000

SEC requires companies to put shareholder resolutions to a vote

1942

NYSE requires listed companies to have an audit committee made up solely of independent directors

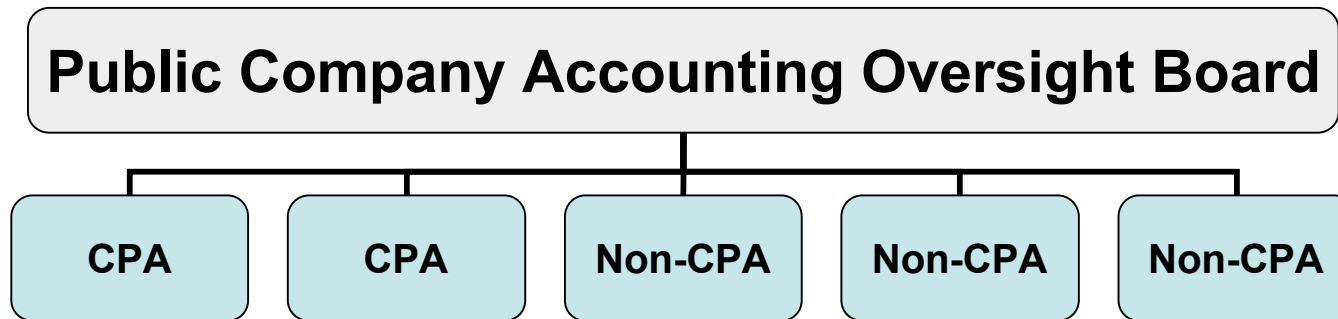
1978

Sarbanes-Oxley Act, broad governance overhaul, becomes law following a wave of business scandals

2002



## Creation of an Oversight Board Overseen by the SEC



<b>Funding</b>	<b>Standard Setting</b>	<b>Investigative &amp; Disciplinary Authority</b>	<b>International Authority</b>
Public companies  +  Accounting firms	Authority to issue  +  Ability to adopt	Empowered to:  1) Inspect 2) Sanction 3) Suspend	Covers foreign firms that: “prepare or furnish” an audit report covering a US registrant



## New Roles for Audit Committees and Auditors

**Audit Committee**

**Independence**

**Management**

- **Auditors Report to Audit Committee**
- **Audit Committee Must Approve All Services**
- **Auditors Must Report New Information to Audit Committee**
- **Some Non-Audit Services Prohibited**
- **Audit Partner Rotation**
- **Employment Implications**

**Outside Auditors**



## Tougher Criminal Penalties for Fraudulent Activities

### ✓ Failure to Maintain Workpapers

- *Felony with penalties of up to **10 years** for willfully failing to maintain “all audit or review workpapers” for at least five years*

### ✓ Document Destruction

- *Felony with penalties of up to **20 years** for destroying documents in a federal or bankruptcy investigation*

### ✓ Securities Fraud

- *Criminal penalties for securities fraud have been increased to **25 years***

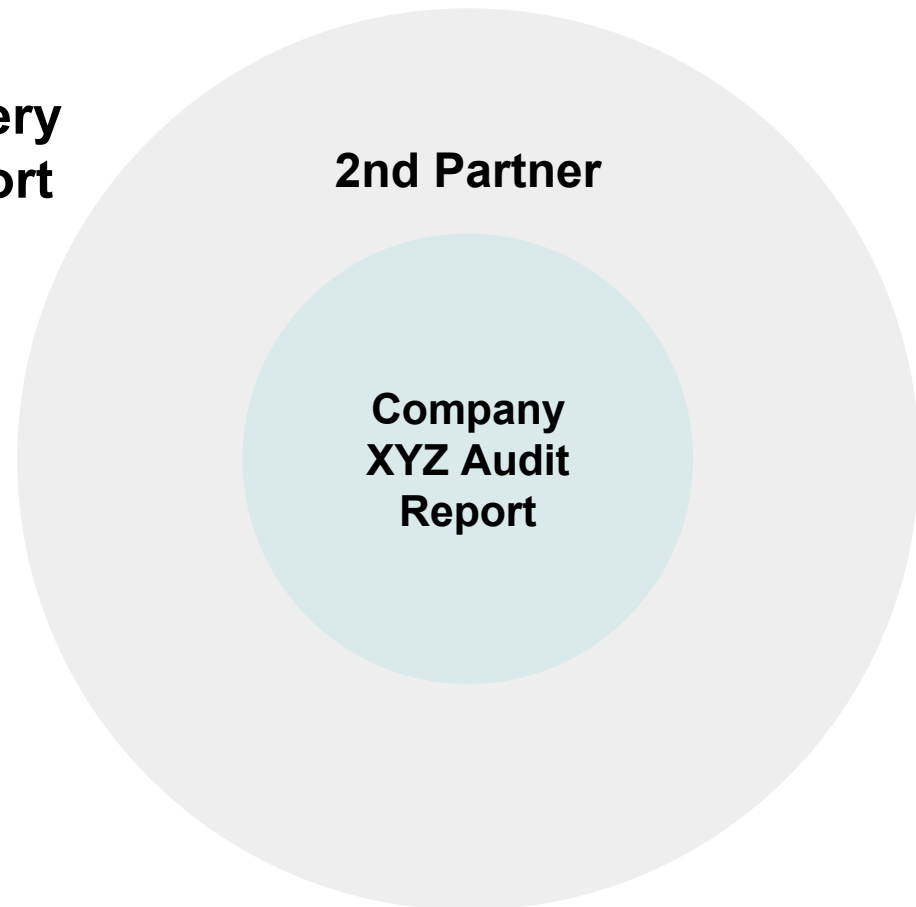
### ✓ Other Provisions

- *Protection for corporate whistleblowers*
- *Bans personal loans to executives*
- *Prohibits insider trading during blackout periods*



## **Financial Reporting and Auditing Process Additions**

- 1. Thorough Second Partner Review and Approval of Every Public Company Audit Report**





## Financial Reporting and Auditing Process Additions

### 2. Management's Assessment of Internal Controls

#### Company XYZ Management Questionnaire

##### Questions to Management:

Yes No

1) Is your firm's internal control structure effective?

2) Are your firm's financial reporting procedures effective?



## Financial Reporting and Auditing Process Additions

### 3. Audit Reports Must Contain Description of Internal Controls Testing

***Company XYZ Audit Report***

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**Description of Internal Controls Testing:**

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## Sarbanes-Oxley's High Costs Places a Disproportionate Burden on Smaller Companies

*"At the AMEX, the median revenues for our companies are \$57 million, which means that compliance costs would consume nearly 1.5% of revenues, severely squeezing operating margins -- in many cases to near zero -- and depleting funds available for a reinvestment."*

*"The compliance costs of Section 404 are severe. Some of our companies told us that their auditing fees have trebled or quadrupled."*

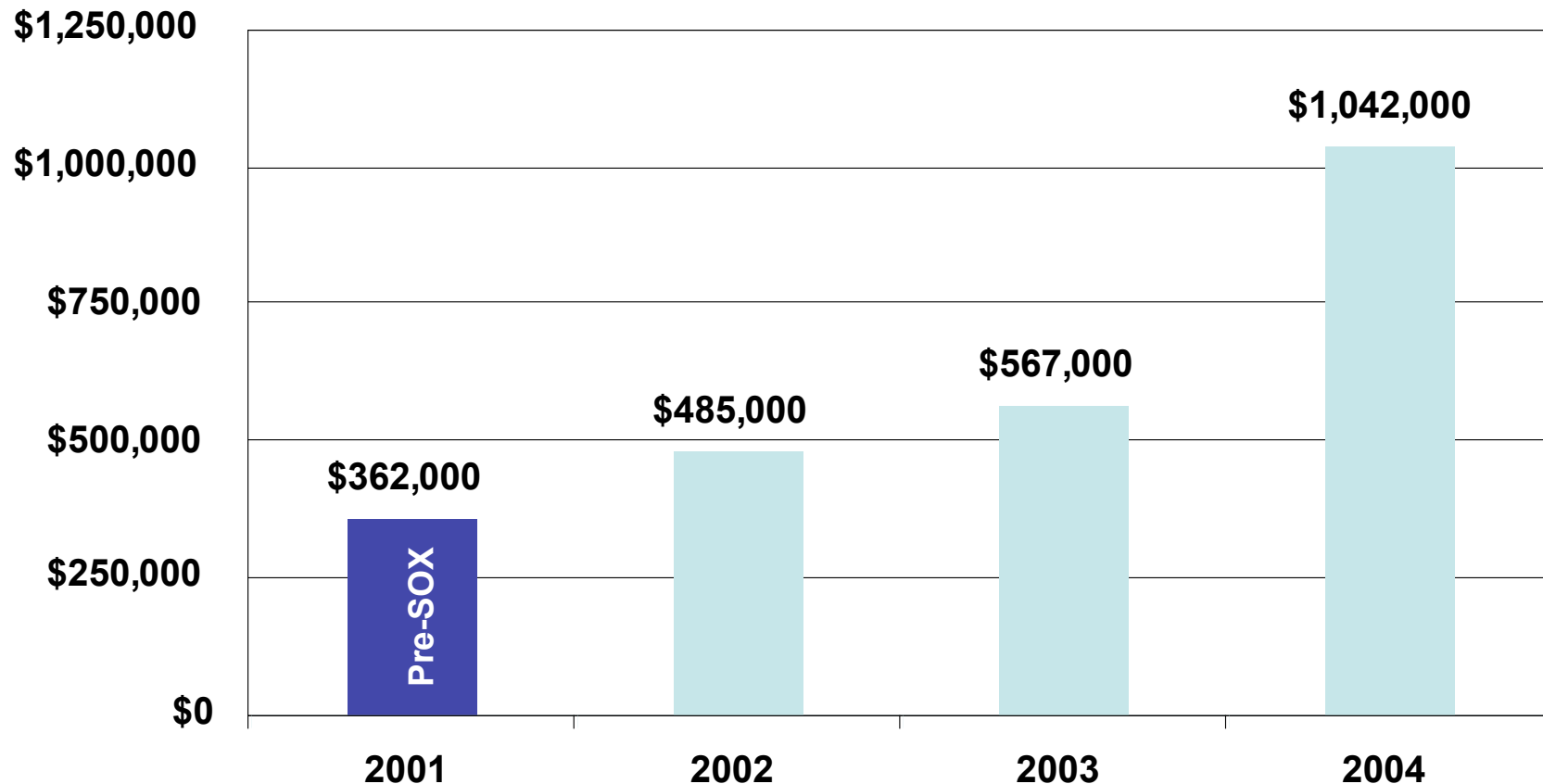
*As one CEO told us: "It is next to impossible for us to meet 404 requirements and still remain profitable to our stockholders. Without adequate relief for small companies, we cannot survive or remain profitable."*

**- NEAL L. WOLKOFF, chairman and CEO  
of the American Stock Exchange**



## Small Company Costs: Significant and Increasing

Average Audit Fees for S&P Small Cap 600 Index Members

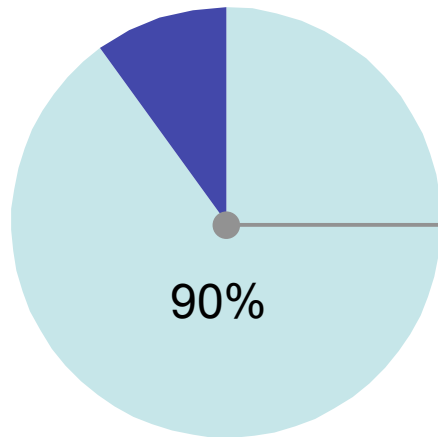


Source: The Wall Street Journal



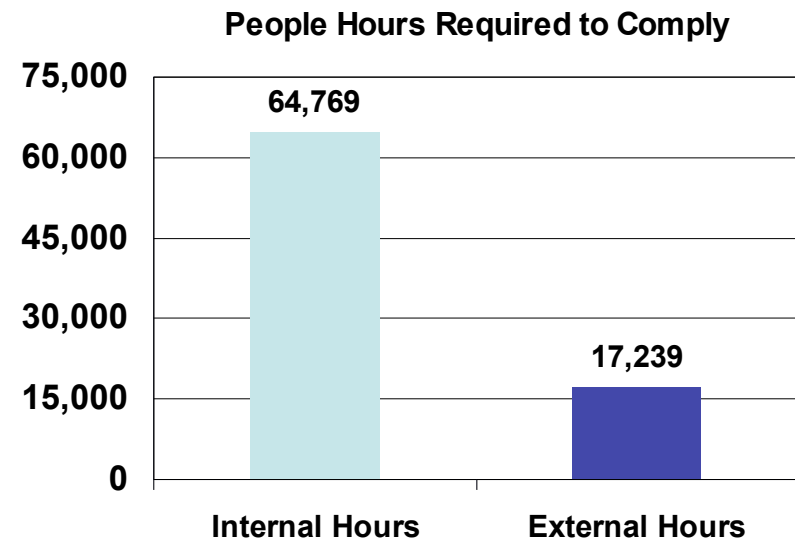
## Large Companies Must Also Devote Significant Resources to Meet the New Standards

Source: Big Four Survey



*90 percent of their publicly traded clients spend nearly \$8 million on SOX Section 404 compliance*

*On average, companies with over \$5 billion in sales require 64,769 internal hours and 17,239 external hours to comply*

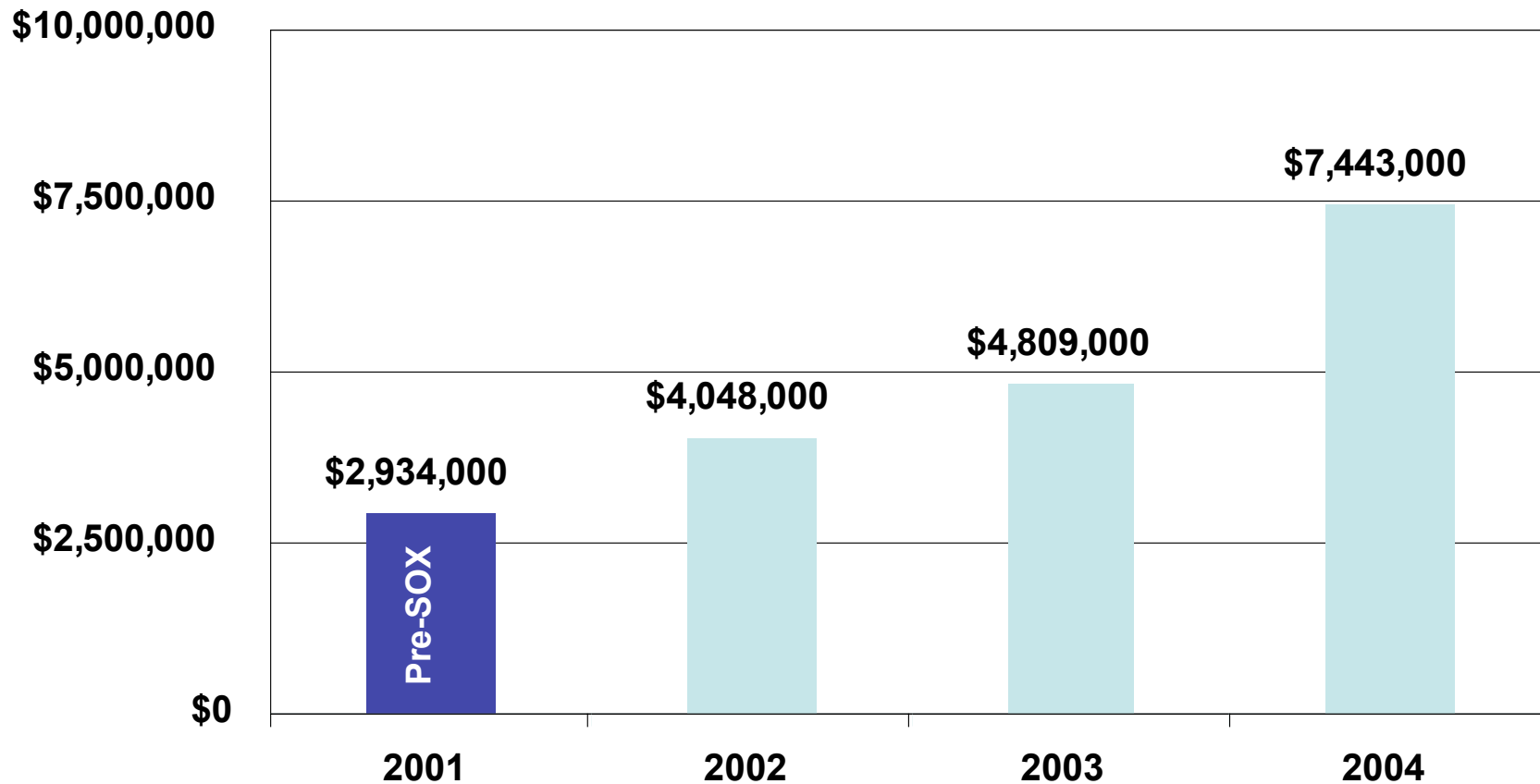


Source: Financial Executives International



## Large Company Costs: Significant and Increasing

Average Audit Fees for S&P 500 Index Members



Source: The Wall Street Journal



## Criticisms of Sarbanes-Oxley

*"SOX fails because its main objective is to audit work that has already been performed, whereas it would be more effective to ensure that companies design, implement, and manage proper internal controls, resulting in sustainable quality built from inside the company."*

*"Sarbanes-Oxley has distracted management from the business of doing business and focused them on documentation, satisfying additional layers of regulation, and that has caused a transfer of energy away from business and profits away from shareholders"*

**- PAUL SHARMAN, president and CEO of  
the Institute of Management Accountants**



## Criticisms of Sarbanes-Oxley

*"There is no question in my mind that the implementation [of SOX Section 404] has been misdirected,"*

*"What was meant to be a top-down, risk-focused management exercise became a bottom-up, 'check the box,' auditor-driven exercise."*

**- CYNTHIA A. GLASSMAN, commissioner and acting chair of the Securities and Exchange Commission**

*"I fear that in the current environment, many executives feel as if they aren't working hand in hand, but are actually in hand-to-hand combat with their auditors as they go through the 404 process!"*

**- PAUL S. ATKINS, commissioner of the Securities and Exchange Commission**



## Praise of Sarbanes-Oxley

*"Sarbanes-Oxley is admittedly costly, but it does address precisely the weaknesses noted in smaller public companies that have fraudulently misstated their financial results....Public companies and their investors will benefit from strong governance and effective internal controls."*

**- DANA R. HERMANSON, Ph.D. Professor of  
Accounting Kennesaw State University**

*"Firms that operate with candor, integrity and engagement are most likely to survive and thrive."*

**- DON TAPSCOTT AND DAVID TICOLL, Authors, *The Naked Corporation***



## Praise of Sarbanes-Oxley

*"To investors, Sarbanes-Oxley is the most important financial market legislation in the last 70 years."*

*"It requires corporate managers to institute strong governance reforms, directors to oversee these reforms on behalf of investors, and managers to assume responsibility for the accuracy of the financial information they provide to investors."*

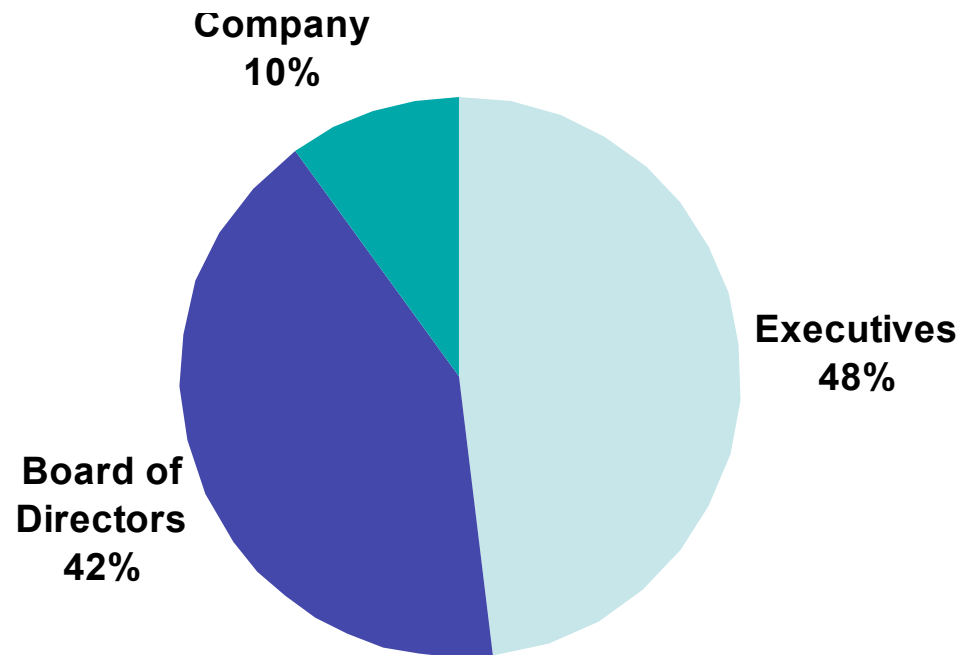
**- REBECCA MCENALLY, vice president of advocacy  
at the CFA Institute**

*"SOX could have a silver lining. Here's why. You have to comply anyway or go to jail; it's the law no going back."*

**- RICH KARLGAARD, Publisher, Forbes**



## **"In your opinion, should punishment for poor corporate governance be directed at...?"**

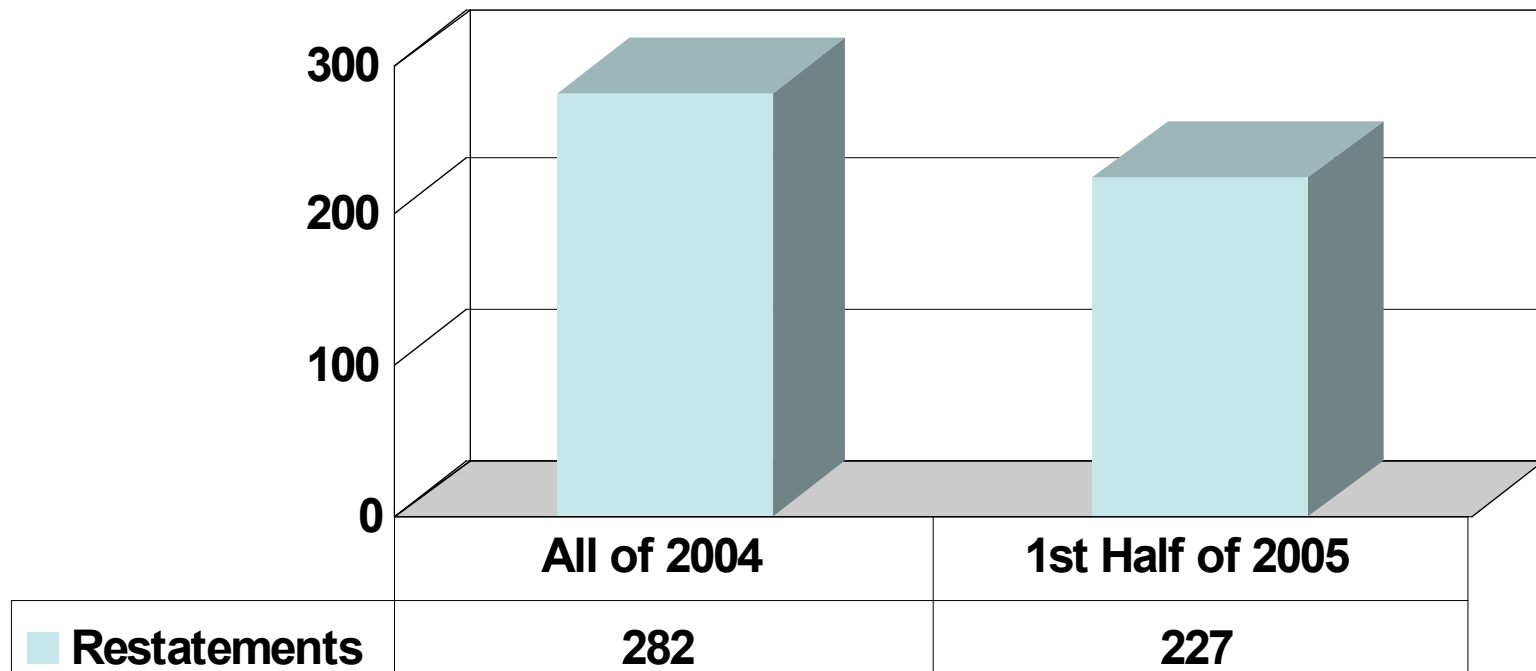


**Source: Wall Street Journal Poll**



## Three Years After Sarbanes-Oxley's Introduction, What's the Verdict?

### New Higher Standards Increase Financial Restatements



Source: The Wall Street Journal



## **Unintended Consequences for Investors**

- ✓ **Fewer Opportunities If Small Companies Go Private to Avoid Costs**
- ✓ **Small Companies' Intrinsic Values and Buyout Prices May Decrease**
- ✓ **Reduced Capital Market Access Hurts Competition and Innovation**
- ✓ **SOX Raises Cost of Capital and Lowers Investors' Rate of Return**



## **Suggestions for Improvements to SOX Regulation**

- ✓ Provide Less Costly Alternatives for Small Businesses**
- ✓ Create a Risk-Based Auditing Approach**
- ✓ Finalize the Regulations and Provide Detailed Guidance**
- ✓ Clarify the Role Auditors May Play**
- ✓ Push for Global Adoption of SOX Type Regulation**



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**Q&A**