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Krispy Kreme, Sarbanes-Oxley, and Corporate Greed

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KRISPY KREME, SARBANES-OXLEY, AND CORPORATE GREED

CRISTINA MICHELLE DECELESTINO

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I. INTRODUCTION

Business news has started to sound like a Shakespearean tale – filled with deception, theft, and greed. The rise and fall of major corporate powerhouses, such as Enron and WorldCom, have made phrases, like “pervasive accounting violations” and “improper financial disclosure,” part of everyday conversations. Average investors lost not only fortunes, but also their faith in Corporate America. They turned to Congress and cried out, “Corporate governance!” In 2002, Congress responded with The Sarbanes-Oxley Act—the most dramatic legislation of federal securities since the 1930s.

Sarbanes-Oxley radically redesigns the federal regulation of corporate governance and reporting. Its purpose is to prevent future scandals and restore investor confidence by creating the Public Company Accounting Oversight Board, revising auditor independence rules and corporate governance standards, expediting financial reporting, and increasing criminal penalties for violations of securities laws. Sarbanes-Oxley has focused corporate governance on the creation of an “adequate internal control structure and procedures for financial reporting.”

In spite of completely overhauling the accounting and auditing professions, some critics of Sarbanes-Oxley claim that the Act is ineffective and does not *prevent* fraud. Sarbanes-Oxley merely adds to an already-long laundry list of accounting and disclosure rules and perhaps ignores the root cause of all of the scandals—human greed. A perfect example in Corporate America of a tale of woe created by greed is Krispy Kreme Doughnuts.

At one time, Krispy Kreme Doughnuts was the example of corporate glory. From its humble beginnings in Winston-Salem, North Carolina this bakery grew into a nationwide retailer of doughnuts. Already a successful stock on the public capital markets, Krispy Kreme became a phenomenon when it positioned itself as a safe, straightforward business model in the wake of the Enron accounting scandal. Unfortunately, Krispy Kreme became addicted to this fame, and the company started to look for ways to report exceptional growth even during business downturns. In 2004, the Securities and Exchange Commission (SEC) launched an investigation into the company's overly aggressive accounting policies that overstated earnings. Then, Krispy Kreme's empire crumbled under shareholder, franchise, and employee lawsuits and criminal charges, exposing its manipulation of investors through improper accounting, misleading statements, and policies of deception. Investors were shocked, as what should have been an icon for success in marketing and stock performance became another calamity of human greed.

The irony of Krispy Kreme's tragedy is that it is juxtaposed with the corporate governance overhaul of Sarbanes-Oxley. Krispy Kreme may be an extreme example of fraudulent accounting, but is not that what Sarbanes-Oxley was supposed to prevent? Perhaps accounting legislation is not the best method for preventing major corporate fraud. Perhaps fraud is not merely violations of federal securities law, but, instead, manifestations of the sins of a greedy corporate culture.

Part II of this article discusses the rise and fall of Krispy Kreme positioned next to the accounting reforms of Sarbanes-Oxley. This section also discusses the controversy surrounding Sarbanes-Oxley's reforms, as well as major areas of business that Sarbanes-Oxley fails to address. Part III of this article proposes alternatives for preventing accounting fraud. This section discusses new roles for independent auditors and principles-based accounting, as well as the creation of "ethics as a corporate asset." It uses Krispy Kreme as an example of how accounting rules do not adequately address the root of corporate scandal – human greed. This article proposes that to overcome human greed, corporations should implement and enforce internal ethics programs at all levels of the corporate hierarchy, restructure rewards and compensation systems to remove the incentive for fraudulent behavior, and require that top executives act as icons for corporate integrity.

II. THE INGREDIENTS

A. *Krispy Kreme—The Concept*

Krispy Kreme is a leading retailer of premium doughnuts that sells close to three billion doughnuts a year.¹ Krispy Kreme has over three hundred fifty stores (both company-owned and franchises) in operation² and almost seven thousand employees.³ Its customers go crazy over its Hot Original Glazed Doughnut. Its stores feature a “doughnut theater,” where customers watch doughnuts being made.⁴

Outside of its retail stores, Krispy Kreme distributes its doughnuts through multiple channels. For example, Krispy Kreme sells prepackaged doughnuts in grocery and convenience stores and fresh doughnuts at universities, industrial centers, and sports and entertainment venues.⁵ It also controls its Cost of Goods Sold with a vertically integrated supply chain, which provides the doughnut mixes, production equipment, and coffee to its stores, both company-owned and franchises.⁶

1. WALL STREET'S FAVORITE DOUGHNUT

In 1937, Krispy Kreme started selling its Hot Original Glazed Doughnuts to customers on the sidewalk from a hole in a building in Winston-Salem, North Carolina. By 1999, Krispy Kreme had coast-to-coast sales of nearly \$220.2 million, and was ready to become a major national retailer with the help of the public financial markets.⁷ On April 5, 2000, Krispy Kreme offered its common stock on NASDAQ under the ticker KREM,⁸ raising \$63 million for three million shares (\$21 per share⁹). Within three days, its stock

¹ CORPORATE FACT SHEET (2006), at <http://phx.corporate-ir.net/phoenix.zhtml?c=120929&p=irol-pubfactsheet>.

² Krispy Kreme Doughnuts Inc., Quarterly Report (Form 10-Q), at 31 (Nov. 9, 2006).

³ Krispy Kreme Doughnuts Inc., Annual Report (Form 10-K), at 15 (April 16, 2004) [hereinafter *2004 Annual Report*].

⁴ CORPORATE OVERVIEW (2007), at <http://phx.corporate-ir.net/phoenix/zhtml?c=120929&p=irol-homeprofile>.

⁵ *2004 Annual Report*, *supra* note 3, at 4.

⁶ *Id.* at 5.

⁷ Alex Salkever, *Before You Bite Into Krispy Kreme...*, BUS. WK. ONLINE, Apr. 10, 2000, at <http://www.businessweek.com/bwdaily/dnflash/apr2000/sw00410.htm>.

⁸ *Id.*

⁹ *Id.*

price almost doubled,¹⁰ and, in September, it reached \$103 per share.¹¹ Krispy Kreme was the second most successful IPO of 2000.¹²

On May 17, 2001, Krispy Kreme transferred its common stock from NASDAQ to the New York Stock Exchange, changing its ticker to KKD.¹³ The day before the transfer, Krispy Kreme reported that its first-quarter net income rose 89% from the previous year.¹⁴ It closed its fiscal year in February of 2002 with annual sales totaling \$394.4 million¹⁵ and a stock price of \$39.02 per share, following a two-for-one stock split in June, 2001.¹⁶ Krispy Kreme's stock performance had become even more famous than their doughnuts!

During Krispy Kreme's 2002 fiscal year, the financial markets were haunted by the terrorist attacks on September 11th and the aftermath of the Enron bankruptcy scandal, which involved corporate abuse by Enron's executives and accounting fraud related to "off-balance-sheet" investments. Enron's demise sparked investor skepticism in the financial markets, major restructuring within the Big Five accounting firms, and the strengthening of the SEC's enforcement power.¹⁷

Nervous investors turned to companies with straightforward business models—like a simple American doughnut shop. Krispy Kreme capitalized on its traditional, brick-and-mortar business structure and welcomed investors weary from the technology bubble's explosion. However, in 2002, these investors were surprised by Krispy Kreme's sudden announcement that the company was abandoning an off-balance-sheet financing plan called a "synthetic lease" in favor of a \$35 million manufacturing and distribution center.¹⁸ The

¹⁰ *Id.*

¹¹ Aney Stone, *How Far Have Net Stocks Fallen? The KREMEY Knows*, BUS. WK. ONLINE, Oct. 20, 2000, at http://www.businessweek.com/bwdaily/dnflash/oct2000/nf20001020_117.htm.

¹² *Id.*

¹³ Press Release, Krispy Kreme Doughnuts Inc., *Krispy Kreme Begins Trading Tomorrow on the New York Stock Exchange; New Ticker Symbol is 'KKD'* (May 16, 2001), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2001 Releases" hyperlink; then follow "Krispy Kreme Begins Trading Tomorrow on the New York Stock Exchange; New Ticker Symbol is 'KKD'" hyperlink).

¹⁴ Davide Dukcevic, *Winner of the Week: Krispy Kreme*, FORBES.COM, May 18, 2001, at <http://www.forbes.com/2001/05/18/0518krispy.html>.

¹⁵ *2004 Annual Report*, *supra* note 3, at 23.

¹⁶ CNNMoney.com, *Krispy Kreme Doughnuts Inc. Historical Stock Quote from Feb. 1, 2002*, at http://money.cnn.com/quote/historical/historical.html?shownav=true&pg=hi&close_date=2%2F1%2F2002&symp=KKD&time=2mo (last visited March 2, 2007).

¹⁷ See Editorial, *The Wrath of the Investor Class*, BUS. WK. ONLINE, Feb. 25, 2002, at http://www.businessweek.com/magazine/content/02_08/b3771134.htm.

¹⁸ Ari Weinberg, *Krispy Kreme Changes Its Plant Financing*, FORBES.COM, Feb. 12, 2002, at <http://www.forbes.com/2002/02/12/0212synthetic.html>.

company decided to leverage the project with more traditional, on-balance-sheet debt. The Chief Executive Officer (CEO), Scott A. Livengood, eased investors' concerns by stating that "[i]n the current economic climate, investors understandably are paying closer attention to the financial strength of their companies. There is no reason for us to do anything that could be misinterpreted, regardless of how legal and acceptable it may be."¹⁹ In addition to its debt restructuring, Krispy Kreme announced that, in the interests of candor, it would accelerate its disclosures of proposed stock sales by its senior executives.²⁰

Furthermore, Livengood emphasized the company's strong sense of values:

Having a set of both brand values and internal cultural values, which is clearly expressed and widely communicated, has been and remains a key priority. As part of that effort [to become a global company] we must make sure we are transparent about our governance, our values, and our aspirations to all our constituencies.²¹

Krispy Kreme hoped that its candor would reestablish investor confidence; which it did. It was credited with the most creative response to an investment environment tainted by September 11th and corporate scandal.²²

In its 2003 fiscal year, Krispy Kreme continued to capitalize on investor hunger for growth stocks in the context of a general market decline. On August 19, 2003, Krispy Kreme shares closed at \$49.20 per share²³—a 235% increase from its initial public offering price on NASDAQ because of its apparent overwhelming success.²⁴ Fortune Magazine called Krispy Kreme "the hottest brand in the land."²⁵

¹⁹ *Id.*

²⁰ *Krispy Kreme Speeds Disclosure on Stock Sales*, TRIANGLE BUS J., Mar. 26, 2002, available at <http://www.bizjournals.com/triangle/stories/2002/03/25/daily19.html>.

²¹ WILLIAM DUNK'S 2002 ANN. REP. ON ANN. REPORTS, LONG ON WORDS; SHORT ON IDEAS: KRISPY HAS RIGHT RECIPE, GLOBAL PROVINCE, at <http://www.globalprovince.com/2002ar.htm> (last visited March 2, 2007).

²² *Id.*

²³ CNNMoney.com, *Krispy Kreme Doughnuts Inc. Historical Stock Quote* from Aug. 19, 2003, at http://money.cnn.com/quote/historical/historical.html?shownav=true&pg=hi&close_date=8%2F19%2F03&symp=KKD&time=5yr (last visited March 2, 2007).

²⁴ Kate O'Sullivan, *Kremed!*, CFO MAGAZINE, June 1, 2005, available at <http://www.cfo.com/printable/article.cfm/4007436?f=options>. Krispy Kreme's 2-for-1 stock split on June 14, 2001 is reflected in the return on the investment (ROI) from the IPO to August 19, 2003.

²⁵ *Id.*

2. IT'S GETTING HOT IN THE KITCHEN

Despite Krispy Kreme's fanatical popularity with investors and consumers alike, the company's fall from grace was fast and severe. On May 7, 2004, Livengood shocked Wall Street with his announcement that expected diluted earnings per share from continuing operations would be 10% lower than its previously announced guidance.²⁶ Krispy Kreme blamed an increasing consumer interest in low-carbohydrate diets, which had been affecting demand across all flour-based food categories.²⁷ Furthermore, Krispy Kreme announced that it would divest its bread bakery division, Montana Mills, by closing a majority of the bakeries and selling the remaining stores.²⁸ This divestiture would result in a non-cash pre-tax asset impairment charge of \$34 million.²⁹ The company also began closing under-performing Krispy Kreme Doughnut stores and its franchises began filing for bankruptcy.³⁰

Krispy Kreme's troubles continued. On October 7, 2003, Krispy Kreme announced that the SEC had begun a formal investigation into the company's buyback of several of its doughnut franchises.³¹ Krispy Kreme denied any improper practices. However, independent accounting experts speculated that company executives used aggressive accounting to increase earnings from the purchase of franchises.³² These buyouts created intangible assets, "reacquired franchise rights," which Krispy Kreme did not amortize because it assigned the assets indefinite lives.³³ If the assets had been amortized,³⁴ non-cash amortization charges would have significantly reduced earnings. Krispy Kreme also did not disclose that some of the sellers of the franchises included the CEO's ex-wife, a chairman of the board, a former chief executive, and a non-

²⁶ Press Release, Krispy Kreme Doughnuts Inc., In Response to Recent Industry Dynamics, Krispy Kreme Updates Business Outlook (May 7, 2004), at http://www.krispykreme.com/investor_relations.html (follow "NEWS RELEASES" hyperlink; then follow "2004 Releases" hyperlink; then follow "In Response to Recent Industry Dynamics, Krispy Kreme Updates Business Outlook" hyperlink).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ Brian Louis, *Stock in Krispy Kreme Doughnuts Drops on Inquiry News, Profit Warning*, WINSTON-SALEM JOURNAL, July 30, 2004, available at 2004 WLNR 14528002.

³² Brian Louis, *Krispy Kreme Under SEC Investigation for Franchisee-buying Strategy*, WINSTON-SALEM JOURNAL, August 17, 2004 available at 2004 WLNR 14528789.

³³ *Id.*

³⁴ Most companies that buy franchise markets do amortize "reacquired franchise rights." Although Krispy Kreme's decision not to amortize this asset was the most aggressive approach, it was not clearly a violation of generally accepted accounting principles (GAAP).

voting member of the board.³⁵ The sellers' relationships with Krispy Kreme were important, because investors suspected that the company significantly overpaid for the franchises involved in the buyback program.³⁶

3. NOW THERE'S A FIRE

As Krispy Kreme's stock price plunged, its shareholders filed derivative lawsuits against Krispy Kreme, its executives, and its independent audit firm, PricewaterhouseCoopers LLP (Pricewaterhouse.) The lawsuits alleged that Krispy Kreme, its executives, and its auditors knew that sales were slowing long before issuing a profit warning in May 2004 and that executives violated securities laws by releasing false financial statements and by issuing false and misleading guidance about Krispy Kreme's revenue and earnings.³⁷ Additionally, the suits alleged that Pricewaterhouse turned a blind eye to the violations "in order to retain Krispy Kreme as a client and to protect the fees it received from Krispy Kreme."³⁸

Troubles extended beyond stock price—Krispy Kreme's average weekly doughnut sales plunged as well, even as new stores opened.³⁹ Franchisees claimed that some stores were getting inflated shipments of corporate-supplied raw materials in the final weeks of a quarter so that corporate would meet its sales goals.⁴⁰ They also claimed that Krispy Kreme shipped high-margin doughnut-making equipment to the stores, long before the stores wanted it—the timing based solely on the corporate financial reporting schedule. Finally, franchisees alleged that Krispy Kreme sold equipment to them, recorded the sales on corporate financial statements, and then bought back the same equipment.⁴¹

In 2005, Krispy Kreme announced that it would restate its financial statements for 2004 as the reported information was not reliable.⁴² The company estimated adjustments related to the franchise buybacks totaling

³⁵ Louis, *supra* note 32.

³⁶ *Id.*

³⁷ Brian Louis, *Krispy Kreme Doughnuts Inc.'s Auditor Added as Defendant in Shareholder Lawsuit*, WINSTON-SALEM JOURNAL, February 23, 2005, available at 2005 WLNR 2781363.

³⁸ *Id.*

³⁹ O'Sullivan, *supra* note 24.

⁴⁰ *Id.*

⁴¹ Mark Maremont & Rick Brooks, *Krispy Kreme Probe Blasts Ex-Managers Over Accounting*, GLOBE AND MAIL (Toronto), Aug. 11, 2005, at B13, available at 2005 WLNR 12635940.

⁴² Press Release, Krispy Kreme Doughnuts Inc., Krispy Kreme Announces Decision to Restate Financial Statements (Jan. 4, 2005), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2005 Releases" hyperlink; then follow "Krispy Kreme Announces Decision to Restate Financial Statements" hyperlink).

between \$6.2 and \$8.2 million to pre-tax income for the previous fiscal year.⁴³ However, the company could not file its past-due quarterly reports for 2005 or its restated 2004 financial statements until it completed its own internal investigation of these matters.⁴⁴ Then, Krispy Kreme replaced Livengood with Stephen Cooper, a restructuring specialist, as interim CEO.⁴⁵

When Krispy Kreme seemed to have hit rock bottom, the company announced that the U.S. Attorney's Office for the Southern District of New York had begun an investigation for criminal misconduct related to the matters also under investigation by the SEC.⁴⁶ Then Krispy Kreme's employees filed a lawsuit against the company's executives for withholding information, which included mismanagement and risky, inappropriate accounting practices that artificially inflated the company's stock, and that the executives' actions caused the employees exorbitant losses in 401(k) accounts and profit-sharing plans which held the company stock.⁴⁷

In April of 2005, the company procured \$225 million in new financing, which it used to pay off approximately \$100 million in outstanding debt, fees and expenses related to its refinancing and restructuring, and provide cash for operations.⁴⁸ At the same time, the company warned investors not to rely on its published financials for fiscal years 2001, 2002, 2003, 2004, and three quarters

⁴³ *Id.*

⁴⁴ *Id.* Krispy Kreme's failure to deliver its financial statements to its lenders by the deadlines constituted a default of approximately \$100 million in outstanding debt; however, its lenders waived the right to terminate the credit facility. *Id.*

⁴⁵ Press Release, Krispy Kreme Doughnuts Inc., Krispy Kreme Announces Management Changes (Jan. 18, 2005), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2005 Releases" hyperlink; then follow "Krispy Kreme Announces Management Changes" hyperlink). Cooper was also the interim CEO, President and Chief Restructuring Officer of Enron. *Id.*

⁴⁶ Press Release, Krispy Kreme Doughnuts Inc., Krispy Kreme Announces Additional Governmental Investigation (Feb. 24, 2005), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2005 Releases" hyperlink; then follow "Krispy Kreme Announces Additional Governmental Investigation" hyperlink).

⁴⁷ Brian Louis, Worker Sues Krispy Kreme Subsidiary over Mismanagement of Pension Plans, WINSTON-SALEM J., Mar. 11, 2005, available at 2005 WLNR 3770624; see also Richard M. Barron, Krispy Kreme Lawsuit Targets Executives for 401(k) Losses, GREENSBORO NEWS & RECORD, Mar. 10, 2005, at A1, available at 2005 WLNR 3754893. The employees allege over \$4 million in losses for their 401(k) accounts and almost \$15 million in their profit-sharing plans. See Brian Louis, Worker Sues Krispy Kreme Subsidiary over Mismanagement of Pension Plans, WINSTON-SALEM J., Mar. 11, 2005, available at 2005 WLNR 3770624.

⁴⁸ Press Release, Krispy Kreme Doughnuts Inc., Krispy Kreme Announces \$225 Million Financing (Apr. 4, 2005), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2005 Releases" hyperlink; then follow "Krispy Kreme Announces \$225 Million Financing" hyperlink)

of fiscal year 2005.⁴⁹ Krispy Kreme finally started to file these financial statements in April of 2006, after going well over a year without any disclosure.⁵⁰ Throughout 2006, Krispy Kreme continued its corporate overhaul in an effort to turn the company around—hiring Daryl Brewster, an expert in the food industry, as President and CEO: closing nearly 100 stores, settling numerous lawsuits with employees, franchisees, and shareholders for millions of dollars; and expanding into Asia and the Middle East.⁵¹ Despite these efforts, Krispy Kreme closed the 2006 calendar year with a stock price of \$11.10.⁵²

B. *The Sarbanes-Oxley Act*

1. SARBANES-OXLEY MAKES A MESS

The details of this saga of corporate fraud and deception at Krispy Kreme are appalling. However, Krispy Kreme's story is even more disturbing in the context of the corporate governance movement after the Enron scandal. After the Enron scandal and the subsequent dissolution of the accounting and consulting firm, Arthur Anderson, investor skepticism led investment analysts to uncover numerous other corporate accounting scandals in major U.S. firms, such as WorldCom and Adelphia Communications.⁵³ Congress thereafter responded by enacting the Sarbanes-Oxley Act on July 30, 2002. The Sarbanes-Oxley Act is the most significant federal securities legislation since the 1930s. Its purpose is to target corporate corruption and restore investor trust in U.S. corporations.⁵⁴ The Act focuses on disclosure and risk management and the auditing and reporting of financial information to investing communities and the SEC.⁵⁵

⁴⁹ O'Sullivan, *supra* note 24.

⁵⁰ Press Release, Krispy Kreme Doughnuts Inc., Krispy Kreme Files Form 10-K for the Fiscal Year Ended January 30, 2005 (Apr. 28, 2006), at <http://www.krispykreme.com/investorrelations.html> (follow "NEWS RELEASES" hyperlink; then follow "2006 Releases" hyperlink; then follow "Krispy Kreme Files Form 10-K for the Fiscal Year Ended January 30, 2005" hyperlink).

⁵¹ Howard W. Penney, *Prudential Sweet Talks Krispy Kreme*, BUS. WK. ONLINE, Oct. 27, 2006, at http://www.businessweek.com/print/investor/content/oct2006/pi20061027_411078.htm.

⁵² CNNMoney.com, Krispy Kreme Doughnuts Inc., Historical Stock Quote from Dec. 29, 2006, at http://money.cnn.com/quote/historical/historical.html?pg=hi&close_date=12%2F29%2F06&symb=KKD&time=1mo (last visited March 2, 2007).

⁵³ Dave Taylor, *What is Sarbanes Oxley and Why Does It Change Everything?*, ASKDAVE TAYLOR.COM, at http://www.askdaveytaylor.com/what_is_sarbanes_oxley_and_why_does_it_change_everything.html (last visited on March 2, 2007).

⁵⁴ *Id.*

⁵⁵ *Id.*

The most significant provisions address financial reporting, corporate accountability, and the role of the independent auditor. The reporting provisions include expediting financial disclosures such as annual reports (from 90 to 60 days) and quarterly reports (from 45 to 35 days), accelerating disclosures of trades by insiders (from 40 days to the second day following the transaction), and mandating public disclosure of CEO and CFO compensation and profits.⁵⁶

Requiring CEOs and CFOs to personally certify the accuracy of financial statements has increased executive accountability, as the submission of false statements carries with it a penalty of up to twenty years in jail.⁵⁷ In addition, executives and directors are prohibited under Sarbanes-Oxley from obtaining personal loans from their corporations.⁵⁸

The auditor provisions include a requirement of auditor independence and a prohibition on auditing firms offering value-added, business-consulting services. Public companies are also required to have an internal audit group, which must be certified by external auditors. Furthermore, the Act established the Public Company Accounting Oversight Board to regulate auditing practices.⁵⁹

Although Sarbanes-Oxley may seem to codify “obvious” requirements of a safe investment community, its consequences reveal that investors probably needed additional federal protections. In 2004, 414 public companies restated their financial reports, up from 323 in 2003 and 330 in 2002 (the year of enactment).⁶⁰ The three most frequent causes of financial restatements were revenue recognition (16.4% in 2004), equity accounting (16% in 2004), and reserves, accruals, and contingencies (14.1% in 2004).⁶¹ These restatements reveal some level of effectiveness of Sarbanes-Oxley. Most importantly, multiple-period restatements, like Krispy Kreme’s reporting situation, demonstrate that Sarbanes-Oxley can effectively point to extremely flawed internal controls and overly aggressive accounting policies.⁶²

⁵⁶ Jonathan Schwartz, *Sarbanes Oxley Act: A Matter of Trust*, PARALLAX ONLINE—THE JOURNAL OF ETHICS AND GLOBALIZATION, at <http://www.parallaxonline.org/sarbanesoxley.html> (last visited March 2, 2007).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ Len Boselovic, *Accounting Miscues Becoming More Common in Corporate America*, PITTSBURGH POST-GAZETTE, Jan. 24, 2005, at B1, available at 2005 WLNR 969490.

⁶¹ Taylor, *supra* note 53.

⁶² Boselovic, *supra* note 60. However, Krispy Kreme did not restate its financials simply because of the Sarbanes-Oxley legislation. Krispy Kreme’s restatements were a result of the SEC’s formal investigation of violations of Sarbanes-Oxley and numerous lawsuits by investors, employees, and franchisees.

In spite of the numerous restated financial reports, many critics of the Act have argued that it has the potential to do more harm than good. Because Sarbanes-Oxley is more reactive than proactive, critics feel that Congress did not fully explore the impact of the Act on, not only law-breaking corporations, but also law-abiding corporations.⁶³ Critics have argued that the Act could have been more efficient if it targeted corporations with questionable practices, rather than arbitrarily adding more rules that impact the financial operations of every public company.⁶⁴ In the wake of mass media attention to the major corporate scandals of 2001 and 2002, every public company must prove its integrity to the investment and enforcement communities.⁶⁵ “The irresponsible acts of a few have tainted the image of many to the point where guilt is now presumed over innocence.”⁶⁶

The Sarbanes-Oxley Act has met extreme resistance from the law-abiding corporate community, because full compliance has proven extremely expensive.⁶⁷ Corporate accountants and internal and independent auditors have struggled with implementing the Act, which regulates almost every level of accounting practice. These high costs of compliance have been extremely burdensome on smaller companies with limited financial, structural, and human resources.⁶⁸

The auditing industry has undergone the most drastic change as a result of Sarbanes-Oxley’s prohibition of the provision of value-added, business consulting services by audit firms. For example, two of the largest professional services firms in the world, Deloitte & Touche and PriceWaterhouse were forced to divest their consulting divisions for fear of accusations of conflicts of interest with their audit divisions.⁶⁹ However, in order to effectively audit, auditors must analyze and evaluate its corporate customers’ entire strategies and operations. Now, independent audit firms must limit their involvement in their customers’ operations, even though consulting services would provide insight

⁶³ Schwartz, *supra* note 56.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ Sarbanes-Oxley compliance costs average \$16 million per company. Jack Martin, *Tightening the Reins*, WEBSPHERE JOURNAL, Jan. 4, 2005, at <http://websphere.sys-con.com/read/47651.htm>.

⁶⁸ Mark Jaffe, *Sarbanes-Oxley Exposes Missteps amid Cost Gripes (Update2)*, BLOOMBERG.COM, at <http://quote.bloomberg.com/apps/news?pid=nifea&&sid=a9Ho3njHvEiA> (last visited March 2, 2007). Small companies must earn an additional \$10 million in revenues per year in order to finance their Sarbanes-Oxley compliance. *Sarbanes Oxley Section 404: What is the Proper Balance Between Investor Protection and Capital Formation for Smaller Public Companies?: Hearing on Sarbanes Oxley 404 Relief before the H. Small Business Comm.*, 109th Cong. 1-8, 2, (2006) (written statement by Keith Crandell, Managing Director, AACH Venture Partners).

⁶⁹ Schwartz, *supra* note 56.

into customers' true financial situations. This results in a reduction in company-specific knowledge during the audit, which will, in turn, reduce the quality of the auditor's risk assessment.⁷⁰

In addition to its broad scope, Sarbanes-Oxley is also controversial for the business practices that it fails to address. The legislation does not provide guidance on how to prevent managers within public corporations from overriding internal controls. The crucial role of the manager as an executor of the Act highlights the importance of executive supervision and oversight. Mid-level managers' failure to implement Sarbanes-Oxley's new controls has resulted in additional corporate scandals at major companies, such as HealthSouth.⁷¹ Furthermore, the enforcement of Sarbanes-Oxley so far has failed to require all CEOs and CFOs to repay bonuses, stock-option gains, and other stock-based compensation based on false financial reports that are later restated. This repayment should be mandatory when a corporation fails to comply with financial reporting requirements because of any internal misconduct.⁷²

2. SARBANES-OXLEY DID NOT PUT OUT THE FIRE

Sarbanes-Oxley has increased the focus upon corporate accounting processes. However, in spite of this increased attention, questionable financial management still occurs within this system of seemingly tight internal controls.⁷³ The case of Krispy Kreme, as well as those of Nortel and Fannie Mae, illustrate that accounting scandals are still prevalent in this era of Sarbanes-Oxley.⁷⁴ Critics argue that Sarbanes-Oxley will never be enough to curb the investing community's appetite for earnings. The pressure to "beat the Street" has not disappeared, nor have compensation incentives, such as stock-option plans, bonuses, and profit sharing for corporate employees. Additionally, performance-based compensation for financial fund managers and investment bankers and analysts fuel the desire for earnings growth.

Huge compensation packages for corporate executives have been blamed for the prevalence of corporate accounting fraud. A large portion of executive

⁷⁰ Richard H. Gifford & Harry Howe, *Regulation and Unintended Consequences: Thoughts on Sarbanes-Oxley*, CPA J., June 1, 2004, at J. 6, available at <http://www.nysscpa.org/cpajournal/2004/604/perspectives/p6.htm>.

⁷¹ Boselovic, *supra* note 60.

⁷² *Id.*

⁷³ Ira M. Millstein, *Mastering Corporate Governance, Part 2: When Earnings Management Becomes Cooking the Books—The Line Between Legitimate and Inappropriate Accounting Techniques Can Be a Blurry One, but the Audit Committee Must Endeavor to Make a Clear Distinction*, 1506 PRACTICING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 17, 23-25 (2005).

⁷⁴ *Id.*

compensation takes the form of stock options. Although disclosed in the footnotes of corporate financial statements, these stock options were not accounted for as costs and had no ultimate effect on the bottom line, unlike other forms of employee compensation.⁷⁵ Employers became more generous with stock options as compensation, which served only to increase the executives' personal stakes in the employer's stock prices. This personal stake created a strong incentive to pump up the stock price, and, in turn, for these executives to shield bad news away from Wall Street.⁷⁶ For example, under Mr. Livengood's direction, Krispy Kreme set an objective of beating analysts' earnings expectations by a penny a quarter, tying executive bonuses directly to this goal.⁷⁷ The fact that bonuses were tied to this objective created a major incentive for executives to hide bad news from their corporate superiors, as well as from the investment community. Unfortunately, personal desires for higher compensation may motivate corporate executives to ignore good judgment and disclosure rules, as evidenced by Krispy Kreme.

III. A NEW RECIPE

A. *The Auditors Come to the Kitchen*

Because of these pressures from "the Street," auditing committees play key roles in ensuring a safe investment environment.⁷⁸ Although accounting is considered a technical profession, corporate accountants actually have considerable creative freedom in making discretionary judgments. Accounting artistry is not limited to large financial transactions, which may attract the critical eyes of the investment community. In very small ways, corporate accountants decide not only *if*, but *when*, to recognize earnings, expenses, gains, and losses. These decisions, especially when aggregated, significantly affect the financial positions of companies, given the annual reporting approach for publicly traded companies. Corporate accountants may rely on generally accepted accounting principles (GAAP) when evaluating these judgment-calls; however, GAAP may not always ensure that the true nature of a financial transaction is disclosed to investors. Krispy Kreme's overly aggressive accounting schemes did not clearly violate GAAP; however, its required restatements demonstrate that its

⁷⁵ MARK JICKLING, ACCOUNTING REFORM AFTER ENRON, ISSUES IN THE 108TH CONGRESS CRS-2 (Congressional Research Service, Library of Congress) (2003) (Order Code RS21530).

⁷⁶ *Id.*

⁷⁷ George Anderson, *Report Issued on Krispy Kreme's Mess*, RETAILWIRE.COM, Aug. 11, 2005, at <http://www.retailwire.com/Print/PrintDocument.cfm?DOC ID=10839>.

⁷⁸ Millstein, *supra* note 73, at 24.

accounting policies did not sufficiently disclose the true nature of its financial transactions.

Therefore, the role of independent auditors should be to ensure that the corporate accountants have revealed to investors the true substance of the “deal.” Sarbanes-Oxley could have achieved this result simply by requiring that auditors certify that publicly-filed financial reports actually give “a true and fair view of the state of affairs of the company, and that reasonable and prudent judgments and estimates have been made, especially regarding revenue recognition, expenses, and other items that may involve earnings management.”⁷⁹ Sarbanes-Oxley should have required that independent auditors certify quarterly reports as well as the annual reports, in order to identify questionable practices as soon as they arise.⁸⁰ If Sarbanes-Oxley had required this certification it would have refocused the auditing process on “quality and fairness in substance, and beyond accounting mechanics and structure.”⁸¹ Then, an independent auditor could attest, in good faith, to the “discretionary judgments resolved in management’s favour to effect a better earnings picture both currently and looking forward, notwithstanding compliance with GAAP.”⁸²

Under this model, the independent auditor’s role would be to candidly prepare an assessment of a company’s risk management. This type of assessment on the *quality* of the company’s accounting principles as applied in its financial reporting would be a stronger safeguard for investors when compared to the current standard, which only assesses the *acceptability* of the company’s accounting practices.⁸³ Then, the independent auditors would be forced to include corporate policies that promote overly aggressive accounting, such as Krispy Kreme’s, in a company’s risk assessment, rather than merely determining the policies’ compliance with GAAP. If PriceWaterhouse had used such a standard for Krispy Kreme, it could have alerted investors to Krispy Kreme’s arguably legal, yet overly aggressive and inappropriate accounting practices, such as the assignment of indefinite lives to its “reacquired franchise rights,” its overpayment for franchise buybacks from corporate insiders, and its manipulation of the timing of its sales within its internal supply chain.

⁷⁹ *Id.* at 25.

⁸⁰ Todd Wenning, *Steer Clear of Accounting Shenanigans*, THE MOTLEY FOOL, Oct. 7, 2006, at <http://www.fool.com/news/commentary/2006/commentary06100701.htm>.

⁸¹ Millstein, *supra* note 73, at 25.

⁸² *Id.*

⁸³ *Id.* at 22.

B. PRINCIPLES-BASED ACCOUNTING ADDS A NEW TWIST

In addition to this new role for the corporate auditor, the policies of corporate accounting should also be more properly aligned with representing a “true and fair view of the state of affairs of the company,”⁸⁴ rather than simply following the technical rules created by GAAP. Sarbanes-Oxley is largely focused on adding more rules to the already cumbersome GAAP handbook. However, the legislation also calls for the SEC to investigate an alternative accounting system, called principles-based accounting.⁸⁵ The general idea here is that instead of a whole handbook of technical rules, corporate accounting should be based on a few general principles requiring “accountants to produce a true and fair picture of the economic reality of a company’s finances.”⁸⁶ The chairman of the Financial Accounting Standards Board (FASB) endorsed principle-based accounting, because under the current model, “People see the trees and not the forest.”⁸⁷ However, some accounting experts fear that principles-based accounting would merely lead to selective implementation of financial regulations because of great confusion over the legality of various practices.

C. Corporate Ethics—The Most Important Ingredient

1. GREED HAS A BAD AFTERTASTE

Principles-based accounting embodies the idea that GAAP and Sarbanes-Oxley, and any other laundry list of regulations, will not completely prevent corporate fraud. Accounting scandals do not arise solely from thwarting the rules and regulations. Instead, they are manifestations of major human flaws: a fascination with risk-taking and greed.⁸⁸ Because Congress cannot legislate away “greed,” perhaps the best approach to minimizing its effects on investors is through the creation of a corporate asset based on ethics.

Forcing corporations to comply with general ethical standards perhaps did not have to be implemented through a complex set of accounting regulations. In fact, these corporate scandals may, in form, seem to be about all accounting

⁸⁴ *Id.* at 24.

⁸⁵ Jickling, *supra* note 75, at 4.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Knowledge@Wharton, *Corporate Fraud on Trial: What Have We Learned?*, Mar. 30, 2005, at <http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1131>.

discrepancies, but, in substance, they are clearly all about greed.⁸⁹ The fact that the financial markets reward innovators and risk-takers creates corporate leaders who are willing to gamble on new ideas and procedures.⁹⁰ Unfortunately, these are the same leaders who may refuse to heed warning signs of the danger ahead and may take excessive or fraudulent risks with corporate assets.⁹¹ Krispy Kreme's post-Sarbanes-Oxley troubles reveal that the greed of numerous players—executives, employees, investment bankers, fund managers, and investors—outweigh any penalty of law. Legislation may not prevent unethical conduct, and may only provide a procedure for dealing with bad behavior within the legal system.⁹² Therefore, the only way to curb future corporate scandal is to address ethics, or the lack thereof, within business professions.

One remarkable effect of Sarbanes-Oxley is the birth of the “Corporate Ethics Industry.” Immediately after the legislation passed, corporations tried to demonstrate their commitment to ethics by hiring ethics consultants, creating Chief Compliance Officer positions, establishing committees to handle complaints of misconduct, and issuing corporate codes of ethics.⁹³ Corporations hoped these efforts to create the appearance of an ethical business environment would persuade federal investigators and prosecutors to be more lenient if and when any noncompliance issues arose. For example, Krispy Kreme's website has links to its Code of Ethics for Chief Executive and Senior Financial Officers, its Code of Business Conduct and Ethics for Members of the Board of Directors, a charter for its internal audit committee, a General Code of Business Conduct and Ethics, and a Corporate Governance Guideline.⁹⁴ These documents cover a huge range of topics, including insider trading, competition and fair dealing, conflicts of interest, working with a spouse, and employees' use of the Internet.⁹⁵ However, the existence of such documents at Krispy Kreme, as well as the large rule books filled with accounting regulations, did not give rise to an ethical organizational culture or curb the major incentive for Krispy Kreme to satisfy Wall Street's hunger for earnings.⁹⁶

Perhaps the business professionals at Krispy Kreme and other American firms have not yet incorporated “ethics” into their daily decision-making,

⁸⁹ See *id.*

⁹⁰ See *id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ Sarbanes-Oxley requires corporations to issue codes of ethics. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406, 116 Stat. 745 (2002).

⁹⁴ Krispy Kreme, at <http://www.krispykreme.com/investorrelations.html> (Click “Corporate Governance”) (last visited March 2, 2007).

⁹⁵ *Id.*

⁹⁶ Krispy Kreme's accounting irregularities, discussed below, demonstrate the ineffectiveness of GAAP and Sarbanes-Oxley in combating “human greed.” See Knowledge@Wharton, *supra* note 88.

because they are still unclear as to its definition. Who should set the standard for ethics in a corporate context? The government? The industry organizations? The international governing bodies? The third-party ethics auditors? In the United States, corporate ethics is largely an area of internal determination, rather than federal or state regulation.⁹⁷ Corporations define their own ethical standards in line with their corporate charters, relevant regulatory bodies, and interested investing communities. Generally, corporations utilize two types of ethical programs: 1) code and compliance; and 2) values.⁹⁸ However, neither of these programs will prove effective unless the corporation itself ensures their enforcement. If management acts as the only mechanisms of enforcement, then these ethics standards can be ignored as easily as accounting standards have been in the past. Perhaps, the independent auditors should also be responsible for ensuring compliance with internal ethical standards as well as accounting and disclosure regulations. Alternately, perhaps an association for business professionals, similar to The American Bar Association for attorneys, could regulate corporate ethics with an ethical code of conduct, a professional licensing system, and a review board for violations.⁹⁹ These rules could create consistent behavior across the profession, regardless of personal beliefs, and could also act as a guide for making difficult decisions, especially when conflicts of interest exist.¹⁰⁰ Most importantly, corporate officers could then be responsible for ensuring compliance throughout the management hierarchy of the organization.

2. THE CEO AND HIS SOUS-CHEFS

The saying, "The fish rots from the head," reflects that idea that unethical corporate culture starts with a company's top executives.¹⁰¹ An effective CEO possesses the ability to set a tone of ethical conduct that can saturate a corporate

⁹⁷ Malte Sussdorff, *Adding Corporate Ethics to the Bottom Line*, CSREUROPE.ORG, Nov. 9, 2000, at http://intranet.csreurope.org/news/csr/one-entry?entry_id=114283.

⁹⁸ *Id.*

⁹⁹ Scott Harshbarger & Robert Stringer, *Creating a Climate of Corporate Integrity*, THE CORP. BOARD, May-June 2005, at 10, 12.

¹⁰⁰ *Id.*

¹⁰¹ An infamous example of corrupt corporate executives creating a corrupt corporate culture is Crazy Eddie, the now-defunct electronics retailer. Crazy Eddie was involved in combinations of white-collar crimes and financial fraud. Sam Antar, the former CFO, stated that he and the former top executives committed these crimes, because morality was never an issue for their corporation. "We never had one conversation about morality during the 18 years that the fraud was going on." Herb Greenberg, *Making a Strong Case for Sarbanes-Oxley—A Former Crook Argues Against Watering Down Securities Law*, MARKETWATCH.COM, Oct. 11, 2006, at <http://www.marketwatch.com> (enter search for "Greenberg Sarbanes-Oxley"; then follow "Herb Greenberg: A reformed crook's view of Sarbanes-Oxley" hyperlink).

culture.¹⁰² An ethical corporate culture is created “when values that transcend narrow self-interest are built into the practice and structure of the enterprise.”¹⁰³ A CEO’s integrity has become increasingly important in determining corporate culture as a direct result of the recent exposure of the misbehavior and excesses of a few CEOs of major corporations, including Krispy Kreme’s Livengood.¹⁰⁴

If a CEO continually focuses on corporate integrity and frequently assesses the existing integrity systems within its management hierarchy, the entire corporation’s culture can slowly move toward a strong ethical focus.¹⁰⁵ Promoting this type of corporate environment could be more effective than the imposition of legal penalties, because it could deter unethical conduct before it even takes place, rather than punishing it after the damage has already been done.¹⁰⁶

Because most current and future business executives will be educated in business schools, recruitment of educational institutions is essential in order to convince these future leaders that ethics are a critical factor for financial success.¹⁰⁷ If business schools start teaching “ethics as a corporate asset,” business leaders will start to include ethics into corporate profiles.¹⁰⁸ Executives can reinforce this concept through internal ethics education programs.¹⁰⁹ Such educational programs should not only focus on management, but should also involve every level of employee in the protection of an ethical corporate culture.¹¹⁰ Ethics can also be reinforced throughout a corporate hierarchy through compensation and rewards programs. Compensation and reward programs need to be carefully structured and monitored, to make sure that managers do not focus solely upon “making their numbers” when faced with business conflicts.¹¹¹ If ethical decision-making is a part of every employee’s

¹⁰² Peter Koestenbaum, Patrick J. Keys, & Thomas R. Weirich, *Integrating Sarbanes-Oxley, Leadership, and Ethics*, THE CPA JOURNAL, Apr. 2005, available at <http://www.nysscpa.org/cpajournal/2005/405/perspectives/p13.htm>.

¹⁰³ Christine Parker, *Meta-Regulation: Legal Accountability for Corporate Social Responsibility*, in THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW (D. McBarnett et al. eds., Cambridge University Press) (forthcoming).

¹⁰⁴ Harshbarger, *supra* note 99, at 12.

¹⁰⁵ *Id.*

¹⁰⁶ Koestenbaum, *supra* note 102.

¹⁰⁷ *See id.*

¹⁰⁸ *See id.*; Knowledge@Wharton, *supra* note 88.

¹⁰⁹ *See generally* Sussdorff, *supra* note 97.

¹¹⁰ The U.S. Sentencing Commission ruled that the lack of an internal ethics education program could be a factor that weighed against a corporation whose employees had been found guilty of fraudulent activities. Greg Farrell & Jayne O’Donnell, *Ethics Training As Taught By Ex-Cons: Crime Doesn’t Pay*, USA TODAY, Nov. 16, 2005, available at <http://www.paradigmshiftpr.com/ethicstraining.htm>.

¹¹¹ Knowledge@Wharton, *supra* note 88.

performance review, then ethics will become an integral part of every employee's career advancement and personal bottom line.

3. ETHICS—TASTES SO GOOD

"Ethics as a corporate asset" can become truly valuable—more than a cliché—if corporations use their own ethical standards as a way to differentiate themselves from other publicly-traded companies as the "right" investment choice.¹¹² By highlighting not only its capacity to produce a high return, but also its commitment to the social contract between business and society, a corporation can ease apprehensive investors' worries about another Enron-like scandal and the resulting financial downfall.¹¹³ However, investors also demand credibility as their skepticism of public relations and advertising increases; therefore, "ethics as a corporate asset" cannot serve as just a promotional tool, as it was for Livengood at Krispy Kreme in 2002.¹¹⁴ Investors expect to see some proof of ethics in action—starting with the major business leaders.¹¹⁵ Additionally, "ethics as a corporate asset" can be economically valuable, because it can help to prevent decreases in either brand equity and reputation or other sources of competitive advantage during periods of extreme investor skepticism.¹¹⁶ Clearly, "ethics" should be more than just a buzzword after the tangible and devastating financial losses at Krispy Kreme.

However, the fact that each day new corporate scandals are headlined in the news illustrates that "ethics as a corporate asset" has not yet been embraced by business professionals. A 2005 survey of members of the Association of Certified Fraud Examiners revealed that only 17% of members feel that there will be a permanent shift among business professionals toward fraud prevention and corporate integrity in the foreseeable future, 39% feel that interest in corporate ethics will fade within the next five years, 32% feel that this interest has already begun to fade, and 12% feel that there has been no change at all among business leaders.¹¹⁷ An even less fortunate statistic is that 67% feel that institutional fraud is more commonplace today than it was five years ago.¹¹⁸ These fraud examiners agreed that Sarbanes-Oxley has helped corporations and investors identify weaknesses within internal control systems; however, they are

¹¹² Sussdorff, *supra* note 97.

¹¹³ See generally, *id.*

¹¹⁴ See *id.*; Global Province, *supra* note 21.

¹¹⁵ See *id.*

¹¹⁶ Harshbarger, *supra* note 99, at 16.

¹¹⁷ SmartPros.com, Fraud Examiners Doubt that SOX Will Change Culture, Nov. 10, 2005, at

<http://accounting.smartpros.com/x50502.xml>.

¹¹⁸ *Id.*

promoting alternative methods, such as ethics training, shareholder derivative suits and criminal penalties for controlling fraud and enhancing compliance.¹¹⁹

IV. CONCLUSION

Although the accounting regulations contained in Sarbanes-Oxley are not the final solutions for the lack of ethical behavior in business, the legislation does set up the framework for compliance and the legal penalties for noncompliance. However, Krispy Kreme and its fraudulent corporate colleagues have proven that compliance with a set of accounting rules, like GAAP and Sarbanes-Oxley, may not reveal a fair state of affairs of a corporation. Additionally, executives who are devoid of any moral compass will always look for loopholes in the legislation.¹²⁰ Sarbanes-Oxley may help investors *identify* fraudulent accounting practices, but, alone, it is not enough to combat corporate greed. Therefore, the best approach to actually *preventing* accounting and other types of fraud is by incorporating ethics into Corporate America's bottom line.

¹¹⁹ *Id.*

¹²⁰ *See id.*