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Lara Bergen
*University of Massachusetts Boston*

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**Lara Bergen**

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*Lara Bergen recently completed her Master's in Economics at Boston University. She previously received her B.S. in Economics and minor in Mathematics at the University of Washington, and hails from Coeur d'Alene, Idaho. She currently works in consulting at Spinnaker, LLC in Boston. Lara has lived in China for six months prior to graduate school and Lara is looking to further her career in international finance or financial consulting with an emphasis on Asian markets.*

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## Introduction

In the wake of the 2001-2002 Arthur Andersen accounting scandal and collapse of Enron and WorldCom, the government, the investors and the American public demanded corporate reforms to prevent similar future occurrences. Viewed to be largely a result of failed or poor governance, insufficient disclosure practices, and a lack of satisfactory internal controls, in 2002 Congress passed the Sarbanes-Oxley Act seeking to set standards and guarantee the accuracy of financial reports.

The Sarbanes-Oxley Act (known as SARBOX or SOX) sought to address these concerns through making executives responsible for company accounting statements, redefining the relationships between corporations and their auditors, and restructuring the internal audit systems of public corporations. Since the implementation of the law, SOX has redefined the corporate accounting world. It is widely viewed to be the most important piece of corporate governance and disclosure legislation since the Securities Act of 1933 and Securities Exchange Act of 1934.

This paper first outlines the provisions of the SOX Act, analyze its implications for firms and investors, and then address some of the key external effects of the implementation of and compliance with the SOX Act.

## The Sarbanes-Oxley Act

The Sarbanes-Oxley Act, named after co-creators Senator Paul Sarbanes of Maryland and Representative Michael Oxley of Ohio, was passed in July 2002 in an attempt to restore investor confidence in corporate America following the multi-billion dollar accounting scandals at Enron and WorldCom. The following section outlines key provisions of the SOX Act and details some of the objectives of each.

The Act first establishes the Public Company Accounting Oversight Board (PCAOB – hereafter referred to as the Board), which works jointly with the SEC to oversee auditors of public companies with a goal to "protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports" (PCAOB, Our Mission). The PCAOB operates under the same jurisdiction as the SEC and has the authority to discipline violators of the Act. It sets out guidelines separating Board members from public accounting firms, and defines auditing, quality control, independence standards and rules, and disciplinary actions and procedures.

Section two outlines the functions of auditors and clarifies their independence from their clients. Subsection 201 details which functions cannot be performed by public accounting firms contemporaneously with an audit, as an attempt to prevent conflicts of interest in firm accounting. These functions include investment management, human resources services, services related to bookkeeping and financial statements, and actuarial services. Exceptions can be approved by the Board and are made in cases where the revenue paid for such services contributes less than 5% of revenues paid to the auditing firm. Other sections outline audit partner rotations, accounting firm reporting procedures, and executive officer independence. Specifically, subsection 206 states that the CEO, Controller, CFO, Chief Accounting Officer or similarly positioned employees cannot have been employed by the company's audit firm for one year prior to the audit.

Section three defines corporate responsibility. It first creates public company audit committees consisting of board members who cannot receive payments outside of service on the board. It declares that executive officers must accompany their financial statements with a declaration certifying statement accuracy, with the knowledge that failure to include this document must be knowing and intentional to ensure liability. It gives federal courts the authority to penalize executives who attempt to influence or manipulate financial statements by granting "any equitable relief that may be appropriate or necessary for the benefit of investors" (AICPA, 2005).

Section four details disclosure and internal audit procedures. It prohibits loans to executives and presents a timeline for disclosure of executive/owner transactions. Of particular note is Subsection 404 (hereafter referred to as Section 404), which requires "each annual report of an issuer to contain an 'internal control report'" (AICPA, 2005). This section has emerged as the most difficult and costly to implement, and consideration of its effects will constitute a large portion of this paper. Requirements for the internal control report include the following: "(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting" (AICPA, 2005). In addition, Section 404 requires each firm to disclose if its senior financial officers have or have not adopted a code of ethics and to present the contents of this code.

The remainder of the Act outlines SEC responsibilities including minimum standards for practicing attorneys, requisites for conducting studies, an increase in monetary resources for implementation of the Act, authority to freeze payments, extension of whistleblower protections, and enhancement of white-collar fraud penalties. In addition, it included a provision for a General Accounting Office (GAO) study analyzing the consolidation of public accounting firms since 1989.

**Effects of SOX Act on Public Companies**

The SOX Act has been viewed by some as a controversial reaction by Congress to investor and public outrage at deception by public companies, compounded by excessive compensation to executives (Bumgardner, 2003). As a result, an expansive amount of literature focuses on analyzing the costs and benefits of the SOX Act to companies. This section will look at the costs of implementation of the SOX Act, largely resulting from Section 404, to large, mid-, and small-sized public companies. In addition, it will look at some global trade issues resulting from the US law and external effects on accounting firms and the IT sector.

*Factors affecting all firms*

Section 404 mandates creation of an internal control structure, and assessment of its effectiveness. This control structure involves controls on internal financing reporting and auditing. Implementing this control structure has proven more expensive than expected, with 2004 SOX costs estimated to have risen 62% in July over January expectations, according to surveys of 224 public companies conducted by Financial Executives International. These increases were largely due to internal costs, with a smaller jump in external costs and fees charged by external auditors (FEI, 2005). A March 2005 follow-up to this survey found 217 companies reporting a 39% increase in costs, due largely to increases in external costs for consulting and software, and in part due to increased fees from external auditors (FEI, 2005). The SEC estimates that companies will collectively spend 5.4 million staff hours each year complying with SOX, and AMR Research estimates that US companies will spend $6.1 billion this year for manpower, IT, and consulting services (CFO, 2004). Much of the costs of implementing Section 404 may consist of sunk costs. As a company designs and perfects its own individual control structure, it may incur many one-time expenses, but in the long term may gain efficiencies through improved financial reporting and a better ability to track internal expenses.

SOX compliance is mandatory for public companies, and thus resources must be allocated to its implementation. The diversion of these funds from other, potentially profitable endeavors may result in improper investments or risk mitigation that could result in a loss of value or innovation to firms. Firms also lose productivity with the necessity of allocating manpower to compliance instead of profitable activity. Many CEOs have had to divert energy from strategic decision-making to reviewing accounts and travel between locations to check control structure arrangements. Some of the financial resources required to implement SOX cannot be included in returns on investment (ROI) calculations of the firm. For example, information technology resources and software used to improve efficiency and thus improve financial reporting may not necessarily be included in the ROI of SOX, given the efficiency improvement motivator. Thus, in meeting ROI targets, SOX may fall short of acceptable levels or may have no "returns" at all.

Many larger, forward-looking firms view SOX as an opportunity to streamline their internal structure through taking advantage of new software designed to improve networking of company resources and information. This software has improved the security of information in many firms, and implementation has discovered loopholes and areas for improvement within the companies. Other companies are struggling to keep up, however, especially mid-sized and small companies.

*Small and mid-sized public companies*

Mid-sized and small public companies have incurred relatively larger costs in implementing SOX. Given that the professional costs and managerial time varies little with company size, small and mid-sized companies must allocate a higher percentage of revenue to SOX compliance (Morgenstern and Nealis, 2004). Many of these firms have considered such measures as reverse stock splits to shrink the company to a size below that required to meet SOX's strictest requirements, or have considered delisting the company.

According to a Wharton School study, delisting of public companies tripled in 2003 from 2002 (Leuz, et, al., 2004). This act of becoming a private company may be an attempt to save money or to avoid public scrutiny through the SOX Act. The Wharton study found that most companies de-listed their shares in an attempt to avoid the high costs of complying with the SOX Act, with some smaller companies listing costs of as high as $500,000 to comply (AP, 2004). Some companies, however, de-listed to avoid outside monitoring and scrutiny, leading the study's authors to suspect that firms were not being managed in the most efficient way or that their compensation was excessive (AP, 2004). The study found that some of the firms with "higher free cash flow and lower-quality accounting" were more likely to "go dark" – to deregister from the SEC and become private firms (AP, 2004).

Independence of board members may also place hardships on smaller companies. Many publicly listed small companies have few board members, and the chief financial officer may act in the capacity of other positions. Smaller firms may not have the resources necessary to recruit qualified individuals to meet independence requirements.

The SEC has made moves to attempt to alleviate some difficulties faced by small and mid-sized firms. A one-year extension for reporting controls was given to corporations with assets of $75 million or less. In mid-December, 2004, the SEC announced the establishment of an advisory committee to assess the effects of SOX and securities laws on smaller public companies, with the objective of making recommendations for change.

*SEC and PCAOB Recommendations*

Since the passage of SOX, the Board and the SEC have attempted to address high costs incurred in SOX compliance by suggesting that auditors tailor their audit procedures to the needs of each company, and thus try to combine their overall audit with the internal audits completed through the control structure to reduce duplication of services. They have suggested that more discretion be used in evaluating which controls to focus on in detail, and to try to identify those areas that might have difficulties in advance of audits. In addition, they suggest companies consult with auditors in establishing a functional control structure prior to attempts at implementation. Documentation and testing of information technology internal controls have also been reduced to only general IT controls in addition to financial-related systems, to ensure reliable financial information while reducing the number of controls necessary.

*Global Trade Effect*

Very little focus has been placed on effects of SOX compliance on global trade. SOX requires companies involved in international trade to establish controls for import-export operations and global supply chains. These management processes must be published in annual and quarterly reports to investors. In addition, companies have to report their efforts to "identify, assess and respond to risk such as terrorist attacks" (Field, 2004). These requirements do not supersede existing laws enforced by agencies such as Customs and Border Protection, the Department of Commerce and the Food and Drug Administration. However, wrongful declarations and errors in valuations of imports/exports will face legal action under SOX as well as customs agencies.

Another key implication for international trade is the requirement by SOX of disclosure of all off-balance sheet transactions, obligations and arrangements, with failure to comply resulting in delisting by the SEC or barring of international trade. Many firms have low international trade volumes, and as such may know very little about their customs compliance. SOX requirements present yet another hurdle for international trade compliance.

*Power to the Big Four and the IT Sector*

Following the collapse of Arthur Andersen, the main auditing and accounting firms became four: Deloitte, KPMG, PricewaterhouseCoopers, and Ernst & Young. The dominance of these firms and their experience in SOX-compliant auditing has allowed them to charge potentially inflated fees for their services, and the GAO study mandated by the SOX Act concluded that smaller firms faced significant barriers to entry (Economist, 2005). Smaller accounting firms have seen advantages, however, benefiting from conflict-of-interest laws that prevent larger firms from continuing some of their non-audit work. Many law firms have also seen increases in consulting work through provision of compliance assistance.

Additionally, compliance with SOX requires computer technology to integrate and maintain accurate information, networks, and databases. Many IT companies have seen their profits increase as they have developed software to assist in SOX compliance that needs installation and consulting support.

**Implications of the Act for Investors**

Co-creator Rep, Michael Oxley stated: "The average investor does feel that they are being treated more fairly now and the bad guys are being punished for wrecking their faith in those publicly traded corporations. Yes, there is something psychological about seeing some CEOs and top corporate execs doing the perp walk. I think that has a certain effect on the average investor" (Business Wire, 2004). While research in the field of behavioral finance and the effects of investor sentiment are still relatively new, prospect theory suggests that people are "easily influenced by framing, that is the context and ambience that accompany the decision problem" (Cowles Foundation, 2005). Empirically evaluating effects of the accounting scandals on investor sentiment is difficult, however. Share price declines from January 1st, 2001 to June 26th, 2002 of Enron (99.9% decline), Global Crossing (99.7%) and WorldCom (93.8%) following major accounting scandals indicate a strongly negative effect of "fiddling accounts" (Economist, 2002). Contagion effects, where investors view firms directly and indirectly connected to an accounting scandal negatively, also played a role. Termed "Enronitis," this contagion not only affected firms with direct ties to Enron, they had a wide market effect on firms ranging from General Electric to Rolls Royce (Arnold, 2002). Clearly, investor sentiment was not only expressed as public outrage, but also affected the valuation of public firms and the US stock market, thus creating a need to improve investor sentiments and maintain confidence in the US financial markets.

The SOX Act was created as an attempt to prevent fraudulent behavior in financial statements, and as such one must first consider motivators for fraud. Pressure to perform, expectations placed on executives by analysts, and compensation factors such as stocks that, in theory, increase in value as a company's performance improves, all can serve as motivators to act in manners that would make the company appear financially more attractive. Both common sense and empirical evidence (Ross, 2005) indicate that positive earnings shocks will positively affect stock returns, thus increasing the impetus to state positive earnings when compensation is tied to stock value. The provisions of the SOX Act requiring executive accountability for financial statements and increasing penalties for white-collar crime are designed to provide motivation for executives to enforce accuracy in their financial reporting. In addition, the internal control structure created in Subsection 404 mandates a framework for accounting standards from the individual level, thus restricting opportunities to commit fraud and preventing compounding effects from the individual level.

The implementation of a code of ethics strengthens anti-fraud objectives by encouraging a standard of ethical reporting at the individual level, thus furthering the motivation to prevent minor accounting errors that may result in large scale fiscal errors. Statements of adherence or waiving of the code of ethics, as well as public disclosure of the contents of such agreements, allows investors to observe the motivations of the firms in their accounting practices.

Board independence provides additional safeguards against fraud risk. In the SEC's Final Rule on the Act, it recognized this importance: "strengthening auditor independence should provide investors with more confidence that the accountants are playing their 'gatekeeper' role related to companies' financial reporting and provide further assurance that the financial condition, results of operations, and cash flows of companies are fairly reflected in their financial reports thereby allowing public companies less costly access to the capital markets." (SEC, Final Rule)

Risk management, reduced fraud risk, enhanced governance, and strengthened controls as a result of implementation of the SOX Act all provide somewhat intangible benefits to investors. Given the dependence of the US economy on its financial markets, however, and the jobs created and maintained through the financial sector, maintenance of a strong financial sector is vital for the US economy and the well-being and standard of living of its citizenship. If strengthening of investor confidence through improved accuracy and accountability of public companies reflects positively on the US economy, the intangible benefits may outweigh the calculable costs to public corporations of compliance with SOX.

**Conclusion**

A plethora of literature disparaging the effects of the SOX Act has been circulating since the Act's passage. A majority of this discourse focuses on the costs of implementing Section 404's internal control structure, and very little addresses potential benefits to investors. This may be due to the intangibility of investor benefits and the lack of conclusiveness in behavioral finance analyses. Implementation of the legislation is still in its infancy and creation of a functional and efficient control structure will likely take time to complete. An effectual controls system may simplify accounting decisions by presenting accurate and complete profit and cost statements that otherwise may have been more discretionary and based on broader, less informed accounting assessments. The creation and adherence to a code of ethics may improve efficiency of financial data collection, resulting in lower costs of financial restatements and auditing research.

Costs to firms may prove prohibitory, however, and the results of the SEC's investigations of the effects of securities laws and SOX on small public companies will be interesting in this context. The postponement or reconsideration of investments due to reallocation of resources to SOX compliance may result in less risk taking on the part of management, which could have the result of repressing potential growth and innovation. Increased legislation may be viewed by companies and investors alike as signaling more government interaction in financial markets, a result that may have unforeseen negative results, such as capital outflow and further outsourcing of US business functions.

The SOX Act has both positive and negative current and potential effects. Full evaluation of the Act at this juncture is likely premature, however, and further analysis and time will be needed to determine if this "reactionary" Congressional Act has a predominating positive effect of increased investor confidence in the market or a prohibitory cost that results in lowered productivity of public companies and dilution of the dominant US financial services market.

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