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Analysis into the Effect the Sarbanes-Oxley Act of 2002 has had on Investor Confidence in Audited Financial Statements

An honors thesis presented to the School of Business, University at Albany, State University of New York in partial fulfillment of the requirements for graduation from The Honors College.

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May 2015

Abstract

This paper studies the impact that the Sarbanes-Oxley Act of 2002 (SOX) has had on investor confidence in audited financial statements. Most studies of SOX examined its effect on audit quality, but the principal goal that government officials wanted to accomplish was to restore investor confidence in audited financial information following the frauds at Enron, WorldCom, and other public companies. The main method used in gathering data is a small survey to investors, where they answered questions regarding certain parts of SOX to gain insights into investors' perspectives. After analyzing the survey results as well as researching scholarly works on other key sections in SOX, it has been determined that SOX has had a significant impact on investor confidence in audited financial statements. Certain sections have stronger impacts than others, and can be used by public companies to appeal better to investors.

Acknowledgements

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I. INTRODUCTION

This paper focuses on the effect of the Sarbanes-Oxley Act of 2002 (SOX). This law greatly affected the accounting and auditing profession. It is important to study how this law has affected investors, auditing firms, public companies, and the economy as a whole. This paper mostly focuses on the effect SOX has had on investors, although the findings and recommendations will also interest regulators and public companies. Investors need to have confidence in the market for the economy to survive. One of the chief reasons that SOX was put into place was to increase investor confidence. This paper analyzes the relationship between SOX and investor confidence.

II. BACKGROUND

The U.S. markets had been very inconsistent in the recent years leading into SOX. During the late 1990's into 2000, the Dotcom bubble took place. During this bubble, technology stock prices surged, only to come crashing down. Markets went up substantially in the late 1990's as a result, but then decreased substantially in 2000. The markets were able to stabilize for a while, but investors became extremely cautious as a result of fear of over speculating again. Because of this caution, audit failures were very important to investors, as it represented extremely high risk in their investments.

Shortly after the Dotcom bubble was over, some of the largest audit failures occurred during the early 2000's. This precipitated the passing of SOX. There were many audit failures before SOX was instituted, such as Xerox, WorldCom, and most notably, Enron (Patsuris, 2002). The audit failure at Enron was the leading factor in the creation of SOX. Simon Deakin and Suzanne J. Konzelmann of the University of Cambridge go as far as to say that parts of SOX

mirror the audit failure at Enron, citing specifically the new standards for corporate governance in the law (Deakin & Konzelmann, 2003).

Because of these high profile audit failures, regulators wanted to build back confidence in audited financial statements. If audit failures continued to occur to large companies, investors would surely have responded by taking money out of the stock market, which has an adverse effect on the economy.

There were many structural problems with how public companies worked that may have led to some of these audit failures. One problem that was increasing significantly at the time was the provision of consulting services by auditing firms. Auditing firms were making significantly more money providing consulting services to clients than by auditing them. This caused a clear conflict of interest as the auditing firms had significant interest in maintaining lucrative consulting contracts with many of the firms they were auditing (Levitt, 2002).

Another problem was the corporate governance of public companies and the allocation of responsibilities. The boards of directors at many companies were weak, there was no formal standard for having a code of conduct, and the Securities and Exchange Commission (SEC) did not have enough resources. In some cases, the CEO and CFO did not accept enough responsibility over the financial statements to make sure they were done truthfully.

Maybe the most important problem in the auditing profession before SOX was that auditors were self-regulated. There was no independent oversight for auditors. Auditing standards produced by the Auditing Standards Board (ASB) were used as the basis for public company audits prior to SOX. The ASB is run by the AICPA, which means the standard-setting body is not independent of the auditing profession.

The government's solution to these problems was the enactment of the Sarbanes-Oxley Act of 2002. One goal of the law was to increase audit quality, which would lead to an increase in confidence in the financial statements by investors. While there is substantial evidence that SOX has increased audit quality (McMullin, 2009; Center for Audit Quality, 2008; Ernst & Young, 2012), the amount and reasons for change in investor confidence has not been adequately researched to this point.

Summary of Sarbanes-Oxley

In 2002, Republican Congressman Michael Oxley and Democrat Senator Paul Sarbanes each supported their own bills to improve public company financial reporting. Congress then reconciled the two bills and made one law. The law progressed quickly, due to the sense of urgency caused by the public company frauds that happened in recent months. The House and Senate both passed the bill a day after it came out of the joint House/Senate committee to reconcile the two bills, and President George W. Bush signed it into law on July 30.

SOX is a comprehensive law that greatly changed how public companies produce financial statements. President Bush called SOX "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt" (Bumiller, 2002). SOX contains multiple sections that outline new procedures for public companies and auditing firms to follow. While there are many sections to SOX, there are a few sections that will be discussed in this paper. These sections are the key parts of SOX, and have the most impact on public company financial reporting. These sections are: §101, §201, §203, §302, §401, §404, §406, §409, §802, and §906. These sections are the backbone of SOX, and cover the most important changes that the law made in public company financial reporting.

Section 101

This section is under Title I – Public Company Accounting Oversight Board. The section is called: Establishment; Administrative Provisions. This created the Public Company Accounting Oversight Board, also known as the PCAOB. This organization was created to oversee the auditing profession. Some of the specific jobs of the PCAOB are to register accounting firms that audit public companies, create and maintain a code of conduct for auditors, issue auditing standards for the audits of public companies, inspect and investigate registered accounting firms, and enforce its rules.

The creation of the PCAOB marked the first time in accounting history that the auditing of public companies became externally regulated. Auditing was self-regulated before SOX, and this created many potential problems, some of which were manifested in the early 2000's with high-profile audit failures. By adding external regulation, auditors become more liable for providing higher quality audits, and executing the PCAOB's audit policies in a professional and ethical way. The threat of failing inspections is important, and studies have shown that PCAOB inspections have led to a reduction in abnormal accruals by companies that are permitted by the auditor (Carcello, Hollingsworth, & Mastrolia, 2011).

Section 201

This section is under Title II – Auditor Independence. The section is called Services Outside the Scope of Practice of Auditors. This section prohibits auditors from providing most non-audit services to their clients. The services prohibited include: bookkeeping and other accounting services, financial information systems design and implementation, appraisal services, actuarial services, internal audit outsourcing services, management and human

resources functions, investment services, and any other service the Board or audit committee of the issuer does not approve (Sarbanes-Oxley Act of 2002).

By limiting these services, the audit firms become much more independent of their clients. As stated earlier, non-audit services by audit firms were becoming a much higher percentage of firm revenue, so firms were building significant interest in their clients, which is a conflict of interest. This section reduces audit firm interest in its clients significantly.

Section 203

Section 203 is also under Title II – Auditor Independence. The section is called Audit Partner Rotation. This section states that the lead audit partner as well as the reviewing audit partner cannot participate in the audit of the same client for more than five consecutive years. This rule helps strengthen auditor independence for a few reasons. One reason is that the current audit partner becomes more accountable for their actions. This is due to the fact that when partners rotate, the new partner will take a hard look into what the previous audits looked like and what the previous partner did on the audits. If the current partner knows this, they will be much more inclined to proceed through their audits with more caution.

The audit partner's relationship with the client can also become emotional to the point where professional judgment can become effected. In a recent article, research showed that "much evidence suggests that auditors who are familiar with a client make judgments that are more aligned with client preferred outcomes. In addition, familiarity can lead auditors to place too much weight on client explanations and representations" (Church, Jenkins, McCracken, Roush & Stanley, 2015). Auditors' familiarity with clients will be reduced as a result of partner rotation.

Section 302

Section 302 is under Title III – Corporate Responsibility. The section is called Corporate Responsibility for Financial Reports. It requires the CEO and CFO to sign off on financial statements, certifying the following: the officers have reviewed the statements, the statements are not missing any material information, and the statements are fairly presented. Officers are also responsible for maintaining internal controls, which includes timely evaluations, reporting significant deficiencies in internal controls, reporting fraud by someone involved with internal controls, and reporting significant changes in internal controls.

The main goal of this section was to increase the accountability of the executive officers in producing financial statements. By requiring the CEO and CFO to certify the financial statements, it does just that. Top executives can't claim that they were oblivious to material misrepresentations on financial statements. This section also ensures that executives are liable for damages as a result of negligence in maintaining internal controls or failing to fairly state financial information.

Section 401

Section 401 is under Title IV – Enhanced Financial Disclosures. The section is called Disclosures in Periodic Reports. This part requires public companies to report all material information regarding adjustments and any other important qualitative data. This includes disclosing information on off-balance sheet financing, as well as any information to ensure that the financial statements are not misleading. What this section accomplishes is to make the financial statements more transparent, and to require enough information in the footnotes so that

investors can understand the business and not be unaware of any material activities engaged in by the company.

Inadequate footnote disclosure was one problem at Enron before its failure. Enron's financial statements were complex and hard to understand. This was true for investment experts and financial professionals, not just the average investor. Andre Meade, who was the head of United States utilities research at Commerzbank Securities in 2001, said while talking about Enron's statements, "All that is compressed into one set of numbers, and it's really hard for analysts to determine where they are making money in a given quarter and where they are losing money." He also mentioned how it was "really disconcerting" how Enron had most of its business in an area where investors couldn't understand what was going on (Oppel Jr, 2001). §401 directly addresses this problem.

Section 404

Section 404 is also under Title IV. The section is called Management Assessment of Internal Controls. It requires public companies to maintain adequate internal controls and to have an internal control audit performed by the company's external auditor. An evaluation of the internal controls of the company must be presented in the annual report.

This part of SOX may be the most costly to firms, as they have to establish and maintain functioning internal controls, as well as pay for the audit of the controls. It also increases the importance of having strong internal controls because the audit firm will issue an opinion on the controls. Therefore, any opinion that is not unqualified may alarm investors.

Section 406

Section 406 is under Title IV. The name for this section is Code of Ethics for Senior Financial Officers. All this section requires is that public companies disclose whether or not they have a code of conduct for financial officers. If a company does not have a code of conduct, they must also disclose why they don't have one. This is a neat rule because it almost forces every public company to have a code of conduct because if they don't, it would look extremely suspicious to investors.

Section 409

Section 409 is under Title IV as well. The section is called Real Time Issuer Disclosures. This section requires public companies to communicate to the public any material changes in financial standing. These changes need to be reported clearly, understandably, and promptly. The section states that all information that "is necessary or useful for the protection of investors and in the public interest" must be reported quickly. The importance of this rule is that if changes happen that may affect investors' decisions, they should not be hidden. Investors have the right to know material changes in the company they invest in, and it is most useful when this information is reported on a timely basis.

Section 802

This section is under Title VIII – Corporate and Criminal Fraud Accountability. The section is called Criminal Penalties for Altering Documents. The main rule that this section establishes is that no one can alter or destroy documents during investigations or bankruptcy. This is another rule that came directly from Enron's collapse, as accountants from Arthur Anderson, LLP had destroyed documents related to their audit of Enron while they were under

investigation (Weil, Emshwiller, & Paltrow, 2002). Based off this section, accountants and others who are caught altering or destroying documents (but not fish)[1] can face severe fines or imprisonment. This decreased the motivation for anyone to even attempt to change documents.

Section 906

Section 906 is under Title IX – White-Collar Crime Penalty Enhancements. This section is called Corporate Responsibility for Financial Reports. This section holds executive officers liable if they do not certify financial statements. It builds off §302, as that section defines what the certification means, and §906 requires officers to complete the certification. If officers do certify the financial statements knowing that the statements do not satisfy all requirements, officers can be penalized with a large fine and/or jail time. This is another motivating factor that makes executive officers more likely to certify statements only if they believe the statements are fair and accurate.

Economy after SOX

The passage of SOX did appear to stabilize the markets for a while, and there was evidence of fewer audit failures immediately after the act became effective. However, the stock market crash of 2008 changed this drastically, and the economy entered into a deep recession as a result. One of the main causes of this crash was that several huge financial institutions either failed or nearly failed. This alarmed investors because these were strong companies with strong financial statements. When Lehman Brothers crashed, it was discovered that Lehman had

[1] The U.S. Supreme Court ruled that *fish* were not documents in a recent case against a fisherman, in which he was being charged for catching fish that did not fit size requirements. The fisherman threw the fish overboard during the investigation, which caused officials to charge him of violating SOX §802. The Supreme Court ruled in favor of the fisherman (Liptak, 2015).

engaged in deceptive reporting practices on its financial statements by a method of accounting called Repo 105, which allowed Lehman to hide debt from investors (Zibel, 2010).

With the stock market in a state of flux in 2008, the government once again needed to enact new legislation to bolster investor confidence. The government's solution was the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. Among many things, such as limiting certain dangerous practices by financial institutions and establishing the Financial Stability Oversight Council, the Dodd-Frank Act amended parts of Sarbanes-Oxley.

Key Changes to Sarbanes-Oxley in Dodd-Frank

The Dodd-Frank bill made slight changes to some sections of Sarbanes-Oxley. The important amendments were improving whistleblower protection (§922) and exempting small public companies from having to have internal controls audits (§989G). While whistleblower protection increases investor protection, the small company exemption decreases investor protection.

Section 922

This section is called Whistleblower Protection, and is under Subtitle B – Increasing Regulatory Enforcement and Remedies. It strongly increased the rights and protection of whistleblowers, which should motivate more people to provide information on fraud. Under SOX, whistleblowers were just protected from standard discrimination, demotion, harassment, etc. With the amendments made in Dodd-Frank, whistleblowers have increased power, including right to representation, anonymity, monetary rewards, and a longer statute of limitations. Whistleblowers can now "blow the whistle" on a fraud and receive a hefty reward for it. The

award can range anywhere between 10 – 30 percent of the money recouped by government agencies. In fact, in September 2014, the SEC awarded a whistleblower more than $30 million as a result of helping it solve a case (SEC, 2014). The increase in statute of limitations is significant as well, as the original time period for whistleblowers to report violations was only 90 days from the violation. Now, the time period stretches two years from the violation.

Section 989G

Section 989G is called Exemption for Nonaccelerated Filers. This section is under Subtitle I – Public Company Accounting Oversight Board, Portfolio Margining, and Other Matters. This section added an exemption to §404 of SOX. The exemption is for non-accelerated filers, which are companies with a market capitalization of $75 million or less. These types of public companies now do not have to comply with subsection B of §404. This means that they do not need an internal controls audit for the annual report. This is an important exemption because it saves low market cap firms a lot of money by allowing them to avoid an internal controls audit. However, it also decreases investor protection by not requiring an audit opinion on the company's internal controls.

III. SURVEY

A survey was given to a sample of investors. Investors were required to disclose background information about themselves, and then answer questions. The questions and answers are analyzed throughout this section of the paper. Eleven investors took part in the survey. These investors all currently reside in the U.S.: one in Arizona, one in North Carolina, one in New Jersey, and the remaining eight in New York. Four have 20-29 years of investing experience, four have 30-39 years of experience, and two have 40 or more years of experience.

One investor has only been investing for six years, and had not had exposure to investing in the pre-SOX era, so that subject's answers will be excluded from most analyses. Investors were also asked to disclose within a choice of three ranges, how much they invest. Two invest under $100,000, two invest between $100,000 and $1,000,000, and seven invest over $1,000,000. Eight investors said they invested monthly, while three investors said they invested once a year or less.

All investors that were interviewed are considered to be average investors. Therefore, the sample should be relatively representative of the average investor population. While the sample size is small, it is large enough to make preliminary assessments and recommendations based off of the responses. Each main conclusion would likely have to be studied in more detail to determine its effects on different types of investors, as well as other entities such as public companies, consumers, and the government. A summary of some of the results are included in the following table[2]:

[2] See the Appendix for explanations of the Likert scale responses.

Summary of Investor Survey

Questions / Responses	1	2	3	4	5	6	7	8	9	10	AVERAGE
How many years have you been investing?	40	25	30	20	30	29	30	50	25	30	30.9
How much do you invest?	$100K - $1M	Over $1M	$100K - $1M	Over $1M	Over $1M	Over $1M	Over $1M	Over $1M	Under $100K	Over $1M	N/A
How frequently do you trade?	Monthly	Monthly	Yearly or less	Yearly or less	Monthly	Monthly	Yearly or less	Monthly	Monthly	Monthly	N/A
How well do you understand the creation of the PCAOB?	3	5	4	2	5	5	4	1	5	2	3.6
How well do you understand mandatory internal controls audits in SOX?	3	5	5	2	5	5	3	1	3	1	3.3
How well do you understand audit partner rotation in SOX?	3	5	5	1	5	3	3	1	3	1	3.0
How well do you understand restrictions on outside services provided by external accountants in SOX?	3	5	5	1	5	5	4	1	3	1	3.3
Did the passage of SOX in 2002 affect your investing strategy?	No	No	No	No	No	No	No	No	Yes	No	N/A
Does the auditor's internal controls report affect whether you invest in a company or not?	No	Yes	No	No	Yes	No	No	Yes	Yes	No	N/A
Does the requirement of having the CFO/CEO sign off on financial statements increase your confidence on the validity of reported numbers?	No	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	N/A
Has the 2008 stock crash affected your confidence in financial statements?	Yes	No	No	No	Yes	No	No	Yes	No	No	N/A
Are you just as confident in financial statements of IPO's as you are with veteran companies?	Yes	No	Yes	No	No	No	No	No	Yes	No	N/A
Do you have any concerns about financial statement validity going forward?	No	Yes	No	Yes	Yes	No	Yes	Yes	No	Yes	N/A
How much would required internal controls audits for low market cap companies increase your confidence?	4	4	4	3	5	3	3	4	4	1	3.5
How much would mandatory audit firm rotation increase your confidence?	4	4	1	2	3	3	3	4	4	3	3.1
How much would more frequent audit partner rotation increase your confidence?	4	3	1	2	3	3	3	4	4	1	2.8
How much would increased auditor liability for audit failures increase your confidence?	4	2	1	2	5	3	4	5	4	3	3.3
How much would stricter auditor independence rules increase your confidence?	4	4	3	3	4	3	4	3	4	3	3.5
How much would your confidence decrease if there was no requirement of an internal controls audit?	4	5	4	4	5	4	4	5	4	5	4.4
How much would your confidence decrease if there was no audit partner rotation?	4	2	1	3	3	2	4	5	4	3	3.1
How much would your confidence decrease if there was no requirement of CFO/CEO to sign off on financial statements?	4	4	4	3	5	4	5	4	4	3	4.0
How much would your confidence decrease if the PCAOB no longer provides oversight to the external auditing profession?	5	5	3	3	3	3	3	4	4	3	3.6
How much would your confidence decrease if a blue-chip company has an audit failure and goes bankrupt?	4	3	5	4	2	2	2	5	4	1	3.2

Market Effects

Sarbanes-Oxley resulted in many changes for public markets. These changes were not just in compliance and auditing. One of the main effects of SOX on public companies is increased costs. The most expensive piece of SOX for most companies is §404, which requires management to establish and maintain internal controls, as well as have an internal controls audit performed. While higher costs for larger public companies may be worth extra protection for investors, these costs may hurt smaller companies. Larger companies will have little problem adding some expenses to their bottom line, because they can afford it; for smaller companies, compliance with SOX can offset any income they have. This has had an effect on the public markets. For example, Marv Dumon of Investopedia suggests that SOX has reduced initial public offerings (IPO's) in the U.S. He believes that SOX has led some companies to not go public, delist from public exchanges, and to list on foreign exchanges to avoid higher costs from compliance (Dumon, 2009). The article was written before the amendment to SOX that added an exemption to lower cap companies was announced, so part of this problem has been addressed, but still exists for small companies that have equity above $75 million. Stephen Willits and Curtis Nicholls of *The CPA Journal* support Dumon's assertion as well, as they stated in an article that the incidence of going-private transactions following the passage of SOX "indicates that SOX was more costly for smaller and less liquid firms" (Willits & Nicholls, 2014). This article was published after the amendments to SOX, so it considers the exemption.

The costs also affect business decisions for companies that currently fall into the exempt category, as it will be more costly to them to raise equity if it pushes the company over the $75 million threshold. There are also indirect changes that add more protection to investors. This added protection is in the form of having fewer IPO formations. IPO's have been declining

drastically in success rates over the past two decades (Weild, 2011). Weild's study shows strong evidence of how IPO's have not performed well and that they are below market averages. Consequentially, fewer IPO's on the market will decrease the number of investors that lose money on their investments.

According to the survey, only three of the eleven investors said they were just as confident in financial statements of IPO's as they were with veteran companies. Based off the higher fraud risk of IPO's and the survey results, it can be assumed that having fewer IPO's is a strong protection for investors. There are some concerns with this outcome, however. Firstly, if investors have more confidence in a veteran public company over an IPO, they will likely avoid IPO's in any case. Whether there were more or fewer IPO's during a given year should not affect investors' confidence because they will be impartial or against them either way. Another concern is that having fewer IPO's hurts the U.S. economy as a whole, which can hurt investors in the long-term. The last significant problem is that a decreased number of IPO's results in less investment options for the public. While these problems may be negative externalities of SOX, IPO's have a higher risk than other public companies and removing the riskier investments from the market may benefit investor protection.

Audit Quality

While the main goal of Sarbanes-Oxley was to increase investor confidence, the law did this by creating ways to increase audit quality. In this regard, SOX has been extremely successful. Audits have become more transparent which makes the end result of the audit more valuable. The additions to compliance, procedures, and uniformity have helped make this possible. There have been studies that support these points, such as Ernst & Young's "The Sarbanes-Oxley Act at 10" report. Part of its main conclusion is that SOX has been very

beneficial to audit quality, which has led to benefits for the markets and investors. Another important study was done by the Center for Audit Quality (CAQ) in 2008. This study surveyed audit committee members and asked questions related to SOX. The CAQ concluded that "even in the face of market turbulence, audit committee members have high confidence in the quality of audited financial statements and consider the Sarbanes-Oxley Act (SOX) a positive influence" (Center for Audit Quality, 2008). Among the results were a majority of audit committee members saying that audit risk declined after SOX, and a majority said that SOX had a positive impact (Center for Audit Quality, 2008).

While audit quality has been unquestionably improved, how does this translate to investor confidence? In general, increased audit quality should increase investor confidence in audited financial statements, however, other factors such as media perception and economic recessions can skew these results to the average investor. For example, in the CAQ's "Main Street Investor Survey," the percentage of those who have some, quite a bit, or a great deal of confidence in audited financial information released by public companies in the U.S. dropped from 80% to 70% from 2007 to 2009 (Center for Audit Quality, 2008). This was likely due to the stock market crash. The percentage has slowly risen to 75% in 2014, but is still lower than what it was before the crash.

<u>Investor Comprehension of SOX</u>

The initial enactment of Sarbanes-Oxley greatly impacted public companies and audit firms. The effect it had on investors is hard to measure as a whole, but there are some key components that could be analyzed. One component is the knowledge of Sarbanes-Oxley by investors. There were surely many investors who heard about Sarbanes-Oxley but did not fully understand the bill. Unless investors have an auditing or accounting background, it may be hard

to understand. The basic concept of SOX protecting investors can be understood, but it is harder to believe if investors don't know the facts. In fact, according to the survey, of the ten investors who have been investing before and after the passage of SOX, only one investor changed how he approached investing. This would seem to point to SOX not greatly affecting investor confidence when passed. However, a more in depth analysis of what parts of the annual reports these investors commonly use to choose their investments will be needed to make a stronger conclusion. It will also be important to see which parts of SOX are understood, and how various parts of the annual reports affect investing decisions.

The survey asked investors who have invested before and after SOX what parts of a company's 10-K they read. Here are the results:

Section of 10-K	No. of Investors
Financial statements	8
Management's discussion and analysis	6
Auditor's opinion on financial statements	5
Auditor's opinion on internal controls	5
Changes/disagreements with accountants	5
Management's report on internal controls	3
Management's conclusion on controls and procedures	2

One take away from these results is the fact that management's report on internal controls and management's conclusion on controls and procedures are the least used. These are both additions to the 10-K as a result of Sarbanes-Oxley. It is also noteworthy that the auditor's opinion on internal controls is used by half of the sample. This means that this is somewhat useful to investors. Many investors may prefer to read the auditor's opinion on controls rather than management's opinion, while still being heavily interested in the controls. Financial statements are heavily used, as would be expected. This shows that it is important for companies

and their auditors to be able to produce accurate financial statements because many investors will rely on them as an important piece to their investing decisions.

Another group of questions that was answered by survey respondents was related to their comprehension of some key parts of audits that comply with SOX. Each interviewee was asked to rate his/her own understanding of each part on a scale of 1-5. These parts were the creation of the PCAOB, mandatory internal controls audits, audit partner rotation, and restriction on outside services by external accountants. A lower understanding of any category would represent a lesser importance to investors in the sample, while a greater understanding would make the category more important.

Creation of PCAOB

Of the ten investors that have invested before and after the passage of SOX, the average response was 3.6. Only three investors responded with an answer below three. This indicates that the majority of the sample understands the creation of the PCAOB. This means that the creation of the PCAOB likely had a significant effect on a majority of investors.

In addition to asking about the comprehension of the PCAOB, investors were asked how their confidence would be affected if the PCAOB discontinued their oversight of the external auditing profession. This was rated on a scale of 1-5 with 1 meaning no decrease in confidence and 5 being a great decrease in confidence. Every investor answered with a 3 or above, which means that they all would lose confidence if the PCAOB were eliminated. This is pretty clear evidence that the creation of the PCAOB has been a very positive component of SOX. Even investors that did not have a great understanding of the PCAOB understood that it has some importance in making financial statements more accurate.

Mandatory Internal Controls Audits

Of the ten investors, the average response to the question of understandability of mandatory internal control audits was 3.3. Only three investors answered with a number below three. A majority of the sample has some understanding of mandatory internal control audits, indicating that the inclusion of this standard has some importance to investors.

However, investors were also asked if the auditor's internal controls report affected investors, and only four investors answered that it did affect them. This was surprising, as some investors that understood internal control audits did not use them in their evaluation of a company. On the other hand, there were still four investors (40% of the sample) that use these reports. This appears enough for §404 audits to be important in helping investors gain confidence in financial statements. Further analysis would have to be done to examine how the auditors' different opinions on internal controls affect investors' decisions on a company.

Audit Partner Rotation

The average response to comprehension of audit partner rotation was 3.0. There was a large variance in this answer, as the standard deviation was 1.63 for this question. With §203, SOX made audit partner rotation mandatory every five years. While this may not seem important in the grand scheme of things, this is costly to audit firms. Audit partners usually need a few years to become familiar with new clients, and only after an initial period are partners comfortable with the audit. Making audit partners rotate every five years eliminates years off the end of a client-partner relationship where the partner is most comfortable. These years where partners now have to rotate would be the least costly because of the knowledge partners would

build up. As a result, auditors are losing out on the most profitable years with their clients and have to go through more years adjusting to new clients, which increases costs to the firm.

With a largely variable response, many investors likely have a good understanding of audit partner rotation. Because of this, a change to more relaxed rotation, or an elimination completely of audit partner rotation may negatively affect investors' confidence. It is also justifiable to assume that audit partner rotation provides more confidence to investors, especially if they understand the concept. This is an investor protection that audit firms and audit clients pay a cost for.

Restrictions on outside services by auditors

The average response to the investor's understanding of outside services provided by auditors was 3.3. Only three investors answered with a response less than 3. This is something that a large majority of investors should understand. As a result of this rule, auditor independence is greatly strengthened, which should increase the confidence of every sophisticated investor. Even though some may not understand the exact details of what is restricted, the general goal of this stipulation in SOX is something that investors will look to as a strong protection.

Overview of Investor Comprehension of SOX

Out of the four key parts of SOX that were asked to investors, only audit partner rotation was not graded above three. There was still a mild understanding in this category. This shows that investors are at least aware of these provisions of SOX. To the investors that understand and know about these rules, their confidence in the accuracy of financial statements should increase as a result.

A pattern that exists with these specific questions is that the investors who answered with lower ratings were consistent in not knowing these parts of SOX. Except for three investors whose averages on these four questions were 1.00, 1.25, and 1.50, all other investors answered above three on all questions. This means that for generally informed investors, if they understand some of SOX, they will understand most of it. On the other hand, some investors may know very little about SOX at all. In review, for the three lower-rated investors, SOX most likely had very little effect on their confidence in financial statements.

In the actual population of all investors in the U.S., a similar ratio of investors really understanding SOX to investors not understanding SOX makes sense. This would make a majority of investors well informed about SOX. Because of this, SOX should have an effect on the majority of investors if most of them are informed about it. The amount of effect SOX has is determined throughout the rest of the paper. As for the group of investors that are not well informed about SOX, they will likely reap the benefits of the law without even fully understanding it. As long as the amount of investors that are not informed stays low, as it is currently, SOX will be able to have an impact on a majority of investors, therefore having the ability to significantly change investor confidence.

Effect of Key Parts of SOX on Investors

After covering which parts of SOX investors understand, the next analysis is to find out how each part of SOX truly effects investors. This will be imperative in making evaluations about the overall effectiveness of SOX on investor confidence. Using this analysis, recommendations can be made as to whether certain parts of SOX can be improved to add even more investor protection, or rules can be relaxed to save public companies money (depending on if investors truly benefit from the rule).

Requirement of CEO/CFO to Certify Financial Statements

Investors were asked to answer if the requirement of having the CFO and CEO sign off on financial statements increases their confidence on the validity of reported numbers. Of the ten qualified investors, eight responded that this did increase their confidence. This rule was instituted in SOX by §302. This is strong evidence that this provision in SOX had a positive effect on investor confidence in financial statements. Previously, there was no such rule for executives to sign off on financial statements. This rule is neither burdensome nor costly for companies of all levels, and simply requires the CFO and CEO to acknowledge responsibility for financial statements.

In addition to answering if the signatures of the CFO and CEO improved confidence in financial statements, investors were asked how much their confidence would decrease if this rule was not required. The average response was 4.00, and all investors responded with 3 or above. This is another indication that this was a key addition to SOX for investor confidence.

Audit Partner Rotation

Before SOX, audit partner rotation rules were not as strict as they are now. Investors were asked how much their confidence would decrease if audit partner rotation was not required. The average response was slightly above 3. Investors in the survey seemed indifferent about partner rotation, although most agreed that there would be some amount of decreased confidence if audit partner rotation was eliminated.

Investors also were asked how much their confidence would increase with even more frequent audit partner rotation. The average of the responses was 2.8. There are a few reasons why this question got a low response. The first is that the current level of audit partner rotation is

sufficient. Investors have shown in other responses to audit partner rotation that the SOX rules have increased their confidence. Increasing rotation further may have limited effects on increasing confidence, as auditor independence is already strengthened. Another reason is that too frequent audit partner rotations can actually decrease audit quality. If the audit partner is always new there will be more incentive for the auditor to cut corners to reduce costs. The auditor will always be uncomfortable because they won't have a firm grip on the company if they have no familiarity with it. While these things increase auditor independence, it can decrease audit quality.

Mandatory Internal Controls Audits

Investors were asked how much their confidence in financial statements would decrease if internal controls audits were not required. There was a strong response for a significant decrease in confidence. The average response was 4.4. Every investor responded with either a 4 or 5, meaning that investors would have a strong decrease in confidence if internal controls audits were not done.

This contradicts the previous data that was discussed, as less than half of the investors said that they had a moderate understanding of what an internal controls audit was, and less than half also said that the auditor's internal controls report did not affect their investing at all. This demonstrates that investors are at least aware of this provision in SOX and that they understand it is a protection that is valuable to investors. Without understanding how it works or even looking at the auditor's opinion on internal controls, investors still derive confidence from this rule.

Another set of answers that agrees with this assertion is the responses to how much required internal controls audits for lower cap companies that are currently exempt increase

investor confidence. The average response for this question was 3.5. The increase in confidence is not as strong as the decrease in confidence for losing internal controls audits, although some of that can be attributed to investors having concerns over lower cap companies in general. This is another example of how investors in the survey have shown that internal controls audits are a positive influence on their confidence.

Auditor Independence

While auditor independence is not tied specifically to one section of SOX, it is a main component of SOX. Most sections are designed to strengthen auditor independence. Auditor independence is important for investors, because it eliminates much of the incentives auditors have to allow material misstatements or fraud to occur in public companies. The survey asked investors how much stricter auditor independence rules would increase their confidence, and the average response was 3.5. This agrees with the premise that investors believe auditor independence is important. This question was also used as a measure for investors who may have been not as knowledgeable about the specifics of some of the other sections of SOX. However, every investor knows what auditor independence means and every single response given was 3 or above. What this shows is that rules in SOX that can increase auditor independence have a positive effect on investor confidence.

Taking this a step forward, investors were also asked how much mandatory audit firm rotation would increase their confidence. The average response was 3.1. Audit firm rotation is not required in SOX, but it is another measure of auditor independence. With an average response above 3, this again shows that investors value auditor independence.

Because SOX increased auditor independence greatly, and investors have shown to value auditor independence, there is a clear benefit to investor confidence as a result of these sections.

Auditor Liability

Another question that is not directly related to any part of SOX is how much increased auditor liability for audit failures effects investor confidence. The average response to this question was 3.3, which demonstrates the sample would have an increase in confidence. This makes sense, because if the auditor has more to lose, they will be more likely to try to do a better job, which leads to higher quality audits. While SOX does not increase auditor penalties for audit failures, it does require more work to be done by the auditor. In essence, by requiring auditors to go through more steps and holding auditors to higher standards, SOX increases the responsibility of auditors. With increased responsibility, there are more chances for auditors to make a mistake, which may cause them to become liable. Even though there are no explicit standards for auditor liability in SOX, there is an implicit increase in auditor liability. Therefore, if investors value increased auditor liability, SOX does deliver this. This is a positive factor on investor confidence.

One section that does broach the topic of auditor liability is §802. This section made it illegal for the auditor or anyone else to destroy documents while under investigation. This made sure that auditors would be held accountable for mistakes they made that were found in evidence, rather than the auditor being able to destroy the evidence before being searched. This rule improved the quality of documentation by auditors, which increases audit quality.

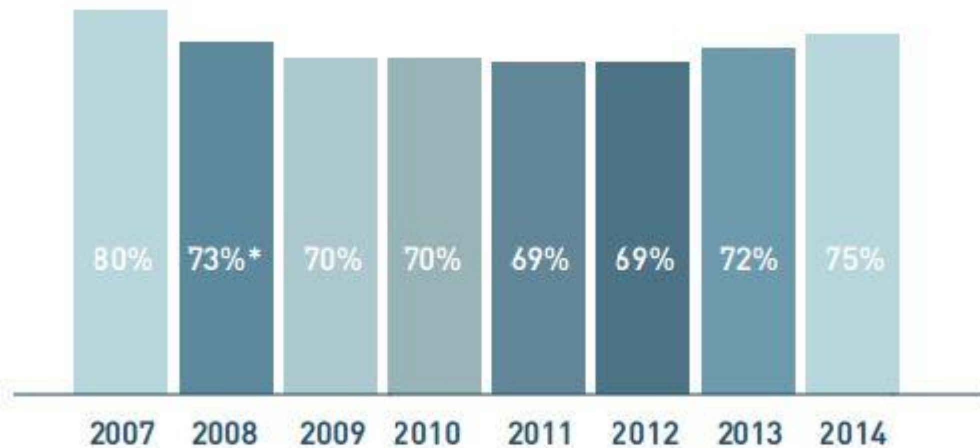
Investor Outlook on SOX

Given the responses to the questions thus far, investors have derived confidence from SOX; however, some of the perceived value of SOX could be adversely affected by external events. A couple of questions were asked to broach this topic.

The first question was if the 2008 stock market crash affected investors' confidence in financial statements. Of the ten investors, three said the crash did affect their confidence and the remaining seven said it did not. This demonstrates that a majority of investors still had confidence in the accuracy of financial statements. Ostensibly, the sample of investors did not blame SOX for the crash. The larger blame of the stock market crash went more toward banks and their risky financial transactions. There is a difference between faith in the market and faith in financial statements. It is important to distinguish between the two because there was an obvious lack of confidence in the market at the time of the crash.

On the other hand, the CAQ has contradicting results. Over the last several years, the CAQ has asked people how much confidence they have in audited financial information released by public companies. The following graph shows the results of this question for the past eight years:

FIGURE 7: Confidence in Audited Financial Information Released by Publicly Traded U.S. Companies



*Change is statistically significant from previous year.

The results of this survey show a clear drop in confidence in audited financial information in 2008 – 2009, which is almost certainly a reaction to the stock market crash. This is evidence that there are a large group of investors that have lost confidence as a result of the crash.

While both survey groups have shown some investors losing confidence, as a whole, there are still a majority of investors that maintained confidence in financial statements after the crash. The loss of confidence by some investors is partially expected because of the lack of trust that occurs when the market goes into recession. Even though the trust is rooted in market concepts, the whole system starts to be questioned when people are looking for blame. Audit failures did play a part in the crash, although it was not the main cause.

The investors in the current study were also asked how much their confidence would decrease if a blue-chip company had an audit failure and went bankrupt. The average response to this was 3.2, showing a slightly above average decrease in confidence. This scenario represents a

case where SOX fails, and an audit failure is allowed to happen. The results make sense in that if there is a high profile case of a financial statement fraud, there is reason to believe that SOX may not be working well enough. This is an extreme event, and if it were to occur it would likely lead to amendments to SOX, just as the stock market crash in 2008 led to changes.

Since SOX was enacted, the closest example of an audit failure in a blue-chip company that then went bankrupt was Lehman Brothers. This was tied closely with the stock market crash, and it is hard to gain any insights on how investors reacted specifically to this event. It can be assumed that with the response of 3.2, investors responded slightly negatively to it.

Long term, these results show that a majority of investors still believe in SOX. It bodes well for the future as the merits of SOX have stayed strong through one of the toughest periods in the stock market since SOX was enacted. A stock market crash and blue-chip failure have had the power in the past to rock the markets, but SOX is a steadying force for investors currently. With it in place, investors have a great chance of maintaining confidence even through rough times in the future.

The last question regarding the future outlook of investor confidence was very general. Investors were asked an open-ended question about whether they had any concerns about financial statement validity going forward. Six investors said they did have concerns, while four investors did not have concerns. These responses were unexpected based off of the prior results. It would appear that investors have increased confidence due to SOX, and that it will last through extreme events, but they still have some concerns. Realistically, it is impossible to have zero risk in audited financial statements, so the fact that audits will never be 100% accurate is a factor of constant concern. There could also be general uncertainty in the future trends of the market. Overall, it looks like investors are satisfied, but will always be concerned just because of what

has happened in the past. Even though there was nothing as powerful as SOX, there were still auditing standards and other control procedures in place prior to SOX to avoid financial misstatements. For investors who invested through the early 2000's, it will always be difficult to be completely confident.

IV. ANALYSIS OF SOX PROVISIONS NOT ADDRESSED IN THE SURVEY

The survey of investors covered many of the key components of SOX, and demonstrated how they felt about certain issues regarding SOX. To keep the survey at a reasonable length, some key parts of SOX were not addressed. The key parts mentioned earlier in the introduction that were not discussed in the survey analysis are discussed and analyzed using previous works by scholars and professionals.

Financial Disclosures

SOX greatly improved the quality, quantity, and timeliness of disclosures public companies must report. In the past, companies were not disclosing enough information, which created ambiguity about certain financial information. The desired effect is to decrease investor uncertainty and increase transparency by public companies. SOX has achieved this, as stricter standards have resulted in more information being available to investors. Real time issuance requirements also ensure that no information gets delayed from being published. Studies have shown that this has resulted in decreased uncertainty and increased transparency in the view of investors (Akhigbe & Martin, 2008). Investors with less uncertainty about financial statements will have increased confidence, so this is a beneficial standard. Increased transparency also allows investors to have more confidence in comparing different companies, knowing that they are looking at comparable information. Enhanced financial disclosures as well as real time

issuance are not the most popular requirements because they are not directly blamed for any high profile failures and are not very costly to public companies or auditors; however, these are extremely important and very beneficial to investor confidence.

Code of Ethics

SOX required in §406 that public companies must disclose whether or not they have a code of conduct, which caused every company to develop a code if they had not previously. There is evidence that the new codes that resulted from this section are improved (Canary & Jennings, 2008). With the improved codes, companies are more likely to follow through with the code and operate in a more faithful manner. In the report published by Canary and Jennings, they concluded that this was true, and that companies took the codes more seriously after SOX was passed.

The true benefit to investor confidence is unclear, as there are likely a large faction of investors who don't even read the code of conduct for financial officers. However, the improved quality of the codes as well as results of companies following them more strictly is a strong protection for investors. There are surely some investors who value this, while others may be minimally effected.

White-Collar Crime

SOX increased penalties for fraud and made top executives more liable for knowingly certifying financial statements with material misstatements. These penalty enhancements increase the responsibility of executives and hold them accountable for misstatements under their watch. While the goal of this was to deter executives from committing white-collar crime, this has not been the case (Balganesh & Sklansky, 2009). The sentencing of white-collar criminals

has not resulted in the deterrence of fraudulent activity. Therefore, §922 has not been very effective. While the premise of this section was on point, the result has not been desired. Investors may have derived value from the enhanced white-collar penalties, but the results have not shown a decrease in the occurrence of illegal activity. The effect on investor confidence, if any, is very small as a result of white-collar crime penalty adjustments.

Whistleblower Protection

Additional whistleblower protections were added as amendments to SOX after the stock market crash. The main goal of this section was to promote more whistleblowers to come forward and release information about possible misstatements on public company financial statements. This goal has been accomplished so far in its short history, as whistleblower tips and awards have risen each year since the added protection came into effect (SEC 2014 Annual Report to Congress on the Dodd-Frank Whistleblower Program). As a result of these increased cases, material misstatements are being stopped before they can occur, and companies that are committing these crimes are paying the price. This demonstrates strong success in increasing whistleblower tips because investors have a better chance of being protected from these misstatements before they happen. Whistleblower awards are normally highly publicized, so investors see the results of these protections. Because of this, investors should have an increase in confidence.

V. CONCLUSION

Because there are many key components to Sarbanes-Oxley, each component must be analyzed separately to evaluate the impact of each on investor confidence. This is the most useful

way to analyze SOX by finding out how much each component effects investor confidence and how much the act in whole effects investor confidence.

Investor Comprehension of SOX

Investors have a moderate understanding of Sarbanes-Oxley. Most investors understand the general ideas behind SOX, while many others have a mild to excellent understanding of SOX. The average investor has some sort of understanding of SOX and acknowledges the protections it gives. Very sophisticated investors certainly know about SOX and likely derive increased confidence from almost every key component in the act. Unsophisticated investors that have minimal involvement in their investments may not realize the full value SOX has to offer in providing safety for their investments. The value for them is in the success of the market and the absence of large audit failures.

Investor comprehension of SOX may also be affected by the time investors started investing. The early 2000's was a period of audit failures and public company scandals that made many investors question the legitimacy of financial statements. Investing during that time was difficult and rebuilding confidence afterwards required an extremely tough law, which SOX has been. For investors to regain confidence, they needed to buy into SOX. The strong bounce back in markets is evidence that investors have regained confidence. For investors that started investing after this period, they did not experience the pre-SOX environment and may take for granted the protections that SOX gives. This decreases the value of SOX to these types of investors. This was evident in the survey, as the one investor who was removed from most of the analysis because he started investing after SOX had less knowledge of SOX. He was effected less by SOX on multiple parts than the average response.

Overall, SOX has reached enough investors to make its desired impact. The comprehension and awareness of SOX by investors is sufficient to be able to judge SOX by its contents and not discount it for being complicated or unknown.

Effects of Key Parts of SOX on Investors

In general, investors responded positively to questions about each key section in SOX. Investors have increased confidence as a result of every important section of SOX. This is strong evidence that SOX has had a big impact on investor confidence. As for the sections that were not discussed in the survey, the requirement for disclosing a code of ethics and enhanced white-collar crime penalties have not made a large effect on investor confidence, although enhanced financial disclosures and whistleblower protections have made a big impact.

Investor Outlook on SOX

The investor outlook on SOX is inconclusive. Investors were mixed in their responses to various questions. The answer of how investors think SOX will hold in the future likely depends on how the actual results start to play out. Investors will react negatively to events that demonstrate failure of SOX, and positively if SOX continues to deter illegal activity. Investors think that SOX has given them many protections, but based on past scandals and audit failures investors can never be fully sure. Investors likely understand there will always be some risk of audit failure and that they can never be fully protected.

Total SOX Effect on Investor Confidence

To determine the total effect SOX has had on investor confidence, every topic about the law must be covered. The survey and analysis has covered all areas, and has given enough information to draw a conclusion on SOX as a whole. Based on this information, it has been

shown that confidence in financial statements has greatly increased as a result of SOX. Audit quality has also increased. These are both desired outcomes of SOX, and each are extremely beneficial to investors and the economy as a whole. While many firms have to deal with additional costs due to SOX, it is worth considering the success it has had since its inception. With increased confidence, investors are more willing to invest in U.S. public markets, which boosts the economy. With audit quality increasing, these investments are safer, and risk goes down, increasing their value. If SOX had not been passed, investor confidence would most likely be much lower in the public markets. Similarly, if some parts of SOX were removed from the act, investor confidence would go down.

VI. APPENDIX

<u>Investor Survey</u>

1. How many years have you been investing?

2. How much do you invest?

3. How frequently do you trade?

4. How well do you understand the creation of the Public Company Accounting Oversight Board (PCAOB) in SOX on a scale of 1 - 5? (1 = Do not understand, 5 = Fully understand)

5. How well do you understand mandatory internal controls audits in SOX on a scale of 1 - 5? (1 = Do not understand, 5 = Fully understand)

6. How well do you understand audit partner rotation in SOX on a scale of 1 - 5? (1 = Do not understand, 5 = Fully understand)

7. How well do you understand restrictions on outside services provided by external accountants in SOX on a scale of 1 - 5? (1 = Do not understand, 5 = Fully understand)

8. Did the passage of SOX in 2002 affect your investing strategy?

9. Which of the following parts of a company's 10-K do you read? (You may choose more than one)

10. Does the auditor's internal controls report affect whether you invest in a company or not?

11. Do you think internal audits help reduce audit failures / produce more accurate results?

12. Does the requirement of having the CFO/CEO sign off on financial statements increase your confidence on the validity of reported numbers?

13. Has the 2008 stock crash affected your confidence in financial statements?

14. Are you just as confident in financial statements of IPO's as you are with veteran companies?

15. Do you have any concerns about financial statement validity going forward?

16. How much would required internal controls audits for low market cap companies (Currently SOX lets low cap companies be exempt from having internal controls audits) increase your confidence? (1 = Does not increase confidence at all, 5 = Greatly increases confidence)

17. How much would mandatory audit firm rotation increase your confidence? (1 = Does not increase confidence at all, 5 = Greatly increases confidence)

18. How much would more frequent audit partner rotation increase your confidence? (1 = Does not increase confidence at all, 5 = Greatly increases confidence)

19. How much would increased auditor liability for audit failures increase your confidence? (1 = Does not increase confidence at all, 5 = Greatly increases confidence)

20. How much would stricter auditor independence rules increase your confidence? (1 = Does not increase confidence at all, 5 = Greatly increases confidence)

21. How much would your confidence decrease if there was no requirement of an internal controls audit? (1 = Does not decrease confidence at all, 5 = Greatly decreases confidence)

22. How much would your confidence decrease if there was no audit partner rotation? (1 = Does not decrease confidence at all, 5 = Greatly decreases confidence)

23. How much would your confidence decrease if there was no requirement of CFO/CEO to sign off on financial statements? (1 = Does not decrease confidence at all, 5 = Greatly decreases confidence)

24. How much would your confidence decrease if the PCAOB no longer provides oversight to the external auditing profession? (1 = Does not decrease confidence at all, 5 = Greatly decreases confidence)

25. How much would your confidence decrease if a blue-chip company has an audit failure and goes bankrupt? (1 = Does not decrease confidence at all, 5 = Greatly decreases confidence)

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