

The Unintended Consequences of Sarbanes Oxley Act

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Abstract

This paper argues that Sarbanes Oxley Act has given investors a fresh breath of life with a renewed sense of confidence in the US financial market. Sarbanes Oxley Act tend to minimize corporate collapses, audit failures and litany of financial restatements that permeated the corporate arena, the financial market several years and bred deep cynicism and public anger. Sarbanes Oxley Act is signed into the law to restore confidence in investing public and financial markets through a combination of rules and oversight that address conflict of interest on investor side and the lack of accountability on the corporate side to improve corporate governance. It aimed at to compensate for the failure of governances that culminated in Enron, WorldCom and Tyco financial scandals. Corporate managers are being held accountable for corporate governance and Sarbanes Oxley Act also detects what firms can and cannot do. All corporate senior officers and participants in the preparations of published financial reports have increased responsibilities and consequences for failing to leave up to the standard and responsibilities. Due to SOX, the top corporate officers such as the CEO and CFO are required to take personal responsibility by certifying both quarterly and annual financial statements and disclosure. Firms have better internal control environment as a result of Sarbanes Oxley Act. This translates to a more accurate and reliable information conveyed to investors who would rely on published financial statements to make informed investments decisions.

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I. Introduction

On July 30, 2002, the Public Company Accounting Reform and Investors Protection Act popularly known as Sarbanes Oxley Act was signed into law by President George W. Bush. The act is spawned in the wake of massive financial fraud and accounting scandals that rocked and sent shocking wave across corporate world and the Wall Street. Investors Protection Act is considered to be the most sweeping, comprehensive, and a significant legislative action directed at corporate governance activities since the Securities Act of 1935 and the Securities Exchange Act of 1934.

In the turn of the century, financial fraud and accounting scandals that manifested corporate world enraged the public and financial market to the point that political action was considered necessary, the result of which is the Investors Protection Act of 2002. Prior to the passage of the Sarbanes Oxley Act (SOX), the Securities and Exchange Commission (SEC) had been the nation's leading regulating agency for public enforcement of securities laws and regulation that protected investors. In 2000 before the passage of Sarbanes-Oxley Act, the US financial market was in downwards spiral and investors lost confidence in the capital market. The objective of the Investors Protection Act is to address the numerous violations of corporate governance rules and lax internal control procedures executives committed during the wave of accounting and financial scandals that affected corporate world over five years. Investors Protection Act was the government's reaction to the public's growing skepticism about the ability of the existing corporate governance laws and regulations to control and discourage unethical and illegal financial and accounting practices.

Sarbanes Oxley Act created a quickfix to stimulate the economy in an attempt to restore investors, public, and international finance market participant's confidence in the US financial system by promoting due diligence, integrity, and honesty in the cynical business world caused by corporate financial improprieties and accounting scandals. Sarbanes-Oxley Act aimed to compensate for the failure of corporate governance that had culminated in the widespread of financial and accounting scandals. The rush to enact the Sarbanes Oxley Act failed to address some key areas of the act that may have adverse impact on businesses, auditing firms, and as well as foreign firms trading in US financial markets. Sarbanes Oxley Act gave birth to the establishment of a Private Company Accounting Oversight Board (PCAOB) whose role is to oversee and inspect the audits of public companies that are subject to securities law.

The PCAOB also requires the management to assess and report on the effectiveness of internal control over the financial reporting. Section (404b) of the Sarbanes Oxley Act calls on independent auditors to attest to the management effectiveness of the internal control. Investors view the auditors' attestation on Internal Control over Financial Reporting (ICFR) as beneficial. In October 22, 2003, PCAOB made it illegal for any US based accounting firm to issue an audit report to a Securities and Exchange Commission reporting company unless the company is registered with the Board. Registration of accounting firms is the basis for the Board's authority over the auditing firms and PCAOB would periodically inspect the registered accounting firms. The PCAOB is also saddled with the responsibility of establishing auditing and other professional standards that govern public company audit. The new standard would require the auditor's opinion to refer to the Board's authority. Prior to Sarbanes Oxley Act; auditors were governed by a system of self regulation which did not preserve their ability to act independently and objectively to be watchdogs.

Compliance and Implementation Costs

There is a considerable concern about the adverse effect and counter-productive of Section (404) of Sarbanes-Oxley Act. It has been suggested by critics that Section (404) reporting requirements is diverting significant amount of executive time and the company resources away from the firms' and stifles the ability of the firms to generate profit. A survey conducted and published by the Financial Executive International (FEI) in 2006 reveals that firms spend average of 22,786 labor hours to comply with Section (404) in 2005. An online survey by a National Association of Corporate Directors from December 2005 through February 2006 reveals that the percentage of directors who put in 200 or more hours in the board related work nearly doubled from 34 percent to 65 percent since the passage of Sarbanes-Oxley Act. Section (404) has created an incentive for firms to go private or refrain from going public.

The costs of complying to Section (404) of the act has been generally viewed and perceived by critics and corporations to be high and places undue financial burden on firms or companies. In 2007 a survey published by the Financial Executive International shows that the average compliance costs of Section 404 of Sarbanes-Oxley Act incurred by firms was approximately \$3.8 millions in 2006.

Some critics believe that the compliance costs will fall as firms become conversant with the law and improve on the internal control. In response to the high compliance costs of Section (404) of the Act, the PCAOB issued an Accounting Standard No. 5 to replace its Auditing Standard No. 2. This guideline reduced the total compliance cost of Section 404 of the Act. In 2007 series of legislative actions were taken to minimize the compliance costs without compromising the effectiveness of the Act. There have been an ongoing and a popular outcry by critics against the burden of compliance costs that the Sarbanes Oxley Act has placed on publicly traded firms'.

The critics claim that compliance costs is driving some of the domestic firms to delist their stocks from stock exchanges and go private. Zhang (2007) in his study of investigation of costs, examined stock price reaction to Sarbanes-Oxley Act related events, based on the believe that security returns should over an unlocking events should reflect expected costs and benefit of Sarbanes-Oxley Act. His investigation reveals that the US stock returns around such events are negative. Based on his investigation Zhang concluded that Sarbanes-Oxley Act imposes significant net costs to firms. Leus (2007) states that such studies by Zhang have methodological limitations, and suggests a need for care in attributing negative returns to Sarbanes-Oxley Act and in interpreting evidence on the compliance cost associated with the Act.

According to 2006 Government Accountability Office (GAO) report, the number of public companies that went private increased significantly from 143 in 2001 to 2004, with greatest increase in 2003. Engel, Hayes, and Wang (2007) tested the hypothesis that compliance costs fall disproportionately on small firms paving way for them going-private. They provide evidence that suggest that, there is a higher incidence of firms going private following the passage of Sarbanes-Oxley Act. They also addressed the net costs imposed by Sarbanes-Oxley Act by analyzing firms decision to go private based on the believe that the firms will avoid the costs associated with Sarbanes-Oxley Act by going private whenever the costs outweigh the benefit. The GAO report also states that smaller private companies wanting to go to public were spending time, efforts, and other resources to convince the investors that they could meet Sarbanes Oxley Act requirements. The Act applies to foreign firms that rely on American Depository Receipts (ADR). Some domestic firms are trading on "Pink Sheets", a term used to describe companies who trade on electronic quotation system that is not regulated by Securities Exchange Commission.

Sarbanes Oxley Act equally affects domestic and foreign firms who trade conventionally on US Financial market. ADR are negotiated financial instruments issued by foreign firms and backed by shares issued in their domestic country through a depository institution that acts as a custodian. The firms that use ADR's have the option to delist in the United States Financial market but continue to be publicly traded in their home country. The overriding concern is, did these companies delist because of compliance costs, or because Sarbanes Oxley Act has made it less comfortable for the corporate managers and the controlling shareholders to engage in financial improprieties. The analysis of stock price reaction at delisting date shows a negative stock price response. This is an indication that investors were disappointed that firms avoided corporate governance improvement required by SOX. Hostak, Karaoglu and Yang (2007) argue that the delisted companies are motivated by the managers desire to protect their private benefit that Sarbanes Oxley Act would curb and investors seem to understand that these delisting are not value enhancing for shareholders and their firms. They found no evidence that de-listings were motivated by avoiding the compliance costs.

Dodd-Frank Wall Street Reform Act under Section 989 G(b) is required to conduct a study to determine how the SEC could reduce the burden of complying with section (404b) for smaller firms with market capitalization between \$75 millions and \$250 millions while maintaining investor protection for such firms. The study must consider whether any methods of reducing the compliance burden or a review of whether a composite exemption for such firms from section (404b) compliance would encourage to list on US exchanges in their initial public offerings (IPOs). Dodd-Frank Wall Street Reform exempted approximately of the reporting issuers from Section (404b) and the Staff does not recommend further extension of this exemption.

The commission report says the Securities and Exchange commission is also monitoring Committee On Sponsoring Organization (COSO's) work to review and update its internal control framework, which is common framework used by management and auditors alike in performing assessment of Internal Control over Financial Reporting (ICFR). McKay (2003) and Frigo and Litman (2004) state that increased disclosure and related internal control requirements introduced by Sarbanes-Oxley Act are frequently cited catalyst in the recent movement to "go dark".

Nelson (2003) argues that the recent wave of deregistration has left many shareholders without access to accurate, publicly available information about the firms in which they have ownership stakes.

Initial Public Offerings

US financial market is viewed by foreign and domestic firms as the primary place for companies to raise operating capital by listing their stocks. The compliance reporting requirements requires due diligence team of lawyers and accountants to ascertain that the compliance of the firms of going IPO's are met and satisfied. Well intended and meaningful firms see these requirements as good and designed to protect to potential investors, however firms with hidden agenda find the provisions in Sarbanes Oxley Act as extremely burdensome for IPO's firms. In 2008 there was a decrease in the number of companies going IPO's not as a result Sarbanes Oxley Act but as a result of global economic recession.

Decrease in the number of firms going IPO in 2008 meant that the firms were less able to raise capital in the financial market. This decrease in IPO has spurred criticism from corporate managers and auditors who attest that Sarbanes Oxley Act is too bureaucratic, costly and cumbersome.

US Government Accountability Office (US GAO) reports that 1999 to 2004, Initial Public Offerings (IPO's) by firms with revenue of \$25million decreased substantially from 70% of all IPO's in 1999 to 45% in 2005. Sarbanes Oxley Act was one of the several factors identified by GAO as affecting this number and in addition to the general increase in the direct expenses of the IPO's process. In 2013 foreign companies have returned in a significant number to the United States financial markets for their initial public offerings launches. They were attracted by the flexible exchange rule and buoyant stock market. The data collected by the New York Law firm Pepper Hamilton LLP to buttress this point. He states that according to the data 28 foreign firms have raised capital in US IPO's in 2013.

The following countries Bermuda, Canada, China, Israel, the Netherlands and the United Kingdom are the most foreign countries with countries that list in the US financial markets. The Jumpstart Our Business Startup Acts 2012 (JOBS Act 2012) has also attracted many smaller companies to the US financial markets by providing even greater flexibility for emerging companies that generate less than \$1 billion in annual revenue.

One of the concerns of the JOBS Act is that the act opens the way for misconduct by ignoring SOX's checks on internal control for few years. The president informed the Justice Department and the SEC to keep an eye out to protect investors.

Financial Restatements

Sarbanes-Oxley Act requires firms to assess the effectiveness of their internal controls over financial reporting are geared towards preventing financial misstatement that could be material to the financial statements in pursuant to the Foreign Corrupt Practices Act of 1977. Publicly held firms have long been required to maintain effective internal controls system. Sarbanes-Oxley requires the publicly held firms to evaluate their financial internal control and to disclose the results of the assessments annually.

Internal controls over financial reporting are processes that provide assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with the Generally Accepted Accounting Principles and international Accounting Reporting Standards. The Audit Analytics report published in 2009 found that the rate of financial restatements was 46% higher for firms that did not comply with all of the Sarbanes-Oxley Act internal control provisions. The annual Audit Analytical report on financial restatements for 2014 provides highlights on trends in financial restatements over the fourteen-year period. The report states that, the quantity of financial restatements has leveled off and the severity has remains low in the last five years, however financial restatements have increased from accelerated filers for the fourth straight years. The Audit Analytics report pointed out that during 2014, the average income adjustment per restatement by publicly traded firms was \$1.9million, the lowest during the last eight years reviewed.

Many years after the passage of Sarbanes Oxley Act, the Securities and Exchange Commission waved the requirement for privately held firms. This waiver allowed the auditing firm that was responsible auditing Bernard L Madoff's Investment Securities firm to avoid registering with the Board and to avoid government oversight the Sarbanes Oxley Act was designed to create. In 2008 Benard L. Madoffadmitted perpetrating a ponzi scheme and afterBenard L. Madoffponzi scheme the SEC began taking a decisive and comprehensive steps to reduce chances that such frauds go undetected in future.

SEC examiners across the country routinely reach out to third party stakeholders during the routine exams to verify the existence and the integrity of all or part of assets managed by the firm. MadoffoperatedInvestments Advisory and broker-dealer firm that misappropriated clients funds in the tune of \$65 billions and used an obscured auditing firm Friehling&Horoitzwhich did not register with the PCAOB.

In January 2009, the Securities and Exchange Commission allowed the waiver to lapse after the news of Bernard L Madoff'sponzi scheme broke and its devastating effects on individual investors and financial market. The regulators have stepped up the oversight of broker-dealers, the firms used by millions of investors to trade, since the arrest of Benard L. Madoff. The Public Company Accounting Oversight Board (PCAOB), the U.S audit watchdog adopted new standard under the 2010 Dodd-Frank Wall Street reform law to write standard that will routinely inspect and discipline auditors of broker-dealer firms.

Under the new adopted standard, the auditors of broker-dealers who take custody of client's monies will be required to conduct reviews of those brokerages' internal control to ascertain that that the brokerages are complying with the Federal net capital rules and make sure that customer financial assets and resources have not been misappropriated. In addition, the broker-dealer firms are required to file compliance report with the SEC to verify that they are following the Agency's capital requirements and customer's protection rules. Auditors of these privately held firms are required to register with the Board and are to be held accountable for ethical and professional standard violations set forth by the Board.The SEC chairman Mary Jo White plans to refocus the agency's effort on accounting fraud, this may be viewed that the SEC believes that financial statement fraud has not significantly declined or been eliminated as a result of Sarbanes-Oxley Act.

Sarbanes-Oxley Act has been instrumental for strengthening the CEO and CFO responsibility and accountability for all financial disclosures and related controls and the increased professionalism and engagement on the part of firm's auditcommittees.Yet, some critics question its objective citing its inability to prevent the circumstances that led to financial crisis of 2008. Given the magnitude audit failures, a great deal of effectiveness of Sarbanes-Oxley Act depends on the vigor to which it is enforced.

The question remains as to whether the SEC and the Department of Justice's enforcement of SOX has been sufficient or captured. On July 30, 2012, the Wall Street Journal notes "that the threat of jail time for corporate executive who knowingly certify inaccurate financial report got away largely unsued".

Conclusion

The passage of the Sarbanes Oxley Act, rejuvenated investors, public, and as well as foreign firm's confidence in the US financial market and the market began to improve in the month after the act became a law. The positive sign of Sarbanes Oxley Act include increased registration of international firms and their securities in US financial market and a shift from private equity securities to public equity securities.

Sarbanes Oxley Act is well intended legislation designed to protect investors from accounting and financial schemes by corporate managers. It is very unfortunate that critics and corporate managers see faults in every twist and turn in the Act. These companies who delist and IPO's firms who see Sarbanes Oxley Act problematic may be, are the firms that may be engaged in accounting and financial misappropriations, such as earnings manipulation, restatement, and untimely revenue recognitions, and may have internal control issues. The exit of these firms from the financial market may be good to the investors and the financial market.

All of the compliance costs would seemingly worthy of approval and herald with glee if investors, corporations, and public had increase confidence in the US financial markets. The cost of investor's confidence in the companies, the US financial market, and good economy should overrides compliance and the implementation costs of section 404 of Sarbanes Oxley Act.

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