Business Perspectives and Current Developments With Respect to the Sarbanes-Oxley Act

Marjorie Chan
California State University at Stanislaus

The purpose of this article is to present the business perspectives on the Sarbanes-Oxley Act (SOX) gathered over a year after it was passed in 2002 and to discuss the current developments of the Act. Business perspectives with respect to SOX were gathered by telephone interviews with 17 participants in September and October of 2003. On the average, each taped telephone interview was 30 minutes in length. The interview data are confirmed with the current developments of the Act. For example, the interviewees pointed out that although the Act contributes to accuracy, greater disclosure and transparency in financial reporting, it involves significant implementation costs which are even more substantial for smaller public companies. The latter may go private. These views are still valid to date as evidenced by the efforts of the SEC and the Public Company Accounting Oversight Board (PCAOB) to lower the costs of SOX compliance especially for smaller public companies. Future research should examine whether Auditing Standard No. 5 contributes to cost-effectiveness in SOX compliance. In terms of practical implications, businesses should make use of the new Auditing Standard No. 5 and the new management guidance to improve the cost-effectiveness of SOX compliance.

INTRODUCTION

This study provides the perspectives of business executives gathered back in 2003 with respect to some of the provisions of the Sarbanes-Oxley Act of 2002 (SOX) and current developments of SOX. It provides the current efforts on the part of the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), the Advisory Committee on Smaller Public Companies (ACSPC) to the SEC, and the governmental and private sectors to correct the criticisms of the Act. An outline of the paper is presented as follows. SOX is first described. Interview questions and interviewees' perspectives on various criticisms of SOX were reported. The paper ends with the current efforts to address the criticisms of SOX.

THE SARBANES-OXLEY ACT of 2002

Corporate malfeasance and accounting fraud led to the downfall of various major corporations. The resultant shareholder losses, layoffs of employees together with losses of their retirement savings brought about congressional and public scrutiny. The Sarbanes-Oxley Act was signed by President Bush on July 30, 2002 to address the corporate ills. SOX includes 11 titles, each of which is briefly described here. Title I establishes a new Public Company Accounting Oversight Board with investigative and disciplinary powers over the public accounting profession. Title II addresses auditor independence. The external auditor or auditing firm should not have any relationship with the issuer (the legal entity that registers and sells securities to the public on the market) for which an audit is performed. It prohibits auditors from offering certain types of non-audit services such as bookkeeping, valuation, investment banking and the design and implementation of financial information systems. This title requires the rotation of senior audit partners, and the external auditor has to report to the issuer's audit committee.

Title III addresses corporate responsibility. The audit committee has to consist of all independent directors, and at least one of them has to be a "financial expert." Section 302 of this title requires both the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) each individually to certify the firm's annual or quarterly financial report. The certification should indicate that the financial report does not include material misstatements or the omission of material facts. The CEO and CFO are responsible for designing internal controls in order to ensure that all material information pertaining to the company and its consolidated subsidiaries properly flows to them. They have to include in the financial report their assessment of the effectiveness of the firm's internal controls. Section 302 requires both the CEO and CFO to individually certify that they have disclosed to the outside auditors and the audit committee material weaknesses in the firm's internal controls and the latter's significant deficiencies in terms of design or operation. The CEO and CFO have to certify that they have disclosed to the firm's external auditors and audit committee fraud committed by anyone who plays a role in the firm's internal controls. The signing officers have to reveal in the financial report corrective measures with respect to internal controls' material weaknesses and significant deficiencies. If there were material changes to internal controls subsequent to the evaluation date that could affect internal controls in a significant fashion, the signing officers have to disclose these changes.

Title IV pertains to enhanced disclosures of financial transactions such as off-balance sheet transactions, pro forma information and equity transactions on the part of corporate officers and major stockholders. Title IV prohibits personal loans to executives. It requires the firm to adopt a code of ethics for senior financial officers. Also, reasons would have to be provided if a code of ethics were not in place. Section 404 of Title IV constitutes the most costly provision of SOX. It requires management oversight for and the assessment of the effectiveness of the firm's internal control structure and financial reporting procedures. The firm's external auditor has to attest to management's assessment of internal controls and to report on it.

Title V addresses conflicts of interests that may occur with respect to securities analysts' public recommendations of equity securities. Title VI describes the SEC's resources and its authority to bar individuals from practicing in the securities field. Title VII describes studies and reports regarding the consolidation of public accounting firms, credit agencies' role in securities market operation, violations on the part of securities professionals against securities laws, enforcement actions, and investment banks' role in helping public companies such as Enron and Global Crossing to manipulate earnings and obscure these companies' real financial picture.

Title VIII describes criminal penalties in terms of fines and/or imprisonment for a maximum of 20 years for record falsification, destruction, or alteration. This title indicates that the United States Sentencing Commission shall review the adequacy of the Federal Sentencing Guidelines with respect to obstruction of justice and fraud enhancement. This title incorporates whistleblower protection to employees of public corporations against retaliation for furnishing evidence of fraud.

Title IX describes the enhanced criminal penalties for white collar crimes and conspiracies. The United States Sentencing Commission shall review and amend the Federal Sentencing Guidelines to ensure that the latter reflect the seriousness of the white-collar crimes. Section 906 of this title requires the CEO and CFO to certify that the information presented in a periodic report fairly and accurately describes the firm's financial status and operational results. A CEO or CFO who knowingly certifies an inaccurate financial report can be fined up to $1 million and/or imprisoned for up to 10 years. A CEO or CFO who engages in willful violations by certifying a false financial report can be fined up to $5 million and/or imprisoned for a maximum of 20 years.

Title X indicates that the CEO should sign the Federal income tax return of the corporation. Title XI describes that record tampering and impediment to official proceeding will be fined and/or imprisoned for up to 20 years. This title addresses that the Federal Sentencing Guidelines for offenses related to securities and accounting fraud have to be amended so as to reflect the serious nature of the offenses. Retaliation against informants will result in a fine and/or imprisonment for up to 10 years. It also addresses the increases in criminal penalties under the Securities Exchange Act of 1934 ("Sarbanes-Oxley Act of 2002," 2002).

BUSINESS PERSPECTIVES ON ISSUES AND SPECIFIC CRITICISMS WITH RESPECT TO THE SARBANES-OXLEY ACT

As there were issues and criticisms with respect to SOX, this author sought the business perspectives of various organizations during September and October of 2003 on SOX. The Act requires a majority of independent directors to fill board seats; therefore, the issue of the potential shortage of candidates was raised (Schroeder, 2003). Another important issue pertains to the criteria for director selection. According to the July 22, 2003 *Wall Street Journal*, critics of the Act and the proposed rules of the exchanges blamed that the regulatory efforts failed to address significant issues such as the following:

- Minimal evaluation of directors' own performance.
- Exclusion of shareholders from direct access to the proxy for director nominations.
- With the overemphasis on compliance, boards and management may become risk-averse.
- Overgenerous executive compensation.
- Difficulties for whistleblowers to communicate directly with board members (Hymowitz & Lublin, 2003).

The research participants were asked to provide their perspectives with respect to the aforementioned issues of the Act, pros and cons of the Act, and whether or not the Act would prevent a major scandal such as WorldCom or Enron.

Method

Business perspectives of various organizational leaders on SOX were gathered with telephone interviews in September and October of 2003, over a year after SOX was passed. As the board of visitors of this author's alma mater consists of notable business leaders from various industries such as banking, finance, consumer products, food, and so on, several of them were approached. Five of those contacted consented to an individual telephone interview or to get higher-level employees in their companies to participate in telephone interviews. Aside from individuals on the board of visitors of this author's alma mater, other organizations as indicated in the following were contacted. Three formidable high-technology firms were approached and this author succeeded in getting the participation of all three. Due to their knowledge of SOX, two pension fund systems and a public accounting firm were contacted for participation, and they all consented to participate. Since Sox involves corporate governance reform, this author would like the perspectives with respect to the improvement of boards and investor relations. Therefore, two not-for-profit organizations, one pertaining to the improvement of corporate board practices and another pertaining to the best practices in investor relations were contacted, and both consented to participate. As the author would like to get more Fortune 100 and 500 companies to participate, some investment banking firms and cosmetic companies were contacted, and four executives from three New York-based firms consented to participate. A total of seventeen interviewees from 16 organizations participated in this research. The author had received the permission from all 17 interviewees to tape the telephone interviews, each of which, on the average, was 30 minutes in length.

Interviewees

Seventeen interviewees from 16 organizations participated in this research. According to the 2003 Fortune 500 in terms of revenues (*Fortune.com, 2003)*, five Fortune 100 companies (four public companies and one private pension system), and four Fortune 500 companies (three public companies and one private firm with public bondholders) were among the participating organizations. The remaining seven participating organizations consisted of one smaller public company, two private firms, one private limited partnership, one public pension system and two not-for-profit organizations. The interviewees consisted of three Chairmen, three Presidents, two CFOs, six Counsels (one of which bears the Corporate Secretary title as well), one Vice President of Investor Relations, one Corporate Secretary, and one Director of Sarbanes-Oxley.

Interview questions

The research participants were asked to provide their perspectives with respect to the previously described issues of the Act, pros and cons of the Act, and whether or not the Act would prevent a major scandal such as WorldCom or Enron.

Interviewees' Responses to Issues

Director Shortage?

With respect to the question whether the Act would create a shortage of independent director candidates, 11 of 17 interviewees answered to the negative, two answered to the affirmative, three emphasized the difficulty of finding independent directors rather than the shortage of independent director candidates, and one commented that it would be speculative to say that the Act might create a shortage of independent directors. Even for those who answered to the negative, a majority recognized the challenge of getting qualified independent directors. With respect to two interviewees who expressed the possible shortage of independent directors, one said the following:

> I think it is going to be a problem in Corporate America. It is a combination of adding greater time burden on directors, more work, greater risks, greater liabilities for lawsuits and pressure to avoid paying them too much. When you add all that together, you are turning it into a relatively undesirable position, and so a lot of the people who would be the best directors are not going to want to do it. Also, the pressure for independence will tend to exclude active CEOs, who are often the best outside board members.

With respect to those who commented that the Act would not create a shortage of independent directors, many expressed that the shortage would only occur if companies looked for strictly sitting CEOs, celebrities, and luminaries to be board directors. As long as companies are willing to draw these directors from a broader net of qualified and experienced people with good judgment, then there should not be a shortage of independent directors.

Criteria for Director Selection

A majority of the participants' perspectives were well summarized in one interviewee's answer. The latter described the criteria in terms of three components: principle-based characteristics, core competences and experience. Principle-based characteristics refer to integrity, accountability, independent-mindedness and courage to challenge the board. Core competences encompass a proven track record, expertise in a specific area such as finance, and significant knowledge of the industry. Experience refers to what the company needs that will add value to the board. For example, a company may need someone who has a background in a specific area such as technology, or mergers and acquisitions, and so forth. Most interviewees also emphasized the importance of having a diverse board with different areas of expertise and perspectives. One participant commented that in addition to functional diversity, ethnic- and gender-based diversity can bring about a positive impact on the board. Five participants brought out the importance that board members work collegially together. In other words, an individual director's cultural fit with the company and the board has to be considered. Two participants pointed out that as companies expect board members to participate in board meetings, committees, site visits and various activities, it is absolutely essential to examine the current responsibilities of each director candidate to be sure that the latter can make the time commitment to duties of a board member if elected to a company's board. Two big companies touted for prominent individuals as board directors, and one of them stated: "You want people of the greatest possible stature, people who have so much prominence and self-confidence on their own that they will be able and willing to stand up to the CEO in a situation where that is appropriate."

Evaluation of Directors

Neither the Sarbanes-Oxley Act nor the exchanges require the performance evaluation and removal of weak directors. It was reported that only 30% of the boards evaluate individual members (Hymowitz & Lublin, 2003). Participants were asked to express their views on this issue. All 17 interviewees agreed that board evaluations, either formal or informal, should be done. All participating organizations, except for two, conduct board evaluations on a regular basis. Three emphasized that the issue revolves around the decision with respect to what evaluation process to use rather than whether or not the boards are evaluated. The different evaluation processes currently used by the participating organizations are discussed as follows.

The three different evaluation processes used by the participating companies include self-evaluations, peer evaluations, and informal evaluations by the nominating committee which puts the board up for reelection. For example, one company performs an annual formal self-assessment of the board as a whole, and then each director evaluates his/her own performance. An outside consultant is hired to analyze the evaluation results and to make suggestions for improvements in board process or composition. Companies can also conduct self-evaluations of board performance or individual director performance instead of both. Data can be analyzed by internal staff as opposed to an outside consultant.

Similar to the self-evaluation process, a peer evaluation process can be formal or informal. One participant mentioned a peer evaluation process whereby each board member evaluates his/her fellow board members on an anonymous basis. The evaluations are then compiled in order to identify those who should not be reelected in the view of their fellow board members. One participant considered that an informal networking process whereby a director engages in one-on-one discussion of a fellow director's performance with other directors on the phone can promote candor. Directors are more likely to feel uncomfortable to discuss the performance of a fellow director in a formal meeting with a big group of people in a big room. One participating organization has the board as a whole to evaluate each director, and then the directors are evaluated by the Chairman of the board. For companies that do not have a formal director evaluation process, a nominating committee can informally evaluate directors' performance before nominating them for reelection. A nominating committee is aware of each committee Chairman and fellow directors' views with respect to a particular director's performance. Furthermore, a nominating committee can examine the attendance and committee participation record of each individual director. Therefore, an informal director evaluation process can be performed by a nominating committee.

One participant brought out the drawbacks of some of the evaluation methods. For example, if a director's performance is poor, the Chairman should have a one-on-one discussion with the individual on a confidential basis. Peer evaluations can only have a negative impact in this situation. With individual self-evaluations, there may be a discrepancy between an individual director's evaluation of himself/herself and the committee Chair's evaluation of this individual. The rating one gives oneself tends to be higher than the one given by someone else. Therefore, this participant stated that self-assessment of the overall board performance should precede self-assessment of individual directors.

Shareholders' Lack of Direct Access to Proxy Materials for Director Elections

One of the criticisms of the Act is that it does not address the issue that shareholders do not have direct access to proxy materials for director elections. Interviewees' perspectives were gathered with respect to the inclusion of shareholder nominees in proxy materials for director elections. One private company and two pension fund systems were in favor, and one public company did not have a position on this issue. Thirteen of 17 interviewees were not in favor of it. A majority of the participants considered that the nominating committee with all independent directors as required by the SEC should nominate all the directors. Shareholders should be encouraged to recommend candidates to the nominating committee. The latter has to develop the minimum qualifications and specific skills that a director should possess. It has to come up with a process for director selection, and both the criteria and process have to be disclosed completely. This expanded disclosure is expected to reveal whether or not the same standards are used to evaluate both shareholder nominees and non-shareholder nominees. Six interviewees raised the concern that a shareholder nominee may represent a special interest group, and not all shareholders. Two participants emphasized the importance of a cohesive board that operates with trust, collegiality and openness. Shareholder nominees who may have their own agenda will have an adverse effect on the board. Two interviewees mentioned that it is important for the board to have continuity, and granting shareholders access to the proxy materials for director election tends to disrupt the governance process. Another two interviewees expressed concerns with respect to various arbitrary criteria proposed by the SEC such as the percentage of share ownership or the length of time that shares have been held to determine nominating security holder eligibility.

There has been an ongoing debate with respect to the expansion of shareholder power (e.g., Bainbridge, 2006; Bebchuk, 2005). However, on November 28, 2007, the SEC voted 3 to 1 to authorize companies to deny shareholders access to the proxy for the nomination of corporate directors (Taub, 2007).

Would Compliance Lead to Risk-Aversion?

With respect to the question as to whether or not corporate boards and management would become risk-averse due to the focus on compliance with the Act, 6 and 10 of 17 interviewees answered to the affirmative and negative, respectively. One interviewee considered the question too broad to provide a “yes” or “no” answer. Three interviewees who answered to the affirmative and the one who did not provide a definitive answer pointed out that a balance has to be struck between a focus on compliance and innovation which enhances revenues, shareholder interests and the good of the total organization. One of these interviewees also brought out the issue that as resources are allocated for compliance, there will be less resource allocation for other activities, and this may be an implication of possible risk-aversion. Two of these participants also mentioned that the aversion to risk is brought about by a highly regulated environment with increased criminal penalties. As for the remaining participants who answered to the affirmative, one interviewee supported the argument raised by Peter Wallison of the American Enterprise Institute for Public Policy Research. Wallison (2003) pointed out that as independent directors work on a part-time basis, and professional managers run the companies on a full-time basis each day, the latter’s knowledge of the companies’ business far exceeds that of the former. Consequently, independent directors are more likely to choose a cautious as opposed to a risky course of action. One interviewee expressed that the Act may create so much caution that internal audit may double-check and triple-check everything. People may start to worry about their own shadow all the time. One participant commented that the newness of the Act and the SEC’s interpretations and rules setting “will certainly put directors in a company in a more risk-averse situation.”

As for the 10 participants who answered to the negative, their view is that companies will pay more attention to the accuracy and the full disclosure of financial statements, but the Act will not affect strategy formulation. Companies will also carefully evaluate the “business, legal, and reputational consequences” of their activities. As both CEOs and CFOs have to certify financial statements, much more discussion will be devoted to various company activities than in the past.

Based on a large sample of U.S. and U.K. firms, Bargeron, Lehn, and Zutter (2008) examined empirically whether risk-taking on the part of U.S. firms compared to U.K. firms had declined between the pre-enactment and the post-enactment of SOX. Their results indicate that SOX had a chilling effect on U.S. public firms' risk-taking behavior. They found that in the post-SOX period, U.S. firms, compared to the U.K. firms, had significantly increased their cash holdings and significantly decreased their capital and R&D expenditures. Their results reveal that in the post-SOX period, compared to U.K. firms, the riskiness of U.S. firms' equity had significantly declined. Their results also indicate that after SOX, there was a significant increase in the probability that an initial public offering (IPO) was conducted in the U.K., and for firms in high R&D industries, this effect was particularly high.

The Issue of Excessive Executive Compensation as Raised by Critics

One participant expressed that the Act was not designed to address every issue that each individual has in a specific area. Another stated that the Act's intention is to insure accuracy and fair reporting in financial statements; therefore, the subject of excessive executive compensation is not addressed by the Act. If excessive executive compensation were an issue in a company, shareholders could exercise their choice to vote out the directors. Three participants consisting of two pension systems and one private firm agreed that certain reforms should be undertaken to address the abuses in executive compensation.

Eight of 17 participants pointed out that as long as pay is tied to the overall performance of the firm, the criticism of excessive compensation will not be justified. They also mentioned that the compensation committees will be more thorough in their evaluation of the appropriateness of compensation packages due to the recent scandals. However, three participants considered that executives need appropriate incentives to enhance the performance of a firm, and in order to keep good quality leadership, top dollars may have to be paid. It is a matter of supply and demand. If executive compensation were reduced in one firm, the firm's high-performing CEO would move to another company. Three participants did not consider excessive executive compensation to be an across-the-board issue, and one did not consider it an issue at all. Two of these participants mentioned that this issue has come in cycles. Two also mentioned that excessive executive compensation was seen in only a few extreme cases. Chan (2008) presented a detailed discussion of the various perspectives with respect to whether or not executive compensation is excessive.

Procedures for Whistleblowers

One of the critics' complaints is that it is difficult for whistleblowers to have direct communications with the board. Although employees, shareholders and the public submit their complaints to companies by dialing the hotlines set up by the latter, these confidential complaints are frequently screened by management before they will reach the board. The Sarbanes-Oxley Act requires board audit committees to set up procedures to receive complaints with respect to accounting issues, and all participants of this study did not indicate any problem with this requirement. They have set up the procedures for complainants as required by the Act, and some participating companies' procedures are described as follows.

One participating organization has a third-party hotline for complainants who can call in, and an independent operator will transcribe all the comments and forward them to the Audit Committee Chair. As an independent firm handles the company's whistleblowers, the complaints can be kept confidential and the complainants can be kept anonymous. Two other participating organizations also use a third party hotline for the same purpose. Another participating organization uses a procedure whereby those who have accounting concerns can communicate in writing with the Board and the Audit Committee through the Office of the Corporate Secretary. All finance- and accounting-related complaints are investigated by the Director of Corporate Audit who also reports them to the audit committee at its next meeting. All serious complaints are communicated to the Chair of the Audit Committee by the Director of Corporate Audit prior to the meeting. Two other participating organizations also assign the internal audit department to investigate whistleblowers' complaints before it reports them to the board level. Another participating organization has mechanisms for whistleblowers to communicate anonymously with the compliance committee and the board directly as well. The compliance committee is composed of executives involved in core staff functions. This body is responsible for the investigation of all alleged improprieties. One participant pointed out that many companies are working towards the compliance with this particular requirement by establishing the appropriate guidelines and processes.

Pros and Cons of the Act

Sixteen of 17 participants considered that the Act contributes to accuracy, greater disclosure and transparency in financial reporting. The Public Company Accounting Oversight Board created by the Act registers all public accounting firms and it sets standards for the latter's preparation of companies' audit reports. This board has investigative and disciplinary powers, and it is held to higher standards when compared to the past disciplinary boards controlled by industry. One interviewee considered this to be beneficial.

Two participants lauded the provision that auditors of public accounting firms are prohibited from providing non-auditing services to client firms. This provision can greatly lessen the conflicts of interests. One participant complained that this provision does not go far enough, for auditors can still perform services other than auditing such as tax services. One interviewee commented that with the criminal penalties, the Act has teeth in it. An external auditor has to report strictly to the Chair of the Audit Committee, who has the authority to hire and fire the external auditor and to review the latter's performance. A majority of the interviewees stated that a great deal of time and resources will be focused on enhancing the level of good governance. The Act protects the interests of the shareholders and the employees, and its objective is to restore public confidence. Two interviewees pointed out that it is important for the companies to look at the Act as an opportunity to improve processes, procedures, internal controls, disclosure and corporate governance practices.

With respect to the cons of the Act, 40% of the interviewees criticized that the Act consists of inconsistencies, ambiguities, vagaries, broad provisions which are difficult to interpret. A proportion of this group of interviewees also commented that the legislation with good intent was put together in haste. The Act deals with not only public companies, but accounting firms, lawyers, credit analysts, and so on. In the words of one interviewee, the Act has "a large number of disparate parts to it that do not form necessarily an integrated whole." The Act binds all public companies with "one size fits all" requirements.

Three participants disagreed with the provision which prohibits companies from making loans to directors and executive officers. They considered this provision to be "overly broad." It prohibits even intraday loans to executives. One participant pointed out that historically, a corporation made an intraday loan to an executive who exercised the stock options by buying the stock at, for example, an option price of $20 a share, and then selling shares at a market price of

$50 a share on the same day. The executive could pay back the loan to the corporation within the same day. With this current provision, an executive has to come up with cash by liquidating his/her investment and paying taxes. After exercising the option, and selling the company's stock, the executive can get the cash back for reinvestment. In other words, an executive has to go through the whole process just because Sarbanes-Oxley's provision prohibits even a one-day loan from a company to senior executives.

Sean Harrigan, past President of the California Public Employees' Retirement System (CalPERS), agreed with the Act's provision which prohibits companies from making loans to directors and executive officers. He stated the following:

> Whenever companies make loans, do they make loans to their other employees? Absolutely not! This is not the executives' money to play with as they see fit. The earnings of the corporations belong to the owners of the corporations, not the people who are there to manage them…It is not their money. They should not have unequivocal access to the resources of the companies that they manage for the owners of the companies.

Two participants also complained against the two separate CEO/CFO certification requirements. As CEOs and CFOs are already required to certify financial statements under the Securities Exchange Act, they now have to provide a second certification under the Sarbanes-Oxley Act. One participant considered this "an overkill."

Seventy percent of the participants pointed out that significant costs are involved in the implementation of the Act. One participant estimated that for a Fortune 100 company, it may involve 20,000 to 50,000 hours of work in order to comply with Section 404 of the Act, which requires the documentation and assessment of each internal control of the company. In addition, companies hire outside experts to give advice with respect to the implementation of the Act. Another participant stated that as board responsibilities and workload are much greater, more hours are involved in board meetings and committee meetings. Some interviewees also acknowledged that the costs for smaller companies are even more substantial. Three participants touched on the issue that due to the Act, private small firms may not go public and publicly held small companies may go private. Another participant brought out the issue that the costly compliance requirement of the Act presents a more difficult challenge for a foreign company as opposed to a private company. Greater costs are always involved for a private company to be converted to a public company. As for a foreign firm trying to be listed on a US stock exchange, it used to be a relatively cost-free undertaking to expand its equity base. However, with the regulatory requirements of the Sarbanes-Oxley Act, a foreign company's decision to be listed on a US stock exchange is a much more difficult one compared to a private company's decision to go public.

One participant voiced the concern that the Act may end up with "more disclosure of information, but less clarity and transparency of what the information says." This participant cautioned that there is a distinction between disclosure and transparency. There can be a great amount of disclosed information; however, if the information were not presented in a comprehensible way, a lack of transparency would result. Another participant indicated that the Act shifts to the board a great deal of managerial responsibility. This individual considered it inappropriate for the board to take on a management role, for the board has an oversight role.

A majority of the interviewees also raised the concern that the Act with its compliance focus and criminal penalties may lead to risk-aversion on the part of the board and management. This aspect has been discussed previously. Two interviewees suggested that in addition to compliance with the Act, companies should examine what the processes required by the Act can do to fully benefit the organization as a whole. If not, the opportunity for improvement within the companies will not be optimized.

Can the Act Prevent Corporate Malfeasance?

In sum, all the interviewees considered that although the Act goes a long way to deter fraud, it will not prevent corporate malfeasance. Some of their comments are quoted as follows. One interviewee commented that the Act "will not make dishonest people honest." Another participant stated: "You can't legislate ethics. You are either ethical in your behavior or you are not. You can't write rules on ethics." Another emphasized that "the misconception is that the Act will prevent corporate malfeasance, but it will not."

DISCUSSION

The study reported was based on data collected in September and October of 2003, fourteen and fifteen months, respectively, after SOX was passed. However, the concerns expressed by the interviewees with respect to SOX such as compliance cost, the disproportionate burden on smaller public companies and the latter's strategy to go private in order to stay out from under SOX are still valid to date. The author would like to update the developments of SOX by discussing the current efforts on the part of the SEC, the Public Company Accounting Oversight Board, and the SEC's Advisory Committee on Smaller Public Companies to address the concerns of the Act.

Sox's Compliance Cost in 2006

According to the Financial Executives International's (FEI) 6th Sarbanes-Oxley compliance survey in 2006, compliance cost for Section 404 of SOX was less in the third year than in each of the first two years of adoption. Based on 172 companies with over $75 million market capitalizations, the 2006 average compliance cost for Section 404 amounted to $2.9 million, which was 23% less than the 2005 figure. The 2006 internal and external compliance costs in terms of people hours were also down, and there was a 10% decline with respect to the time used by internal staff to comply with Section 404. Average internal staff hours in 2006 amounted to 18,070 to comply with Section 404. This constitutes a 10% drop from 2005. Average external people hours in 2006 added up to 3,382, a decrease of 14% from 2005. Auditor attestation fees in 2006 were 0.8% less than those incurred in 2005 ("FEI Survey," 2007).

The survey results indicate that the total average compliance costs for companies with decentralized operations and those with centralized operations amounted to $4 million and $1.7 million, respectively. With respect to the costs and benefits of Section 404 compliance, 78% indicated that the costs outweighed the benefits, while 22% indicated that the benefits outweighed the costs. Based on the responses from 172 companies, 60% reported greater investor confidence with Section 404 compliance; 46% reported greater accuracy in financial reports; 48% reported greater reliability in financial reports; and 34% concurred that fraud prevention or detection was attributed to Section 404 compliance ("FEI Survey," 2007).

Total compliance costs had decreased by 35% since the first year of SOX's adoption. Learning curve effects, greater efficiencies, and more advanced software and technical systems contributed to the compliance cost decline ("FEI Survey," 2007).

Auditing Standard No. 2 Replaced by Auditing Standard no. 5

The implementation of SOX's Section 404 is very costly due to its two main provisions:

(1) Material weaknesses in the control system of the firm must be evaluated, disclosed and certified by the CEO and the CFO.
(2) There must be auditors' attestation to the disclosure of material weaknesses ("Sarbanes-Oxley Act of 2002," 2002).

As pointed out by Coates (2007), with the increase in disclosures of material weaknesses in firms' control systems due to SOX, there are greater incentives to correct identified material weaknesses. The substantial amount that firms have spent on controls to correct disclosed weaknesses may outweigh the potential benefits. However, lawsuits and SEC sanctions would follow if material financial misstatements resulted due to disclosed, but uncorrected, material weaknesses in the firms' control systems. Therefore, executives have great incentives to overspend on controls in order to avoid external liabilities. As auditors are required to attest to management's disclosures of material weaknesses, they also have the incentives to push for greater spending to correct all material weaknesses.

In order to decrease the incentives for control spending, PCAOB came up with a new auditing standard. PCAOB's Auditing Standard No. 2 (An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements) was approved on June 17, 2004 by the SEC. Due to the inefficiencies and costliness of this auditing standard, the SEC approved on July 25, 2007 PCAOB's Auditing Standard No. 5 (An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements) to replace Auditing Standard No. 2. The new auditing standard and the SEC's new management guidance aim to achieve more efficient and effective implementation of Sox's Section 404. The objective is to bring the latter's implementation cost in line with benefits (Securities and Exchange Commission, 2007b).

Auditing Standard No. 5's improvements over Auditing Standard No. 2 involve the following:

(1) Instead of having a compliance focus, Auditing Standard No. 5 steers auditors to focus on risk and materiality, and to perform only the necessary tests in various areas.
(2) With Auditing Standard No. 5, the audit is made scalable so that a company does not have to design a control system that fits the audit standard. The new standard expects less internal control testing for companies of smaller size and less complexity. Alternative controls can also be used.
(3) Auditing Standard No. 5 steers auditors to focus on areas with the highest risk. Under Auditing Standard No. 2, auditors were required to evaluate in detail management's process of evaluating the company's internal controls. Under the new standard, the focus of the audit is not on management's evaluation process, but on the effectiveness of a firm's internal control over financial reporting. Consequently, unnecessary procedures are eliminated from the audit.
(4) Auditing Standard No. 5 uses a principles-based approach to determine when and to what extent the auditor can use, in the internal control audit, work performed by people other

> than internal auditors. The auditor's determination is based on the objectivity and competence of those, other than internal auditors, who have performed the work (Securities and Exchange Commission, 2007b).

Effects of SOX on Small Firms

Based on the studies focusing on market reactions to events surrounding the enactment and implementation of SOX, Kamar, Karaca-Mandic, and Talley (2007) concluded that SOX's effects on small firms were consistently negative, but SOX's effects on large firms were inconsistent. They voiced that the different event dates and control variables used in the event studies contributed to the inconsistent results. Leuz (2007) also criticized the event studies (e.g. Engel, Hayes, & Wang, 2007; Jain & Rezaee, 2006; Li, Pincus, & Rego, 2008; Zhang, 2007) which could not rule out that the findings were caused by events unrelated to SOX. Leuz (2007) pointed out that as SOX applies to all the firms that are registered with the SEC and listed on the stock exchanges, there is not the existence of a control group of firms that are not affected by SOX. Therefore, there is the difficulty of not being able to remove effects that are not SOX-related. Both studies (Jain & Rezaee, 2006; Li, Pincus, & Rego, 2008), which did not differentiate firms in terms of size, found significantly positive stock returns around SOX event days. Consequently, they considered SOX to be beneficial to the complying companies. On the contrary, Engel et al. (2007) found that SOX was associated with overall negative abnormal returns. As smaller and less liquid firms had even lower returns, they interpreted that SOX compliance costs were more onerous for them. Zhang (2007) found significantly negative cumulative abnormal stock returns around key SOX events, and she considered this to be evidence that SOX imposed on complying firms net costs. Her results also indicate that the postponement of Section 404 compliance resulted in significant cost savings for small firms.

Kamar et al. (2007) examined the studies with respect to SOX and firm deregistration. They clarified that firms can deregister their stock with the SEC by going dark or by going private. Firms are going dark if they succeed to reduce the number of shareholders below 300 by cashing some out. Firms are going private if they succeed to get private acquirers to buy all the shares. Based on a review of these studies, they noted that compared to going-private transactions, going-dark transactions were more associated with the avoidance of compliance cost especially after SOX. For example, Engel et al. (2007) found that compared to the pre-SOX period, there was an increase with statistical significance in the number of firms going private in the post-SOX period. However, when these authors dropped from the statistical analyses the going-dark firms that still traded in the over-the-counter market, the increase in the number of firms going private after SOX was no longer statistically significant. Leuz, Triantis, and Wang (2008) found that during the 1998-2004 period, there was an increase in the number of firms going dark after SOX; however, the number of firms going private did not increase over the sample period. They attributed the increase in firms going dark largely to SOX. In a survey of 110 of 236 firms that deregistered with the SEC by either going dark or going private between January 2001 and July 2003, Block (2004) reported that respondents, particularly smaller firms, cited most frequently especially after SOX the cost of being public as the primary reason.

Aside from SOX, Karmar *et al.* (2007, 2008) cautioned that deregistration decisions could be affected by contemporaneous factors such as financial market liquidity and the weakness of the public capital market around the time of SOX's enactment. Independent from the SOX effect, financial market liquidity could motivate private investors to engage in acquisitions and the public capital market's weakness could lead to firms' exodus from the market. These authors separated SOX's effects from other contemporaneous factors' effects on firms' decision to go private by using a control group consisting of foreign firms. They found that in the first year after SOX's enactment, there was a substantial increase in the propensity of small U.S. firms to be acquired by private rather than public acquirers. The study did not identify a similar effect with respect to large U.S. firms or in the second year after SOX's enactment. The authors' interpretation of the findings suggests that the small firms exited immediately from the public capital market in order to avoid compliance with SOX, and the large firms that were more able to adapt to the new regulations remained public.

As SOX compliance requirements may be more onerous for small firms, the SEC exerted efforts to address this issue. On March 23, 2005, the SEC chartered the Advisory Committee on Smaller Public Companies to assess the SOX effects on smaller public companies. In light of the disproportionate cost and burden associated with SOX's Section 404 compliance requirements for smaller public companies, the Committee recommended scaled regulations for smaller public companies that comprise the lowest 6% of total U.S. equity market capitalization. The groups of smaller public companies that qualify for scaled regulations are microcap and the small cap companies. Microcap companies have less than $128 million in equity market capitalization, and small cap firms have between $128 million and $787 million in equity market capitalization. With scaled regulations for firms based on size, SOX's Section 404 requirements would be scaled down the furthest for microcap firms.

The Committee also had recommended carve-outs for smaller public companies. For example, one of the primary recommendations from the Committee involves granting exemptive relief from SOX's Section 404 requirements to microcap companies with annual revenue less than $125 million and small cap companies with less than $10 million in annual product revenue. Another primary recommendation from the Committee involves granting microcap companies with annual revenue between $125 million and $250 million and small cap companies with annual revenue less than $250 million and annual product revenue greater than $10 million Section 404 external audit of internal control exemptive relief (Security Exchange Commission, 2006).

In May 2007, the SEC adopted interpretive guidelines for management on Section 404 compliance (Securities and Exchange Commission, 2007a). On July 25, 2007, SEC approved PCAOB's Auditing Standard No. 5 (Public Company Accounting Oversight Board, 2007). Both the SEC's new management guidance and the PCAOB's New Auditing Standard No. 5 scale down the requirements for small companies with respect to their evaluation and assessment of internal controls over financial reporting. Hopefully, these efforts would lessen the burden and costs on the part of small firms to comply with SOX.

The Effect of SOX on U.S. Cross-Listings of Foreign Firms

Zhu and Small (2007) concluded from their study that since 2002, the decrease in the new cross-listings of foreign firms on U.S. stock exchanges and the increase in the delistings of foreign firms already cross-listed on the U.S. stock exchanges point to SOX's chilling effect on the global competitiveness of U.S. capital markets. Litvak (2007) found that compared to foreign firms that were either cross-listed but not subject to SOX or non-cross-listed, there were significant decreases (increases) in the stock prices of SOX-exposed foreign firms during news of the Act's applicability (inapplicability) to foreign issuers. Her results also indicate that weaker stock price declines were experienced by faster-growing companies especially in countries that were poorly governed, and stronger decreases were experienced by high-disclosing companies and companies from high-disclosing nations.

In order to make the U.S. markets more competitive and attractive to foreign private issuers (the SEC's term for private firms organized external to the U.S.), the SEC approved new Rule 12h-6 to be effective June 4, 2007 that will make it easier for foreign private issuers to engage in deregistration and termination of all reporting requirements under the SEC. Prior to this new rule, foreign private issuers could deregister from the SEC only if there were fewer than 300 shareholders in the U.S. Many foreign private issuers complained that the rule then in effect was difficult to meet for their securities might have generated only minimal U.S. interest, but with a U.S. shareholder count of more than 300, they would not be able to deregister. Thus, Rule 12h-6 uses a "volume-based" approach instead of the number of shareholders to determine foreign firms' deregistration. Under the new rule, a foreign private issuer will be allowed to deregister from the SEC if the U.S. average daily trading volume of the company's securities is no greater than 5 percent of the worldwide average daily trading volume during a recent 12-month period. Due to the burdensome compliance requirements and costs of SOX and the old rule with respect to deregistration that was difficult for foreign private issuers to meet, the U.S. capital market was losing its appeal. With new Rule 12h-6 which makes it easier for foreign private issuers to deregister from the SEC and terminate all reporting requirement, the U.S. market will regain its appeal to foreign private issuers (Hogan & Gimenez, 2007).

Implications for Research and Practice

Future research should examine whether Auditing Standard No. 5 would lower the costs of SOX compliance. If not, future research should also look into questions such as the following. Would there be an increasing number of smaller public companies going dark or going private? How about the foreign firms? Would there be increasing delistings of foreign firms and decreasing new listings of foreign firms on U.S. stock exchanges?

It does not seem likely that SOX would disappear. Therefore, businesses should exert maximum efforts to improve efficiencies in SOX compliance with the help of SEC's management guidance and PCAOB's new Auditing Standard No. 5. If the latter failed to achieve meaningful cost savings in businesses' compliance efforts, then the business sector would have to appeal to the SEC and the PCAOB to grant regulatory relief. The PCAOB may have to modify Auditing Standard No. 5 in order to achieve meaningful efficiencies in SOX compliance. The SEC had previously refused to grant exemptive relief to foreign firms, microcap and small cap companies from SOX's Section 404 requirements. However, if Auditing Standard No. 5 failed to achieve cost-effectiveness in SOX compliance, these firms would definitely push for the option of carve-outs.

In all practicality, if SOX compliance costs far outweighed the benefits, management of U.S. private firms should seriously consider keeping their firms private or go public on a foreign exchange. With respect to smaller public firms, management may consider going private. As for the management of foreign firms, they may opt for cross-listings on exchanges in countries other than the U.S., and they may opt to delist from U.S. stock exchanges the securities that have already been cross-listed in the U.S.

REFERENCES

Bainbridge, S. M. (2006). Responses: Director Primacy and Shareholder Disempowerment. Harvard Law Review, 119, (6), 1735-1758.

Bargeron, L., Lehn, K. & Zutter, C. (2008). Sarbanes-Oxley and Corporate Risk-Taking. Working Paper, University of Pittsburgh, Pittsburgh, PA.

Bebchuk, L. A. (2005). The Case for Increasing Shareholder Power. Harvard Law Review, 118, (3), 835-914.

Block, S. B. (2004). The Latest Movement to Going Private: An Empirical Study. Journal of Applied Finance, 14, (1), 36-44.

Chan, M. (2008). Executive Compensation. Business and Society Review, 113, (1), 129-161.

Coates, J. C., IV (2007). The Goals and Promise of the Sarbanes-Oxley Act. Journal of Economic Perspectives, 21, (1), 91-116.

Engel, E., Hayes, R. M. & Wang, X. (2007). The Sarbanes-Oxley Act and Firms' Going-Private Decisions. Journal of Accounting and Economics, 44, (1-2), 116-145.

FEI Survey: Management Drives Sarbanes-Oxley Companies Cost Down by 23%, but Auditor Fees Virtually Unchanged. (2007, May 16). PR Newswire. Retrieved October 12, 2007, from http://sev.prnewswire.com/banking-financial-services/20070516/NYW02416052007-1.ht...

Fortune.com. (2003). The 2003 Fortune 500. Fortune.com. Retrieved September 20, 2003, from www.fortune.com/fortune/fortune500/company/top500/0,1735...

Hogan, J. M. & Gimenez, A. M. (2007, April 2). SEC Approves Streamlined Deregistration for Foreign Private Issuers. Law.com. Retrieved May 8, 2008, from www.law.com/jsp/PubArticle.jsp?id=900005477577

Hymowitz, C. & Lublin, J. S. (2003, July 22). Corporate Reform: The First Year: Boardrooms under Renovation; Scandals Prompted Changes, but Critics Say More are Needed to Prevent Another Enron. Wall Street Journal, pp. B1, B7.

Jain, P. K. & Rezaee, Z. (2006). The Sarbanes-Oxley Act of 2002 and Capital-Market Behavior: Early Evidence. Contemporary Accounting Research, 23, (3), 629-654.

Kamar, E., Karaca-Mandic, P. & Talley, E. (2007). Sarbanes-Oxley's Effects on Small Firms: What is the Evidence? In S. M. Gates & K. J. Leuschner (Eds), In the Name of Entrepreneurship? The Logic and Effects of Special Regulatory Treatment for Small Business (pp. 143-168). Santa Monica, CA: Rand Corporation.

Kamar, E., Karaca-Mandic, P. & Talley, E. (2008). Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis (Rand Working Paper Series No. WR-300-2-EMKF). Retrieved April 23, 2008, from http://ssrn.com/abstract=1096371

Li, H., Pincus, M. & Rego, S. O. (2008). Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management. Journal of Law and Economics, 51, (1), 111-134.

Leuz, C. (2007). Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions. Journal of Accounting and Economics, 44, (1-2), 146-165.

Leuz, C., Triantis, A. & Wang, T. Y. (2008). Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations. Journal of Accounting and Economics, 45, (2-3), 181-208.

Litvak, K. (2007). The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US. Journal of Corporate Finance, 13, (2-3), 195-228.

Public Company Accounting Oversight Board. (2007, May 24). Auditing Standard No. 5 – An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements and Related Independence Rule and Conforming Amendments (PCAOB release no. 2007-005). Retrieved September 2, 2007, from www.pcaob.org/Rules/Docket_021/2007-05-24_Release_No_2007-005.pdf

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18 and 28 U.S.C.).

Schroeder, M. (2003, July 22). Corporate Reform: The First Year: Cleaner Living, No Easy Riches; Critics Say Sarbanes-Oxley Law Hobbles Stocks, Chills Risk Taking, but Upshot Is Far Less Dramatic. Wall Street Journal. Retrieved May 7, 2008, from http://proquest.umi.com/pqdweb?did=373372811&sid=2&Fmt=3&clientld=17873&RQT=309&VName=PQD

Securities and Exchange Commission. Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission. (2006, April 23). Final report of the Advisory Committee on Smaller Public Companies to the United States Securities Exchange Commission. Retrieved September 2, 2007, from http://sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

Securities and Exchange Commission. (2007a, June 20). Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (Release nos. 33-8810 and 34-55929). Retrieved September 2, 2007, from www.sec.gov/rules/interp/2007/33-8810.pdf

Securities and Exchange Commission. (2007b, July 25). SEC Approves PCAOB Auditing Standard No. 5 Regarding Audits of Internal Control over Financial Reporting; Adopts

Definition of "Significant Deficiency" (Press release 2007-144). Retrieved July 26, 2007, from www.sec.gov/news/press/2007/2007-144.htm

Taub, S. (2007, November 28). SEC Snubs Proxy Access. The 3-1 Decision Is a Bitter Pill for Shareholder Activists Who Wanted to Democratize Corporate Boardrooms. CFO.com. Retrieved May 9, 2008, from www.cfo.com/article.cfm/10208333?f=related

Wallison, P. J. (2003, September 1). Blame Sarbanes-Oxley. On the Issues, AEI Online. Retrieved May 9, 2008, from www.aei.org/include/pub_print.asp?pubID=19123

Zhang, I. X. (2007). Economic Consequences of the Sarbanes-Oxley Act of 2002. Journal of Accounting and Economics, 44, (1-2), 74-115.

Zhu, H. & Small, K. (2007). Has Sarbanes-Oxley Led to a Chilling in the U.S. Cross-Listing Market? The CPA Journal, 77, (3), 32-37.