Will the SEC Embrace a Softer Sarbanes-Oxley?

Published: April 18, 2007 in Knowledge@Wharton

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

When the Sarbanes-Oxley (SOX) Act was passed by Congress and signed into law in 2002, its goal was to protect investors through increased disclosure and stiffened internal controls. The law was passed following accounting frauds at Enron, WorldCom and other U.S. companies.

But on April 4, 2007, the Securities and Exchange Commission announced it will revisit some of SOX's rules. The primary focus will be the heavy financial costs of Section 404, which requires auditors of most publicly listed companies to verify the effectiveness of the company's internal controls and procedures for financial reporting.

"These needed improvements in the Sarbanes-Oxley process are especially urgent for smaller companies that will begin complying with Section 404 this year," said SEC chairman Christopher Cox in a statement earlier this month. "The result of the new auditing standard for 404, together with the SEC's new guidance to management, should make the internal control review and audit more efficient by focusing the effort on what truly matters to the integrity of the financial statements."

The SEC expects to receive new standards from the Public Company Accounting Oversight Board (PCAOB), a private sector corporation enabled under SOX to oversee the auditors of public companies, by the end of May or early June, in time for the 2007 financial statement audits.

It's the kind of issue that defies easy categorization, with few people coming down firmly either for a revamping of SOX or against it. At the same time, however, Wharton professors and others suggest that any move to soften SOX should be thoroughly considered so that the investor benefits of the legislation are not lost.

As Wharton management professor Martin Conyon notes, finding the right mix of cutting costs while protecting investors may not be simple. "Sarbanes-Oxley was enacted at a time of extreme distrust regarding corporations," says Conyon, who, in general, supports SOX as it currently stands. "The demand for tightened standards was rather high. If that demand has scaled back, perhaps it is time for the level of regulations to change. But the focus on costs should not exclude the benefits delivered by Sarbanes-Oxley. And investors may be willing to absorb [higher] costs in order to gain a greater level of confidence in the [financial reporting] system."

Listing with the Pink Sheets

The Financial Executives Institute (FEI), an advocacy group that represents financial executives, believes that the heightened emphasis on internal controls, corporate governance and the role of financial executives brought about by Sarbanes-Oxley have all been positive, says Grace Hinchman, senior vice president of government affairs for the organization. Yet she also expresses concerns about the steep costs of compliance.

"Available cost data, including FEI surveys, indicate that the rules and standards related to the implementation of Section 404 of the Act still require significant attention," she says, noting that Section

404, as it stands, incurs outsized compliance costs.

According to a 2006 FEI survey of 274 public companies, the average cost for Section 404 compliance, though down from previous years, was $3.8 million during fiscal year 2005. In February 2007, the organization sent letters outlining its concerns to the SEC and to the PCAOB.

In fact, the SEC's decision to revisit Section 404 appears to be a tacit acknowledgement that the high costs of complying with Section 404 may actually deprive some investors of information, as a growing number of smaller companies exit from the major stock exchanges to go private or list with services like the "Pink Sheets," an electronic quotation medium that is not subject to SOX disclosure requirements. Consequently, instead of providing more information to investors, these companies provide none.

"The Sarbanes-Oxley Act has significantly increased the costs of SEC reporting, in particular due to its internal controls requirement, says Christian Leuz, a former Wharton accounting professor who is now at the University of Chicago's Graduate School of Business. He is the co-author of a paper titled, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations."

Leuz and his team reviewed the 484 firms that delisted from major exchanges between 1998 and 2004 and went to the Pink Sheets. Of the total, 372 of the delistings occurred between 2002, when Sarbanes-Oxley was enacted, and 2004. Leuz notes that in 2001, 43 companies "went dark" or deregistered from major exchanges to less-onerous ones, or simply went private. In 2002, the number edged up to 67, but in the next year, 183 public companies delisted and 79 went private. In 2004, which was the most recent year he studied, 122 companies delisted and 66 others were bought out.

The costs of complying with Sarbanes-Oxley can range from $500,000 for a smaller firm "to millions of dollars for large ones," notes Leuz, who co-authored the study with Alexander Triantis and Tracy Wang from the University of Maryland's Robert H. Smith School of Business. Many surveys of executives indicate that these costs either prompted them to delist or drove them to consider taking such a step, he adds.

Wharton accounting professor Wayne Guay acknowledges the value-added that SOX has delivered, but he also notes that heavy compliance costs may reduce its effectiveness. Specifically, he says, the costs of SOX can be seen in the rising number of companies either going private or, in the case of non-American companies, choosing to list on the London exchange or other non-U.S. exchanges.

"SOX is an expensive proposition, so scaling back some provisions, particularly for smaller companies, may make sense," says Guay. "It is also important to remember that a key objective of Sarbanes-Oxley was to improve corporate governance through greater independence of the board of directors, greater accountability of top executives, and fewer conflicts of interest among auditors. Given these largely positive developments in corporate governance encouraged by SOX, it seems reasonable to question whether Section 404 provides incremental benefits that outweigh its costs. "

SOX Supporters

Some groups, however, are firmly in favor of SOX. "Since its passage, the [Sarbanes-Oxley] Act has helped enhance the integrity of the capital markets and restore investor confidence," notes a February 16, 2007, letter sent to the SEC by the Center for Audit Quality, an accounting industry organization that works closely with the American Institute of Certified Public Accountants. "We strongly believe that any regulatory changes must not erode that foundation. As the Securities and Exchange Commission (SEC) advances its proposals in this area, we strongly believe that change should flow primarily from the desire to reinforce the significant benefits of effective internal controls over financial reporting, rather than a drive to cut costs."

A partner with a Big Four CPA firm also appears to cast a vote of confidence in favor of SOX, although he has concerns about the costs.

The Sarbanes-Oxley Act in general, and Section 404 in particular, has clearly benefited investors by driving greater transparency and improving corporations' internal control systems, says Raymond Beier, a senior partner with PricewaterhouseCoopers in New York City. He leads the firm's National Technical Services Group, responsible for identifying and addressing emerging business, regulatory and reporting

All materials copyright of the Wharton School of the University of Pennsylvania.

issues.

"Although financial investors have received benefits, there is a cost component that can hurt the bottom line of some companies and can't be ignored," he says. "Larger companies are able to absorb the expense and fold the compliance activity into their standard operating procedures, but smaller enterprises may not have a significant revenue base over which to spread the additional costs."

He notes that although publicly held companies long had to shoulder more reporting and other expenses, even pre-Sarbanes-Oxley, "the debate has heated up, and with 404 it's now a public policy question: What are the appropriate responsibilities that a company should take on when it goes to the public for funding?"

Beier says the SEC is engaged in a balancing act, trying to fine-tune Section 404, perhaps making it scalable, while continuing to deliver an added layer of protection to shareholders. "We don't know just yet what the result will be," he says. "But we should find out in the next few months."

Scalable Standards for Different Companies?

The SEC's review of Section 404 was prompted by conclusions documented in a report issued on April 23, 2006, by its Advisory Committee on Smaller Public Companies, a body whose mandate included an examination of the impact of SOX on smaller businesses. Perhaps the committee's most controversial finding was that for smaller companies, "...the current costs of the requirement for an external audit of the effectiveness of internal controls over financial reporting are disproportionate to the benefits...."

Its recommendations included establishing a new system of scaled or proportional securities regulation for publicly held "microcap" companies (equity capitalization of approximately $128 million or less) and "smallcap" companies (equity capitalization between $128 million to $787 million).

While microcaps account for only 1% of the total value of the capitalization of the U.S. equity markets, they make up 52.6% of all U.S. public companies. Similarly, although smallcaps represent only 1% of the total value of the capitalization of the domestic equity markets, they constitute 25.9% of U.S. public companies.

For all the talk about protecting investor rights, some officials wonder how much attention investors are really paying to the issues.

At an April 12, 2006, meeting of the SEC's advisory committee, co-chairman Herbert Wander noted that "...most of the comments we received [regarding modifications to Section 404] were from issuers. I think that was to be expected. We received 14 from professional groups and trade organizations; and the big-eight [sic] accounting firms all submitted comments. I frankly was disappointed by the lack of professional investor comments. There were a few, but not really very many. Perhaps that's a message that we should think about -- that their lack of comments may mean something."

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

Knowledge@Wharton All materials copyright of the Wharton School of the University of Pennsylvania.