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Sarbanes-Oxley

Five years under the thumb

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Corporate America is learning how to live with the tough regulations introduced after the collapse of Enron

FOR the leaders of corporate America it has been five long years. The Sarbanes-Oxley Act, widely known as SOX, was signed into law on July 30th 2002 by George Bush, who called its tough new rules the "most far-reaching reforms of American business practices since Franklin Roosevelt was president". The hope was to restore public confidence in American business, which had been badly shaken by huge corporate scandals, such as those which led to the bankruptcies of Enron and WorldCom.

The act created a new regulator for the accounting industry: the Public Company Accounting Oversight Board. To address some obvious conflicts of interest, auditors were prohibited from doing a variety of non-audit work for clients. Firms had to establish independent audit committees, company loans to executives were banned, top executives had to certify accounts and whistleblowers were given more job protection if they reported any suspicions of fraud.

In the act's now notorious section 404, managers were made responsible for maintaining an "adequate internal-control structure and procedures for financial reporting". Companies' auditors were required to "attest" to the bosses' assessment of these controls and disclose any "material weaknesses". Failure to comply could result in tough new criminal penalties.

Controversial from the start, SOX came to be despised by many businessmen in America (and beyond, where it has touched big foreign firms). Even its authors have reservations, conceding that its hasty passage into law meant it was badly drafted in parts. "Frankly, I would have written it differently," Michael Oxley, one of the former congressmen who drafted the act said in March. He added that the same was true of his co-author, Paul Sarbanes. "But it was not normal times."

The charges levelled against SOX are numerous and serious. Top of the list is the price of compliance. It soon became clear that the costs of implementing SOX's provisions, particularly section 404, far exceeded the modest sums initially predicted. The act is now widely regarded as a licence for audit firms to print money—ironic in that it was these fee-driven firms that, arguably, encouraged the lax accounting that led to the legislation.

Beyond its immediate price-tag, SOX stands accused of undermining America's entrepreneurial spirit. Barely a year after it became law, William Donaldson, then chairman of the Securities Exchange Commission (SEC), wondered if by unleashing "batteries of lawyers across the country" the legislation would lead to a "loss of risk-taking zeal" due to a "huge preoccupation with the dangers and risks of making the slightest mistake". Others argue that the act has backfired. Rather than restore confidence in public companies, they claim, it has weakened America's stockmarkets, by driving domestic firms into the arms of private-equity buyers and prompting foreign firms to list their shares elsewhere.

Number crunching

How plausible are these accusations? An army of academics has weighed in on the great SOX debate. But their analyses are hindered by two difficulties. First, SOX was one of a number of post-Enron initiatives, ranging from tougher listing requirements for firms to longer jail sentences for errant executives. Untangling the effects of SOX from these other changes is hard. Nor is it easy to work out how investors and businessmen—who were trying to come to terms with the bursting of the late 1990s stockmarket bubble—might have reacted to the corporate scandals without SOX.

Some academics have concluded that the costs of SOX far outweigh the gains. A much-debated 2005 study by Ivy Zhang, then of the William E. Simon Graduate School of Business Administration, estimated that the law's costs exceeded any benefits by a mind-boggling $1.4 trillion. That controversial figure was derived from an econometric estimate of "the loss in total market value around the most significant legislative events"—in other words it assumes that, after taking account of other news, any drop in share prices as the new rules were enacted was thanks to SOX.

In a more recent study, Leonce Bargeron, Kenneth Lehn and Chad Zutter, of the University of Pittsburgh, argue that SOX has "had a chilling effect on risk-taking" by publicly traded American companies. Using a sample of British companies as a benchmark, the study found that American firms have significantly reduced their investment in R&D and overall capital spending, while increasing their holdings of cash. Collectively, they concluded, this reveals a "statistically significant reduction in risk-taking after the adoption of SOX".

The academics found a second measure to support their conclusions. The standard deviation of share returns—a measure of risk—also fell for the American firms relative to their British counterparts. On the other hand, the study also reported that the riskiness of American companies post-SOX was higher than in the mid-1990s, before the stockmarket bubble got really out of hand. And the ratio of R&D and total capital spending to assets—and thus, presumably, the appetite for risk—was considerably higher in America than in Britain before and after SOX.

Messrs Bargeron, Lehn and Zutter also looked at 9,258 initial public offerings in America and Britain between 1990 and 2006. They found that post-SOX, the probability of listing shares in Britain rose sharply. This seems to support the view that SOX has weakened America's stockmarkets, by driving domestic firms into the arms of private-equity buyers and causing foreign firms to list elsewhere. Others, however, dispute that claim. The past year has seen several official inquiries into the competitiveness of American financial markets, supported by the treasury secretary and the mayor of New York, among others. None pinned much blame on SOX, pointing instead to a range of problems including America's addiction to litigation.

Kate Litvak, of Texas Law School, used a different technique to gauge SOX's effect on America's capital markets. In a recent paper she examined its impact on the shares of firms listed both in America and abroad. Shares of cross-listed firms tend to trade at a premium to shares of similar firms that are not. Cross-listed firms seem to gain extra credibility by subjecting themselves to tough foreign corporate-governance requirements, as in America. Ms Litvak found that the cross-listing premium declined after SOX, suggesting that investors believed that the costs of the legislation would, on average, exceed the benefits for cross-listed firms.

In a study published last year by the University of Southern California, Ehud Kamar, Pinar Karaca-Mandic and

Eric Talley investigated whether SOX had driven firms out of the public markets. Using a sample of 8,266 acquisitions by private-equity firms in 76 countries between 2000 and 2004, they found that after SOX was passed, it became relatively more likely for small public firms in America to be sold to private-equity buyers than similar small firms elsewhere. But there was no change in the relative likelihood of larger American-listed firms going private. This seems to support the view that SOX is particularly burdensome for smaller companies.

Not all academics are anti-SOX. Luigi Zingales, of the University of Chicago, argues that it was a public-relations triumph, quickly restoring confidence. "The fact it was there, it was strong, it was done quickly, was very important," he says. This, he notes, was in contrast with his native Italy, which took "two years and lots of bickering" to get a new law after an Enronesque scandal at Parmalat.

Making the audit committee independent and giving it, not the boss, the responsibility for hiring the auditor, was also a big step forward, says Mr Zingales. It may have contributed to the improved performance of auditors which Mr Zingales, Alexander Dyck and Adair Morse report in their paper "Who Blows the Whistle on Corporate Fraud?". The three economists examined 230 alleged corporate frauds in America during 1996-2004. They found that, pre-SOX, only one-third of big corporate frauds were uncovered by those with a responsibility to find them, such as auditors, industry regulators or the SEC. Employees were more likely than anyone to report corporate wrongdoing. After SOX, however, the proportion of serious frauds discovered by those professionally responsible for doing so rose to 50%. In particular, there was a "stunning increase in the role of auditors (a four-fold increase in the relative frequency of detections) and of the SEC (a doubling of their importance, albeit from a very low level)".

Sharpening up

Alas, the economists admit they "cannot determine" what part of the post-Enron reforms has led auditors to sharpen their scrutiny of companies. Could it have been the severing of their consulting businesses from their auditing clients? Or was it the salutary effect of the demise of Arthur Andersen, or the required increase in professional scepticism now demanded from section 404? In other words, they do not know whether this is "a permanent change or a temporary reaction to an event that made the risk of bad auditing salient".

The professionals may have a sharper eye, but successful whistle-blowing by employees fell after SOX, from 20.7% to 15.6% of cases. This, argue the three economists, "suggests SOX's modest incentives are not very effective". They seem to have brought a surge in frivolous accusations by disgruntled and fired employees rather than tips about serious fraud. Far better, say the three economists, to replicate the financial incentives for whistle-blowing used in America's health-care system, which have led to a higher rate of fraud detection but scant increase in frivolous accusations.

Another good sign is that the costs of complying with SOX are coming down. According to the latest annual study of compliance by Financial Executives International, a club for chief financial officers, even the hated section 404 is costing less. The group's poll of 200 companies with average revenues of $6.8 billion found that the typical cost of section 404 compliance was $2.9m in 2006, 23% lower than in 2005. Internal staff time also fell, by 10%. Adapting to section 404 involved high start-up costs, but now "efficiency gains are being realised", says Michael Cangemi, the group's chief executive.

Better still, under pressure from the SEC, the Public Company Accounting Oversight Board has changed its guidance on how to implement section 404. Until now, auditors have been encouraged to be zealous with internal controls, replicating much or all of the work of a firm's internal auditors, and testing the robustness of internal controls against every imaginable risk. The new audit standard, which was approved by the SEC this week, allows a more pragmatic, commonsense approach. Some estimates suggest that compliance fees could fall by as much as half.

Yet, as seems to be the way with SOX, not everyone welcomes this reform. Stephen Bainbridge, the author of "The Complete Guide to Sarbanes-Oxley", argues that "nothing the SEC has done or plans to do will change the existing incentive-structure for officers and directors. The firm's top management will still have plenty of incentives to spend shareholder money on protecting themselves from SOX liability."

Others are more sanguine, and see SOX as part of the inevitable swings in America's regulation of business. In a study, Mark Roe of Harvard Law School argues that scandals such as the fall of Enron are the result of two "core instabilities" in America's system of corporate governance: the separation of the ownership and control

of big firms, and weaknesses arising from America's decentralised system of regulation. These two instabilities have combined to create some sort of "fundamental large-firm problem" in each decade since the second world war.

If history is any guide to the outcome of reforms such as SOX, America will "solve the current issues—or more plausibly, reduce them to manageable proportions—but then sometime later, somewhere else, another piece of the corporate apparatus will fail," argues Mr Roe. "We'll patch it up, we'll move on, we'll muddle through. That's what will happen this time, and that's what will happen next time."

Links to the papers and reports referred to in this briefing can be found at: www.economist.com/sarbanes-oxleysources

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