Ross Roundtable on

The Sarbanes-Oxley Act of 2002:

Ten Years Later

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Paul Zarowin (NYU) welcomed the participants and said that he hopes to be worthy of the position long held by Baruch Lev, a renowned giant in academic research, whose efforts as Director of the Institute established Roundtables that have that have become a "*center of dialogue"* between business and society. He is looking forward to the opportunity of continued success aided by Sy Jones (Associate Director) whose many years in practice provides the perfect complement and counsel. The Roundtable provides a mutually beneficial venue for practitioners and regulators to discuss important and timely regulatory issues.

April Klein (NYU) moderated the panel, and provided a brief history setting the stage for the discussion of the Sarbanes-Oxley Act (SOX): Ten Years Later". Professor Klein noted that it has been an amazing decade. We have witnessed a spiraling market decline attributed to:

- The burst of the internet bubble
- 9/11 –Terrorism hits home.
- Unprecedented financial accounting scandals.

In response to the scandals Congress signed SOX into law, "The most far reaching reform to business practice since FDR" (George Bush). Now 10 years later, this controversial law is vociferously debated with calls for repeal pitted against those who believe SOX saved the financial markets.

The panel of discussants has been in the trenches, on the front lines, and at the helm of private and public business entities, regulatory agencies, boards of directors, etc. and it would be impossible to do justice to the scope of their knowledge or experience in every conceivable facet of these entities in this summary. They have experienced the trials and tribulations of carrying out, sometime onerous, rules and regulations. They understand the burdens of supervision and enforcement. And thus are ultimately fully aware of their responsibilities in formulating rules and regulations, and the economic and political consequences thereof. They come to the *"table"* with different –and sometimes controversial--points of view which are neither based on media hype nor bar-stool rhetoric. The panel presented cultivated and thought-provoking comments worthy of respect and consideration.

Panelists' Commentaries

Proponents of SOX reform stated that it is their firm belief that SOX, a response to a systemic breakdown, restored investor confidence. SOX ended 100 years of self regulation by the accounting profession. Today over 40 countries have similar regulatory regimes. Accomplishments:

SOX--

- Reduced conflicts of interest by prohibiting certain auditing and consulting services for the same client.
- Mandated independent audit committees and required issuers to disclose if a financial expert is on the auditing committee.
- Increased accountability requiring CEO/CFO certification of financial statements.

- Restricted loans to officers on preferential terms.
- Instituted claw-back provision.
- Ended back dating of stock options.
- Established whistle blower protection.
- Required disclosure of off-balance sheet arrangements,
- Required public companies to have a system of internal financial control.

There is a common belief that since the passage of SOX restatements are down as are class-action lawsuits; the accuracy and reliability of corporate disclosures has improved. SOX is all about restoring investor confidence and providing transparency and accountability. It is about more honest record keeping and better business transactions. It was not designed to address failure in honest financial reporting or failures in business judgment.

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It was noted that many companies, e.g. Time Warner, had adopted codified company-wide policies and procedures prior to 2002 that were in keeping with the provisions prescribed into law by SOX. Although the one-time legal costs of implementation were significant, SOX did not result in any major changes for these firms. A three-tier analysis in terms of levels of significant effects was presented:

1. The loan prohibition and code of conduct for senior executives had little, if any, impact on procedures in place.
2. Required certification[1] by the CEO/CFO made it clear that they were personally accountable and liable for the financial statements. This had a cascading effect, creating a series of certifications at several levels. The associated costs were moderate; but the impact was significant as well as positive.
3. The most significant impact in terms of cost relate to fulfilling the requirements of Section 404 of the Sarbanes-Oxley Act that mandates that publicly-traded companies must establish internal controls and procedures for financial reporting and must document, test and maintain those controls and procedures to ensure their effectiveness. This has been very significant in terms of time spent and out of pocket costs, but "not quite as clear" in terms of benefits.

Time Warner was presented as an example of firms that have always maintained an internal audit department, had adequate internal controls, and a financially literate and independent audit committee. The directors are experts. Documentation thereof was provided by requiring members to fill out comprehensive questionnaires to assess their financial literacy and self report if they met the qualifications. No changes in committee memberships were required.

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As noted previously, the broad experience of many participants provided a firm foundation for their beliefs that SOX helped restore investor confidence by providing stronger audit committee accountability, tighter auditor independence rules, better disclosure, and against perhaps the expectations of many, CFO/CEO certification had a significant and positive effect on behavior. Thus the transition from self regulation to independent overseer has created a greater sense of responsibility and improved audit quality. Did it prevent all bad acts? Legislation cannot do that. However, the SEC review of companies every few years has been an additional deterrent to bad acts.

[1] Sarbanes-Oxley Act Section 302 pertains to 'Corporate Responsibility for Financial Reports'.

Some poignant commentary was provided by discussants who do not favor SOX. Many in this country believe that pre-SOX our country had 70 years of the world's most sophisticated and effective securities regulation. Many financial scandals were uncovered during this period, and resulted in the perpetrators going to jail for decades. An attestation to the fact that the system worked! Why, if we have this super proud, effective regulatory regime, and fabulous markets are we talking about the law of the jungle? The "crisis of confidence" was instigated by a series of economic and political events, and it is myopic to place the blame on illegal practices.

Regulation is only desirable if the benefits exceed the costs. The costly regulation was enacted to deter illegal practices. "What have we "bought" with SOX? Did we buy investor confidence? Did we buy honest markets?" As previously noted, the individuals who perpetrated illegal acts prior to 2002 were severely punished. R*ational expectations* lead to the assumption that this would serve to reaffirm investor confidence. No one can either affirm or deny definitive real-time causal relationships. Will SOX reduce the incidents of waste, fraud or abuse? Or is the ever increasing hierarchy of external oversight adding a dead-weight loss? Human incentives to commit illegal and unethical acts remain undeterred by elegant econometric equations predicting rational optimal behavior.

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There was a consensus of opinion that SOX has been incredibly expensive. However, when firms, e.g. TIAA-CREF have the responsibility of managing ½ $trillion in assets, prudence dictates doing whatever it takes to fulfill management's obligation as efficiently and effectively as possible. Exercise of due diligence must not only avoid harm but has to improve the welfare of investors. There can be no question that the certification requirement changed behavior. CEO's and CFO's are asking more questions; demanding detailed explanations before signing off. This had a ripple effect on all levels of management, with increased focus leading to positive results

The costs of regulation include economic and behavioral consequences. There can be no argument that the original SOX legislation had many faults, some of which have been modified. There are many who believe that SOX may have been one of the causes of the financial crisis. Their theory being that the focus on 404 compliance and concerns over what constitutes "appropriate risk" created a check list environment that stifled entrepreneurship. None the less, many agree that the benefits of SOX far outweigh the costs thereof. Increased confidence in the accuracy of the numbers and the reduction of restatements is priceless. In addition, installation of more efficient internal controls has provided cost-saving benefits for many firms.

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Mixed commentary included statements recognizing that "*most* of SOX" was absolutely necessary. Given that over 50% of Americans are significantly invested in the market, this great engine of our economy had to be addressed forcibly. The media frenzy and outrageous demands forced Congress to intervene without delay. Although Section 404 may have had the right set of principles and objectives, it was the implementation of 404 by the SEC and PCAOB that had severe behavioral consequences. The "numbers game" described by Arthur Levitt in 1998 was in full swing. "Every quarter end was like incoming scuds; people trying to find accounting methods for meeting earnings estimates". Given the pressures of Wall Street, this scenario has not disappeared completely. But SOX rebalanced the perceived risk/reward equation by making the penalties more clearly evident. Audit quality has improved significantly, and audit committees are more diligent.

It was also noted that the failure of neglecting to apply to derivatives, asset-backed securities, and similar financial instruments the same basic rules we had for our corporate bond and equity markets led to the financial crisis. As with SOX, firms will decry the additional costs of applying new standards. There are always tradeoffs, imperfections, and unforeseen consequences. SOX, although far from perfect, has achieved its objectives. Participants, who in general, did not support SOX, recognized that the emphasis of SOX on the independence of the Board and audit committee was an important reform that will restore the respectability of the audit profession. However, it was suggested that internal development of these reforms would result in more optimal outcomes. As a result of the federally mandated changes and fear of liability, audit committees have started to resemble Kabuki theatre. Everyone has their roles, expressions, and checklist in hand—replacing the free give and take of ideas. Section 404 is another great idea with similar negative consequences. Fear of litigation has resulted in risk officers analyzing risk from an auditor's point of view; abandoning gut feelings for checklists; formulas replacing incentives.

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An overview of SOX-related major research findings published in the top tier accounting and finance journals was presented. The number of articles, 538, is a testimony to its enormous impact.

- Internal control deficiencies are highly correlated with a higher cost of capital.
- Form 4 reporting requirements had a major impact on equity incentive behaviors, in particular the prohibition of backdating stock options.
- Some studies suggest that smaller firms were more likely to go private because of compliance costs, and deregister after SOX.
- There is no evidence of significant earnings-management benefits.
- Most research does not support a negative relationship between independence and non-audit services.
- There is a negative relationship between fees and earnings management, systems designs and restatement.
- Pre-SOX research supports the net benefits of longer auditor tenure, higher quality audits, and lower costs of debt.
- Post-SOX research documents a positive relationship between auditor tenure and earnings quality. Auditor tenure is unrelated to client use of earnings management to beat analyst forecasts

The theoretical constructs and proxies developed by academics for measuring costs and benefits are imperfect, and are confounded by a host of events. Therefore, it is not surprising to find a lack on consensus on the benefits of SOX. The debate over the benefits of SOX will continue, the investigations and research will be ongoing, and in all probability the bottom line will be "inconclusive".

Discussion Highlights:

> Mandated disclosures under SOX do not address the run up of risk. If you put enough money on the table in front of a manager he will take on greater risk. Furthermore, Delaware corporate law immunizes directors from taking on all but intentional wrong doing. You cannot legislate morality, wisdom, or caution. What you can legislate away are the incentives driving up the risk and reckless conduct.
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> The provision in the NYSE listing standards requiring companies to have their audit committees perform an annual analysis of financial risk is an important and salutatory change.
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> **Comment:** The legislation took away a major contribution of auditors to their clients. Senior members of auditing firms are in a position to help their clients evaluate risks. Risk analysis is an essential part of the audit.

Response: They cannot consult, but they continue to supply us with information on the risk of the company.

Although there has been no *mea culpa,* after 10 long years the PCAOB[2] (AS16) acknowledges that “auditors could have armed an audit committee with critical information to probe areas that presented risk to investors…and prevented financial reporting failures that led to enormous legal fees, fines, ruined careers and damaged investor confidence.” No *mea culpa*—the standard is “eliminating ***perceived*** constraints… and fosters robust communication of auditor to audit committee”.

Comment: The auditors pushed the ball into the compliance mentality. The details were not outlined in the standard. Instead of taking the risk approach they had taken for decades, they went into great detail instead of looking at the big picture of these standards.

Response: Momentary silence.

Comment: It is difficult to figure out the behavioral implications of a standard.

Response: The behavioral consequences (and enormous costs) of the legislation could have been modified if consideration had been given to the environment –which at the time was: *“gotcha”* -- *“Peek a Boo, we are watching you”.*

"The right to swing my fist ends where the other man's nose begins." *Supreme Court Justice Oliver Wendell Holmes, Jr.*

Have audit committees, boards of directors and managers lost their right to freely “swing” their opinions because the PCAOB’S *nose* is always within reach?

The controversy surrounding the passing of “the most far reaching reform to business practice since FDR” remains unabated, and will perhaps remain thus until such time (if ever) that the level of confusion, claims of misinterpretation and skewed perceptions become resolved.

At a Roundtable in April of 2008, Professor April Klein said:

“Understanding risk can perhaps be taught, but not regulated”.
Is anyone out there listening?

[2] pcaobus.org/News/Speech/Pages/08152012_DotyStatement.aspx