

# Sarbanes-Oxley: Corporate transparency or cost trap?<sup>1</sup>

Robert L. Formaini, Senior Economist and Public Policy Advisor,  
Research Department, Federal Reserve Bank of Dallas

Thomas F. Siems, Senior Economist and Policy Advisor, Research Department,  
Federal Reserve Bank of Dallas

The U.S.'s massive and prosperous economy is often considered the envy of the world. With roughly 293 million inhabitants, the U.S. churned out nearly U.S.\$12 trillion in goods and services in 2004. By way of comparison, the twelve countries that comprise the European Monetary Union<sup>2</sup> have about 307 million people and produced approximately U.S.\$9.5 trillion, and Japan, the world's second-largest economy, has a population of about 128 million people and had 2004 GDP of around U.S.\$4.6 trillion. But the U.S. is not only larger, it is also more productive and growing faster than most other developed nations. Over the past decade, real GDP growth in the U.S. has increased at an average annual rate of 3.3 percent, compared with the rather anemic growth of 2.1 percent for the EMU countries and a paltry 1.2 percent per year in Japan. What is America doing right that other countries are apparently ignoring, or doing wrong? Is America's free-market, capitalist framework somehow better than other models? And can one expect America's superiority to continue to result in faster growth and higher productivity?

While there are scores of things that America is doing right, and clearly doing better than many of its global trading partners, in this paper we address a new regulation that may, in fact, seriously threaten America's future growth prospects and its traditional brand of capitalism. Rushing to legislate after a string of financial scandals, capped by the spectacular demise of Enron and accounting irregularities at WorldCom and other companies, on July 30, 2002 the Congress brought forth P. L. 107-204: the Sarbanes-Oxley Act of 2002 (hereinafter referred to as SOX). The original intent of the new law was to make managers and directors of corporations more accountable to shareholders, i.e. to improve corporate governance and boost investor confidence. While greater corporate transparency is a worthy goal, the manner in which the law is being executed seems to be far more burdensome than imagined and could dramatically curtail the kind of business risk-taking that creates new jobs and wealth.

SOX was originally argued for on grounds that it would increase corporate transparency and, hence, raise investor confidence in the paperwork offerings of the companies they either owned or might buy. In other words, an implicit assumption behind SOX was that market imperfections were denying adequate, accurate, and timely information to investors. What were not adequately discussed in the rush to pass SOX were the future market distortions that the Act itself might create. Instead of repairing what many believed to be market imperfections by trying to better detect fraud and acts of financial collusion, the costs and burdens of implementing SOX might greatly outweigh any potential benefits. In the race to protect workers and investors, the pendulum may have swung too far in the direction of increased regulatory oversight, particularly for smaller companies.

## The pendulum swings

The stated purpose of SOX was to increase the transparency of publicly-traded firms' financial disclosures and to ensure that their boards of directors were accountable. With the Act in place, and firms rushing to try and comply, it was predicted by proponents that the number of future economic scandals would be minimized relative to what occurred prior to the Act's passage. SOX itself is sixty-six pages in length and divided into eleven major areas: public company accounting oversight, auditor independence, corporate responsibility, enhanced financial disclosures, analyst conflicts of interest, commission resources and authority, studies and reports, corporate and criminal fraud accountability, white-collar crime penalty enhancements, corporate tax returns, and corporate fraud and accountability. The intent of SOX is clearly desired: that individual and institutional investors should have unbiased, corruption-free information regarding their investments. If this is accomplished through SOX, investor confidence will increase, which is a good thing for any market.

SOX is far-reaching. Firstly, it establishes a super accounting board that functions as a non-profit foundation chartered in

<sup>1</sup> The views expressed in this paper are those of the authors and not necessarily those of the Federal Reserve Bank of Dallas or the Federal Reserve System.

<sup>2</sup> The twelve countries that are in the European Monetary Union and have adopted the euro include Austria, Belgium, Finland, France, Germany, Greece (since January 2001), Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

the District of Columbia. This Board oversees all public accounting firms and such firms now have to submit extremely detailed information to the Board, including all audits performed, fees charged, statements of quality control policies in place, lists of employees and their qualifications and certifications, any information regarding criminal or civil actions affecting the firm, and any other information the Board requests in the furtherance of its mandate. All this reporting, registration, and oversight is financed by both tax money and fee assessments on all monitored accounting firms. Accounting firms subject to oversight are required to be uniform in following whatever procedure(s) the Board adopts for their profession. Each regulated firm will also be physically inspected at least once per year if it serves over 100 clients, and not less than every three years if it serves less than 100 clients. Of course, there are dozens of procedural parts of SOX that attempt to deal with the conduct of these inspections, citations, defenses, suspensions, firm conduct, compliance and non-compliance, etc. Anyone who desires a quick education concerning complicated, costly, and burdensome regulation can do no better than to read this law cover-to-cover.

SOX continues a recent trend in federal and state rule-making in that it criminalizes many things, laying down very harsh potential penalties for those who intend to violate the law, and more unfortunately, even for those whose intent is not criminal but who unknowingly violate the law's provisions. This is the first and most questionable assumption underlying SOX: that there is, or can be, a single, objectively determined accounting set of figures for each firm that is correct and therefore legal, while all others are incorrect and fraudulent. Accounting is not an exact science, and more than one interpretation of how things are done in a firm is not only possible, but remains the most general case. Indeed, accountants disagree about many things, both general and specific to the firms they audit. In other words, judgment is needed as well as theory and, where human judgments are made, disagreement is inevitable and perfectly objective legal rules are a

chimera. This is not to say that incremental normalizing of techniques and accounting definitions might not be valuable for the accounting industry. After all, that is what GAAP standards are for. But normalization towards some mean definitional matrix does not automatically require large federal legal interventions into the accounting industry as SOX supporters seem to believe.

This becomes extremely important for any person who is asked to sit on a corporate board, or who is already sitting on one. That is not just in the publicly-traded private sector; SOX is already beginning to trickle into non-profit organizations, causing them all the same problems, notably a shortage of willing directors. SOX makes it more difficult to attract and retain qualified directors and executives<sup>3</sup>. The criminal liability for allowing anything to occur that is, ex-post, judged to be in violation of SOX can be, as the law is written, devastating. Title IX of SOX is 'White Collar Crime Penalty Enhancements,' and it means what it says. Fines of up to U.S.\$5 million per offense per person, and up to U.S.\$25 million per offense per company can now be levied. Additionally, individuals found guilty under SOX can receive imprisonment terms, along with the aforementioned fines, of up to 20 years per count. SOX pre-empts state regulators by setting up complex, internal corporate oversight processes that had always been, prior to SOX, the domain of the states. In fact, SOX goes a long way toward the completely anti-federalist result of de facto federal chartering corporations as it nationalizes corporate law.

Of course, securities fraud was already illegal before SOX was passed under then-existing SEC regulations. SOX's contribution in this area is simply to increase the severity of those earlier SEC Act fraud penalties. But given SOX, taken together with the federal government's channeling of more resources into corporate fraud investigations, no publicly-traded company officer, or board member, can afford to be anything other than extremely vigilant<sup>4</sup>. Undoubtedly, this was an outcome hoped for by SOX's proponents.

3 Peregrine, M., and J. Schwartz, 2005, "EO director recruitment and retention in a post-Sarbanes world," *The Exempt Organization Tax Review*, 47:3 (March)

4 William J. C., 2005, "The costs of being public after Sarbanes-Oxley," Working Paper No. 05-4, Emory School of Law - Law and Economics Research Paper Series

But the flip-side of this increased vigilance and the punitive nature of SOX may make directors and executives more risk averse and more afraid to take risks on new ideas and new technologies that create jobs and wealth. One of the hallmarks of America's traditional brand of capitalism is its capacity to innovate and to create and reinvent itself by embracing change and channeling risks to high value-added outcomes. Americans make up just 5 percent of the world's population, but produce roughly one-quarter of the world's output. America leads in developing technological advancements and in efficiently and effectively taking resources (human, capital, and financial) to produce value-added goods and services. And the U.S. does this by embracing what economist Joseph Schumpeter called the process of 'creative destruction,' or the churn. That is, new industries that create economic growth simultaneously destroy specific jobs as new technologies replace older ones. But for innovation and the churn to work effectively, firms (and governments) must take risks. Free markets rely on signals from market participants and allow firms to adjust without need for central direction. And while this process is not tidy – there are winners and losers – the benefits of America's brand of capitalism clearly far outweigh the costs.

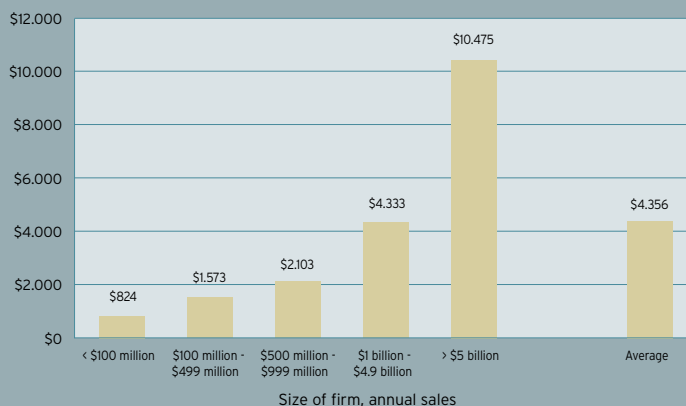


Figure 1 – Millions of dollars spent on compliance with Sarbanes-Oxley section 404 during year one  
 Source: Financial Executives Internation, "Sarbanes-Oxley Section 404 Implementation Survey"

### The cure can be worse than the disease

But regulations, though they may produce benefits, are never free, and SOX appears to be very costly. Certainly, greater disclosure and reporting requirements will increase costs associated with auditing and record-keeping, but few companies have revealed how much SOX compliance has cost them. Most cost estimates have come through surveys and stock market event studies. Survey estimates of SOX's cost to business generally range from about U.S.\$1.6 million to U.S. \$4.4 million per company each year depending on their overall size (Figure 1). A research study at the University of Rochester found that U.S. financial markets lost U.S.\$1.4 trillion in value following SOX's passage in July 2002, although it is hard to say all of these losses are directly attributable to SOX<sup>5</sup>.

Whatever the direct costs of compliance may be, the opportunities forgone because of SOX-related expenditures and time-related investments in learning and overseeing its provisions will also greatly burden all affected companies. And unfortunately, the additional burdens appear to impact smaller companies more heavily. Moreover, any payback in terms of reducing fraud has yet to be demonstrated. Beyond that, talented and competent potential directors will be discouraged from serving on boards in the future because of the extreme personal liability risks that SOX created.

But not everyone agrees that SOX is costly. Regulators, hardly the most objective observers, often think that costs associated with their activities are overstated by those affected. And pro-regulation newspapers can be relied upon to echo their views<sup>6</sup>. But realistically, if SOX were not time-consuming and expensive, it would hardly be able to achieve anything close to the type of positive results pro-regulation advocates are arguing that it will, or eventually, achieve. They can not have it both ways: either SOX will mandate big changes in corporate structure and policies, which means big costs, or it will not be very costly and, therefore, not very effective. At this point, it appears that it is already costly. Its effectiveness will have to be judged at a future time. In the meantime, one of the stranger outcomes of this new law is noted in a Wall Street

5 Bialik, C., 2005, "How much is it really costing to comply with Sarbanes-Oxley?" Wall Street Journal, June 16. The article also notes that other studies that looked at the same question have found that stock prices rose following the passage of SOX. The different results primarily stem from the definitions used in determining the period of study that might influence immediate investor response. In summary,

the costs of SOX (over time for individual companies or as a snapshot of the market to reflect investor sentiment) are unknown and little good information exists to get precise measures.

6 Glater, J. D., 2005, "Here it comes: The Sarbanes-Oxley backlash," New York Times, April 18

Journal editorial: 'The greatest SOX irony is that its main beneficiaries are the same big accounting firms that the politicians blamed for Enron, WorldCom and the other scandals. The Big Four accounting firms audit the majority of public companies, and by some estimates up to 30% of [Section] 404 costs will be paid to these external auditors... The feds killed Arthur Andersen for its many sins (including Enron), but its offending partners simply scooted to one of the other firms and are laughing all the way to their new vacation homes.'<sup>7</sup>

In fact, the so-called Big Four auditing firms are thriving under SOX, and all of those auditing costs are borne by companies, their employees, and consumers generally. How much auditing is enough? The federal cartelization of accounting, reducing the so-called Big Five firms to four after destroying Arthur Andersen is a strange but predictable by-product of the legislation. And, should the government bring charges against KPMG as currently contemplated, there could then be but three major accounting firms left, severely restricting companies' ability to get the kind of allegedly accurate auditing that the law demands. Beyond this, precisely how much accounting is enough? SOX does not tell us, but the new law creates strong incentives for companies to switch their resources to both internal and external over-auditing. Despite all the frenzy to comply, hundreds of companies failed to meet the 2005 deadline and have asked for extensions<sup>8</sup>.

Sometimes overlooked in the most recent rash of corporate scandals is the unintended consequences of prior government regulation on CEO and corporate executive compensation. (One can only imagine the results should SOX be applied to the government that authored it<sup>9</sup>.) One Clinton-era reform was disallowing the expensing of any corporate salary over a maximum of U.S.\$1 million. This led to the widespread use of stock options, which can be expensed, as the preferred method of compensating CEOs and other top corporate officials. And that in turn led to the practice of trying always to get the company's stock price to go up because that made executive salaries go up in tandem. This sent the wrong incentive signal to executives and many acted irresponsibly as a result. It led

further to disputes between insiders and outsiders, as well as regulators, over exactly how and when options ought to appear as an expense. Again, there is no scientific answer to this question. In a rational world, it would be a judgment call by the firm and the IRS. SOX changes all that. And further, it opens up the entire area of internal and external controls to lobbying by interest groups who want the Public Company Accounting Oversight Board (PCAOB) to define corporate costs in a manner coincidental with their particular lobbying interests, such as 'environmental damage.'

Two predicted effects of SOX, given the costs imposed and economic incentives it has created, are that people will decline invitations to sit on boards of directors and companies will 'delist' from American exchanges and/or go private in an attempt to avoid the regulation. Both things are now occurring. Today, it is far less attractive for companies to become publicly-traded. This may put companies on American stock exchanges at a cost disadvantage relative to other internationally traded exchanges. The year after SOX passed, 198 firms delisted, triple the number of the previous year. The number of executives sitting on more than one board has declined by over 50 percent during the same period. Foreign firms wishing to be listed on American exchanges have fallen as well<sup>10</sup>. The increasing conservatism in board decision making – a byproduct of SOX's extraordinary penalties for ex-post determinations of decision failure and the concomitant additional bureaucracy that SOX demands – will not be good for future American entrepreneurial risk-taking. Nor will rising costs of capital be good for the economy generally. And the increased turnover in boardrooms – up by 24% in 2004 alone – will not be good for companies struggling to cope with a tough, competitive international trading system<sup>11</sup>.

All regulations create litigation and SOX will be no different. Class action lawsuits have already begun to boom under the law, and many more will be filed in the near future, most claiming that the provisions of SOX – especially Section 404's complex and tough demands for perfect internal controls, which have resulted in so many companies missing their 10-K filing

7 "SOX and stocks," Wall Street Journal, Review and Outlook, April 19, 2005

8 "Reports filed late this year," Dallas Morning News, April 25, 2005. The article points out that 1,800 publicly traded firms (20 percent of the total) have requested such extensions. Accounting costs and efforts have doubled since SOX took effect. The article claims that the total annual costs range from U.S.\$150,000 for small firms to U.S.\$10 million for large ones.

9 Kudlow, L., and E. Norcross, 2005, "A Sarbanes-Oxley for Congress?" Wall Street Journal, April 15

10 "More CEOs say 'no thanks' to board seats," Wall Street Journal, Review and Outlook, January 28, 2005

11 "SOX and stocks," Wall Street Journal, Review and Outlook, April 19, 2005. The same editorial also asserts that SOX is a 'trial lawyer roadmap.'

deadlines – were not perfectly met. In fact, internal controls failures coming to light have accounted for less than 10 percent of all previous corporate prosecutions. Most corporate scandals occur because of leaks from whistle blowers, many of whom wind up filing lawsuits against their former companies. Those incentives alone give government a powerful tool with which to monitor internal corporate decision making and, not surprisingly, plaintiff's attorneys are already filing suit under its broad provisions.

But perhaps the largest drawback to SOX is that it places American-owned firms at an international competitive disadvantage. Foreign owned firms are not subject to SOX unless they are publicly listed on American exchanges. They need not be and they know it. That is what the move toward delisting is about. But beyond that, the tens of thousands of foreign-owned firms that would not be on our exchanges anyway all receive an implicit cost subsidy from SOX. It will be as if American-owned firms are in an international soccer match but are being forced to compete with 50-lb. packs on their backs. In fact, when one considers the alleged rationale for SOX – that it will increase transparency for existing and potential owners of all affected corporations' stock – it seems a bit weak considering the large number of foreign equities Americans hold, all of them in companies that do not have SOX to deal with. If SOX does what advocates say, then it is a subsidy to all American exchange-listed stocks. Over time, this contention will be empirically investigated. For now, all claims concerning this must remain speculative.

### **Mending SOX**

The costs of Sarbanes-Oxley are beginning to be felt by corporate America and they appear to be a large and continuing cost of doing business. The benefits that are claimed for this legislation are speculative and completely, as of now, unproved. At this point, it appears that the Congress overreacted to a couple of outlying corporate incidents and then proceeded to saddle the rest of corporate America with a 'guilty until proven innocent' law whose consequences will be far-reaching and felt for some time to come. Those conse-

quences include higher regulatory compliance costs, reduced profitability and competitiveness of U.S. public companies in the global economy, and greater exposure and personal risks of civil and criminal penalties for directors and executives.

SOX needs to be mended if America's brand of capitalism – based on creativity, innovation, prudent risk-taking, and free and open markets – is going to be sustained and keep the U.S. ahead of its global competitors. Certainly, managers need to be held accountable to shareholders. But it is clearly a difficult task to mandate specific bookkeeping requirements by threatening severe criminal penalties. Instead, corporate governance policy should aim to reinvigorate the market for corporate control to discipline managers and directors, not to deter them from doing their jobs effectively.