The Impact of the Enactment of the Sarbanes Oxley Act in the United States, 2002 on the Improvement of Corporate Finance and Good Governance Behavior

Abstract:

The massive corporate failure in the United States of America (U.S.) in the 1990s and early 2000s as epitomized by the fall of Enron, Worldcom among others resulted in myriad lawsuits and erosion of shareholders wealth. The governance of public companies was brought to question. The politicians were under pressure to provide leadership to the mess that is corporate failure. The house and U.S. senate passed into law new legislation that set the pace for new corporate governance in the U.S. The Sarbanes–Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House), or by ‘SOX’ generally, established new requirements for public company corporate boards, officers, and auditors. This Act included criminal penalties and directed the Securities and Exchange Commission (SEC) to oversee its implementation. John Nugent (n.d) observes: “Subsequent to the enactment of SOX, we have witnessed the financial implosion of the 2007 to 2010 period where firms such as Lehman Brothers, Bear Sterns, AIG and others have been involved in one way or another in the collapse of the mortgage markets through acts deemed improper and/or imprudent. So the mere passage of a statute does not appear to serve as a remedy for bad human behavior.” This observation brings to fore an important question: Did the enactment of the Sarbanes Oxley Act in the Unites States in 2002 improve corporate finance or good governance behavior? In an attempt to answer this question, the paper reviews literature and empirical evidence on this subject matter.A section of the literature faults the enactment of SOX for not improving good governance behavior. We have witnessed in the post SOX era, the collapse of financial institutions such as Lehman Brothers and others through acts that are considered improper. Romano (2004) criticizes the process of enacting SOX. She believes it was done in haste without backing of empirical research. She also questions the requirement by SOX calling for a completely independent audit committee; she reckons that this should optional since it is sub-optimal. Cohen et al. believe that because of the liability requirements associated with Section 304 of SOX, executives now bear risk formerly born by investors. This may impact negatively on the value of the company since the executives will act risk averse and as such unable to invest. On the other hand, there was some evidence supporting SOX in its quest to improve governance behavior. Agrawal and Chadha (2005) findings support one of the principal requirements of SOX, which is the inclusion of an independent financial expert on public company audit committees. Increasingly, companies are taking congnisance of the governance rating and are striving to achieve high scores. Uzen et al. (2004) find that enhanced corporate governance, increased board independence, and independent financial expertise on the board increases the effectiveness of board monitoring as reflected by fewer shocks; accounting restatements and instances of fraud. The evidence from literature is inconclusive and therefore further research should be done in order to gain sufficient evidence to answer the question whether SOX has led to improved corporate governance