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

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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 SarbanesóOxley 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 ÷SOXø 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: õSubsequent 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.ö

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.

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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.

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Introduction

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 subcommittee of U.S. Senate investigated Enron corporation after its collapse. They issued a report titled : õThe role of the board of directors in Enronøs collapse.ö The findings from the report was troubling as far as corporate misgovernance is concerned. The role of the board of directors and management of Enron leading to its collapse was brought to light. The auditors, who are supposed to be the õwatch dogö for the shareholders failed to play their role and were almost complicit to the õcrimeö. The aftermath of all this was that the governance of public companies was never going to be the same again.

The house and U.S. senate passed into law new legislation that set the pace for new corporate governance in the U.S. The SarbanesóOxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known by ÷SOXø 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.

The Sarbanes Oxley Act of 2002 objective is to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. The SOX is divided into eleven titles that provide guidance and specific requirements. This include: public company accounting oversight board, 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, corporate fraud and accountability.

SOX mandated the reforms of U.S. business practices for public companies with a view of enhancing corporate responsibility and to deal with corporate fraud. The Act restricts public accountants to their independent audit work and tax work for public companies. As a result, public accountants are not allowed to perform other non-audit work for the companies in which they are auditors. The Act provides that every public company must have board audit committee. The auditors are supposed to report to the audit committee and not management. The audit committee must pre-approve all the services offered by the auditors.

The SOX establishes the Public Company Accounting and Oversight Board (PCAOB). The mandate for PCAOB is to set standards for audits, attestations, and reviews of public companies and to register and regulate auditors of public companies. Key guidelines issued by PCAOB require auditor independence to be maintained, management must accept responsibility for internal controls, integrated audit of internal controls to verify managementøs assessment of financial statements and internal control over financial statements.

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The paper is organized as follows. Firstly, we look at the corporate governance framework as defined by various authorities, then Presentations of the facts, discussion of the facts, conclusion, recommendations and areas of further research.

Presentations of the facts

In this section, the paper presents the findings obtained from review of literature and empirical evidence from various scholars. These facts are presented with a view of answering the question of whether the enactment of the Sarbanes Oxley Act in the Unites States in 2002 improved corporate finance or good governance behavior.

Michaud, D. and Magaram, K. (2006) sought to answer the question of whether it is evidence that social science research follows what gets media attention, or it forms an organic whole attempting to advance a solution to the governance crisis. Their paper developed an overview of the part of year 2004øs corporate governance research that answers partially the question

The over 200 articles were evaluated on six factors: intent, hypothesis, sources, methodology, relevance and importance, on a score between zero and one for each factor, providing for a score between zero and six for each article.

The articles were then clustered into four categories: the role of the board in explaining the corporate governance crisis, the relationship of executive and director compensation and corporate governance, the effect of governance indices on firm performance and the market for corporate control.

The following is a review of their findings:

Uzen, Hatice, Samule H. Szewczyk & Raj Varma. (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.

Agrawal and Chadha (2005) test the causal relationship of corporate governance to frequency of

corporate accounting scandals. Thus the metric to measure aberrant corporate behavior by the firm is the frequency of earnings restatement. The sample set consists of 159 public U.S. firms that restated earnings during 2000 and 2001. The authors assessed the magnitude of restatements based on the number of quarters restated and the percentage change of the cumulative average abnormal returns (CAAR) resulting from restatements. They find that financial restatements effecting four quarters or less of operations led to a more substantial change in reported firm

income. Second, when assessing the CAAR values it impact (time duration effect) was limited. Their findings support one of the principal requirements of SOX, which is the inclusion of an independent financial expert on public company audit committees,

Cohen, Daniel A., Dey, Aiyesha & Lys, Thomas, (2005) views the issue of compensation mix as a contracting problem. The advent of SOX has laden the CEO or CFO with heavy responsibilities Thus management is subject to increased risk. Under agency theory management should receive the highest net benefits when taking the principalsø interests into account. The firm, specifically the compensation committee developing the executive compensation contract, does not want to force the agent (management) to take on unfair risk. The authors also address the effects of SOX on managementøs propensity for risk taking (R&D and capital investment policies are used as a proxy for managementsø risk propensity).

Cohen et al. are interested in managementsø risk taking behavior; they believe that because of the liability requirements associated with Section 304 of SOX, executives now bear risk formerly born by investors. The authors posit that the expected response of management, that may not be able to spot internal firm fraud, would be to manage the firm in a manner that reduces potential liability by lower variances in expected returns and correspondingly the chance of an earnings surprise.

Cohen et al.øs findings are interesting in that while the change in CEO compensation structure to one of more fixed compensation, may reduce the shocks of unanticipated earnings restatements and loss of shareholder value (the incentive of earnings management is removed)

this structural change to executive compensation may have unintended derivative effects; a reduction in managementøs desire to take reasonable risks (increasing R&D and capital expenditures) would retard the long-term growth of shareholder wealth. Cohen et al. note that their research findings are preliminary.

According to Michaud, D. and Magaram, K. (2006), there were two papers did not fit any of the clusters (Romano (2004) and Jensen et.al (2004) articles). The conclusions reached by the authors of these two papers are not based on formal empirical or experimental research. Rather, the authorsø opinions are a derivative of many years of corporate governance research and interaction with directors and management.

Romano (2004) reviews the process surrounding the development and passage of the Sarbanes-Oxley Act of 2002 (SOX) and, in the authorøs judgment, the absence of applied corporate governance research to support the principal requirements of SOX.195. The paper is critical of process surrounding the development of SOX, notably Section 301 that requires the audit committees of U.S. public firms be comprised entirely of independent directors. She is concerned that this, along with other key provisions of SOX, where largely the result of corporate governance õpolicy entrepreneursö taking advantage of public crisis driven by the collapse of two major U.S. Enron and WorldCom, that occurred during a midterm congressional election cycle.

Romano developed an extensive review of academic literature and concluded that there was a lack of empirical evidence to support key provisions mandated by SOX, notably the

independence of audit committees. Romano also provides a clear analysis of the legislative process that took place in committee hearings conducted by the U.S. Senate and House of Representatives. This analysis indicates that the most of the testimony utilized by experts testifying before the U.S. Congressional Committees is based on the expertsø opinions rather than empirical evidence. Romano would have preferred a gradualist approach to the immediate corporate governance crisis in 2001-2002 flowing up from courts, rather than a top down driven imposition of policies constructed on an ad-hoc basis by Congress. She argues further that provisions such as Section 301 calling for a completely independent audit committee be changed to optional rather than mandatory compliance for U.S. public companies. Moreover, she argues that the European Union should be careful not to incorporate U.S. SOX styled approach in any new EU corporate governance reforms.

The second paper by Jensen, Michael C., Murphy, Kevin J. & Wruck, Eric G. (2004) analyzes the impact of the incentive-based executive compensation programs, that became ubiquitous during the 1990s, and how these schemes inflated CEO salaries, distorted pay-for-performance, and created incentives for management to engage in aberrant behavior.

Jensen et.al (2004) proposes a comprehensive scheme for alignment of management /shareholder interest through improved compensation contract design. The findings /recommendations of the authors posited in this 2004 paper do not utilize any formal empirical research. Rather, they are opinions based on several decades of published research findings related to corporate governance. Jensen et al. propose a revised approach in executive

compensation contract design that modifies the metric and time horizon utilized to evaluate management performance.

There are four key philosophical arguments that underpin Jensen et al.øs governance recommendations:

Firstly, the creation of shareholder value should be the firmøs sole objective in establishing governance practices; a statement of corporate vision / strategy must guide the company in the creation of shareholder value. Secondly, the execution of strategy and attainment of goals must be the metric utilized (by the board) to evaluate management. Thirdly, stakeholder theory is indeterminate and thus does not provide a basis for principled decision making. Lastly, the remuneration of management must reflect the firmøs objectives, strategy and corporate vision.

The principal underlying these recommendations is that senior management must be held accountable for firm performance and that equity (stock options) awarded to management are a real cost for shareholders (alternatively they could be sold to investors) and thus cannot be given away in excess (as was the outcome in many CEO compensation packages of the 1990s). Jensen et al. believe that the greatest impact on the corporate governance of public firms will be a derivative of criminal and civil court action. Directors now understand that they may be criminally liable individually for their actions.

Corporate fines are meant to punish and deter wrongful conduct (Sarokin, 2009). However, such fines must be significant enough to have a chance of altering behavior, and such

fines must be enforceable and be levied on the party responsible for the wrongful act if there is to be a chance of affecting behavior. Few laws have been successfully instrumental in prosecuting the actual corporate wrongdoers where the issue of proving ÷intentø remains a major obstacle. õPfizer agreed to pay $2.3 billion to settle fraud claims regarding its marketing practices. According to the New York Times, it is the largest criminal fine of any kind ever. But whom does it punish and does it deter? Usually when corporate fines are imposed, the corporate officers who authored and implemented the fraudulent conduct either remain and continue to receive their salaries, options and other benefits, or if they have left the company, their pensions and benefits remain intactö (Sorkin, 2009).

The fact the fines are mainly levied on the company as opposed to the officers and directors, defeats the very purpose of corporate governance. SOX have attempted to mitigate this by providing for personal criminal liability for the directors and officers of the company.

Robert Rosen (2002) wrote on the risk management and corporate governance: the case of Enron. He explains the findings of the U.S. senate subcommittee that investigated Enron, as instances of more general problems of corporate governance These problems derive from the now dominant strategies of õprogressiveö corporate organisations which the author has renamed õredesigned corporationö Enron was a redesigned corporation. Rather than imposing hierarchical controls, redesigned corporations heavily rely on horizontal (e.g. peer) controls. Accountability in redesigned corporations is wanting. Risk management policy was also a problem in Enron. The risks for using financial innovations were not addressed properly. The board and those in the finance committee did not have sufficient derivatives background yet the company was using

derivative extensively. To the business community, Enronøs failure is only partly that of inadequate legal and accounting gatekeepers. More importantly, it demonstrates a business failure.

At the heart of Enron debacle was the conflict of interest. The SOX provides for independence of auditors and also the board of directors in order to fight conflict of interest in organizations that may lead to corporate failure.

Robert Rosen (2002) focuses on Enronøs bad business deals. He submits that if change is necessary in corporate law, it is not just because of corporate non-compliance, but also because corporations need to protect themselves from entering bad business deals.

The corporate governance ratings have become prevalent since the advent of SOX and the clamor for corporate governance. The ratings may have forced companies to õget their acts togetherö as far as corporate governance is concerned in a bid to attract favourable ratings. Matthew and Katten Rosenman in their article õThe ratings game: corporate governance ratings and why you should care.ö highlight among other things why directors and other officers should care about the corporate governance ratings.

The first reason is bad Press. The widespread media coverage can have an adverse effect on the corporation. Therefore corporations cannot afford to have bad corporate governance practice. The second is the increasing empirical evidence that good governance correlates with increased shareholder value and particularly bad governance is a red flag for increased risk. Shareholder activism is another concern. This is manifested mainly in the annual meetings and is

evidenced by shareholders resolutions. The directors have to be sensitive to the interests of shareholders. Also there are new regulations favouring shareholders governance. The regulators are making rules in favour of shareholders. Therefore, the regulators are reinforcing the need for good corporate governance.

Jensen (2001) examines the role of the corporate objective function in corporate productivity and efficiency, social welfare, and the accountability of managers and directors. The author points out that at the heart of the current global corporate governance debate is a remarkable division of opinion about the fundamental purpose of the corporation. The critical question is how we want to measure the performance of organizations. Economists would argue that the long run firm value maximisation is the ultimate measure of performance. On the other hand stakeholder theory contends that managers should decisions that take into account of the interests of all the stakeholders in a firm. However the stakeholder theory fails to provide a complete specification of the corporate purpose o objective function. There is no single criterion to be measured. He contends that 200 years of economics and finance indicate that social welfare is maximised when all firms in an economy attempt to maximise their own total firm value. Social value is created whenever a firm produces an output, or set of output, that is valued by its customers at more than the value of the inputs it consumes in the production of outputs. The issue has been the apparent existence of conflict between the shareholders and other stakeholders. This has led to ranking the stakeholders in terms of whose interest comes first. The real issue should be what corporate behaviour will get most out of the societyøs limited resources not whether one group is or should be privileged than another.

Jensen (2001) proposes a way of improving governance by melding together what he calls enlightened value maximization and enlightened stakeholder theory. Enlightened value maximisation recognises that communication with and motivation of an organisationøs managers, employees and partners is extremely difficult. Value seeking tells an organisation and its participants how their success in achieving a vision or in implementing a strategy will be assessed. Employees and managers must be given structures that will help them resist the temptation to maximise short-term financial performance. The underlying principle here is that a company cannot maximise the long-term market value of an organisation if it ignores or mistreat any important stakeholder.

Enlightened stakeholders theory adds the simple specification that the objective function of the firm is to maximise total long-term firm market value. It recognises that value creation gives management a way to assess the tradeoffs that must be made among competing constituencies.

Discussion of the facts

John Nugent (n.d) observes that numerous attempts via different laws and regulations have failed to limit corporate wrongdoings or serve as a means for punishing those who have carried out such wrongful acts. He posits that it seems prudent therefore to see whether fines placed on the entity (÷the principalø and indirectly the shareholders) versus on the ÷agentsø (officers and directors) of the entity have a long lasting and negative effect on the entityøs stock price. Hence he conclude that while a party other than the one that carried out the wrongful act incurred the

fine (the principal), the party paying the fine (the principal) in over half the cases had its stock price increase within 90 days after the fine was sustained.

Robert Rosen (2002) paper differs from most other analyses of Enron because it is not focused on the deceptiveness of Enronøs balance sheets and its improper accounting practices. Rather, it focuses on Enronøs bad business deals. If change is necessary in corporate law, it is not just because of corporate non-compliance, but also because corporations need to protect themselves from entering bad business deals. He posits that the task for redesigned corporations, and the law to the extent it is able, is to govern these work councils by improving internal risk management controls. The paper hopes to begin the process of seeking such understandings

Matthew and Katten Rosenman in their article õThe ratings game: corporate governance ratings and why you should care.ö It is unclear how important corporate governance ratings will ultimately be to investors. Indeed, the utility of such ratings is weakened by the apparent lack of consistency between rating services. To the extent ratings are relative, they will also become less important over time as practices generally improve and the bar is uniformly raised. Many large institutional investors have their own programmes for measuring governance and will not rely on a service to measure these issues. Others simply do not think these ratings are relevant to investment decisions about the quality of a company or its management. Nevertheless, both investors and issuers may find it increasingly difficult to avoid the implications of governance ratings which may be viewed as a proxy to a companyøs regard for its shareholders.

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.

Conclusions

The objective of this paper was to attempt to answer the 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 reviewed 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.

Recommendations

Romano (2004) recommends that provisions such as Section 301of SOX calling for a completely independent audit committee be changed to optional rather than mandatory compliance for U.S. public companies.

Jensen et al. (2004) recommend two important things that focus on CEO compensation. They call for the use of an õeconomic value addedö (EVA) measure that relies on firm return on equity adjusted for cost of capital. The second recommends metric adjustment, time horizon, which calls for the creation of executive õbonus banksö that facilitate negative, as well as positive, bonuses for management based on firm EVAs.

Robert Rosen (2002) recommends that if change is necessary in corporate law, it is not just because of corporate non-compliance, but also because corporations need to protect themselves from entering bad business deals. Therefore, the corporate governance approach should be broad.

John Nugent (n.d) submits that for fines and penalties to work, they must be imposed on the parties who carry out such wrongful acts.

Areas for further research

John Nugent (n.d) examined the parties responsible for corporate wrongdoing (agents) and the inadequacy of the laws that are applied in many such instances. The paper also examined stock prices before and after the announcements and imposition of corporate fines where it was mentioned that stock price changes could be driven by factors other than the fines themselves such as: market conditions, individual riskiness of the stocks, investor sentiments, other supply and demand issues, etc. To further examine the finding of John Nugent (n.d), the reasons for the fines could be distinguished between ÷management faultøand ÷non-management faultødepending on whether the management was mainly and directly responsible for the acts that led to those fines being imposed. This could then lead to a study of the difference of abnormal returns between ÷management faultøfines and ÷non-management faultøfines. If a difference in returns or the timing of such returns was found to exist depending on ÷management faultø or ÷non management faultø, such a finding might provide even further opportunities for time arbitrage in exploiting a bounce back in stock price after the imposition of a fine.

Michaud D. and Magaram K. (2006) reviewed 19 articles written during 2004 that show promise in advancing corporate governance research. They noted concerns with respect to firm performance metrics utilized in some of the articles. In order to advance understanding of what corporate governance structures and procedures enhance agency, independent variables that

indicate good governance should be retested against a more reliable measure of firm performance, economic value added.

Michaud D. and Magaram K. (2006) believe that the greatest impact on the corporate governance of public firms will be a derivative of criminal and civil court action. Directors now recognize, based on the recent settlements of the civil suits of Enron and WorldCom, that they are now more likely to face an individual financial penalty for a failure to provide strong oversight of CEO behavior, a key component of an effective corporate governance system. Further research should be done to empirically test this hypothesis.

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