

Sarbanes-Oxley: A Benefits – Cost Analysis

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Sarbanes-Oxley – Effects on Public Corporations

- Management assessment of internal controls (Title IV, Sections 404, 407)
 - Management responsibility
 - Annual assessment of effectiveness
- Audit Committee (Title III)
 - members must be independent
 - committee directly responsible for appointment, compensation, and oversight of independent auditors
 - one member must be a financial expert (section 407)

SOX Effects on Corporations

- Corporate responsibility for financial reports (Title III)
 - CEO and CFO must certify that
 - They reviewed the report
 - Based on their knowledge, report does not contain any untrue statement of omit material information
 - Disclosures present operations and financial condition fairly
 - Internal controls were evaluated and are effective
 - Have disclosed material deficiencies and frauds to auditors
 - Significant changes in internal controls subsequent to audit

SOX Effects on Corporations' Officers and Directors

- Must not fraudulently influence, coerce, manipulate or mislead auditor for purpose of making financial statements materially misleading.
- If financial statements are restated due to “material non-compliance” with requirements, bonus and incentive-pay, profits from security sales are forfeited

SOX Effects on RPA (Registered Public Accountants)

- Register with Public Accounting Oversight Board (PACOB)
- Annual quality inspections every year for RPAs that audit more than 100 issuers
- Inspections at least every three years < 100
- Lead and reviewing partner must rotate off every five years
- CEO, CFO, Chief Acctg officer cannot be employed by audit firm during year preceding the audit

SOX Limits on Auditor Services

- Specified non-audit services cannot be provided to client, including
 - Financial information systems design and implementation
 - Investment management and securities services
 - Legal and expert services unrelated to the audit
- Tax services may be provided

Public Company Accounting Oversight Board (PCAOB)

- Establishes auditing, related attestation, quality control, and ethics standards
- Inspects and disciplines RPA firms and auditors
- Sanctions include temporary suspension or permanent revocation of registration of firms and individuals
 - Subject review by SEC

Financed with fees on issuers, based on capitalization

Possible Benefits from SOX to Investors

- Reduce misleading or fraudulent financial statement that result in mispriced stock prices
- Reduce fraud by corporate officers
- Improve audits of corporations to bring about above listed benefits
- Increase investor confidence in financial reporting so as to reduce transaction costs

Potential Benefits Depend on the Extent of the Problem

- 12,000 corporations file periodic financial statement with the SEC
- At least six studies have examined multiple data sources for indications of restatements over 1987, 1997 through 1999, 2002
- Not all of these are the result of deliberately misleading or fraudulent “information” or of inadequate audits

Studies of the Extent of the Problem

- Big five CPA Firms (1997-99): 96
- All SEC AAER, 1987-97: approx 300, 204 sampled, mostly small corporations (30 per year)
- SEC study of “bad practices”, 1997-2002, 227 corporations (45 per year)
- FEI study of restatements, 1997-2000, 224 (56 per year)
- Palmrose & Schotz, 1995-1999, 492 (98 per year)
- GAO, 1997-2002, 845 (169 per year)
- Table showing reasons for restatements

Extent of the Problem Cont.

- Numbers increased in more recent years
 - SEC enforcement following Levitt's concerns
 - Changes in rules – restate rather than write off over later periods
 - Changes in rules – treatment of in-process R&D
- Number due to materially misleading or fraudulent statements – not known, but small relative to approx. 12,000 reporting corporations (hundreds a year)

Extent of the Problem Cont.

- However, restatements and possible fraud at very well known corporations and their auditors:
 - Enron: Arthur Andersen
 - Adelphia: Deloitte & Touche
 - AOL/Time Warner: Ernst & Young
 - Bristol-Meyers-Squibb: Pricewaterhousecoopers
 - Computer Associates: Ernst & Young
 - Global Crossing: Arthur Andersen
 - Merck: Arthur Andersen
 - MicroStrategy: Pricewaterhousecoopers

Extent of the Problem Cont.

Well known corporations and their auditors cont.

- PeopleSoft: Ernst & Young
- PNC Financial Services : Ernst & Young
- Qwest: Arthur Andersen
- Tyco: Pricewaterhousecoopers
- Waste Management: Arthur Andersen
- Worldcom: Arthur Andersen
- Xerox: KPMG

Enron: The Prime Mover

- What did Enron do that was wrong (except fail)?
 - Used a myriad of devices to present financial statements that presented misleading data, although they largely followed GAAP rules
 - Did not disclose debt, making it appear instead as revenue and cash flow from operations
 - Recorded sales to controlled SPEs at inflated prices
 - Hid losses with options written by Fastow-controlled entities that were economically bankrupt
 - Wrote up assets and recorded gains from marking assets to “fair values” (permitted by the SEC)
 - Tax transactions that took advantage of FASB rules

Enron, Continued

- What Enron did that violated GAAP:
 - Did not disclose guarantees of debt (FAS 5)
 - Did not disclose related party (Fastow) transactions as required
 - Recorded future income as present income
 - Recorded \$1.2 billion in receivable for stock issued to Fastow SPE as a stock issuance
 - Did not consolidate SPEs where outside “independent” investors’ equity was less than 3% of assets

What Arthur Andersen Did Wrong

- Helped Enron financial-engineer to meet letter and avoid substance of GAAP
- Decided close calls in Enron's favor
- Apparently did not audit fair values or even helped Enron "justify" high amounts
- Required Enron to restate financial statements when \$1.2 billion of stock-issue-receivable error and a major SPE non-consolidation was discovered

What Andersen Did Wrong Continued

- Did not heed agreement with SEC to avoid problems, following Waste Management, etc. debacle
- Did not recognize the incentive of its auditor-in-charge to keep the client happy (indeed, emphasized and rewarded such behavior)
- Called in Paul Volcher and then didn't follow his proposals
- Fired David Duncan instead of defending him (he then testified against AA)
- Looked guilty as sin!

Conclusions on Benefits

- CEO and CFO requirements
 - Probably worthwhile for them to ask some questions and take responsibility (they get the big bucks, after all)
- Audit Committee requirements
 - Useful, particularly with respect to hiring, monitoring, and dismissing the auditor
 - Financial expert requirement – OK if finance and accounting professors were asked to be directors
 - Enron board was more than qualified

Benefits continued

- Rotation of auditors
 - probably a benefit
- Limitation on hiring CFO, etc.

probably not a benefit

However, limit on corporation hiring auditor as CFO or chief accountant probably would be a benefit (they know what auditors do and how to avoid being caught)

Benefits continued

- Non-audit collateral services
 - No benefit, as no evidence supports the contention that these services corrupted audits
Furthermore, tax advice and advocacy still permitted
 - Will raise the cost of both audits and other services (economies of scope no longer available)

PCAOB

- Will PCAOB actually reduce financial statement misstatements and inadequate audits?
 - Major problems have been misstatement of revenue and expenses (violations of GAAP)
 - Non- or inadequate of disclosure of debt (violation of GAAP)
 - Fair-value accounting (being emphasized by SEC and FASB)
 - Rules rather than principles (US legal system and professional staffing of FASB results in demand for and supply of rules)

PCAOB Continued

- Incentive for auditor keeping the client happy
 - PCAOB examinations are unlikely to do more than Public Oversight Board did
 - Inadequate incentives for individual auditors to risk losing clients
 - Auditor in charge and confirming partner should sign the financial statement
 - They and others with senior responsibility for audits that fail to reveal frauds and material misstatements for any reason should be almost automatically disciplined

Cost of SOX

- Discussed and delineated by preceding presentations
 - firms going private
 - Cost if the decision were based on avoiding unnecessary and wasteful costs imposed by SOX
- Cono Fusco – examination of 222 firms that announced going private
- Thomas Hartman – survey (not stated how conducted, non-response bias)

Cost of Sox continued

- Annual costs

internal controls (section 404): Grace Hinchman FEI study of 321 corporations (not stated how conducted, non-response bias). Question (may have been answered): why the additional costs? Shouldn't companies already have effective internal control systems?

Foley and Lardner – 450 proxy statements randomly chosen, 328 usable data – OK (universe size?)

Survey – 5000 sent, 32 returned (serious possible bias). Which companies and number of companies the data presented are based is not disclosed

Conclusions: Benefits and Costs

- CEO, CFO statements and Audit committee:
benefits (positive) probably exceed costs (small)
- Fewer misleading and fraudulent financial statements, assuming this actually happens:
benefits (positive); but, since this applies to few corporations, costs probably exceed benefits
- Improved audits as a result of PCAOB oversight:
benefits could have been achieved by SEC with actions against individual auditors; PCAOB cost probably exceeds benefits

Conclusions: Benefits and Costs

- GAAP changes

fair value accounting and rule-following will probably result in more problems

- Principles vs Rules

change attestations to include a “true and fair” override

return to traditional matching concept and restriction to reliable (trustworthy) numbers