



Sarbanes-Oxley and the Ebbers Conviction

By Peter J. Wallison

The recent conviction of Bernard Ebbers, the former chairman of WorldCom, has once again raised the question of whether the Sarbanes-Oxley Act was necessary or cost-effective. Supporters of the act have argued that Ebbers's wrongdoing demonstrates the need for a law that mandates strict oversight of corporate managements. Opponents note that imposition of civil or criminal penalties after the fact—the way that financial fraud has traditionally been handled—would have been sufficient, and that it is not good policy to burden all businesses in order to catch a few wrongdoers. Even if we assume that the strictures of the act will be effective, they will only reduce or prevent losses for those companies where losses from financial fraud would have occurred but for the act's requirements. Accordingly, to justify the act on a cost-benefit basis, it would be necessary to find that the benefits received by the shareholders of these few unknown companies will be greater than the costs that will be borne by the shareholders of all companies—including those who would have suffered no fraud losses even if the act had never been adopted. Even if this were a fair distribution of costs, it seems highly unlikely that the benefits will outweigh the costs. The only other way that the act can be justified is through some generalized effect in restoring investor confidence, thus raising all corporate values. But the data on market activity around the time it became clear that the act would become law clearly shows that, if anything, the act caused a decline in investor confidence rather than a restoration.

There are reasons to believe that the Sarbanes-Oxley Act and its implementation by the Securities and Exchange Commission (SEC) went well beyond what was necessary to address the financial and accounting frauds at Enron, WorldCom, and several other companies. The signal element of the act is that it places responsibility on people and systems—directors, auditors, accountants, and internal controls—to prevent fraud and other forms of financial manipulation pre-emptively—that is, *before* they occur. Before Sarbanes-Oxley, wrongdoing of this kind was thought to be deterred by punishing the wrongdoers after the fact and compensating, through civil damage recovery, those who have suffered losses. The Ebbers conviction—which reflects the operation of the traditional system—raises the question of

why that was not deemed to be sufficient after Enron and WorldCom, and whether the costs of the new preventive mechanisms outweigh their benefits. Of course, even post-hoc enforcement can be overdone and impose excessive costs. The recent Supreme Court decision overturning the conviction of the Arthur Andersen accounting firm—a conviction that destroyed the entire firm and about 28,000 jobs in the United States alone—is a classic example of wasteful prosecutorial overkill. Indeed, the Arthur Andersen case seems to be the analog in the enforcement field of the same frenzy that seized Congress when it enacted Sarbanes-Oxley.

When Is Regulation Justified?

The strongest case for regulation can be made in cases of market failure, where competition or other market activity will not provide an optimal

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outcome, particularly in terms of product quality, price, and overall efficiency of production. Natural monopoly markets are the classic case for the efficacy of regulation, since in such instances regulation acts as a kind of substitute for competition. Regulation, as in local zoning laws, can also be appropriate when used to obtain socially useful ends that cannot be achieved by market activity alone.

In some circumstances, regulation can also be an effective substitute for the tort system—especially in cases where horrific losses can fall on some who cannot be adequately compensated by legal action after they have suffered a loss. The FDA's pre-testing and licensing of drugs is an example of this. Its costs, paid by all companies and ultimately included in the cost of pharmaceuticals, are appropriate because neither financial compensation nor prosecution of wrongdoers can adequately place victims back where they would have been absent the loss or can effectively deter subsequent, equally costly, errors by manufacturers. Pre-emptive regulation of this kind, however, is (or should be) exceptional, because it is highly inefficient; it imposes regulatory costs on everyone to prevent a few cases of loss.

This suggests another justification for preventive or pre-emptive regulation. If a potential abuse might be widespread, so that losses are likely to occur frequently, fall widely on society, and would be difficult to compensate through the tort system, it is often efficient to impose the costs in advance, so as to save the expense of having to punish wrongdoers and reduce the incidence of loss. That is why, for example, all states review insurance contracts before they are offered to consumers. Because of an asymmetry of information, consumers cannot protect themselves against contractual provisions that may reduce the coverages they are anticipating when they purchase insurance. The advance review and approval process raises insurer costs, which all consumers must pay, but it reduces the chances that consumers will be deprived of the coverages they expect when they ultimately make a claim.

Sarbanes-Oxley does not fall into any of these categories. There is no indication—except in the fevered imaginings of the far left—that fraud and financial manipulation are endemic to corporate America. The losses in Enron, WorldCom, and other well-known cases were caused by fraud and other forms of deception by managements. These losses could be and are being compensated by civil actions under the securities or tort laws—many of which are currently underway—and it is

highly likely that similar wrongdoing by others will be deterred in the future by civil and criminal actions against the wrongdoers, Bernard Ebbers being the most recent prominent example. The punishments have been severe. The managements involved are now unemployed, indicted, or convicted—and in some cases all three. The companies have suffered major stock market losses, collapsed, or merged. There is little reason to believe that other managements in the future, having seen these results, will have much incentive to follow the same path.

However, this outcome—although it was certain to occur—was not considered a sufficient deterrent by Congress, which set out in Sarbanes-Oxley to establish a system that would prevent fraud before it could be committed. The mechanism Congress chose was an enhanced corporate governance structure that placed responsibility for the detection and prevention of fraud on gatekeepers such as independent directors, auditors, and accountants, and on a complex system of internal controls. It is doubtful that such a system could ever be fully effective; the ways that a determined management might manipulate a company's financial results are virtually infinite, and there is little likelihood that such deceptions will be found. The result of the legislation has been a substantial expense for companies, added liabilities for directors and accountants, and a number of other potentially significant intangible costs—the damage of which it is still too early to assess. Still, it is possible to argue, as many of the act's supporters do, that there have been benefits flowing from the enhanced corporate governance and internal control regime the act imposed. One intangible benefit is said to be improved investor confidence in the markets, and many companies note that they have found flaws in their internal control systems.

It is in this context that a cost-benefit analysis of Sarbanes-Oxley should be pursued. The question in this case is not whether the act has or will have some salutary effects—any regulatory regime will produce some benefits—but whether it will be so much more effective than after-the-fact civil or criminal punishment that the additional costs imposed on companies and the economy are outweighed. If not, then it is simply a tax on doing business—reducing investment, employment, competitiveness, and profits, and as such should be substantially modified or repealed. To consider this question properly, it is necessary to review the major Sarbanes-Oxley provisions, and their direct and indirect costs.

Major Provisions and Costs

The act made several major changes to existing law:

- required the audit committees of all public companies to consist entirely of independent directors, and required that the audit committee have responsibility for engaging and compensating the company's independent auditor;
- created a regulatory body, the Public Company Accounting Oversight Board (PCAOB), to make rules for auditing, to oversee accounting firms in their auditing function, and to establish rules for the independence of accountants as auditors;
- adopted rules requiring officers of companies to take personal responsibility for financial disclosures and prohibiting conflicts of interest; and
- required an assessment of the effectiveness of internal controls by management, to be audited and approved by the company's independent accountants—the so-called section 404 requirement.

Measurable Direct Costs. The act's requirements have substantially raised the direct dollar costs of public companies for accounting and auditing services, in some cases by well over 100 percent.¹ Financial Executives International, an organization of chief financial officers, recently surveyed its members and found that the cost of section 404 compliance alone averaged \$4.36 million per company.² By one report, companies will spend \$6.1 billion this year for Sarbanes-Oxley compliance.³ Conversations with chief financial officers suggests an average of \$4.36 million per company is understated, since many companies may not have included internal audit costs or the expenses of consultants who helped design internal controls that would meet Sarbanes-Oxley standards. A recent article in *Barron's*, for example, reported that one company, Yellow Roadway, the largest trucker in the United States, had to divert 200 employees to work on Sarbanes-Oxley matters, and spent an additional \$10 million on outside accountants and auditors.⁴

Increases in accounting and auditing costs were predictable because the big four accounting firms have very little effective competition for the auditing of large or global companies; this has permitted them to raise their

rates relatively easily and to pass along to their clients their own substantial costs for implementing section 404 and complying with the regulations of the PCAOB. In one report, the big four firms raised their fees by an average of between 78 percent and 134 percent in 2004.⁵ It is no surprise, then, that these four large firms all reported double-digit increases in profitability for 2004, despite the fact that Sarbanes-Oxley required the termination of much of their consulting work for audit clients.

Recently, responding to complaints from public companies about the cost of implementing section 404, the SEC sponsored a roundtable at which some of these concerns could be aired. After the roundtable, the SEC and the PCAOB issued guidance for accountants, urging them to adopt a "risk-based" approach to reviewing a company's internal controls—to focus most of their attention on the areas where substantial losses could occur, and to spend less time on controls for areas where the likelihood of loss was remote. Auditors were enjoined to use their judgment and common sense in deciding where to place most of their attention in implementing section 404.

Although a positive step in some senses, this guidance is likely to have very little practical effect. Accountants know that their reasonable judgments today, when reviewed with hindsight in a lawsuit after a loss has occurred, may not be given any credit. The best defense, in this case, is to do more than necessary. Certainly, there is no incentive to cut back on the scope of such an audit. Nor are their regulators—the SEC and the PCAOB—likely to grant auditors any absolution for using their judgment and common sense when an Enron-like press frenzy occurs in the future. Criticism from a regulator can be a career-ending event for the partner in charge of an audit, and despite the guidance from their regulators, accounting firms are likely to continue to spend considerable time on what might seem to some to be minor matters.

In offering this guidance, both the SEC and the PCAOB praised the results of Sarbanes-Oxley and section 404, and neither regulator suggested that the regulations themselves be modified or their scope reduced. Yet, in implementing regulations for section 404, the SEC seems to have gone beyond the requirements of the act. Section 404 authorized the SEC to prescribe regulations for a "control report" that would contain management's assessment of the company's control structure "for financial reporting."⁶ However, the SEC's

regulation goes further, requiring that companies have internal controls intended to prevent “unauthorized acquisition, use, or disposition” of the company’s “assets.”⁷ This language expands the scope of section 404 to the safeguarding of assets, requiring that companies have internal controls in place to protect themselves against problems such as embezzlement and theft of their assets. It is not at all clear that the safeguarding of assets is an element of financial reporting, and the chances that a theft or other loss of assets would have a material effect on financial reporting are very remote. Yet creating a virtually fail-safe system of internal controls to safeguard assets is a major component of the costs that companies have incurred. If the SEC and the PCAOB were serious about reducing the costs of implementing section 404, much relief could have been provided simply by repealing those portions of the SEC’s own regulations that expand the scope of the internal control audit beyond what Congress specified in Sarbanes-Oxley.

One of the most interesting efforts to estimate the measurable—i.e., quantifiable—costs of Sarbanes-Oxley is an event study by Ivy Xiying Zhang of the William E. Simon Graduate School of Business at the University of Rochester. In this study, Zhang looks at significant events in the adoption of the act and its subsequent implementation and relates these events to stock market reactions. After controlling for various factors, Zhang concludes that the total loss of share values attributable to the key events associated with the adoption of Sarbanes-Oxley—the president’s speech on Wall Street on July 9, 2002; the Republican House leadership abandonment of efforts to water down the bill on July 18; and the Senate-House conference bill report on the bill on July 24—resulted in a cumulative loss of \$1.4 *trillion* for the shareholders of public companies. This would be consistent with the idea that the burdens of the act were seen as far outweighing the benefits. Specifically, on the question of the benefits of improved corporate governance, the Zhang study indicates that companies that were perceived to have weak corporate governance before the enactment of Sarbanes-Oxley actually lost more value than others, indicating a market view that little benefit and significant cost would arise from the “improved” corporate governance required by the act.⁸

The additional costs for accounting and audit services have fallen most heavily on smaller companies, and there has apparently been an increase in going-private

transactions since the adoption of the act, mostly among these companies.⁹ Anecdotal reports suggest that many private companies that would have gone public have declined to do so because of the added costs they would now incur to comply with the act, and a number of foreign companies have either sought to withdraw from the U.S. market or have decided not to list their securities for trading in the United States.

In addition to the direct costs of complying with the act, public companies have had to assume the cost of funding the PCAOB and the Financial Accounting Standards Board, the accounting group that has the authority to establish generally accepted accounting principles. The PCAOB’s budget for 2005 is over \$130 million, a 30-percent increase over 2003, all of which is paid for by levies on public companies. The SEC has authority to control the budget of the PCAOB but little incentive to do so, and the costs of this regulatory body—like all bureaucracies—are likely to grow substantially in the future. Articles are beginning to appear in the press about the PCAOB’s waste of time and money.¹⁰

These tangible costs are substantial. What are the tangible benefits? Many companies have found flaws in their systems of internal controls, but the fact that some companies realized these benefits cannot justify imposing the costs on all companies. If there is a justification, it must reside in the idea that additional auditing, greater care by audit committees, and better internal controls will reduce fraud or financial manipulation—and will reduce it by substantially more than the deterrent effect of the Ebbers conviction. Even without data, this is a difficult case to make. Frauds, by definition, are hidden; a determined management can hide deceptive accounting from the most determined auditors and directors. This is exactly what happened in WorldCom. It is extremely doubtful that all the added costs associated with Sarbanes-Oxley, and particularly section 404, will prevent frauds and financial manipulation by managements bent on falsifying earnings. In that case, the huge losses in market values found in the Zhang study, and the immense cost incurred by companies in complying with the act, will never be recovered.

Commentators who recognize this fact fall back on the argument that, whatever the tangible costs, Sarbanes-Oxley has had an important and valuable intangible effect in restoring investor confidence.¹¹ This seems flatly wrong. There is in fact no evidence that investors ever lost confidence in the market as the

result of Enron and WorldCom. The Dow Jones Industrials Index rose after the disclosure of both the Enron losses on November 9, 2001, and the fraudulent WorldCom accounting on June 26, 2002. In reality, the market did not collapse until July 9, when the president spoke on Wall Street and called for tough new regulation. That day, the Dow fell 179 points. The following day, when the Senate adopted the Sarbanes bill in a unanimous vote, the Dow fell another 283 points.¹² Accordingly, despite frequent statements that Sarbanes-Oxley “restored investor confidence,” the opposite seems to be true. As shown by the careful Zhang study, as well as an analysis of when the stock market actually began to decline, the sharp stock market losses after Enron and WorldCom occurred when it appeared that Sarbanes-Oxley or something like it would actually pass Congress. If investors lost confidence in anything, it was in the good sense of the political class; it is equally likely, as Zhang suggests, that the share value losses that occurred as Sarbanes-Oxley moved toward enactment reflected the market’s realistic assessment of the costs that the new law would impose on all public companies, over and above any possible benefits.

Indirect or Intangible Costs. But perhaps the act’s most important costs are intangible—deriving more from its spirit and underlying assumptions than from its words—and these costs are not susceptible to measurement in dollars:

1. *Impairment of corporate risk-taking.* Sarbanes-Oxley may be impairing the risk-taking by private sector companies that is the driving force of economic progress. The underlying assumption of the act is that management requires supervision—that it cannot be trusted to engage auditors and prepare honest financial statements. That is why the act required that the audit committees of public companies consist entirely of independent directors and assume sole responsibility for engaging and compensating the companies’ auditors. Congress appears to have thought that only in this way could management’s manipulation of a company’s financial statements be prevented, and that the normal process of after-the-fact prosecution would not be sufficient. However, once management’s integrity was at issue, the company’s financial reports were not the only area where some might believe that management needed supervision. Accordingly, after the enactment of Sarbanes-Oxley, and in the same spirit, the New York

Stock Exchange and NASDAQ both adopted rules that require a majority of the directors of listed companies to be independent.

Having now been constituted as a governing majority because of doubts about the integrity of management, it is understandable that newly empowered independent directors would believe that they have some responsibility not only for the company’s financial disclosures, but also for overseeing management’s business decisions. This sense is fostered by provisions of the act, the SEC’s regulations, and the recommendations of the newly empowered corporate governance consultant community. These encourage the independent directors to meet separately from management, choose a lead director, have regular access to independent counsel, and choose their successors without consulting management. None of these steps is in itself objectionable, but in combination they set up the independent directors as a counterweight to management. That appears to be what has happened in many companies. Although it is too early to test this proposition fully through carefully designed studies, there is reason to believe that this mandated change in corporate governance, by empowering independent directors as a group, has reduced corporate risk-taking.

For one thing, managements and boards have different incentives that result in different attitudes toward risk-taking. Management’s financial compensation and reputation is much more closely linked to earnings growth than that of directors, and new ventures and investments that will produce greater profits all involve additional risk. One academic study has found that since the enactment of Sarbanes-Oxley, public companies have been reducing their research and development costs—one element of the investment process—and this is a possible indication that risk-taking is being reduced.¹³ Independent directors may also be averse to risk-taking because—almost by definition—they know little about the company’s operations and fear the lawsuits and reputational costs that might be associated with the losses from failed ventures. From the point of view of independent directors, it is far better for a company to restrain its growth and produce steady profits than to take the risks associated with reaching for dominance in its market or entering entirely new areas of activity.

Corporate aggressiveness has probably also been restrained by the burdens on management time imposed by the act and its associated regulations. According to

reports from CEOs and directors, a great deal of management and board time is now taken up with Sarbanes-Oxley compliance, rather than with discussion of the company's business. This must take a toll on the willingness or ability of U.S. companies to compete aggressively, both domestically and abroad.

2. *Excessive focus on GAAP financial statements.* In establishing the PCAOB and placing great emphasis on the role of the audit committee within public companies, Congress made two major errors: it implied that the accuracy of financial statements could be substantially improved through better auditing, and it set up GAAP financial statements as the most important disclosure about a company's business. These actions reflect a serious misunderstanding of the inherent capabilities of the GAAP accounting system.

As most accounting specialists know, GAAP earnings are highly dependent on predictions by management about an unknowable future; the collectibility of receivables, the useful life of productive assets, the degree to which a multi-year contract has been completed, and the likely return on pension plan investments in the succeeding year—among many other management judgments—are all major determinants of earnings in any given year and are both inherently unknowable in advance and fundamentally unauditible. For this reason, most financial analysts use discounted cash flows and not GAAP earnings to measure the value of companies; they follow the old precept: “earnings are an opinion; cash is a fact.” In November 2003, a group of accounting specialists and policymakers were invited by the American Assembly to consider the future of the accounting profession. Their report noted:

Financial statements, simply because of the way they are presented to the user, appear to claim a degree of exactitude that is, in fact, unrealistic. As a result, a large part of the investing public believes these reports—when properly audited—are precise and accurate. In fact, they are the result of a long series of judgments by managers, accountants and auditors. Nearly every number on a balance sheet or income statement requires an initial judgment or estimate by management, followed by a review of that judgment by an auditor. . . . Despite the creation of rules aimed at bringing precision to the auditing process, that exactitude remains both elusive and illusory.¹⁴

Accordingly, the implication that the reforms in the act have increased the reliability of financial statements is more likely to mislead investors over the long run than to restore their confidence.

Moreover, for the last twenty years, accounting theorists have been pointing out that GAAP is becoming less and less useful for financial disclosure. This is because the GAAP financial reporting system was developed for the industrial economy, where value was produced by hard assets such as machines and equipment. These were purchased at arms length, carried at cost on balance sheets, and—to compute earnings—depreciated over time against the revenues they produced. Today's economy, by contrast, is a knowledge economy, where most companies create value through the intellectual effort that produces intangible assets such as computer programs, pharmaceutical designs, patents, contractual relationships, brands, and the like. Because the costs of this activity—largely salaries and similar expenses—are written off under GAAP in the year incurred, they do not result in the creation of balance sheet assets. As a result, the most important productive assets of many companies are frequently not found on their balance sheets. In the mid-1990s, for example, the SEC forced AOL to write off the promotional costs it had incurred in sending out millions of computer disks to potential customers. Although this unusual promotional method created a large membership list—the company's most important productive asset—the value of this asset appeared nowhere on AOL's balance sheet.¹⁵

The immediate effect of this is a distortion of earnings, which are reduced in the year these costs are written off and increased in subsequent years when earnings are not burdened by the depreciation of the balance sheet asset that produced them. Professor Baruch Lev of the Stern School of Business at New York University, and an internationally renowned expert in accounting theory, summarizes this problem well:

The most significant and urgent change required in the present accounting system relates to the recognition of assets. Current GAAP essentially rules out practically all intangibles from being recognized as assets. This includes both internally generated intangibles and most acquired intangibles. . . . Such a broad denial of intangibles as assets detracts from the quality of information provided in the balance sheet. Even more serious is its adverse effect on the

measurement of earnings. The matching of revenues with expenses—the fundamental process underlying earnings measurement—is distorted by front-loading costs (the immediate expensing of intangibles) and recording revenues in subsequent periods unencumbered by those costs.¹⁶

Thus, by setting up an entire structure to make sure that audits are conducted properly—including the PCAOB and the audit committee structure within each corporate board—Congress has bolstered a financial disclosure system that was already out of date. Indeed, the GAAP system of accounting is already so deficient for measuring and disclosing the balance sheet values and earnings of knowledge-based companies that the act's single-minded focus on improving GAAP audits is almost incomprehensible. What is necessary is not a better regulatory structure to assure the proper auditing of GAAP financial statements, but an entirely new system of metrics and indicators that will allow analysts and investors to better assess whether companies are creating value. Pointing the SEC and accounting priorities in the direction of improved auditing of GAAP financial statements sent the entire financial disclosure system down a blind alley, and is likely to delay for many years the development of a better system for assessing the value of companies in a knowledge economy.

3. *Greater liabilities for directors.* The act's reliance on independent directors as gatekeepers to prevent financial fraud has resulted in greater director liability. To be sure, directors were always required to be diligent in overseeing the actions of management, and directors are held liable for material misstatements by the company in connection with the sale of securities unless they can show due diligence in attempting to ferret out the facts. But the act's emphasis on the role of independent directors in preventing financial wrongdoing appears to have created a political rationale for exposing them to special liability when losses occur.

In the recent WorldCom settlement, for example, despite the fact that the WorldCom matter was a fraud—which by definition involves deception and concealment—the independent directors of the company were required to pay an average of more than \$2 million each out of their personal assets. Although the directors' liability could have been covered by the company's liability insurance, Alan G. Hevesi, the comptroller of the State of New York and the lead plaintiff in

the action, apparently refused to settle unless the independent directors suffered some direct financial penalty. He argued that personal losses by the directors were necessary in order to assure that directors are diligent in the future—for which he was lavishly praised by media commentators.¹⁷ As a result, it is likely that others will make similar demands on independent directors in the future, and that in turn will increase the difficulty companies now face in finding qualified candidates for these positions. It is ironic, of course, that punishing the gatekeepers after the fact is considered necessary to get them to perform more effectively, but punishing management after the fact for financial fraud was not considered sufficient to deter wrongdoing.

The Verdict

The tangible and intangible costs associated with Sarbanes-Oxley are significant. The question raised by the Ebbers conviction is whether it was necessary to incur these costs in order to prevent the kind of financial fraud reflected in the Enron, WorldCom, and other corporate scandals. The defining element of the act—as with all regulation of its kind—is that it imposed costs on all public companies, even those where financial fraud or manipulation was unlikely to occur. If we subject Sarbanes-Oxley to a cost-benefit test, we have to ask two questions: will it prevent financial fraud, and if so will it prevent so much financial fraud that its benefits outweigh its costs?

If we consider only direct, tangible costs, it appears unlikely that the act can be justified on a cost-benefit basis. The additional costs that it has imposed on public companies—in the form of additional accounting and auditing expenses and the creation of new internal controls—amount to many billions of dollars, but the benefits—if any—accrue only to those companies where frauds might have occurred *but for* these new regulations. Unless we believe that the potential for financial fraud is pervasive or endemic in American business, it is clear that all companies have been compelled to incur costs that might—at most—benefit the shareholders of very few.

Moreover, it is even doubtful whether this small group of hypothetical companies—those where fraud would have occurred—has actually received any significant benefit, since it is unlikely that better corporate governance and tighter internal controls will actually result in the prevention of fraud or financial manipulation by a management that is determined to do so. The sharp

decline in corporate share values when it became clear that Sarbanes-Oxley would become law reflects the market's verdict on the act: it will impose substantial costs without significant corresponding benefits.

The only way in which the act may be deemed to have benefited all companies and all shareholders is through restoring investor confidence. This, if it occurred, would enhance all corporate value and amount to a significant intangible benefit. However, as noted above, there is no significant evidence that investors lost confidence in the market or in the honesty of corporate disclosure as a result of Enron, WorldCom, or any of the other corporate scandals. On the contrary, there is strong evidence that investors took these scandals in stride, and did not begin to reduce their exposure to the market—or sell off stocks generally—until it became clear that costly legislation would be adopted. If investors never lost confidence, the idea that the act restored—or was necessary to restore—investor confidence is clearly fallacious.

Accordingly, it is extremely difficult to conclude—even at this relatively early stage in its implementation—that Sarbanes-Oxley conferred more tangible or intangible benefits than its tangible and intangible costs. The conviction of Bernard Ebbers and the guilty pleas of the others involved in the corporate scandals that gave rise to the act seem at this point a far more cost-effective way to deter, and thus prevent, financial fraud.

Notes

1. A *USA Today* survey indicates that audit fees increased 40 percent in 2004, on top of a 17-percent increase in 2003. "New Accounting Rules Raise Price of Audits," *USA Today*, April 13, 2005. Anecdotal reports suggest that these numbers are low. There are many reports of doubling and tripling of fees. In the same article, eBay reported that its audit fees rose 130 percent in 2004.

2. Financial Executives International, *FEI Special Survey on Sarbanes-Oxley Section 404 Implementation*, Member Survey, March 2005.

3. Steven Marlin, "Gaining Strength from Sarbox," *Information Week*, March 21, 2005.

4. Scott S. Powell, "Seeking a Cure for Sarbox," *Barron's*, May 2, 2005.

5. Mike Brewster, "Are the Big Four Gouging?" *Chief Executive*, March 1, 2005.

6. *Sarbanes-Oxley Act of 2002*, Public Law 107-204, 116 Stat. 745 (2002) codified at 15 U.S.C. 7262.

7. *Code of Federal Regulations*, sec. 240.15d-15 (2003).

8. Ivy Xiyang Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," (paper, William E. Simon Graduate School of Business Administration, University of Rochester, February 2005), available at w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf.

9. Ellen Engel, Rachel M. Hayes, and Xue Wang, "The Sarbanes-Oxley Act and Firms' Going-Private Decisions," (paper, Graduate School of Business, University of Chicago, May 6, 2004).

10. "Oversight Board Gets Red Marks for Pickiness among Audit Firms," *Wall Street Journal*, April 13, 2005. See also Peter J. Wallison, "Rein in the Public Company Accounting Oversight Board" *AEI Financial Services Outlook*, February 2005, available at www.aei.org/publication21833.

11. For an extended discussion of the shortcomings of focusing on improving investor confidence as a goal, see Alex J. Pollock, "The Government Should Not Try to Promote 'Investor Confidence,'" *AEI Financial Services Outlook*, April 2005, available at www.aei.org/publication22232.

12. The details of these events are covered in Peter J. Wallison, "Sarbanes-Oxley as an Inside-the-Beltway Phenomenon" *AEI Financial Services Outlook*, February 2005, available at www.aei.org/publications/pubID.20582/pub_detail.asp; and Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002."

13. Daniel Cohen, Aiyasha Dey, and Thomas Lys, "The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs," (paper, Kellogg School of Management, Northwestern University, July 2004).

14. The American Assembly, *The Future of the Accounting Profession*, Report, November 13–15, 2003: 16–17.

15. A more complete discussion of this issue may be found in Robert E. Litan and Peter J. Wallison, *The GAAP Gap: Corporate Disclosure in the Internet Age* (Washington, D.C.: AEI Press, 2000).

16. Baruch Lev, *Intangibles: Management, Measurement, and Reporting* (Washington, D.C.: Brookings Institution Press, 2001), 123.

17. The WorldCom settlement is covered more fully in Peter J. Wallison, "The Enron and WorldCom Settlements: Politics Rears its Ugly Head," *AEI Financial Services Outlook*, March 2005, available at www.aei.org/publication22026.