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The Successes and Shortfalls of the Sarbanes-Oxley Act of 2002

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Abstract

The collapse of Enron and its auditor, Arthur Andersen, in 2001 marked the greatest financial scare since the Great Depression. Enron, along with several other scandals, such as WorldCom and Waste Management, sent a financial shockwave throughout the United States. As a result, the public was no longer confident in the United States' financial markets and the work being done by independent auditors. In order to satisfy the public and ensure that a case, such as Enron, would not happen again, Congress proposed and passed the Sarbanes-Oxley Act of 2002. This paper presents an analysis of the Sarbanes-Oxley Act of 2002, specifically regarding its successes, shortfalls, and overall effectiveness. We find that the Sarbanes-Oxley Act had mixed effects. Specifically, we found an overall decrease in abnormal accruals and financial restatements. However, we also found that the Sarbanes-Oxley Act has incentivized stagnation in smaller public firms, as well as harmed the audit quality of smaller audit firms.

Introduction

The turn of the century marked one of the greatest financial crises the United States has ever seen. The first sign of the impending collapse occurred in 2001. One of the largest energy companies in the world, Enron, received scrutiny for a confusing footnote in its financial statements (Thomas). As a result, analysts began to investigate the complexity of transactions and overall operating environment of Enron. The company quickly imploded from the pressure to produce support for its reporting. In a matter of nine months, Enron's stock dropped from $80 to $30 per share (Thomas). The Securities and Exchange Commission then began looking into some of Enron's related party transactions. After several adjustments, Enron's stock price dropped to less than $10 per share (Thomas). By December of 2001, Enron's stock closed at 26 cents per share; the firm simultaneously filed for the largest-ever United States bankruptcy (Douglass).

The downfall of Enron called into question the disclosure practices and independent audit process in the United States. The media, Congress, and the American people were no longer confident in the financial markets of the United States. Although the Big Five public accounting firms at the time made a joint statement to improve disclosure, it was seen as too little, too late (Thomas).

At the time, Arthur Andersen LLP was Enron's external auditor. As a result, Andersen was paired in the scandal and also received heavy scrutiny. In March 2002, Arthur Andersen was indicted on one count of obstruction of justice related to Enron. The indictment was a result of an investigation that claimed Andersen shredded working papers related to the Enron case. The firm was convicted and agreed to discontinue providing audit services for publicly traded companies. After Andersen's public imagine was tarnished from the conviction, the firm swiftly dissolved. It is important to note, however, that the firm maintained its innocence throughout the trial and appeal. Later, the conviction was subsequently overturned 9-0 by the Supreme Court in May 2005. Unfortunately, it was too late as most of the professionals of the firm had already left. The dissolution of Andersen marked a turning point in the financial realm of the United States. One of the five largest auditors in the world was officially wiped out. It was clear that a lack of professional skepticism would no longer be tolerated. The dissolution of Arthur Andersen served as a wake-up call; it served as a turning point in the world of auditing.

Although Enron and Arthur Andersen were punished, the public was not satisfied. The collapse of these two firms marked the greatest financial scare since the Great Depression. Moreover, the Enron case was not the only incident of fraud leading up to 2002. Rather, Enron was seen as the last straw. In fact, some of the largest financial scandals in the history of the United States' financial markets occurred before SOX. Besides Enron, there were three other significant scandals that took place near the issuance of SOX.

First, the Waste Management scandal occurred in 1998. Waste Management was found to have reported $1.7 billion in misstated earnings. Waste Management settled and paid a fine of $457 million ("Waste Management Settles Suit"). Arthur Andersen was the external auditor of Waste Management and was fined as a result. Second, the WorldCom scandal occurred in 2002. WorldCom inflated its assets by $11 billion through capitalizing carrier line charges instead of properly expensing them ("WorldCom Company Timeline"). The scandal remains as one of the largest scandals in the history of the United States. Arthur Andersen was also the external auditor of WorldCom. Lastly, the Tyco scandal also occurred in 2002. Tyco management stole $150 million through fraudulent stock sales ("Timeline of the Tyco International Scandal").

PricewaterhouseCoopers was the external auditor of Tyco. These three scandals, as well as many more, received national media attention and became a major public concern.

As a result, the public was no longer confident in United States' financial markets and the work being done by independent auditors. In order to satisfy the public, Congress proposed and passed the Sarbanes-Oxley Act of 2002. In fact, not only was it passed but it received a unanimous vote in the Senate with only one person abstaining (United States Senate).

The goal of SOX was simple: protect investors (Atkins). However, this required a major overhaul of the government regulation of public companies and their respective external auditors. The implementation of SOX required a refocus on corporate responsibility and the importance of stockholder value. However, the purpose of the legislation was not simply to show political reaction (Atkins). Rather, SOX was the government's opportunity to incite meaningful change regarding corporate governance. It also presented an opportunity for convergence between the United States' approach and the rest of the world's approach to corporate governance (Atkins). The potential to begin the convergence process was a stirring possibility at the time. According to the SEC Commissioner at the time, "a primary goal of the SEC should be to make it inviting for the global businesses to offer and list their securities in our markets. Sarbanes-Oxley does not have an effect on this goal" (Atkins). As a result, it appears that convergence is still possible even with increased regulation.

Protecting investors was the overarching goal of SOX and there were many initiatives that the SEC took on to do so. One of the most significant goals of SOX was the establishment of the Public Company Accounting Oversight Board (PCAOB). It was intended "to oversee accounting professionals who provide independent audit reports for publicly traded companies" (SEC). Its responsibilities include: registering public accounting firms and establishing audit, quality control, ethics, independence, and other standards relating to public company audits. Additionally, it is responsible for conducting inspections, investigations, and disciplinary proceedings of registered accounting firms, as well as enforcing compliance with Sarbanes-Oxley as a whole (SEC).

Another significant goal of SOX was to strengthen and expand the role of audit committees. Specifically, “Sarbanes-Oxley requires the audit committee to be responsible for the outside auditor relationship, including the responsibility for the appointment, compensation, and oversight of a company’s outside auditor” (Atkins). SOX also requires that audit committee members must be independent from management.

While the creation of the PCAOB and the strengthening of audit committees was a major step toward preventing fraud, SOX also established measures to explicitly state who could be held liable for fraud. For example, SOX requires that both auditors and executives can be held liable. Specifically, CEOs and CFOs of public companies are now required to sign-off on financial reports to confirm that they are accurate and complete (SEC). Shortly after SOX was passed, the SEC also required the CEOs and CFOs of the 947 largest public companies to file statements pledging to the accuracy of their most recent reports (SEC).

Lastly, SOX established several other rules and regulations. For example, SOX established nine categories of non-audit services that cannot be performed for an audit client. These include: bookkeeping services, financial information system design and implementation, appraisal services, and actuarial services. Other prohibited services include: internal audit outsourcing services, management functions, investment banking services, legal services, and any other service that the PCAOB determines to be impermissible (SEC). Another example of a standard set by SOX is audit partner rotation. The rotation is to be completed on a five-year basis so that the engagement is given a “fresh look” but still maintains a high level of quality (SEC). Additionally, any person in a financial reporting oversight role of a company must have a one-year cooling off period (SEC). In other words, a member of an engagement team must wait a year before working for his/her former client in a financial reporting oversight role. A financial reporting oversight role is described as a position that has significant influence on a company’s financial statements. Next, SOX established that accounting firms could no longer incentivize their professionals to sell or promote other services to their audit clients (SEC). The SEC believes in establishing high audit quality and argues that attempting to sell other services could take away from that quality. Lastly, SOX focused on establishing expanded disclosure. For example, SOX requires that all audit and non-audit services must receive pre-approval from the audit committee. Also, SOX requires that companies report fees for audit services, audit-related services, tax fees, and all other fees for the prior two years in their annual proxy statement.

As a result, the overarching theme of SOX is to enhance the overall quality of reporting by both registered companies, as well as independent auditors. After several major accounting scandals, the United States government took a firm action to protect investors. After 12 years, one can now attempt to assess the effectiveness of the law.

Methodology

As the purpose of this research is to analyze the effectiveness of SOX, this paper analyzes a multitude of academic sources regarding SOX. The sources include both proponents and antagonists of SOX in order to critically review both angles. As SOX is a significant piece of legislation and resulted in many changes, this paper focuses on five critical impacts of the law. The five areas include: the creation of the PCAOB, expanded role of audit committees and board of directors, additional liability for fraud, implementation of internal control analysis, and a change in financial reporting culture. As the paper focuses on these five areas, the scope is be limited as such.

Analysis

Creation of the Public Company Accounting Oversight Board (PCAOB)

This paper analyzes five major impacts of SOX within the financial realm of the United States. One of the most significant effects of the law was the creation of the Public Company Accounting Oversight Board (PCAOB). As the United States' financial market collapsed in the early 21st century, the public demanded increased regulation to ensure a similar collapse would not happen again. Specifically, external auditors received heavy scrutiny from the public. After the failure of Arthur Andersen, the public no longer maintained confidence in the external audit process. As a result, Congress included the establishment of the PCAOB as part of SOX.

The establishment of the PCAOB resulted in a major shift in regulation of public accounting firms. As DeFond and Francis state, "SOX has transformed the auditing industry from a "self-regulated" industry to an industry controlled by a quasi-government agency." The creation of the PCAOB resulted in a governing body that could now oversee the actions of external auditors. As the public heavily relies on the opinions of the auditors, regulation theoretically should help to validate their opinions. Congress believed in regulation for two significant reasons. First, "external auditors are the most direct monitors of financial reporting and constitute the first line of defense against potential earnings or accounting manipulation" (A. M. Abdel-Meguid et al., 286). The external audit firms serve as the watchdog for financial reporting. As investors and creditors cannot oversee operations of companies across the United States, it is necessary that external auditors provide assurance that financial statements released by companies to the public are accurate. Secondly, auditors' financial dependence on clients essentially works as a "built-in anti-independence factor" (Mautz and Sharaf). While external auditors theoretically are supposed to provide assurance, there is an inherent conflict of interest in the system of auditing companies. As auditors rely on clients for business, it is hard to proclaim that the auditors' opinions are completely unbiased.

As a result, it appears that some regulation is necessary. One of the main goals of the creation of the PCAOB was to oversee audit quality of publicly traded companies. Prior to the financial scandals in the early 21st century, audit quality began to go awry. Between 1997 to 2008, abnormal accruals peaked in 1999 for Big Four Audit firms and in 2000 for non-Big Four auditors (Rutledge, Karim, and Luo). As a result it is evident that there was not enough oversight prior to SOX.

Today, the PCAOB continues to oversee audit quality of publicly traded companies. However, after over a decade later, the impact of the PCAOB remains in question. Specifically, this paper points to inspections of the Big Four public accounting firms. After a decade of inspections, the PCAOB should enhance audit quality and decrease audit deficiency rates. However, this is not the case. In fact, 46% of KPMG's inspected audits in 2014 were determined to be deficient. (Whitehouse). Moreover, the Big Four had an average overall audit deficiency rate of 33% in 2014 (Whitehouse). As a result, one out of every three audits is not done properly by the largest public accounting firms in the world. This is a significant concern for the effectiveness of the PCAOB and it does not appear to be slowing down. KPMG has seen a rise in its deficiency rating every year since 2009 when the PCAOB began providing data to the public (Whitehouse). While the three other Big Four firms have improved their deficiency rate in 2014, the amount of audit deficiencies is still a concern. However, it is important to note that the

PCAOB inspection selection process is neither random nor representative. Rather, the PCAOB takes a risk-based, directed sample approach (Center for Audit Quality, 3). Therefore, the selection process focuses on targeting several significant risk factors. According to the Center for Audit Quality, "risk factors include the nature of the company, including its industry and market capitalization; audit issues likely to be encountered; and whether the company has significant operations in emerging markets" (3). As a result, while the average deficiency rate is relatively high, it can be partially attributed to the difficult nature of the inspected audits.

While audit deficiencies are a significant concern, the public has also expressed concern regarding the PCAOB's international effectiveness. As SOX was a law implemented in the United States, the PCAOB is primarily recognized strictly in the United States. In fact, "the PCAOB has no jurisdiction over issuers, their boards or audit committees, the accounting principles or regulations followed by issuers in the preparation of financial statements, or the regulators of audit firms in other countries" (Wedemeyer, 938). As a result, this presents a significant problem for the PCAOB as many companies operate internationally. This has led to substantial challenges for the PCAOB regarding international audit firms and public companies (Wedemeyer, 938).

Lastly, another significant concern facing the PCAOB is its lack of transparency. After the creation of the PCAOB, SOX specifically spelled out that the PCAOB would keep its regulatory process opaque (Wedemeyer, 938). In doing so, the PCAOB gives companies an opportunity to improve their quality controls. As a result, public disclosure is seen as a punishment for companies that refuse to improve. However, the public has criticized the PCAOB's lack of overall transparency. Critics contend that the lack of disclosure has led to a decrease in the PCAOB's credibility with third parties (Wedemeyer, 939). As a result, while the creation of a regulatory body has improved oversight, it appears that enforcement and disclosure can be significantly improved.

Expanded Role of Audit Committees and Board of Directors

While the PCAOB established additional oversight and regulation of financial reporting, Congress also wanted SOX to enhance current oversight. Specifically, SOX augmented the role of audit committees and also emphasized the importance of the board of directors. Once again, it is difficult for investors and creditors to oversee every company across the United States. As a result, audit committees and boards of directors are established to oversee each company. Specifically, audit committees have the responsibility of choosing and dismissing a firm's external auditor, as well as maintaining communication with them to ensure management is reporting accurately and presenting a fair representation of the business at hand. On the other hand, the board of directors represents the shareholders' interests. The board's responsibility is to ensure investors that management is operating in their best interest and that they are receiving a fair return on their investment. As a result, both the audit committee and the board of directors represent two important bodies that are in place to ensure management is operating effectively and ethically.

After the variety of accounting scandals, such as Enron, occurred and SOX was implemented, audit committees immediately began taking action. For example, between 2003 and 2006, 5325 auditor switches were made among publicly traded companies in the United States, which represents 40 percent of all publicly traded firms (Grothe and Weirich). Moreover, in approximately 65 percent of cases, the client firms dismissed their auditors (Grothe and Weirich). As a result, it is evident that there was an immediate, proactive approach towards making change. SOX reinforced to audit committees that if they are not satisfied with the external auditor's work that it is best to move on. One could argue that SOX incited a major paradigm shift, which resulted in so many publicly traded firms switching auditors.

Although audit committees were proactive in changing auditors, one might argue, "Was that alone enough to satisfy proper financial reporting?" Others argue that the message of SOX in and of itself is enough to dissuade fraudsters. However, it is clear that SOX and even changing auditors is not enough. Rather, strong internal governance is necessary to achieve the goals of SOX. For example, Ahmed M. Abdel-Meguid et al. conducted a study that examined the relationship between governance mechanisms and aggressive financial reporting. In this study, they analyzed auditors, directors, and institutional shareholders effect on abnormal accruals. Specifically, the study found that there is a significant positive relationship between auditor economic dependence and signed abnormal accruals in the pre-SOX period (2000-2001). However, there is no significant relationship in the post-SOX period (2002-2004). As a result, one can argue that SOX improved auditor bias. However, the same study then analyzed the effect of governance on both relationships. In both the pre-SOX and post-SOX periods, a positive relationship between auditor economic dependence and abnormal accruals only holds when non-auditor governance is weak. More specifically, the study shows that the greater the strength of non-auditor governance, the weaker the relationship should be between auditor dependence and abnormal accruals. The study defines non-auditor governance as the board of directors, as well as institutional investors.

As a result, while SOX had a positive impact, the results suggest that regulatory legislation, such as SOX, is not a substitute for strong governance mechanisms. In fact, the study cautions against over reliance on SOX and emphasizes the importance of improving governance mechanisms instead. While SOX was an important step, one could argue that fraudsters will continue to be fraudsters. For example, Mintz argues that legislative regulation is not sufficient in and of itself to deter “managerial malfeasance” (595).

So did SOX have any effect on non-auditor governance? In the same study, the researchers analyzed the change in the makeup of the board of directors, as well as the change in the average fraction of institutional shareholders. Regarding the latter, there was an increase in the mean and median value when comparing the post-SOX period to the pre-SOX period. As a result, it is evident that independence increased due to outside ownership. However, when analyzing the average fraction of directors who are members of management, there is also in increase in the mean and median when comparing the post-SOX period to the pre-SOX period. As a result, it would appear that SOX had a mixed effect on non-auditor governance. However, the study suggests that the increase in members of management on the board could be a result of improved data availability in the post-SOX period.

Another study performed by Kaya and Banerjee further analyzed SOX’s impact on the board of directors by observing 124,366 observations for the 2001-2006 period. In the study, it was determined that SOX had a significant positive impact on the percentage of outside directors on the board. In fact, the study shows that there was approximately a 7.5% jump between 2001 and 2002. Moreover, there was a steady increase in outside directors from 2001 to 2006. As a result, the research shows that SOX did in fact have a positive impact on firms’ board of directors. However, although there was an increase in board of directors, several studies challenge the effects of the increased independence.

For example, another study shows that profitability can be harmed by increasing board independence (Bhagat and Black). However, one could argue that this is a direct result of fewer abnormal accruals due to increased independence. In fact, another study examines the relationship between board characteristics and earnings management. It finds that an inverse relationship exists between board independence and abnormal accruals (Klein). Another study suggests that as board independence increases, its monitoring efficiency of management may deteriorate even when considering improved compensation (Kumar and Sivaramakrishnan). However, another study suggests that increasing incentive-based compensation for directors improves monitoring efficiency (Perry). As a result, it appears that board compensation is another factor that should be analyzed as a determinant of SOX effectiveness.

In the same study done by Kaya and Banerjee, director compensation is analyzed from 2003-2006. The study shows that there was an initial increase in compensation from 2003 to 2004; this is believed to be a direct result of the implementation of SOX. Kaya and Banerjee state, “Sarbanes-Oxley Act resulted in increasing directors’ workload and risk thereby reducing their supply, and simultaneously increasing the demand for more independent outside directors. This could have an effect on the higher compensation for directors.” As a result, the increase in compensation from 2003-2004 can be attributed to the decrease in supply of qualified outside directors. However, the study also shows that there is a steady and significant decline in compensation from 2004 to 2006. In fact, by 2005 compensation had fallen below the mark set in 2003. As a result, compensation had essentially reversed to pre-SOX levels. Moreover, the findings suggests that the effects of SOX on firms’ board of directors were “temporary and short-lived” (Kaya and Banerjee).

Implementation of Internal Control Analysis

While non-auditor governance is an important factor in ensuring financial reporting quality, SOX also took it one step further. In 2004, Section 404 was implemented as a branch of SOX. Section 404(a) requires each firm’s management to include a statement in the annual report on the effectiveness and adequacy of internal controls. Section 404(b) requires that each firm's external auditor must attest to management's statement and assessment of internal controls. However, it is important to note that after the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act, firms with a market cap below 75 million no longer have to adhere to Section 404(b).

As Section 404 was seen as a significant stride to improving the quality of financial reporting, results were expected and in many ways they were achieved. For example, a study done on behalf of the Center for Audit Quality (CAQ) that analyzed restatement trends from 2003 to 2012 reported that restatements peaked at 1,784 in 2006, which was shortly after the implementation of Section 404. After 2006, restatements declined rapidly. Specifically, restatements had declined to 711 by 2009 (Scholz, "Financial Restatement: Trends in the United States: 2003-2012"). As a result, it is evident that Section 404 had a significant impact on the reliability of financial statements based on restatements announced.

Several other studies also emphasize the positive impact Section 404 had on financial reporting. For example, a study done by Bedard analyzed the effects of Section 404 on earnings. The study found that Section 404 reduces earnings management and improves earnings quality. Another study examined the impact of reported internal control weaknesses reported under Section 404. The study found that internal control weaknesses lead to more earnings management (Chan et al.).

Although the implementation of Section 404 was a significant measure taken by Congress to improve financial reporting, many firms bore a heavy burden from its effects. After the implementation of Section 404, it was evident that auditors would have significantly higher costs regarding the testing and reporting on internal controls (Griffin and Lont). Moreover, SOX as a whole had already resulted in increased audit hours, effort, costs, and fees (Raghunandan and Rama).

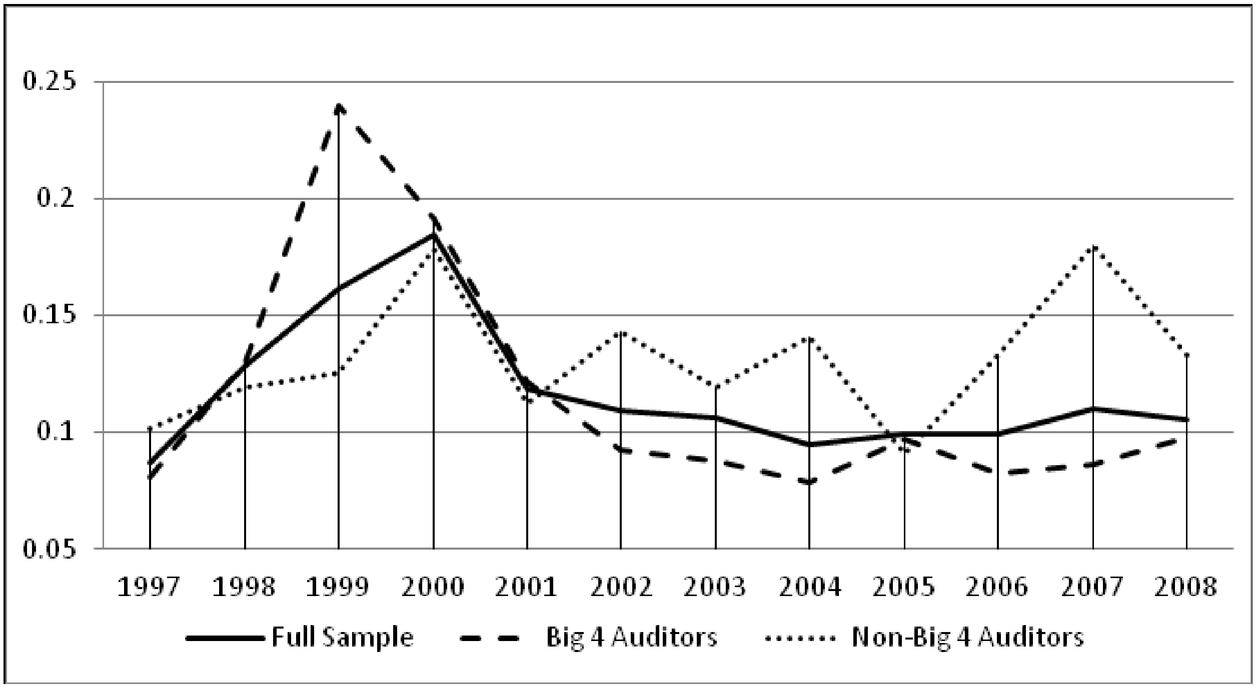
The increase in fees led to a systematic change in reporting. As stated previously, between 2003 and 2006, 40 percent of United States public companies switched auditors (Grothe and Weirich). Specifically, auditors were dismissed in 65 percent of those cases. While some firms chose to switch because they were not satisfied with the auditor's work, others had different intentions. For example, between 2003 and 2006, it was evident that there was a trend to switch from the Big Four toward smaller audit firms (Owens-Jackson et al.). Moreover, the majority of companies that switched to smaller firms had a market capitalization that was less than $75 million (Grothe and Weirich; Owens-Jackson et al.). However, it is important to note that the trend toward smaller auditors could be attributed to a push back from the Big Four as they communicated that they would not have the capacity to handle all of the additional Section 404 work.

The findings in several of the above studies are coupled with the idea that Section 404 brought a tremendous amount of new costs. It appears that many companies had done a cost-benefit analysis of Section 404 and had determined that it was not beneficial as a smaller registrant. For example, Iliev compares firms just above and below the $75 million compliance threshold. He found that Section 404 compliance costs outweigh its benefits, specifically when considering smaller registrants. This presents a problem as many registrants have found the threshold to be a loophole to Section 404, which has resulted in an unintended consequence of SOX. A study done by Gao et al. determined that the overwhelming costs of Section 404 have provided an incentive for firms to deliberately stay small. Moreover, many firms have deliberately maintained a market capitalization under $75 million. These firms will temporarily lower their market capitalization when nearing the threshold just to avoid Section 404(b) compliance. As a result, while one of SOX's goals was to reestablish growth in the financial markets through reporting reliability, it has in fact provided an incentive for smaller companies to inhibit their own growth.

After knowing that many firms are deliberately staying under the 404(b) compliance threshold, the trend to switch towards smaller audit firms holds more weight. While the goal of SOX wanted firms to focus on enhancing reliable reporting, they instead began to focus on circumventing newfound costs. One of the easier methods to do such is to switch to a non-Big Four auditor. Between 2000 to 2002, as well as several years after the passage of SOX, Big Four audit firms increased their fee premium over non-Big Four firms (Asthana et al.). As a result, many firms transitioned to smaller audit firms to avoid additional costs. However, the increasing premium is representative of a movement by the larger firms to enhance audit quality. Consequently, many firms are sacrificing audit quality for cost savings. As a result, it may be valuable to look into the reporting quality of smaller registrants based on this trend.

A study conducted by Rutledge, Karim, and Luo analyzed the effects of SOX on registrants audited by Big Four versus non-Big Four audit firms. The research entails analyzing registrants' discretionary accruals over four time periods ranging from 1997 (pre-SOX) until 2008 (pre-Dodd-Frank). The study presents the following graph:

Figure 1: Absolute Value of Discretionary Accruals over Time (1997-2008)



As seen in Figure 1, the study analyzes discretionary accruals over time amongst clients of Big Four auditors, non-Big Four auditors, as well as a full sample analysis. There are several significant takeaways from its findings. As noted by the “Full Sample” data, there was a significant drop-off in discretionary accruals in 2001 and was relatively maintained over the course of the time studied. As a result, SOX led to an overall reduction in discretionary accruals, therefore inhibiting earnings management. Similarly, the “Big 4 Auditors” data peaked in 1999 and subsequently dropped for the remainder of the studied time. As a result, SOX had a significant impact on the audit quality of Big Four firms. However, the “Non-Big 4 Auditors” data tells a different story. Similar to the previous two samples, the “Non-Big 4 Auditors” data shows a significant drop-off at the turn of the century as several of the major scandals unraveled. Once again, that would imply that SOX had an effect on non-Big Four audit firms as well. However, it appears that the effect was short-lived. In fact, there are two significant data points to analyze. First, non-Big Four discretionary accruals surpassed Big Four discretionary accruals in 2001. This would suggest that while SOX was immediately effective, it did not have as much of an effect on clients of non-Big Four audit firms as it did on clients of Big Four firms. Secondly, non-Big Four auditor discretionary accruals returned to the pre-SOX level in 2007. Specifically, there was an increasing trend in discretionary accruals from 2005 to 2007. One could argue that the increase could be attributed to the passage of Section 404 in 2004.

As discussed earlier, Section 404 drove many firms to stay beneath the Section 404(b) compliance threshold. In fact, the study determined that the majority of sample registrants with Big Four auditors had a market capitalization that was greater than $75 million. However, the majority of sample registrants with non-Big Four auditors had a market capitalization that was less than $75 million. As a result, while Section 404 appears to be effective when firms are above the Section 404(b) threshold, the problem remains that many firms are intentionally dodging the requirement. Consequently, the study suggests that earnings quality for non-Big Four audited registrants actually deteriorated in the post-SOX period.

Based on several studies' findings, it appears that the implementation of Section 404 had mixed results. While earnings quality improved in larger registrants, it also deteriorated in smaller registrants. The costs of Section 404 have been one of its biggest setbacks as many registrants have deliberately found ways to avoid compliance. As a result, one could argue that internal control analysis has been both successful and unsuccessful.

Additional Liability for Fraud

Another significant impact of SOX pertains to increased liability for fraud. As fraud was observed to be rampant in the early 2000s, many called for more severe punishments for offenders. The public also called for transparency in liability, as many executives claimed plausible deniability. As a result, SOX implemented several significant changes regarding liability. First, SOX required that all CEOs and CFOs sign-off on their respective firm's financial statements. As a result, their signatures directly made them liable for any rampant fraud within the firm. Simply, the question of liability was no longer blurry.

Registrants across the United States quickly understood that white collar crime would no longer be overlooked. In 2002 the president and CEO of the American Institute of CPAs (AICPA) made a clear statement on SOX. He said, "[It] contains some of the most far-reaching changes that Congress has ever introduced to the business world. Its scope is large. It contains fundamental reform. Many of its standards are high. And its penalties are stiff" (Melancon).

Although many had strong sentiments regarding SOX preventing fraud, did it actually translate into action? Once again, the trend of restatements can be analyzed as a determinant. In another study conducted on behalf of the Department of Treasury, the trend in restatements was analyzed, as well as the type of restatements. Over the course of the 10 year period between 1997 and 2006, there was a tremendous change in fraud-related restatement. Specifically, fraud was a factor in 29 percent of the restatement in 1997. However; it was a factor in only 2 percent of restatements in 2006 (Scholz, "The Changing Nature and Consequences of Public Company Financial Restatements").

While companies are improving their reporting, audit firms are also taking a proactive approach against fraud. Once again, between 2003 and 2006, 40 percent of United States public companies changed auditors. Specifically, in 35 percent of those cases, the auditors chose to resign (Grothe and Weirich). As a result, it is evident that many audit firms were no longer willing to audit companies that had a high tolerance for aggressive financial reporting. Moreover, a study was conducted to analyze the trend in resignations over time. The study found that resignations for qualified opinion firms in the post-SOX period increased from approximately 28 percent to 32 percent (Stunda and Pacini, 34). As a result, it is apparent that audit firms began to focus more on reputation and audit quality rather than just profits.

Although firms began to take a proactive approach towards fraud, many argue that the increased liability has not resulted in changed behavior. As one scholar states, “While new regulations can impose penalties for violating governance standards, they cannot create an ethical culture that fosters responsible behavior” (Mintz). Although SOX may appear to have mitigated fraud, some scholars believe not much has changed. For example, a prominent accounting analyst recently discussed the case of Valeant. The pharmaceutical company recently received scrutiny for its reporting of a vague variable interest entity. In his findings, the analyst proclaimed Valeant as “Enron déjà vu” (Ciesielski). He claimed that relatively nothing has changed in the 13 years since SOX was implemented. As a result, while strides have been taken to reduce fraud, it appears that it is not a matter of regulation or stiff penalties. Rather, it is a matter of culture.

Change in Financial Reporting Culture

As the public was no longer satisfied with the reliability of financial reporting after scandals such as Enron and WorldCom occurred, one of SOX’s goals was to reestablish a culture built on reliability and truthfulness. While this can be difficult to formally analyze as it is an intangible theme, it is an important component to judge the successfulness of SOX. An analysis can begin with the very implementation of regulation. Some scholars attribute SOX to be a complement to United States Generally Accepted Accounting Principles (US GAAP). One scholar suggests that while US GAAP is traditionally rule-based with bright lines that allow for financial reporting flexibility, SOX is more principle-based (McEnroe). As a result, the combination of the two can be interpreted as the best of both worlds.

However, other scholars disagree. For example, Park and Shin look to Canada as a model. In their research, they argue that monitoring mechanisms did not improve after the issuance of the Toronto's Stock Exchange's Corporate Governance Guidelines of 1994. Moreover, other scholars argue that regulatory legislation can lead to a "box ticking" mentality (Holland). As a result, regulation isn't always the answer and it is not a substitute for good governance mechanisms. Furthermore, some believe that capital markets do a better job of regulating than actual legislation, such as SOX (Ribstein). Also, the implementation of SOX is based on the presumption that governance failures were widespread in the pre-SOX era. However, some argue that that was not actually the case (DeFond and Francis).

This paper judges the improvement of culture on several metrics. First, we look at auditor economic dependence. As mentioned earlier, a study was conducted to analyze the trend in auditor dependence on clients over time. During the pre-SOX era, there was a significant positive relationship between abnormal accruals and importance of client. However, there was no relationship present in the post-SOX period (A. M. Abdel-Meguid et al., 296). As a result, it would appear SOX was successful in improving unbiased auditing. Furthermore, it appears that there has been an overall culture shift amongst auditing firms. Whereas client retention incentives dominated in the pre-SOX era, now reputation protection incentives are valued more in the post-SOX era (A. M. Abdel-Meguid et al., 304).

Another metric to evaluate a culture shift consists of public view of audit opinions. As auditors have issued opinions on financial statements before and after the passage of SOX, one can analyze the reaction to opinions in both eras. As stated earlier, there was an increase in auditor resignations for qualified opinion firms in the post-SOX era. This would point to auditors emphasizing the gravity of an unqualified opinion. As one of the main goals of SOX was to protect investors, it would be valuable to look at their reaction as well. In the same study, “Investors do not demonstrate a significant share price response to unexpected earnings of client firms with qualified opinions in a pre-SOX environment” (Stunda and Pacini, 36). However, the study also states, “Investors demonstrate a significant negative unexpected earnings reaction to qualified opinions in a post-SOX environment” (Stuna and Pacini, 36). As a result, there is a clear shift in opinion of investors after the issuance of SOX compared to beforehand. The study suggests that SOX raised the threshold for the issuance of an unqualified opinion and, therefore, increased the consequences of a qualified opinion (Stunda and Pacini, 38).

Although it appears SOX has had a significant impact on stakeholders, it is important to note that many argue the culture remains the same. For example, Dechow and Skinner argue that earnings management has not been mitigated, but rather it is just in different forms. Also, one can point to the compliance threshold of Section 404(b). Firms continue to find ways to dodge compliance and arguably misrepresent oneself. One could argue that this notion can be extrapolated to other forms of financial reporting dishonesty. As a result, SOX had a mixed effect on the overall culture of the financial atmosphere.

Conclusion

At the time of implementation, SOX was arguably the most significant law to ever be enacted in the financial realm. Its effects were far-reaching and widespread. Its message was strong and clear. As a whole, SOX was implemented to achieve a variety of goals. Most importantly, SOX was intended to reestablish trust in the United States financial markets and protect investors moving forward. Overall, it had many effects on a variety of areas within the financial markets. Some of these effects, such as mitigating earnings management, were intended, while others, such as incentivizing stagnation, were not. As SOX is one of the most significant and far-reaching laws to affect United States financial markets, it is difficult to analyze the entirety of its effects. Some argue that it was necessary and has been wildly successful. Others suggest that it has been woefully unsuccessful and should be repealed entirely. Lastly, some believe that some ideas have worked while others have failed. As a result, this paper presents points of discussion as opposed to a formal opinion on SOX's effectiveness. As the financial realm is an ever-changing body, it remains to be seen how truly effective SOX has been and will be.

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