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A Review of the effects of Sarbanes-Oxley on Stock Price

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A B S T R A C T

The Sarbanes-Oxley Act (SOX) has been in place for over a decade, and the effects of the legislation are widely debated in the business community. The problem to be investigated is the impact of the Act on the disclosure of financial information and the strength of the internal controls a company has in place to determine whether SOX has affected publicly traded companies in the United States. SOX resulted in the creation of the Public Company Accounting Oversight Board and provides for the establishment of audit reporting standards and the investigation, inspection, and enforcement of public accounting firms. The Act has decreased the number of discretionary accruals, addressed the backdating of stock options, addressed material reporting weaknesses, and increased the quality of internal controls. Several significant factors support the assertion that the benefits of SOX outweigh the compliance costs of its implementation.

Keywords: Sarbanes-Oxley, SOX, Stock Price

I. Introduction

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to ensure that corporate disclosure and governance practices were acceptable to the general public. Congress passed SOX in reaction to corporate scandals where large numbers of shareholders were deceived due to financial reporting fraud. Once these scandals became public the public lost trust in American financial markets (Anand, 2007). The rest of this paper is structured to include: the functionality of SOX, issues of financial disclosure and corporate governance, finding and suggestions for future work, and concluding remarks.

SOX is named after the members of Congress who

brought about the Act, Senator Paul Sarbanes and Congressman Michael Oxley. The bill's sponsors and both houses of Congress worked to create legislation that would hold publicly traded companies to higher standards and require more transparent financial reporting methods (Anand, 2007).

The Act requires corporations to have an independent audit committee that includes financial experts and to improve the nature and timing of financial disclosures. Businesses have always expressed concern in the popular press that oversight and compliance negatively impact expenses (Akhigbe and Martin, 2006). However, the popular press contains little other information about the positive effects of SOX with regard to investor confidence and the possible impact on stock price.

SOX increases oversight and reporting demands of the senior management and board of directors within companies. The Act also recognizes the need for mandated disclosure rather than allowing voluntary disclosure

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(Akhigbe, Martin, & Newman, 2008).

The legal requirements of SOX reflect three principles: integrity, accuracy, and accountability. Compliance through the Act reassures investors that the information issued by the company is valid and truthful. SOX requires that companies establish an accounting framework that includes internal controls to insure accurate oversight and financial reporting practices. SOX also requires that the CEO/CFO of a publicly traded company to sign off on the accuracy of the issued financial statements. The penalty for SOX noncompliance includes civil lawsuits, and CEOs/CFOs are personally subject to financial penalties and incarceration (Anand, 2007). By enforcing these actions through SOX, public confidence in financial markets can resume increasing the value of stocks.

To an extent, the concerns that SOX is trying to correct have been shielded from the investigations of audit committees and external auditors. Managers, for a variety of reasons, could manipulate earnings and conceal negative corporate financial information by using various standard accounting techniques as well as could conceal activities under the guise of tax planning strategies (Kim, Li, and Zhang, 2011).

Though managers act in an agency capacity, research argues that such accounting techniques and tax strategies can cause managers to be opportunistic (Chen, Chen, Cheng, & Shevlin, 2010; Desai & Dharmapala, 2006). A wide ranging reasons, including compensation, resume building, and empire building motivates managers to conceal adverse operating outcomes (Ball, 2009). SOX legislation aims to reduce the negative effects of manipulating financial statements and tries to improve the integrity of financial reporting by enhancing corporate disclosure and governance practices (Akhigbe and Martin, 2006).

Many in the business community debate the Act's effectiveness. When considering whether SOX was able to restore confidence in corporate reporting and increase firm value it is important to understand both points of view. Those who oppose SOX believe that the added work and financial costs far outweigh the possible benefits. Supporters of SOX argue that the additional work and costs are worth the increased quality of financial statements to provide peace of mind for stakeholders. It is possible to research both of these viewpoints since SOX has been in effect for over a decade, and the long term effects are visible (Coates and Srinivasan, 2014). However,

methodological limitations present in the research to date make it difficult to ascertain SOX's impact upon equity risk – the focus of this study. Not only does the research present contradictory findings, the methodology employed (such as simple mean-variance analyses) fails to fit the data and is fraught with imprecision (Vakkur, 2012). Coates and Srinivasan (2014) identified several significant contributions of SOX in the past ten years:

- SOX has not changed the relationship between the company and the auditor.
- The SOX Act of today is materially similar to the original version, with exception to the modifications of section 404.
- PCAOB is a strong contributor to the regulatory environment.
- SOX has been used as a basis for other countries looking to improve the financial disclosures in their country.
- SOX mandated disclosures did not impose significant direct costs on organizations.
- SOX has not paved the way for significant Congressional intervention on corporate governance.
- SOX has resulted in improved audit quality which leads to improved financial statement quality.

This paper contributes to the literature in two ways. First, this is one of the few papers to identify a significant positive impact to the implementation of SOX. Second, this research adds to the body of knowledge that SOX has economic and managerial consequences.

II. Issues of Financial Disclosures and Corporate Governance

Prior research indicates that there are varying degrees of quality in financial disclosures. There is an underlying assumption that investors actually read these disclosures and make decisions based on them (Arnold, Bedard, Phillips, & Sutton, 2011). This paper acknowledges that there is mixed evidence on the impact of financial disclosures.

This current research reviews significant literature to summarize the effects of SOX. How investors process information is very important in understanding the impact

of financial disclosures on stock prices. Research by Hogarth (1980) suggests that information processing occurs in three stages: the acquisition, evaluation, and combination of information. When information is hidden, these stages cannot occur; therefore, stock prices are not aligned with an organization's true valuation. Research conducted by Goh and Li (2008) looked into this claim by comparing companies with material internal control weaknesses to companies without them. It was found in 733 organizations that disclosed material weaknesses that a majority of them (59%) remediated (Johnstone, Li & Rupley, 2011). Firms that remediate benefitted with a 151-point decrease in the cost of equity (Coates and Srinivasan, 2014).

When financial information is made public, corporations face an increased likelihood of stock price volatility. Existing research finds firms that "manage" reported earnings can shelter bad information up to a point at which bad information could no longer be hidden by "managing" the numbers. At that point the firm's negative financial information had to be made public, which caused stock prices to decline (Hutton and Tehrani, 2009).

Reliance on financial disclosures is significantly different between professionals and nonprofessionals. Financial professionals access more company information than nonprofessionals and are more likely to view financial disclosures than nonprofessionals (Arnold, Bedard, Phillips, & Sutton, 2011). Evidence also exists that shows professional investors reduce stock price predictions when company risk is assessed as high. These findings suggest that professionals are more optimistic in general, and that some signals of poor financial reporting quality will not impact stock price (Arnold, Bedard, Phillips, & Sutton, 2011). The effects of financial disclosures, either positive or negative, would be even more pronounced if a higher percentage of individuals accessed financial disclosures.

Premature revenue recognition is a type of aggressive earnings management that was practiced in over one third of the 919 financial restatements released in the five year period prior to the enactment of SOX. In the early 1990s, companies were known to save excess revenue in so-called *rainy day funds*. These funds were used to smooth out earnings in years during which companies performed poorly. Income smoothing turned into a darker practice when companies reported revenue that would be earned in future financial periods. With SOX implementation, the penalties that can be levied against CEOs/CFOs encourages them to report conservative results to protect

themselves from potential legal prosecution (Lobo and Zhou, 2006). With the passage of SOX, these restatements have diminished substantially (Coates and Srinivasan, 2014).

Accruals as another method that some CEOs/CFOs may use to affect earnings. Since accruals can be discretionary, the use of them continues even after the implementation of SOX. A sample collection of Canadian companies listed on both the Canadian and US stock exchanges was compared to a control group of companies listed on only the Canadian stock exchange for two years preceding and the two years following implementation of SOX. The data gathered indicated a significant decrease in discretionary accruals in the post-SOX period when compared to the pre-SOX period for companies listed on both US and Canadian stock exchanges. This provides evidence that the companies required to follow SOX employ fewer discretionary accruals, thus indicating an increase in accounting conservatism. Since the companies listed on only the Canadian stock exchange did not experience a decrease in signed discretionary accruals, the increase in conservatism can be contributed directly to the implementation of SOX (Lobo and Zhou, 2009). In fact, Coates and Srinivasan (2014) found that many executive incentive structures are now centered on a lower level of accruals.

Backdating stock options is another method commonly used to manipulate reported earnings. In this practice, the grant date of stock options is retroactively adjusted to lower the exercise price. Naturally, the backdating of any information will raise governance, legal, accounting, tax, and auditing concerns. This practice is seen as a sign of ineffective corporate governance and a tool for managerial opportunism. When companies implicated in the practice of backdating stock options are compared to non-implicated companies, the effect of SOX is much greater on the implicated companies than the non-implicated companies (Hossain Mitra, Rezaee, & Sarath, 2011). Additionally, the type of organization committing this type of manipulation has changed over time from smaller companies to larger companies (Cox and Thomas, 2005).

Jin and Myers (2006) found that when transparency is lacking, a manager has the opportunity to make non-cash assumptions that can manipulate earnings. Managers are willing engage in cover-ups to temporarily hide poor performance to protect their job. According to the Jin

and Myers research, if a string of negative financial news occurs, these managers are unwilling or unable to absorb the more significant losses; in other words, they will cover up minor (but significant) pieces of information but not information with unavoidable consequences. When managers release the unavoidable information, the effects become available in one release, resulting in a significant amount of negative information and the resulting stock price decline.

Avoiding the effects of significant stock price declines is not only a goal of SOX; it is also a goal for shareholders. With the passage of SOX, firms are required to have independent audit committees and disclose whether they have financial experts on their audit committee (Akhigbe and Martin, 2006). SOX has effectively lowered the amount of earnings volatility due to the manipulation of financial data (Hutton, Marcus, & Tehranian, 2009).

Can Ethical Issues be Resolved Voluntarily?

Many of the issues that are covered by SOX could or should have been handled as ethical issues and resolved voluntarily within an organization. Following is a list of such items:

- The Public Company Accounting Oversight Board is charged with reviewing accounting firms for repeated neglect (Jennings, 2009).
- SOX makes it clear that auditors must be independent and should not participate in the development and use of company systems (Jennings, 2009). If auditors involve themselves in the daily activities of a customer, they are not independent and cannot provide an unbiased opinion (Grasso, Tilley, & White, 2009).
- Chief Executive Officers (CEO) and Chief Financial Officers (CFO) must certify that financial statements are fair. If inaccurate, the CFO and CEO forfeit any bonuses and compensation as well as risk incarceration (Jennings, 2009).
- Officers of companies cannot sell stock during certain time periods and must report the sale of any stock within two business days of the transaction (Jennings, 2009). These blackout periods circumscribe major reporting events that may impact stock price (Dailey and Brookmire, 2005).
- Companies must report off-balance sheet transactions for transparency and full disclosure (Dailey and Brookmire, 2005).
- Companies must develop internal controls and make clear the consequences of misbehavior (Grasso,

Tilley, & White, 2009).

These items are important as they document the many issues that SOX is trying to correct. The Act also establishes the need for mandated disclosure. Without the SOX oversight, it is unlikely that voluntary adherence would be accomplished, thus putting shareholder value at risk.

Costs Associated With the SOX Requirements

On the audit side, the cost of complying with SOX is significant. Costs are most commonly associated with the establishment of internal control policies, the use of accounting firms to perform audits, and the hiring of CEO's (Krishnan et al., 2008). In fact, the average audit cost increased 359 percent since SOX's passage, which confirms assertions regarding the heavy financial burden on public companies (Krishnan, Rama, & Zhang, 2008).

Within the company, internal control policies increase costs because compliance utilizes employees, time, and technology. Creating, implementing, and monitoring internal controls often require companies to hire more people. For SOX to be implemented, companies have to identify and document deficiencies in internal controls. Material weaknesses significantly increase total SOX costs; therefore, understanding, controlling, and eliminating these expenses by early identification of issues helps keep long term costs down (Krishnan, Rama, & Zhang, 2008).

Many corporate scandals involved companies that aggressively applied GAAP. The ratification of SOX caused an almost immediate recognizable increase in conservatism in financial reporting. This increase in conservatism can be measured in the decrease in discretionary accruals as well as the change in loss and gain recognition practices (Lobo and Zhou, 2006). Dailey and Brookmire (2005) suggest the following list of governance practices that could be used by companies to remain in compliance with SOX.

- Maintain improved records. Internal control procedures along with accountability reviews must be documented by human resources for both employees and vendors.
- Make ethical standards clear. Human resources should create or update a code of conduct and clearly communicate them to employees including directors and senior management.
- Communicate information on the repercussions for violations. The Public Company Accounting Oversight Board possesses the authority to discipline negligent conduct by public accounting firms by imposing sanctions. CEOs and CFOs can also suffer criminal

penalties for significant noncompliance.

- Put in place a strong and independent board of directors due to greater accountability demands.
- Engrain ethical behavior as a daily necessity, and expect senior management engagement.
- Protect whistleblowers by putting in place protections for employees who report violations.
- Ensure employees are rewarded for actual company performance.

From this list, it is clear that to achieve full transparency in the disclosure of financial statements a company must take significant steps to be compliant.

III. Finding and Suggestions for Future Works

Several significant factors support the assertion that the benefits of SOX outweigh the compliance costs of its implementation. Increasing the quality and accuracy of financial reporting is not the only benefit of SOX: The Act also increased the quality of internal controls. The trust gained by being mandated to report both good and bad information is displayed in the investor confidence. This increases firm value. Additionally, the strengthening of internal control results in the prevention of negative events occurring to diminish that confidence. The Goh and Li (2008) study verifies this claim by comparing companies with material internal control weaknesses to companies without them. They also found that companies disclosing material weaknesses were less conservative in financial reporting. Not only does this mean the firm should be insulated from the occasional release of negative information, the firm is better able to prevent fraud. Other research determined that the effects on stock price were less favorable for firms that lacked independent audit committees, financial experts on the audit committee, financial statement footnote disclosures, and actively involved CEOs. Also, the wealth effects of firms viewed as non-compliant are significantly lower than firms viewed as compliant (Bergstresser, Desai, & Rauh, 2006).

Using the financial sector as an example, the adoption of SOX has had a positive effect on stock price as compliant firms showed significantly higher stock appreciation (Akhigbe and Martin, 2006). This study found that for

financial firm's compliance with SOX increased firm valuation. In a later study by Akhigbe, Martin, and Newman (2008), it was reaffirmed that SOX compliance showed a statistically significant positive appreciation in not only firm value but also in the risk of those firms and the variance of returns.

The current research is significant for multiple reasons. First, it recognizes the need for mandated disclosure. When disclosure is voluntary, the organizations, agency relationship with senior management can be challenged. Second, it exposes the impact of backdating on an organizations stock price. Third, it is consistent with the empirical evidence of previous studies that report the positive association between disclosure and stock performance as relevant and significant (Bekaert and Wu, 2000).

Future research should enhance the information currently available. This may include analyzing the manner to which a top-down or bottom-up financial statement compilation: Will the increase in reported disclosures be permanent, and will the Act lose relevance as managers find ways to circumvent it? Related to this, research could examine whether or not mandatory financial disclosure would mitigate agency problems through intense monitoring. Another area of research could include identifying the level of external reporting fraud in pre- and post-SOX period or with a well-constructed research design, investigate empirical evidence of impact of SOX on the firm value and corporate governance. Still another might be an event study focused on monitoring the change in firm value around SOX.

IV. Conclusion

Many of the issues addressed by the SOX legislation have an ethical undertone. Though many companies were behaving ethically on their own, companies such as Enron and WorldCom were not (Jennings, 2009). Companies must now put in place greater internal controls and make the ramifications of noncompliance clear. The cost associated with compliance is significant, but without compliance, the results of unethical behavior will be detrimental to stockholders. This examination of multiple studies focusing on various facets of accounting—

discretionary accruals, backdating stock options, and internal controls—reveals that SOX has impacted the financial reporting of publicly traded companies. Companies that reported conservatively prior to the implementation of SOX continued to report conservatively in the post-SOX era. Companies that were more aggressive in their financial reporting were greatly impacted in the post-SOX era.

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