SOX

The years 2001 and 2002 revealed a series of major corporate scandals, including the record-breaking bankruptcies of Enron and Worldcom. In response to these scandals Congress passed the Public Company Accounting Reform and Investor Protection Act, commonly known as Sarbanes–Oxley or SOX. SOX implemented a number of reforms intended to prevent a repetition of the corporate excesses of the previous years.

1. It established a Public Company Accounting Oversight Board (PCAOB) to provide independent oversight of auditing services

2. It restricted a firm's auditors from simultaneously undertaking other services for the firm, such as consultancy. This move was prompted by the belief that the high consultancy fees paid by Enron to its auditors led them to overlook the company's dodgy accounting practices. In addition, SOX specified that audit partners should be rotated, and required that all company boards should have an audit committee composed of independent directors and including at least one financial expert.

3. The Act required that senior executives take individual responsibility for the accuracy of financial reports. In particular, Section 404 required management and the external auditor to report on the adequacy of the company's internal control on financial reporting.

4. SOX specified new reporting requirements, including off-balance-sheet transactions, pro-forma figures, and data on share trading by corporate officers.

5. The act set out a code of conduct for securities analysts and required disclosure of any conflicts of interest.

6. It made failure to certify financial reports a criminal offense and specified criminal penalties for alteration of financial records, while providing protection for whistle-blowers.

There were widespread complaints particularly by smaller corporations about the costs of complying with SOX and in particular of complying with Section 404.[1] A study by the law firm Foley & Lardner found that the average cost of SOX compliance for companies with under $1 billion in annual revenue increased by more than $1.7 million to about $2.8 million. The costs of SOX have also been blamed for a decline in the number of foreign firms seeking a U.S. listing and an increase in the number of companies going private or "going dark."[2] What is less clear is whether these costs are outweighed by the benefits of SOX.[3]

[1] In September 2010 the SEC made a concession to smaller companies by exempting them from SOX's Section 404(b), the internal control audit requirement.

[2] Public companies can apply to deregister and cease filing with the SEC (i.e., go dark) if they have fewer than 300 shareholders, or fewer than 500 holders and less than $10 million of assets. However, their stock can still continue to trade publicly. "Going dark" does not seem to be popular with shareholders for the announcement results in an average fall in the stock price of about 10%. See C. Leuz. A.J. Triantis, and T. Wang, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," *Journal of Accounting and Economics*, 45 (August 2008), pp. 181-208.

[3] Zhang cites large negative returns around the time of key legislative events as evidence that the benefits of SOX were smaller than the costs. The potential problems of attributing these returns to the particular events are discussed by Leuz. See I.X. Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002," *Journal of Accounting and Economics*, 44 (September 2007), pp. 74-115, and C. Leuz, "Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions," *Journal of Accounting & Economics*, 44 (September 2007), pp. 146-165.