Vendorprisey

- front page
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Happy Birthday SOX.

July 30th, 2007 · 1 Comment

and a retort to John Dvorak….

Today, I'm reliably informed, is the 5th birthday of the Sarbanes Oxley Act, so at the risk of scaring off yet more readers, some more SOX musings.

I stumbled across some interesting research (and several rantings) on SOX over the weekend. Sad, I know, that I spent Sunday night trawling through Academic Journals, but trust me, it beats German TV.

Have a look at this paper by Robert Prentice, "Sarbanes-Oxley: The Evidence Regarding the Impact of Section 404" . He is the Ed & Molly Smith Centennial Professor of Business Law, McCombs School of Business, University of Texas at Austin. I'm going to quote extensively from the paper here, so please excuse the rather long extracts. I tried to summarise it, but I found it pretty much without a wasted word. The paper links to many other research papers, and is an excellent launch pad to examine SOX via the facts, rather than soapbox rhetoric.

I'm hoping that you would be inclined to take this research seriously than the recent rantings of John Dvorak on SOX. (tip Audittrail blog for the link)

John knows his stuff on technology; I would not presume to challenge him on operating system innards, but frankly his piece on SOX, is not, how shall I put it politely, his best work.

After 5 years in operation, it is time that commentators, tech or otherwise looked at the emprical evidence, rather than relying on heresay.

I'm not saying SOX is perfect, and I have serious concerns about the continued high cost of audit fees.
The law continues to require fine-tuning, and the recent changes to the PCAOB are timely, if not overdue.

Firstly, given the recent options backdating scandals in John's "valley" I'd urge him to read section 409. The backdating scandals cost shareholders roughly 100 billion dollars at the low end of estimations see Gennaro Bernile et al. Section

409 makes this sort of large scale fraud much harder to commit, and makes it far less lucrative. This alone is enough to cover the cost of the SOX implementations for ages.

As we are reminising, please think back to 2002 and remember the state of the market.

As Prentice notes,

> When SOX was passed, the stock markets were nearly in a free fall. From 2000 market peaks, the Dow Jones Industrial Average had dropped 25%, the S&P 500 had declined more than 40% and NASDAQ had plummeted more than 70%.52 Investor confidence in the capital markets was at record lows, causing average trading volume to drop 54%. The lack of confidence stemmed not from worries that Congress would legislate, as conservative pundits have asserted, but from that fact that 84% of the investing public believed that corporate wrongdoing was widespread rather than isolated. Professor Paredes noted at the time that "restoring [investor] confidence might be the most important thing that the SEC and Congress can do, just as it was the top priority during the crisis of confidence following the 1929 stock market crash."

Also

> Indeed, Lord and Benoit's post-SOX study showed that over a two-year period, there was a 27.67% increase in the average share prices for companies that had effective internal controls in both years, a 25.74% increase in average stock price for companies that had ineffective SOX 404 controls in year one but effective controls in year two, but a 5.75% decrease in average stock prices of companies that reported ineffective Sox 404 controls in both years.

and further

> ..consider that in October 2002, "the dark days when the market was most nervous about the quality of financial reporting,"65 credit spreads for investment grade companies were 2.5 percentage points over Treasury rate whereas by 2006 that spread had shrunk to .85%. The managing director of Moody's Investors Services has stated that not all of that shrinkage can be "attribute[d] to 404, but if only 10 percent of that reduction is due to 404, put those numbers in your calculator and you get a benefit that is absolutely enormous.

Prentice then goes on to look at Improving Corporate Governance,Liquidity (see also this paper), financial reporting, fraud detection and deterrence, the impact on the competitiveness of US security markets. It is a through paper, and if you are even vaguely interested in compliance it is a must read.

He concludes by noting

> Faith in U.S. capital markets has been substantially restored following the bursting of the dot-com bubble and the exposure of a scandalous corporate culture at many major corporations. Sarbanes-Oxley and its Section 404 helped enable that resurrection.
>
> The commonly perceived burdens of SOX 404, including implementation costs and impact on U.S. capital markets, are real but have been overstated while its real benefits are often overlooked. Considerable empirical academic evidence indicates that SOX 404 has improved the accuracy of financial reporting, improved liquidity and corporate governance, and helped disclose some frauds and discourage others. That said, it is impossible at this point in time to accurately weigh SOX's total benefits against its total costs. None of the scores of academic studies cited in this article purports to settle definitively the question of whether SOX in general or Section 404 in particular have been, on balance, beneficial. Therefore, what must continue to occur is a careful, reasoned study of SOX's provisions and their impact.
>
> While there is substantial reason to believe that SOX has improved the economy and brought various concrete benefits to the capital markets, if its detractors succeed commercial actors in the U.S. will ultimately view SOX, and especially Section 404, as illegitimate. This eventuality would blunt SOX's

> positive impact upon beliefs, norms, and practices in the U.S. capital markets and its potential to create and sustain a culture of compliance and integrity will be seriously damaged. If that happens, it becomes much more likely that SOX's costs will ultimately exceed its benefits than if SOX 404 is viewed as a legitimate, though somewhat flawed, attempt to restore integrity to the U.S. capital markets. And the current evidence indicates that is much closer to the truth.

John Dvorak also goes about the supposed capital flight:

> Thus they jump onto the London stock exchange or become Canadian corporations, maybe even Swiss corporations. They'll do anything to pick up the extra 4% profit not to mention the advantage of avoiding the SOX paperwork and the worries about missteps.

This defies both logic and the facts. Firstly it assumes there is no cost of compliance or regulation elsewhere. Secondly, there is little evidence for significant "jumping" due to SOX costs. See this post here. and this paper here.

And to show that this blog isnt just a SAP GRC flag waving exercise, I'll quote again from an SAP GRC competitor, Approva, whose recent survey of CEO's points to an entirely different reality from Dvorak's vague *"…blame Sarbanes-Oxley and so does everyone else in the valley" point.*

> Despite widespread media coverage that public companies are begging for a reprieve from SOX, Approva's survey found that 83 percent believe the Sarbanes-Oxley Act ha had an overall positive impact on their companies. And 63 percent believe SOX has been successful in preventing corporate fraud. Seventy percent of respondents believe that investments in SOX compliance will provide benefits beyond compliance alone.

The time for vague blah blah on SOX is so over. To repeat Prentice's words… what must continue to occur is a careful, reasoned study of SOX's provisions and their impact.

Technorati tags: SOX, Dvorak, Prentice, Section 404

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