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Sarbanes-Oxley and Capital Market Competitiveness

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From President George Bush's call for "truthful books, honest people and well enforced laws against fraud and corruption," to Maryland Sen. Paul Sarbanes' admonition that "unless we come to grips with the crisis in accounting and corporate governance, we run the risk of seriously undermining our long-term world economic leadership," Sarbanes-Oxley Act corporate governance reforms were intended to provide stronger laws to deter corporate corruption and to hold violators accountable for harm they cause investors. Signing the bill into law on July 30, 2002, the president hailed the regulation as one of the "most far-reaching reforms of American business practice since the time of Franklin Delano Roosevelt."

Now, in late 2006, when frauds like Enron and WorldCom have fallen out of the news, influential industry groups are hoping to swing the regulatory pendulum in the opposite direction.

For example, the Committee on Capital Markets Regulation was formed in September by academic, business, financial and corporate governance leaders. "Our goal is to provide carefully considered recommendations for adjustments to the current regulatory and liability framework," committee co-chairmen R. Glenn Hubbard and John L. Thornton stated in a *Wall Street Journal* editorial. They say that these "adjustments" — including changes to Sarbanes-Oxley — are needed to improve the competitiveness of American capital markets.

Such anti-regulation initiatives appear to confirm a broader shift in sentiment among policymakers towards a watering down of Sarbanes-Oxley. In an interview with CNBC, Vice President Dick Cheney said, "I think you can make a case that Sarbanes-Oxley went too far. The fact of the matter is — when we had, for example, Enron and WorldCom, the problems that developed from the standpoint of those companies, those activities were illegal before there was any additional regulation put in place."

Securities and Exchange Commission chairman Christopher Cox said in a recent Congressional hearing that Section 404 of Sarbanes-Oxley — which requires certifications by management and opinions by auditors on the adequacy of internal controls — "has been too expensive for investors."

Paul Sharman, president of the Institute of Management Accountants (IMA), said that Sarbanes-Oxley is responsible for "nothing less than a massive erosion of U.S. global competitiveness. The clock is ticking and the global stage is watching — now is the time to be bold and decisive to restore U.S. global competitiveness." Hal S. Scott, a Harvard law professor serving as director of the Committee on Capital Markets Regulation, told *The New York Times* that the committee, whose interim report is expected by the end of this month, will propose "changing Section 404."

In his first major speech as U.S. Treasury secretary, Henry Paulson Jr. told a Columbia University audience, "Often the pendulum swings too far, and we need to go through a period of readjustment. The challenge before us now is how to achieve the right regulatory balance to allow us to become competitive in today's world while guarding against the re-occurrence of past abuses."

New York City Mayor Michael Bloomberg and Sen. Charles Schumer warned in a co-authored *Wall Street Journal* opinion targeting Sarbanes-Oxley, "Unless we improve our corporate climate, we risk allowing New York to lose its pre-eminence in the global financial services sector. This would be devastating both for our city and nation."

"This is an escalation of the culture war on regulation," Duke Law School professor James D. Cox told *The New York Times*.

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Commenting to Reuters, class action lawyer William S. Lerach remarked, "The chutzpah of corporate and Wall Street communities just know no bounds." In that spirit, Ben Stein suggested in his column "Everybody's Business" that when one talks about a "corporation" one should always keep in mind "the widows and orphans who actually own the stock and the company." Stein asks, "Is it really right for prominent American executives, amid a host of scandals involving other executives looting their shareholders blind, to have the best and the brightest of academe and [Wall] Street lobbying for less accountability to shareholders?"

With both sides of the debate engaged, another fiscal period is coming to a close. Long, hard hours are being logged to prepare financial statements and disclosures, to check that they are reasonably accurate, and to provide them to investors. Corporate professionals and management accountants are working on internal control systems to assess the risks they must manage. After all, investors depend on the accuracy and reliability of those disclosures and controls. As IMA's Paul Sharman explains, there is much work being done by "professionals who have been educated specifically on how to design, implement and manage internal control systems."

But are well-trained professionals enough to prevent corporate fraud? As federal district court Judge Thomas W. Thrash Jr., has noted, "corporate insiders and upper management always have the opportunity to lie and manipulate." Similarly, the federal court in the Enron case characterized that fraud as involving "a combination of arrogance, greed, deceit and financial chicanery." U.S. District Judge Melinda Harmon explained, "[Enron management's] greed was rewarded by high salaries, extraordinary bonuses, and the exercise of Enron stock options or sale of company stock, the value of all of which was continuously inflated by their manipulation of Enron's financial reports." Former Federal Circuit Judge Abner J. Mikva elsewhere observed that "greed paired with sloth can subvert the legal system."

For these reasons, corporate governance policymakers must consider the pragmatic reality that real people in real jobs with real temptations and real ethics are at the core of every decision involving accounting and financial reporting.

The question of who has responsibility for accounting and financial reporting is fairly simple under generally accepting accounting principles (GAAP). GAAP states unequivocally that the responsibility for the reliability of an enterprise's financial statements rests with its management. Kirsten L. Flanagan, a shareholder of the Philadelphia accounting firm Shechtman Marks Devor, explained, "GAAP describes objectives and concepts underlying standards and practices existing in the financial markets. APB Statement No. 4, issued in 1970, provides that management of a company, including its CEO, CFO, directors and audit committee members, are ultimately responsible for maintaining effective systems of accounts and internal control, and preparing adequate financial statements."

While a company's accounting department actually prepares financial statements, the chain of command supervising this function typically proceeds from the controller through the chief financial officer to the chief executive officer. The board of directors, which has a responsibility to the company's shareholders to oversee management's performance, generally delegates its responsibility to oversee the company's financial reporting process to an audit committee. These corporate participants, and the functions they perform, are crucial to a company's internal controls for accounting and financial reporting. A company's internal control structure is therefore based upon a group of people working to provide reasonable assurance that the company's financial reporting is reliable, its operations are effective and efficient, and it is complying with applicable laws and regulations.

In July 2006, the Governmental Accounting Office (GAO) released a report to Sarbanes concerning financial restatements. The GAO identified over 1,750 financial restatement announcements between July 1, 2002, and June 30, 2006. It found that the number of public companies announcing financial statement restatements rose by about 67 percent since the passage of Sarbanes-Oxley. The GAO concluded that a variety of factors contributed to the increased trend in restatements, including "increased accountability requirements on the part of company executives; increased focus on ensuring internal controls for financial reporting; increased auditor and regulatory scrutiny (including clarifying guidance); and a general unwillingness on the part of public companies to risk failing to restate." The primary reasons for restatements were to correct errors in accounting and reporting revenue, costs or expenses.

Commenting on the GAO report, Charles D. Niemeier, a member of the Public Company Accounting Oversight Board created by Sarbanes-Oxley, explained:

"Many of these restatements are attributed to errors identified in companies' and auditors' examination of the effectiveness of internal controls. ... Indeed, the number of restatements by U.S. companies in 2005 reached a record level. ... While troubling that this number of material errors in U.S. companies' financial statements still exist, it is, at the same time, a positive sign that, working with their auditors, U.S. companies are getting their accounting on the right path."

In a speech in Sao Paolo, Brazil, Niemeier explained that by the late 1990s, audits were perceived to be "compliance obligations as opposed to the linchpin of reliable financial reporting." He explained that weaknesses in controls over corporate accounting and financial reporting allowed managers "free reign [sic] to manipulate results as reported to investors." Niemeier explained that Sarbanes-Oxley was designed to restore the transparency and reliability of financial statements and disclosures as a basis on which investors could make informed decisions, thereby restoring investor confidence in the integrity of financial and accounting information available in the capital markets.

Commenting on the contention that Sarbanes-Oxley has discouraged companies from tapping U.S. capital markets, Niemeier pointed out that the "greatest costs companies listing in the U.S. face are not compliance costs but rather are underwriting fees. ... The facts appear to confirm the continued attraction of U.S. markets to companies, because of the

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significant valuation premium for companies that can meet the requirements of U.S. listings."

Niemeier says that New York Stock Exchange estimates peg the valuation premium at 30 percent. Similarly, a December 2005 Wharton study found that companies from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms, have a significantly lower cost of capital.

Christianna Wood, senior investment officer at the California Public Employees' Retirement System, told Reuters that the cost of capital for companies listing in the U.S. is 7 percent less than abroad, and valuations are at a 13 percent premium. As a result, "the U.S. share of worldwide IPOs actually has increased since 2001," SEC Commissioner Annette L. Nazareth told *Newsweek*, adding, "SarbOx has not harmed our ability to compete but rather is viewed by other countries as providing valuable investor protections."

While the short-term view may seem like a swinging pendulum of public policy, investor confidence and corporate initiative, the transparency and reliability of U.S. corporate governance systems, accounting and financial reporting standards, and related requirements for internal control structures, over time, lead to the kind of growth in value that is desired by long-term investors, who depend on clear and reliable financial reporting. That transparency and reliability is precisely what has enabled the United States to enjoy its long term economic leadership in the global markets. A philosophy of transparency through reasonably accurate disclosure — which is embedded in the federal securities laws and in Sarbanes-Oxley — is the key driver towards ensuring that U.S. capital markets continue that leadership for years to come. •

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