

## Sarbanes-Oxley in Retrospect

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Sarbanes-Oxley was based on a dubious analysis of the nature of the problem to be solved, and of the goals to be achieved. The problem was thought to be merely a matter of accounting, as though better bookkeeping could have somehow kept Enron and WorldCom solvent. And the stated objective was “to restore investor confidence” in the short term rather than preventing future Enron-like crises by making lasting improvements in institutional constraints and incentives.

The key congressional assumption appeared to be that any problems in business or accounting must be the fault of businessmen and accountants, not the fault of any governmental institutions (such as the IRS, SEC or FASB), or any laws (such as the 1968 Williams Act to protect spendthrift managers against hostile takeovers). So the solution, as usual, was more rules and regulations piled on top of other rules and regulations that had clearly failed.

I believe Sarbanes Oxley was unnecessary, harmful and inadequate.

It was *unnecessary* because the SEC had ample authority to oversee, investigate and enforce honest accounting and auditing. It is already proving to be *harmful* in ways I'll explain later, mainly because it greatly increases the costs and risks of doing business as a publicly traded U.S. corporation and increases the risks of serving as a director or officer. Finally, it is *inadequate* because it failed to encourage the development of institutions and incentives (including an excessive incentive to retain earnings before the individual tax on dividends was reduced) to improve corporate governance over the long haul.

I am first going to highlight a few prominent showpieces of the law, and then cite a few studies and news reports suggesting things are not working out as expected – that the law is already creating many “unintended consequences” but no apparent benefits (except to a growing industry of corporate governance consultants).

Perhaps the most visible symbolic change is that Sarbanes-Oxley required the CEO and CFO to certify that their financial statements “fairly” represent “financial conditions and results,” and face prison sentences if they are wrong. The SEC always had the power to require such a certification ceremony, and in fact did so before Sarbanes-Oxley was enacted. But Section 302(a) is more extreme. It threatens prison sentences of up to 20 years for executives who “*willfully*” certify incorrectly that reports have “*fairly*” presented “financial conditions and results,” or 10 years for doing so “*knowingly*.” Executives can be banned from serving as an officer or director because of undefined “*misconduct*.” They can be required to forfeit one year of back pay if earnings have to be restated due

to “material noncompliance.” Nobody can know in advance what “willfully” or “fairly” or “misconduct” or “material noncompliance” means, so all these potentially capricious punitive measures fail to live up to the rule of law. Certification puts the CEO in the position of a nervous auditor – a job few CEOs are qualified to do -- rather than a general manager who properly delegates such specialized chores to experts.

Another significant changes it that Sarbanes-Oxley required that each Board’s audit committee be comprised entirely of independent directors with no company experience, plus one financial expert who claims to understand all 4500 pages of generally accepted accounting principles. The pretentious effort to redesign corporate boards in Washington D.C. certainly did not follow from any analysis of what went wrong at Enron. The Enron board was 86 percent independent, with a dozen non-employee outsiders including five CEOs and four academics. It was chaired by an accounting professor from the Stanford business school.

In 2000, *Chief Executive* magazine rated Enron’s board among the five best. By contrast, the check-the-box formulas being peddled by corporate governance consultants invariably give Berkshire Hathaway a terrible rating because Warren Buffet has too many people on the Board who know him and his business very well. Yet Berkshire Hathaway’s stock beat the S&P 500 for all but four years since 1965. Stockholders know more than legislators about who should be directors and officers of the companies they invest in.

A particularly grandiose gesture in Sarbanes-Oxley was the creation

of a new Public Company Accounting Oversight Board, financed by what is essentially a tax on stockholders. That taxing authority – as well as the power to put some accounting firms out of business and favor others -- raises serious questions about the Constitutionality of the new Board. The Board evades the rules governing federal agencies, such as the rules for appointments and salaries (\$452,000), by pretending to be a private nonprofit – a dot-org, not a dot-gov. But no genuinely private organization can force us to both pay and obey.

Sarbanes-Oxley requires that non-accountants be a majority of the Board overseeing accounting, which is like having non-physicians oversee the practice of medicine. They will obviously need to rely on accountants, and Board is expected to hire about a hundred of them to do what the SEC and FASB were supposed to do. Having held a job with the Board will look terrific on any accountant's resume, of course, so the Board came up with a code of ethics in the hope of throwing a little sand in the revolving door. That is it's only accomplishment to date.

Let's outline a few of Sarbanes-Oxley's most obvious problems – those that even been noticed by the press:

First, Sarbanes-Oxley makes it harder to attract and retain qualified directors, particularly the required financial expert. “Many companies are having trouble filling this slot,” reports *The Wall Street Journal* (July 29, 2002), “because candidates fear they will be held responsible for auditing problems.” Compensation of outside directors has increased to compensate for increased responsibilities and risks. A study of the Fortune 1000 firms,

by Axentis LLC found that compensation of outside directors rose from \$40,000 to \$100,000.

Second, Sarbanes-Oxley reduces the availability of liability insurance for directors and officers, and greatly increases the cost of such insurance for those who can get it. The Axentis study found the premiums for D&O insurance quadrupled. “Directors' Insurance Fees Get Fatter” was the headline of a *Wall Street Journal* report (July 12, 2002) that found premiums up by as much as 100-300 percent despite reductions in coverage. This is partly due to Sarbanes-Oxley mandates, such as extending the statute of limitations for securities litigation to five years, and to the risk that the law will dramatically expand the potential liability of directors and officers.

A survey of 32 mid-sized companies by the law firm Foley & Lardner found the average price of being a public firm nearly doubled after Sarbanes-Oxley, from \$1.3 million to almost \$2.5 million. The cost of D&O insurance rose from \$329,000 to \$639,000. Directors’ fees doubled, as did accounting, audit and legal fees.

Third, Sarbanes-Oxley makes it harder (particularly for smaller firms) to attract and retain qualified CEOs and CFOs. A new survey by Burson-Marsteller found that 73 percent of chief executive officers said they have thought about quitting, a record high. And 35 percent of other senior executives said they’d turn down the job of CEO if it were offered, up from 27 percent in 2001. When the talent pool shrinks, either the pay of American CEO’s will rise (which was certainly an unintended consequence)

or the quality of American CEOs will fall. The best executive talent may be lured to private or foreign firms.

Fourth, the punitive approach of Sarbanes-Oxley appears likely to make executives overly timid, afraid to take make bold investments in risky new technologies or products. Jeffrey Garten, Dean of Yale's School of Management, predicts, "CEOs are going to become more risk-averse and big investments on risky projects are going to be held back." This makes sense, and it is consistent with the unusually slow recovery of business investment since the 2001 recession. *Washington Post* columnist David Ignatius, in his column "Risk-Takers, Look Out" (June 26, 2002), also worried that, "The new rules and regulations will apply Washington's 'zero-defect culture' – its tendency to criminalize failure – to corporate America. . . . In a zero defect culture, the engine of economic growth begins to freeze up. For this is a barren landscape where only lawyers can survive for long."

Fifth, Sarbanes-Oxley is a "Boon for Slew of Consultants," to quote a recent headline from *The Wall Street Journal* story (August 19, 2003). The article went on to describe "a corporate governance gold rush." The reason is the Sarbanes-Oxley contains so many ambiguities and contradictions that companies faced with draconian punishments for vaguely defined offenses have no choice but to hire expensive consulting services. What is income to the consultants, however, is just like another tax on corporate stockholders -- like the fees used to finance the well-paid Accounting Oversight Board.

Sixth, Sarbanes-Oxley makes it much less attractive to be a publicly traded U.S. firm. An article on "Why Companies Harbor Doubts on Doing

IPOs” in *The Wall Street Journal* (March 24, 2003) noted that “it costs 60% to 100% more for an audit” because of the increased risk to auditing firms, and “insurance coverage for directors and officers’ liability has risen drastically as well.” The number of companies going public, though initial public offerings, dropped from 352 in 2000 to 27 in the first nine months of 2003. Fewer public companies means fewer investment opportunities for smaller investors and less public information about U.S. business (because private firms can keep their information private).

In “The Case for going private” (January 25, 2003) *The Economist* notes that an unusually large number of publicly traded U.S. firms have been taken private since Sarbanes-Oxley became law (26 percent more by one calculation). *The Economist* adds that taking public firms private “will seem even more tempting as the latest round of corporate governance reforms take effect in public firms.” Foreign companies such as Porsche have also said they will not list on the New York stock exchange because doing so would subject them to Sarbanes-Oxley rules, some of which are offensive or illegal in their home countries. The EU complains of this effort to impose U.S. regulations beyond our borders. Concessions to foreign firms are inevitable, but such concessions will then leave foreign firms with the advantage of lower regulatory costs and litigation risks.

Seventh, Sarbanes-Oxley is drastically shrinking the number of accounting firms willing and able to do audits. A *Washington Post* report, “Small Accounting Firms Exit Auditing” (August 27, 2003) noted that many small accounting firms are planning to abandoning auditing of public companies, partly because of difficulty and expense of insuring themselves

if something goes wrong. The GAO recently noted with some alarm that the Big Four accounting firms, down from the Big Eight in 1980, now audit 78 percent of the publicly traded companies in the U.S. Small companies report difficulty finding anyone willing to do their auditing, even at the inflated fees prevalent since this law was passed.

In short, the most concrete consequences of Sarbanes-Oxley are reduced profitability and competitiveness of U.S. public corporations due to higher costs of regulatory compliance, greater exposure to the legal expenses of class action suits, and greater expenses for insurance and directors' compensation to compensate for added personal risks of civil and criminal penalties.

What was *done* in Sarbanes-Oxley clearly created many more costs than benefits (if there are any benefits). Yet what was left *undone* may well be more important. Sarbanes-Oxley suffers from delusions of adequacy.