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15 Years Of SOX: It Is Time To Revisit The Burdens

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Sunday marked 15 years since the Sarbanes-Oxley Act of 2002 was enacted in response to scandals at Enron, WorldCom and elsewhere, introducing strict reforms to improve corporate financial disclosures and prevent accounting fraud. Has the law been effective or too burdensome? This Expert Analysis special series examines the impact of various aspects of SOX.

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During the first six months of President Donald Trump's administration, the focus on deregulation has been centered on repealing or revamping Dodd-Frank. The rhetoric driving the deregulation push is job creation and economic growth; however, Dodd-Frank is centered more on consumer protection and repealing it would likely have a minimal impact on job creation and economic growth.

If the true goal of deregulation is to spur economic activity and create jobs, then President Trump and his administration may want to peer further into history to a time of regulatory "overcorrection" that many believe has stifled access to public capital markets, as well as increased regulatory costs in the form of higher audit expenses, far more than any recent financial regulations ever will. Looking back during the 15-year anniversary of the passage of the Sarbanes-Oxley Act provides an opportunity to consider deregulation that should more positively impact economic growth and job creation.

Similar to the financial crisis that began in 2008, Congress was faced with a different kind of crisis in 2002. High-profile accounting scandals at Fortune 500 companies such as Enron and WorldCom ultimately caused the collapse of the world's largest public accounting firm. Faced with media coverage of thousands of employees — and to a lesser extent, the broader investor community — whose retirement funds were eviscerated overnight by the collapse of some of these companies, the U.S. Congress began a classic case of overcorrection. The Sarbanes-Oxley Act was passed and, with its most burdensome mandate — Section 404 — being the least defined, the term "SOX 404" entered into our lexicon and into chief financial officers' nightmares for the next 15 years. Section 404 requires that public firms have effective systems of internal controls and simply mandates that an outside accounting firm provide an attestation that these controls are effective in preventing fraud.

SOX created the Public Company Accounting Oversight Board as a rule-making and oversight agency for the public accounting industry. The subsequent interpretation and enforcement of Section 404 by the PCAOB has resulted in Audit Standard No. 5 ("AS No. 5"), which requires an audit of the internal controls over financial reporting, which is integrated with the audit of the financial statements. Many believe that the jump from SOX

Section 404 to AS No. 5 is larger than the original intent, particularly when examining the definitions of AS No. 5. The manner in which AS No. 5 defines “material weakness” to include “... a combination of deficiencies …” that could result in a “… reasonable possibility that a material misstatement of the company’s annual or interim financial statements would not be prevented or detected in a timely basis” has resulted in audits of internal controls over financial reporting that go well beyond detecting the types of large-scale corporate fraud and maleficence carried out by members of senior management that gave birth to SOX in the first place.

SOX is often framed as regulation designed so that “Wall Street” doesn’t mislead “Main Street” by ensuring accurate financial statements that are free of the kind of accounting frauds that were front and center of the collapse of Enron and WorldCom. In viewing SOX through that frame, it’s reasonable to assume that any efforts by the Trump administration and the Republican-controlled Congress to significantly amend or repeal SOX would be met with the same uproar that best describes the discussion around Dodd-Frank. However, a more careful consideration of the issue reveals otherwise and gives hope that this could be a bipartisan issue that could be supported by both sides of the aisle. Conveniently, careful consideration of the burdens of SOX versus the risks it solves is available to the current administration and Congress. The fact that the careful analysis in question was prepared by the prior administration further fuels hope that a bipartisan effort could result in meaningful reform 15 years after the original passage of SOX. The concept of reducing regulatory barriers created by SOX is buried in President Barack Obama’s Council on Jobs and Competitiveness 2011 Interim Report:

Regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies.[1]

According to a series of reports and studies on recent U.S. labor data,[2] job growth over the last three decades has been primarily driven by new firms in their first five years of existence. To drive home that point, consider that the 40 million jobs created by those firms over the last three decades have accounted for the same number of total net new jobs[3] in that same period. New, entrepreneurial businesses are clearly the driver of job growth over the long haul. Within the data, it is noted that high-growth businesses that double their revenues and consequently double their employment every few years are the primary drivers of this entrepreneurial job growth.

The 15 years of the post-SOX regulatory environment has been anything but favorable for these types of businesses. The inevitable need for access to public capital markets is key for these high-growth businesses to continue on their trajectory of revenue and employment increases. Why is access to public capital markets critical compared to other sources of private funding? Research indicates that once funding is secured, 90 percent of job creation for public firms occurs after they access the public capital markets.[4] So how has the post-SOX environment impacted access to public capital markets? An examination of the nature of initial public offerings post-SOX tells an interesting story.

The total number of public companies peaked in 1996 at 7,322. The post dot-com bubble era that saw a flurry of mergers of public companies still saw the total at 5,550 in 2001, prior to SOX being passed by Congress. But today, the total number of public companies stands at 3,700 — more than 1,000 less than even 1975

numbers.[5] And while headlines of large-dollar IPOs for companies like Facebook dominated headlines in the first half of this decade, they can distract from the real story. The number of IPOs smaller than $50 million that are typical of young high-growth companies accounted for roughly 80 percent in the 1990s — it has fallen to less than 20 percent in the 2000s.

So, what's the result of SOX's impact on access to public capital markets? Instead of continuing their high-revenue/employment growth rates by accessing public capital markets, early private investors in these businesses seek the easier exit — selling to larger companies. And most American workers are painfully familiar with the fact that a merger and acquisition rarely brings with it talk of rapid job growth — more often the "synergies" of the combined companies spur "role clarity" exercises that generate pink slips. Skeptics may cast doubt on whether compliance with SOX Section 404 is truly a deterrent to accessing public capital markets, but consider this: According to a 2009 study by the U.S. Securities and Exchange Commission, audit fees associated with SOX Section 404 in the first year of being a public company are nearly six times greater as a percentage of assets for smaller companies versus larger companies.[6] These costs simply aren't scalable for smaller companies. The costs — including opportunity costs — are very much a driver of companies seeking alternatives to the public capital markets.

So what's the solution? Repeal SOX or significantly amend it? President Obama's Council on Jobs and Competitiveness 2011 Interim Report makes a number of sound proposals to help address this issue, with one proposal[7] aimed directly at SOX:

Amend Sarbanes-Oxley (SOX) to allow shareholders of public companies with market valuations below $1 billion to opt out of at least Section 404 compliance, if not to all of the requirements, of Sarbanes-Oxley; or, alternatively, exempt new companies from SOX compliance for five years after they go public.

U.S. Congress has begun efforts to revisit provisions of SOX as part of their deregulation agenda. With significant regulatory reform facing an uphill battle, many are hopeful that smaller, more focused reforms could see the light of day. The Financial Choice Act is one such reform that may contain proposed revisions to SOX 404.

The original version of the Choice Act passed the House Financial Services Committee as a priority of committee Chairman Jeb Hensarling, R-Texas. Iterations of the Choice Act have contained provisions that would relax SOX 404 requirements and industry experts are hopeful the provisions will survive in the final version. The current SOX regulations exempt public companies with a market capitalization of less than $75 million from SOX 404. The current version of the Choice Act has raised that threshold anywhere from $250 million to $500 million. There remains hope for an extension of the time frame before such companies need to comply with SOX 404 as well.

In the event that legislation amending SOX doesn't make it out of the U.S. Congress, those hopeful for relief are keeping a close eye on the enforcement side of the SEC. The changing of the guard at the SEC during the early days of the new administration could ease the regulatory burden without any legislative action. By a majority vote of the commission, updates can be made to rule-making requirements or modernization of rules

can be carried out — they simply have to maintain the integrity of the original intent of the law. As discussed above, many believe that SOX 404 enforcement has overreached the original intent of the legislation, including the added dimension of how the Public Company Accounting Oversight Board has executed their oversight over public accounting firms during inspections. Many believe the PCAOB pressure has driven audit firms to scrutinize corporate attestations of internal controls more than originally intended. The trickle-down effect can be pressure from external audit firms — on top of regulatory scrutiny — on companies to conduct more SOX work, and higher audit fees.

The Council on Jobs and Competitiveness 2011 Interim Report said it best and it bears repeating:

Regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies.

Fifteen years of practical supervision and enforcement experience provides enough lessons learned for careful reconsideration of SOX and how it is enforced. Whether it be through legislation or an ease in enforcement by both the SEC and PCAOB, a change to the regulatory environment surrounding SOX should provide more meaningful impact to the growth of the economy and jobs than any other item on the deregulation agenda.

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[1] See page 19 of the Jobs Council Interim Report, available here.

[2] John Haltiwanger et al. Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States (available here); Bureau of Labor Statistics data suggested 44 million net jobs total created in the relevant time period.

[3] Tim Kane, The Kauffman Foundation. The Importance of Startups in Job Creation and Job Destruction (available here).

[4] The Economist, A Helping Hand For Startups (http://www.economist.com/node/21531482); David Weild and Edward Kim, Grant Thornton. Capital Markets Series: Market Structure is Causing the IPO Crisis — and More.

[5] http://politicalcalculations.blogspot.com.co/2015/05/tracking-number-of-publicly-

traded.html#.WIspGVUrLIV

[6] See page 53 of https://www.sec.gov/news/studies/2009/sox-404_study.pdf

[7] See page 19 of the Jobs Council Interim Report, available here.