Articles

The Role of Empirical Evidence in Evaluating the Wisdom of the Sarbanes-Oxley Act

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DEATH, TAXES, and financial scandals—these are the certainties of life. From the latter flows the many amendments Congress has made to the federal securities laws that are now in the eighth decade of their existence. Financial scandals appear necessary to move Congress to address securities regulatory issues. Indeed, much of the Securities Exchange Act of 1934[1] itself can be traced to the highly publicized Pecora Hearings[2] that revealed a wide range of market abuses (many of which are listed in the Act's preamble).[3] The insider trading scandals during the break-and-take days of the early 1980s incensed the public and caused Congress to enact the Insider Trading Sanctions Act of 1984.[4] Further revelations of insider trading abuse, particularly among investment bankers, prompted enactment of the Insider Trading and Securities Fraud Enforcement Act of 1988.[5] A series of market abuses in the late 1980s caused Congress to substantially augment the Securities and Exchange Commission's enforcement powers through the Securities Enforcement Remedies and Penny Stock Reform Act of

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1. Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. § 78 (2000)).

2. *See, e.g.*, *Stock Exchange Practices: Hearings Before the Senate Banking Committee*, 72nd and 73rd Cong. (1932–1934); S. Rep. No. 73-1455 (1934).

3. *See* Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78(b) (2000).

4. Pub. L. No. 98-376, 98 Stat. 1264 (1984).

5. Pub. L. No. 100-704, 102 Stat. 4677 (1988).

1990.[6] And, more recently, the numerous financial frauds revealed in 2001 and 2002 propelled the Sarbanes-Oxley Act of 2002 ("SOX" or "the Act") onto the statute books.[7]

Although one might conclude that SOX is significant because of the wide range of regulatory issues it encompasses, this would be incorrect. SOX's profound contribution lies in the tectonic regulatory shifts it introduces to a handful of issues: creating an independent standard setter for accounting principles[8] and auditing standards,[9] strengthening the internal and external financial reporting procedures,[10] and accelerating disclosure requirements to include more "real time" revelations of financially significant events.[11] Those who have a vested interest in the status quo see the changes as ominous and ill-conceived. These critics are joined by others who prefer the freedom of the marketplace over regulatory intrusions as a means to correct operational failures. Each group of critics points to the untoward entry of federal law into a realm long ceded to the states: corporate governance and the regulation of the internal affairs of corporations. A unifying theme among SOX critics is that the Act's provisions lack solid empirical support.

I. Rehabilitating Accounting Standards and the Auditor

Roscoe Pound reminds us that being a member of a profession is not the same as belonging to an association of grocery stores.[12] A pro-

6. Pub. L. No. 101-429, 104 Stat. 931 (1990).

7. Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108, 116 Stat. 745, 768 (codified at 15 U.S.C.A. § 77s(b) (West Supp. 2006)) (amending 15 U.S.C. § 77s (2000)).

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101–107, 116 Stat. 745, 750–69 (to be codified in scattered sections of 15 U.S.C.).

10. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 401, 116 Stat. 745, 785 (codified at 15 U.S.C.A. § 78m(i)–(j) (West Supp. 2006)) (amending 15 U.S.C. § 78m (2000)) (calling for the SEC to adopt disclosure requirements respecting off-balance sheet financing and other arrangements, as well as the treatment of pro-forma financial statements); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 788 (codified at 15 U.S.C.A. § 7262 (West Supp. 2006)) (calling for management to annually assess the company's internal controls and the firm's auditor to render a report of management assessment); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 408, 116 Stat. 745, 790 (codified at 15 U.S.C.A. § 7266(c) (West Supp. 2006)) (mandating that the SEC review not less than every three years each reporting company's filings with the SEC).

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 409, 116 Stat. 745, 791 (codified at 15 U.S.C.A. § 78m(l) (West Supp. 2006)) (amending 15 U.S.C. § 78m (2000)) (requiring more rapid and current disclosures among reporting companies).

12. ROSCOE POUND, THE LAWYER FROM ANTIQUITY TO MODERN TIMES 7 (1953) (an organized profession is not "the same sort of thing as a retail grocers' association.").

fession, such as the accounting profession, has obligations beyond those to its clients. Many people, however, have good cause to ponder whether some quarters of the accounting profession took their eyes off lofty aspirations of professionalism over the course of the 1980s and 1990s. Simply put, accountants too frequently saw their obligations being to the firm's management and not to the firm's stockholders or others who depended upon the integrity of the financial reporting system to guide their actions. Indeed, the accounting profession is the lynchpin of any market economy.

With the relaxation of professional restrictions during the 1970s,[13] the accounting profession became increasingly competitive. This rise in competition manifested itself in accountants attempting to steal each other's clients, which then placed downward pressure on audit fees. The major accounting firms discovered that by providing non-audit services, they could sample the good life enjoyed by lawyers, investment bankers, and consultants. Their non-audit revenues grew much more rapidly than did their audit revenues.[14] As audit firms became more and more dependent on their non-audit revenues, the historical independence of audit firms from their clients suffered.[15]

SOX rescued the accounting profession from the death spiral in which it entered. As a result of SOX, the Financial Accounting Standards Board ("FASB") enjoyed autonomy from accounting firms for the first time since it was created in 1974. Before SOX, the FASB's primary funding came from financial contributions made by major accounting firms to the Financial Accounting Foundation. The accounting firms' financial support was voluntary, and the individual firms' eagerness to write checks often reflected how much their audit clients appreciated the flexibility they enjoyed under accounting standards and interpretations approved by the FASB. Since SOX, the FASB's financial lifeline is no longer derived from voluntary support from private accounting firms; instead, it is now derived from fees imposed on public companies.[16]

13. *See* Stephen A. Zeff, *How the U.S. Accounting Profession Got Where It Is Today: Part I*, 17 ACCOUNTING HORIZONS 189 (2003) (identifying that competition among accounting firms for audit clients began in 1972 under pressure from federal antitrust regulators).

14. *See* ARTHUR LEVITT, TAKE ON THE STREET 156 (2002) (non-audit fees growing three times faster than audit revenues).

15. For a detailed review of several studies on whether consulting comprised the auditors' independence, see PUBLIC OVERSIGHT BOARD, THE PANEL ON AUDIT EFFECTIVENESS REPORT AND RECOMMENDATIONS (2000), http://www.pobauditpanel.org/download.html.

16. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 108, 116 Stat. 745, 768 (amending 15 U.S.C. § 77s (2000)) (codified at 15 U.S.C.A. § 77s(b) (West Supp. 2006)

Similar financial independence now exists with respect to the development of auditing standards and disciplining auditors. SOX relocates standard setting for auditing procedures and disciplining members in the newly created Public Company Accounting Oversight Board ("PCAOB").[17] Prior to SOX, auditing standards had been under the control of the American Institute of Certified Public Accountants ("AICPA"), whose pronouncements too frequently reflected the wishes of its members. Thus, an indelible contribution of SOX is the severance of the financial purse strings long held by the auditors and their clients over those whose responsibility it was to establish the metrics for financial reporting and procedures for audits.

The course taken in Chapter One of SOX appears to be working. For example, after SOX, the FASB manifested its independence by approving the expensing of stock options,[18] a long-simmering issue. Equally noticeable is the forward movement on the FASB's agenda of the reporting for entity consolidation accounting,[19] which addresses, among other areas, the abuses that won Enron its place in history. The consolidation accounting topic has been on the FASB's agenda for over twenty years. Although the PCAOB is in its infancy, there is evidence of its energy with respect to poor auditing practices that was not investigated under the AICPA. For example, it has now completed, and reported on, two successive reviews of audit samples by each of the Big Four accounting firms. Each round of PCAOB reviews has leveled sharp criticism of practices occurring in the Big Four accounting firms;[20] such criticism did not occur in the love-fest peer reviews overseen earlier by the AICPA's Public Oversight Board. Nevertheless, the PCAOB remains in its formative years, and it is premature to forecast much about whether it will be an effective regulatory body that can rid the profession of poor auditors and poor auditing practices.

(conditioning the SEC's acceptance of accounting standards from a private entity on that entity receiving funding as set forth in Section 109 of SOX).

17. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 103, 116 Stat. 745, 755 (codified at 15 U.S.C.A. § 7213(a)(1) (West Supp. 2006) (conferring broad authority on the PCAOB to adopt auditing standards, subject to oversight and approval per Section 107 of SOX)).

18. *See* FASB Statement 123R (2005).

19. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 94, CONSOLIDATION OF ALL MAJORITY-OWNED SUBSIDIARIES (2005), http://www.fasb.org/pdf/fas94.pdf .

20. *See, e.g.*, Statement Concerning the Issuance of Inspection Reports, PCAOB Release No. 104-2004-001 (Aug. 26, 2004).

A. From Technical Requirements to a Principles-Based System

Chapter Two of SOX has a host of provisions designed to strengthen the auditor's independence. To assure that the auditor's client is not the reporting company's management, but rather stockholders and other financial statement users, SOX anchors the auditor's relationship to the firm's audit committee, which has the exclusive power to retain and discharge the auditor.[21] Moreover, the audit committee is charged with engaging, at least annually, the auditor in a dialogue in which the critical accounting choices, estimates, and judgments are reviewed. This is to assure that the audit committee understands that the firm's financial position and performance are fairly presented—as contrasted with the artful selection of accounting choices and estimates that bear no purpose other than to reach a desirable reporting objective.

It is important to identify the various linkages that have strengthened financial reporting and are provided throughout Chapter Two of SOX. One concern when Congress enacted SOX was that the accounting metrics were too rule-oriented and not based on broader principles. The concern was that the FASB standards were so full of technical requirements that the manner of reporting for a transaction remained in the hands of management who could structure the transaction to technically fall outside the scope of a FASB statement even though the transaction was substantively the very type of transaction the FASB intended its statement to reach. Finding a way to articulate this concern in a statute proved immensely complex, so instead SOX directed the Securities and Exchange Commission ("SEC") to study the desirability and means for achieving a more principles-based accounting metrics.[22] Another approach is to require the reporting entity to include in periodic filing with the SEC the certifications by the chief executive officer and chief financial officer that the financial

21. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (codified at 15 U.S.C.A. § 78j-1(m)(2) (West Supp. 2006)) (amending 15 U.S.C. § 78f (2000)) (audit committee directly responsible for appointment, compensation, and oversight of the firm's auditor).

22. Sarbanes-Oxley Act 108(d) calls for a study of moving to a principles-based accounting. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §108, 116 Stat. 745, 769 (codified at 15 U.S.C.A §77s(b) (West Supp. 2006)). The resulting study of what such a system would entail reflects the obvious challenges of such a system. *See* SEC Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003) http://www.sec.gov/news/Studies/principlesbasedstand.htm. *See generally* James D. Cox, *Reforming The Culture Of Financial Reporting: The PCAOB & The Metrics For Accounting Measurements*, 81 WASH. U. L.Q. 301 (2003).

statements "fairly present . . . the financial condition and results of operations" of the company.[23] The obvious objective of this part of the officers' certification is to assure that the financial reports do more than comply with technical requirements of Generally Accepted Accounting Principles ("GAAP").[24]

Any principles-based system necessarily calls for more judgment than the heretofore dominant rules-based system. Whether this system will prove more successful in communicating the true economic significance of business transactions depends on who exercises the judgment pursuant to a guiding principle. The firm's managers are responsible for accounting decisions and financial reporting. The auditor's role is to assure that the choices, estimates, and judgments exercised comply with generally accepted accounting principles. To use an analogy to sports, management calls and runs the plays, but the auditors act as referees whose role is to assure that management stays within the governing reporting rules. Under a principles-based system, a wider range of choices may exist, with permissible choices being elucidated by a relatively broad objective. If the relationship of the auditor to the audit client had remained as it was prior to SOX, the benefits of a principle-based reporting system—or for that matter, improved financial reporting—would have had less of a chance of being achieved.

B. Keeping the Auditor Independent

Despite enhancing requirements to provide financial certifications and enhancing sanctions for reporting violations, SOX has done little to change the operating environment of managers. The executive's incentives have not changed much compared to pre-SOX. Man-

23. Sarbanes-Oxley Act Section 302 gave rise to SEC Exchange Act Rules 13a-14 and 15d-14, requiring the chief executive officer and the chief financial officer to certify in each submitted quarterly and annual report to the SEC that, among other matters, "the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer of, and for, the periods presented in the report."

24. Among the requirements for executive certifications is that the financial statements "fairly present" the firm's financial position. The full meaning of this requirement is illustrated in *United States v. Simon*, where the Second Circuit upheld an instruction that mere technical compliance with standard accounting and auditing practices did not insulate the auditor from criminal responsibility for false reporting when the auditor knew that the financials statements falsely presented the firm as solvent. 425 F.2d 796, 806 (2d Cir. 1969). Similarly, the officers through their certification must be assured that the firms' financial position and performance are fairly presented, not merely presented according to the technical metrics of generally accepted accounting principles.

agers still want earlier recording of revenues, later recording of expenses, and performance measurements that reward the executives who achieve their numbers. The tension for a principles-based system will therefore be keenest at the intersection of management's reports and their review by the auditor. The independent audit committee is now interjected into this maelstrom by anchoring the relationship of the auditor with the audit committee instead of with the reporting company's managers.

Audit committees have long been a voluntary fixture of American corporate governance. In 1999, audit committees became mandatory for listed companies when the SEC approved improved listing requirements for the New York Stock Exchange ("NYSE"), Americans Stock Exchange ("AMEX"), and NASDAQ.[25] The new listing requirements called upon domestic corporations to have an audit committee composed solely of financially literate independent directors. Each audit committee was called upon to have at least one member with financial sophistication, such as employment experience in finance or accounting, and to have a written charter. The actions by the exchanges were prompted by a Blue Ribbon Committee study,[26] which was prompted by a study of companies charged with fraud between 1987 and 1997. The study found, among other factors, that (1) twenty-five percent of the surveyed companies did not have an audit committee, (2) of those companies that did have audit committees, nearly one-third of the committee members' independence was compromised by close relationships with, or actual participation in, the firm's management, and (3) sixty-five percent of the committee members lacked accounting or financial expertise.[27] Further, the improved listing requirements were not mandatory for foreign issuers, and listed companies had some modest flexibility on whether all members of the audit committee must be independent. SOX changes both of these requirements, mandating that all reporting companies, domestic or foreign, have an audit committee whose members all must be independent.[28] More

25. *See* SEC, Exchange Act Rel. No. 42231 (Dec. 1, 1999) (approving changes in listing requirements of NYSE, AMEX, and NASDAQ).

26. *See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, reprinted in* 54 BUS. LAW. 1067 (1999).

27. *See* Mark S. Beasley et al., Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies, at 5 (monograph published by the Committee of Sponsoring Organizations of the Treadway Commission, 1999).

28. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 202, 117 Stat. 745, 772–73 (codified at 15 U.S.C.A. § 78j-1(West Supp. 2006)) (amending 15 U.S.C. § 78j-1 (2000)); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 117 Stat. 745, 775–77 (codified at 15 U.S.C.A. § 78j-1(West Supp. 2006)) (amending 15 U.S.C. § 78f (2000)).

importantly, SOX anchors the auditor's relationship to the audit committee instead of where it was previously, with management. It does this by empowering the audit committee with exclusive authority to retain and dismiss the auditor.

Furthermore, the likelihood that the auditor will understand its relationship as being larger than the audit client's management is enhanced by how well the audit committee interfaces with the auditor. A strong relationship between the auditor and the audit committee will overcome the natural deference built into auditing standards. That deference arises from the auditor's perspective that the financial statements are the responsibility of the management so that management's choices, estimates, and other accounting decisions are reversed only when outside the applicable principles' based standard. Obviously the auditor's ability to clearly define the parameters of permissible acts depends not only on her own perception of her independence, but also on a healthy understanding of the need to explain her position to an inquiring audit committee. On this point, it is significant that SOX carries forward requirements earlier contained in the NYSE, AMEX, and NASDAQ listing requirements for a dialogue regularly to occur between the auditor and the audit committee. Moreover, now the audit committee must disclose in filed SEC reports whether it has recommended to the board of directors that the audited financial statements should be included in filings with the SEC.[29] The overall impact of this requirement is to draw the audit committee members closer to the publication of the financial statements so that they have a greater sense of responsibility for the reports.[30]

Several points flow from the above. First, the audit committee did not arrive with SOX, and certainly the requirement of an independent audit committee staffed by financially literate members did not emerge explicitly from SOX's mandates. Instead, SOX makes total independence mandatory for all reporting companies and extends the audit committee requirement to regulated foreign issuers. Second, SOX changes the auditor's relationship with the firm from being dependent on management to being dependent on an audit committee. This is truly an important step toward strengthening financial reporting. Third, SOX codifies various requirements previously set forth in

29. Item 304(a)(4) of Regulation S-K, 17 C.F.R. § 228.306(a)(4) (2004).

30. Regarding their legal exposure, consider Howard v. Everex Sys., Inc., 228 F.3d 1057 (9th Cir. 2000) (holding directors who sign Form 10-K as primary participants for misrepresentations made in that document, subject, of course, to the requirement they did so with scienter).

listing standards regarding what the audit committee members and the auditor must regularly discuss and review among themselves.[31] This is significant because it asks the audit committee to view its responsibilities beyond simply hiring the auditor and periodically inquiring into the auditor's performance. The audit committee is now required to review with the auditor the critical accounting judgments, estimates, and choices made by management.

Thus, the steps taken in Chapters One and Two of SOX should be seen as steps calculated to improve financial reporting by public companies. Minimally, the corporate governance environment post-SOX is more hospitable for principles-based accounting metrics to function in the best interests of investors and not be manipulated by managers to serve their interests. More generally, reinvigorating independence for auditors and providing the auditor with a less conflicted "client" than the managers, in combination, redound to the benefit of more reliable financial reporting.

II. It is an Empirical Question

Those who prefer that economic activity be guided solely by the invisible hand of market forces and not by the tightened fist of the government regulator assert, with some predictability, that whether a particular matter should be regulated, as well as the optimal regulatory approach, is an empirical question. This is the thesis taken by Professor Roberta Romano in the most pointed attack on SOX to date.[32] Professor Romano engages in an extensive review of the hearings leading up to the enactment of SOX as well as cataloging the abundant empirical work on such issues as audit committee independence, the impact of non-audit services on financial reporting, and the role of loans to executives. In her review she collects an extensive amount of empirical studies that investigated whether links existed between various financial reporting abuses, audit committee independence, and the relative amount of non-audit fees auditors receive from their audit clients. The various studies she reviews provide a useful backdrop for considering just how we can better employ empiricism in the formulation of regulations.

The issue of the role of empirical support for regulatory initiatives was at the core of *Chamber of Commerce v. Securities and Exchange*

31. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 204, 116 Stat. 745, 773 (codified at 15 U.S.C.A. § 78j-1 (West Supp. 2006)) (amending 15 U.S.C. § 78j-1 (2000)).

32. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1521-29 (2005).

Commission.[33] Following a number of widely-publicized abuses by high ranking employees of mutual funds, the SEC strengthened the governance requirements that a mutual fund must meet if the fund wishes to avail itself of certain safe harbors for transactions between the fund and its advisor or a person affiliated with its advisor.[34] Due to the inherently incestuous nature of mutual funds, invoking the safe harbors is so routine that the heightened governance requirements become the norm for most funds. The cornerstone for the new safe harbors is that seventy-five percent of the fund's directors must be independent, and the chairman of the fund's board of directors must also be independent.[35] Among the Chamber's many complaints is that the SEC, before adopting its new governance rules, should have gathered empirical data bearing upon the effect of an independent chairman on fund performance.[36] The Chamber's argument on this point had support within the rule-making proceeding. A study conducted by Fidelity Management ("Fidelity Study") was submitted to the SEC during the rule-making process. The Fidelity Study showed that funds with independent chairs did not perform better than those whose chairs were linked to the funds' advisors. In adopting the independent chair requirement, the SEC concluded that the Fidelity Study was limited in significance by reasoning that important benefits existed other than fund performance that an independent chair could assist a fund in achieving.[37] Chairman Donaldson was less delicate, observing "there are no empirical studies that are worth much."[38] The Court of Appeals remanded the matter to the SEC to consider the costs mutual funds would incur in order to comply with the two new conditions for the safe harbor, as well as to give adequate consideration to the alternative approach.[39] Under the alternative approach, each mutual fund would be required prominently to disclose whether

33. 412 F.3d 133 (D.C. Cir. 2005). Subsequently, the SEC relied on cost data to support its change in which data was not in the rulemaking record. This action was held improper so that the SEC's adoption of the rule was vacated; however, the court delayed issuing its mandate so as to permit the SEC a chance to reopen the record. *See Chamber of Commerce v. S.E.C.*, 443 F.3d 890 (D.C. Cir. 2006).

34. *Chamber*, 412 F.3d at 133.

35. *See* Final Rule: Investment Company Governance, Inv. Co. Rel. No. 26520 (Sept. 7, 2004) (codified at 17 C.F.R. pt. 270) *available at* http://www.sec.gov/rules/final/ic-26520.htm (last viewed June 10, 2006).

36. *Chamber*, 412 F.3d at 142.

37. *Id.*

38. *Id.*

39. *Id.* at 136.

the fund has an independent or an inside chairman.[40] While not a victory for the SEC, the court was "acutely aware that an agency need not—indeed cannot—base its every action upon empirical data; depending upon the nature of the problem, an agency may be 'entitled to conduct . . . a general analysis based on informed conjecture.'"[41] This does not, however, resolve the question of what the SEC should do when confronted with studies, such as those relied upon by Professor Romano or the Chamber, that conflict with its proposed regulatory initiatives.

At the risk of being placed in a category that includes skinheads who burn books, the author finds the call for empiricism a bit empty. Certainly good empirical studies provide rich insights to both the necessity for regulation as well as the likely impact of a certain regulation. Nevertheless, several reasons come to mind as to why the thoughtful and forceful calls for empirical support for SOX, such as those made by Professor Romano, should only be used to counsel that the empirical tools employed to examine data are peculiarly sensitive to the particular regulatory issue. Moreover, several areas exist where empiricism is not useful in assessing the social welfare associated with a regulatory choice.

A. False Hopes of Event Studies

First is the popular view that the social desirability of a rule can be decided by observed changes in the value (return) of a firm implementing the new rule. On this point, consider earlier studies that conclude derivative suits are not socially worthwhile because their initiative, prosecution, and settlement do not produce a detectable change in the market-price of the corporation on whose behalf the suit is brought.[42] Similarly, some have argued that shareholder rights vis-à-vis the board of directors, or managers on various governance matters, can never get too far out of the optimal range because of the disciplining effects of the market for control on a company whose pro-

40. *Id.* at 144.

41. *Id.* at 142.

42. *See, e.g.*, Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 280 (1986) (finding that successful derivative suits yield no statistically significant abnormal returns in stockholder returns when court denies defendants' pretrial motions); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 61 (1991) ("To the extent that derivative suits consistently return less to shareholders than class actions, there is a greater likelihood that more of these suits are frivolous.").

tection for its owners is too lax.[43] To this end, studies of how stock prices respond positively to announcements of companies reincorporating in Delaware have been invoked as evidence that Delaware's well-recognized management friendly laws are optimal.[44]

In most instances involving public companies, however, the problem with this approach is that the recovery in a derivative suit or the negative value associated with poor governance is neither material vis-à-vis the firm's overall market value nor is it sufficiently material to attract a suitor who would challenge the governance mechanism.[45] In the case of the derivative suit, this is because most derivative suits are not for on-going mismanagement that produces a large loss to the firm. The grist for derivative suits are single-shot transactions, invariably involving a conflict of interest, where the amount is significant to the defendant in the action, and is significant enough to attract an attorney to prosecute the suit on a contingency basis[46] but is not significant to the firm relative to its revenues or market capitalization. These suits are "compensatory" only if compensatory means that the costs of prosecution do not exceed the suits' expected benefits. In sum, the view that the market is the measure of all the benefits and costs of alternative regimes is substantially qualified.

In the governance arena the calculus becomes even more opaque. Good governance, whatever the particular proposal, rarely can be expected to yield quantifiable benefits. Certainly this is the

43. *See* Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

44. A useful review of the studies appears in ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 72–73 (2002). On this point, consider the difficulty of isolating variables that can tilt the studies' findings because of biases within the data set itself. *Compare* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533 (2001) (finding Delaware incorporated firms enjoy a five percent higher value than non-Delaware firms) *with* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 33 (2004) (finding that Daines' study reflects a "small firm effect" and also that the observed greater values disappear in larger firms when examined over time, specifically during 1991–2002).

45. Similar reasoning has been invoked in gauging whether state corporation laws are optimal or suboptimal. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 204–206 (9th ed. Unabr. 2005) (stating cost of suboptimal governance rules are likely to be small and not sufficient to attract a bidder).

46. *See generally* James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984). Because suits are so focused, as a practical matter, their prosecution depends not on the tangible benefits conferred on their plaintiff but also those benefits conferred to the plaintiff's attorney. As a result, such suits are hardly compensatory and, if that is the metric of their social value, they inevitably fail to meet that standard. *See* James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 13–19 (1999).

case in the relatively short term. Corporate governance proposals operate to protect the interest of stockholders and the firm generally as compared with what might happen in their absence. Thus, any expected benefits attributable to corporate governance lay in the uncertain future where there is uncertainty both as to their occurrence and the magnitude of any resulting harm that better governance will avoid. Any quantification of these benefits are not likely to be impounded in the firm's stock price after discounting the uncertainty of their benefit. To be sure, we would expect that internal procedures that make it more difficult for the firm's managers to reward themselves at the company's expense would be taken into consideration by efficient capital markets in pricing the firm's shares. But the weight given to this factor will pale when contrasted with a wider range of factors such as the state of the national and regional economy, the firm's technological edge vis-à-vis competitors, and management's track record for maximizing shareholder value.

This does not mean governance is not relevant; it merely means it will be hard to observe empirical evidence in a security's price variable because it is most likely at the margins of a wide range of inputs in valuing the firm. Conversely, the costs of corporate governance are easily quantified,[47] so that critics of regulation in this area focus their attention on that which is most easily quantified: the cost of regulation.[48]

47. *See* James S. Linck, Jeffry M. Netter & Tina Yang, *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards* (CAFA 2006 Boston Meetings Paper, Working Paper, August 31, 2005), *available at* http://papers.ssrn.com/abstract=687496 (study of nearly 7000 public companies finding that post-SOX expenses related to boards rose dramatically and percentage-wise higher for smaller companies whose director fees (as a relation to $1000 of net sales) rose $0.84 from 2001 to 2004, whereas larger firms fees rose $0.32 during this same time period).

48. An even more fundamental question is the appropriateness of the assumption implicit in event studies that the market measures, fairly accurately and rapidly, all variables that affect shareholder wealth. This, of course, implicates the hypothesis that securities markets are efficient, at least for the universe of companies within the investigators' samples. Quite separate from doubts regarding the efficiency of capital markets in pricing corporate norms is the issue of whether such a focus is too narrow. For the view that empiricists should, at least, explain why their preoccupation with shareholder wealth effects should dominate corporate policymaking in light that many constituencies other than shareholders are affected by the results of such policymaking. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy,* (Fordham Law Legal Studies Research Paper No. 105, Dec., 2005) *available at* http://ssrn.com/abstract=878391.

B. The Lack of Definitive Inputs Frustrates the Realization of Empirical Evidence

A second concern is the indefiniteness of the inputs that are inherent in an empirical evaluation of the benefits of governance. On this point, consider the contrasting results of studies that have examined whether independent directors increase the returns of the companies on which they serve. In a much celebrated study of board size and board composition with firm performance, Professors Sanjai Bhagat and Bernard Black classified the directors serving on the boards of 957 corporations as

> inside directors (persons who are currently officers of the company), affiliated directors (relatives of officers; persons who are likely to have business relationships with the company, such as investment bankers and lawyers; and persons who were officers in the recent past) . . . and independent directors (outside directors without such affiliations).[49]

A particular board's relative independence is then determined by subtracting the proportion of inside directors from the proportion of independent directors.[50] They then measured corporate performance by four metrics: Tobin's q,[51] return on assets (ratio of operating income to assets), ratio of sales to assets, and market-adjusted stock price returns.[52] Further, Bhagat and Black used control variables such as: board size, percent of stock owned by CEOs or outside directors, firm size (proxied by sales), number of outside five percent blockholders, and industry control through classification into industry groups.[53]

They found an inverse correlation between firm performance and board independence.[54] However, this finding is not evidence that a greater number of non-affiliated and independent directors leads to

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49. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 239 (2002) (footnote omitted).

50. *Id.* at 239–40 ("This effectively treats independent, affiliated, and inside directors as having weights of +1, 0, and −1, respectively.").

51. Tobin's q is the ratio of the market value of a firm's assets to the book value of its assets. It is often approximated by the ratio of the market value of a firm's long-term debt and equity to the book value of its long term debt and equity. Tobin's q is used as a measure of good management because high Tobin's q suggests that a firm's managers have produced greater market value from the same assets.

Id. at 236 n.20.

52. *Id.* at 242.

53. *Id.* at 243.

54. *Id.* at 263.

improved firm performance.[55] To the contrary, Bhagat and Black report that "[i]f anything, there are hints that greater board independence may impair firm performance."[56]

It is important to qualify the study by Bhagat and Black. They did not seek more qualitative inputs to assess the relative independence of their "independent" directors. Had they done this, they would have questioned whether more than merely the absence of financial or familial dependence from the firm or the firms' officers should be required for true "independence." What the firm should seek is true independence, and, more importantly, independence should be equated to a commitment to act independently.

Consider the approach taken by Ira M. Millstein and Paul W. MacAvoy, who, in addition to using the independence "grade" assigned to the board by California Public Employees' Retirement System ("CalPERS"), also determined relative board independence from survey data for the 154 observed companies so that a board was determined to be independent if one of the following was present: (1) it had a non-executive chairman or lead director, (2) outside directors held meetings without management present, or (3) there was substantial adherence to the corporate governance principles established at General Motors.[57] They next measured corporate performance by using an excess return metric while controlling for industry classification and the relative life cycle of the firm.[58] They found that only companies that received the highest grade from CalPERS enjoyed an above average excess return,[59] and that companies who satisfied the second metric for board independence did better during the five-year observation period than boards that did not follow one of the three procedures.[60] In contrast to Bhagat and Black, Millstein and MacAvoy conclude that independent boards have a statistically significant positive impact on corporate performance.[61]

The difference between the findings of Bhagat and Black versus Millstein and MacAvoy is their dissimilar inputs. As Millstein and Mac-

55. *Id.* at 233.

56. *Id.*

57. Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1302 (1998).

58. *Id.* at 1302–03, 1310.

59. *Id.* at 1312.

60. *Id.* at 1313 (noting that on average over the five-year period the companies incorporating these procedures into their operation had an excess percentage annual rate of return that was 4.94% higher than companies that did not).

61. *Id.* at 1318.

Avoy make clear, a threshold consideration of any empirical study of the value of a governance change is whether a change in fact has occurred, i.e., the empiricist captured the impact of a change in composition of the board of directors or a change in the level of engagement by the board due to a true change in the board's independence.[62] This concern is equally true for studies of changes in the role and composition of audit committees of the relative amount of non-audit revenues to the outside auditors on accruals and other management-instigated manipulations of financial reporting. Unless one is assured that the audit committees are truly independent, as established by the standards used by Millstein and MacAvoy in their study, there is no reason to believe it was a meaningful examination of the correlation between reporting abuses and the amount of non-audit revenues received by the accountant. It may well be that more non-audit revenues must be directed to the auditor who operates under the watchful eye of a diligent, independent committee. A less diligent audit committee may encourage equally slumbering behavior on the part of the auditor so that less is needed in the way of non-audit revenues to assure the auditor's complicity. To the extent the studies of earnings manipulations have failed also to investigate whether audit committees provide meaningful oversight of the outside auditor, the findings of studies between non-audit revenues and earnings manipulations are seriously weakened.

C. Correlation Versus Causation

Third, there is always the question of just how to interpret the results of empiricism. More particularly, there is a question of to what degree a causal relation between X and Y, the observed misconduct, is necessary to show that X needs to be regulated to prevent Y. We all know that even though a majority of the nation's hurricane insurance is purchased by Florida residents,[63] and Florida has the highest incidences of hurricanes, it does not mean that hurricane insurance causes hurricanes. Or, as my statistics professor, who obviously came from another era, observed, "burlesque does not cause baldness" (a

62. *Id.* at 1299.

63. While there is no data collected for "hurricane" insurance since such a policy does not exist, there is data on "flood" insurance reflecting that in 2004 Florida households consumed 23.1 percent of the United States Flood coverage. National Flood Insurance Program, Total Number of Policies in Force as of September 30, 2004, *available at* http://www.fema.gov/graphics/nfip/totpif2004.gif.

reference to the prevalence of aged but eager gentlemen populating the first row seats of most burlesque shows).

The problem of correlation and causation is reflected in Professor Romano's review of twenty-four empirical studies inquiring into whether the provision of non-audit services by a firm's auditors made it more likely that the firm would engage in a reporting abuse. A handful of the summarized studies found such a connection.[64] To illustrate the challenges faced by the regulators and Congress when confronted with dissimilar study methodologies and conflicting results, consider the following two published studies that were among the more recent studies considered by Professor Romano. In one study, Professors Frankel, Johnson, and Nelson find that the frequencies of abnormal accruals increases as more non-audit services are provided by a firm's outside auditor.[65] In the second study, Professors Ashbaugh, LaFond, and Mayhew make the same findings as the Frankel study,[66] although this result is not reported by Professor Romano. However, when Ashbaugh et al. separated accruals between those that increased income and those that decreased, they found a connection between non-audit fees only with respect to accruals that decrease income—not for accruals that increase income.[67]

Consider the puzzlement of the regulator or even Congress when faced with such conflicting reports. Each study examined financial reports of over 3000 public companies and regressed a variety of variables, such as the ratio of non-audit services against observed discretionary accruals. From this, the statistical significance of variables on the observed accruals were measured and ultimately reported as findings.

The methods used in each of the studies are known to be reliable and commonly used in such empiricism. However, what is not captured is the percentage of the 3000 observed discretionary accruals accompanied by non-audit services by the auditor. That is, the studies did not reveal whether suspect reporting practices occurred in five, ten, or fifteen percent of the observed firms. Knowing these amounts would thereby frame an important policy-making question: how prevalent suspect reporting practices should be to justify regulatory action.

64. *See* Romano, *supra* note 32, at 1604 n.230.

65. Richard M. Frankel, Marilyn F. Johnson & Karen K. Nelson, *The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management*, 77 THE ACCT. REV. 71, 73 (Supp. 2002).

66. Hollis Asbaugh, Ryan LaFond & Brian W. Mayhew, *Do Nonaudit Services Compromise Auditor Independence? Further Evidence*, 78 THE ACCT. REV. 611, 625 (2003).

67. *Id.* at 625–626.

Certainly, policy making, and more precisely discrete cost-benefit analysis of regulation, is not dependent upon the abuse happening in a majority of the cases or even when the variable is statistically significant in explaining among other observed forces a cause for the abuse.

The above illustrative studies raise several questions. First, why have so many talented researchers examined whether non-audit services impact the auditor's independence? There are multiple answers to this question. In the 1980s, the Big Five accounting firms transformed themselves from audit firms that provided a variety of consulting services, to multi-disciplined business advisement firms that also provided auditing services. To this end, cross selling of non-audit services became an important component in each audit engagement partner's total compensation package. This strategy reflected that non-audit services had the potential for considerably more revenue growth than only audit services. In 1970, income from audits represented seventy percent of the Big Eight accounting firms' total revenues; twenty-eight years later just the opposite was the case. Audit revenues did not keep pace with consulting revenues, and in 1998, audit revenues represented only thirty percent of the Big Five's total revenues.[68] It also is worth considering how the provision of non-audit services places a potential carrot-stick in the hands of managers when dealing with an accountant who questions management's reporting of a transaction. Prior to SOX, absent a non-audit relationship, the management could—when pushed by the inquisitive auditor—fire the auditor. However, auditing rules require that the firing of an auditor must be quickly reported on Form 8-K.[69] This admission would surely pique the interests of the investment community and most likely the SEC.

On the other hand, threatening to shift the auditor's lucrative consulting contract to another vendor is not a required reportable event on Form 8-K. Hence, the provision of significant (to the audit engagement partner) non-audit services provides management with greater leverage over the outside auditor than if the auditor provided only audit services. This reality provides ample reason to skeptically

68. *See* The SEC's Proposed Auditor Independence Rules: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs, 106th Cong. (2000) (statements of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission); M. McNamee et al., *Accounting Wars*, BUS. WK., at 157, Sept. 25, 2000.

69. SEC Form 8-K, Item 4.01, *available at* http://www.sec.gov/about/forms/form8-k.pdf.

view the uncontrolled mix of non-audit and audit services by an outside accountant.

It is notable that most of these studies have not found a statistically significant relationship between the amount of non-audit revenues and questionable reporting practices by the auditor's client. This invites the question of what level of significance in practice justifies regulation of the provision of non-audit services? The regressions of data in the studies reviewed by Professor Romano provide broad insights into variables that are statistically significant and insignificant in examining causes for various forms of reporting abuses. Left unanswered in the portfolio of studied firms in each study is the number of instances in each studied universe where the provision of non-audit services compromised the audit. That is, finding a lack of significance in a regression of a set of variables does not answer the question of whether abuses nonetheless are occurring, albeit below the level of statistical significance or significance as against other variables.

. The intuition that non-audit services compromise the independence of the auditor is not set to rest by saying that this occurs only in a minority, or even a distinct minority, of the observed firms. Similarly, if the studies resoundingly show—what, in fact, they do not show—that the provision of non-audit services are statistically significant variables explaining a host of reporting abuses by public companies, would this justify a blanket prohibition? In the face of such a showing, we would expect regulation to be tighter than it is under the present data set.

What this hypothesis reflects is that the treatment, in terms of frequency and magnitude, of misconduct should guide the regulatory course taken. For example, unless there is demonstrative empirical evidence that non-audit services never compromises auditor independence, the intuition would appear to wisely inform regulation.

SOX takes just such a measured course. It absolutely prohibits seven relatively narrow categories of non-audit services[70] and condi-

70. The excluded areas had largely been deserted when SOX was enacted, as by that time three of the Big Four accounting firms had disposed of consulting operations through which most of the prohibited services occurred. Some of the prohibited items can be seen as necessary to prevent the auditor from necessarily auditing its own work. This would be true for bookkeeping, systems design, appraisals, and actuarial services. Other prohibited services compromise its independence because they are essentially staffing or advisory functions in the client's operations, such as running the human resources department, conducting brokerage services, and engaging in internal auditing. Indeed, the latter service is so far afield of the independence we expect of accountants it is no small wonder that these activities were ever tolerated.

tions the provision of any other type of non-audit services on pre-approval by the board of directors.[71] Contrary to the claims of Professor Romano, this reflects the uncertain nature of the empirical data (all of which is too lumpy to identify just when and what type of service is likely to compromise the auditor's independence). Thus, resorting to the well-received monitoring role of independent directors to regulate the company's auditor's provision of non-audit services is a perfectly sensible solution to an otherwise indeterminant empirical base but a soundly based intuitive fear.

Indeed, we might just reverse the question for Professor Romano: what steps would the empirical data she marshals support? How do we resolve which direction to take? Since eighteen out of twenty-four studies upon which she reports find no relationship between non-audit services and financial reporting abuses, does this mean auditors should have no restraints on providing non-audit services to their audit clients? Further, many of the studies relied upon by Professor Romano dealt with corporations whose audit committees did not reflect the strengthening of audit committees in 1999 through the NYSE, AMEX, and NASDAQ listing requirements. As discussed earlier, the frequency of manipulative accounting accruals and other harmful reporting practices are independently linked to the degree of audit committee oversight. Thus, finding no greater accounting accruals when the auditor engages in significant consulting that when there is no consulting may as easily document that consulting is not necessary to corrupt the auditor when there is a weak audit committee. To be sure, empiricism certainly sharpens the focus. Although the studies relied upon by Professor Romano were not considered by Congress, if these studies had been considered Congress most assuredly would have done what it did with SOX—ban some practices outright and condition others on pre-screening.

D. Database Limitations

A final concern for empiricism is the inherent limit of available databases. As examined earlier, investigators depend on how information is collected. Thus, researchers focus on management's classification of directors as being independent rather than the more meaningful standard of the director's attentiveness and active engagement in monitoring management's stewardship of the firm. Similarly,

71. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 117 Stat. No. 745, 771–72 (codified at 15 U.S.C.A. § 78j-1 (West Supp. 2006)) (amending 15 U.S.C. § 78j-1(g)(i) (2000)).

investigators review the amount of non-audit fees relative to the audit fees. A more meaningful inquiry would look at the engagement partner's opinion of the relative importance of audit fees and cross-selling non-audit services. Databases do not reveal this highly personal equation but few would deny that we might better understand the lack of independence demonstrated by Mr. David Duncan, the engagement audit partner at Enron, by the fact that seventy-six percent of his income depended on selling non-audit services to Enron. Studies of the role of non-audit services that fail to capture this variable do not capture the impact of non-audit services on the individual accountant's independence.

Moreover, event studies that measure the abnormal returns of studied companies in relation to a regulated event commonly exclude companies that have become bankrupt or have been acquired. The frequently used Computstat database automatically removes firms when either of these events occur. As a result, studies generally do not include marginal, failing, or failed firms, even though there is good reason to suspect that those firms pose the greatest incentives for insiders to engage in reporting abuses.[72] Empiricism is skewed as related to market regulation issues in terms of shifting the focus more heavily toward healthy, large public companies which leaves the regulatory agencies to rely only on intuition for the smaller, less studied, companies. Empirical insights gleaned from studies of larger companies do not overcome that intuition and, as seen above, the empiricist is necessarily confined by a data-set that does not even reveal whether directors are *engaged* independent directors.

III. Conclusion

SOX is a major piece of legislation and, as typically happens in the final hours before certain enactment, the bill is open to amendments that are less thoughtful than others. There most assuredly were such provisions tacked onto SOX as it rushed to enactment. But as Professor Romano's study indicates, there were extensive hearings

72. An important study of the profile of companies that engage in reporting violations such that they become the subject of SEC enforcement actions found that most are companies with a market capitalization of less than $200 million. Professors Arlen and Carney also report that most of the instances they studied of companies whose executives knowingly engaged in financial reporting violations were companies experiencing financial distress or companies whose executives believed that if they could survive the current fiscal period, they would be able to remedy the financial defalcation they were committing. *See* Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on the Market*, 1992 U. ILL. L. REV. 691 (1992).

predating the July 2002 enactment of SOX. And, as outlined above, there is a coherent core of concepts designed to strengthen the financial reporting process. SOX's major contributions, as reviewed in Part I, are both the thoughtful and integrated responses to the many ills that plagued financial reporting. Central to this mission was assuring the independence of standard setters for both accounting metrics and auditing procedures. Also central was assuring the independence of the outside auditor, by anchoring its relationship with the audit committee and prescribing a framework for an activist audit committee. It's a different world than existed prior to SOX because there is more reason to have faith in the financial reporting of public companies.