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9 YEARS LATER: AN ANALYSIS OF THE SARBANES-OXLEY ACT OF 2002 AND ITS BENEFITS

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Abstract

The Sarbanes-Oxley Act of 2002 was one of the greatest and furthest reaching overhauls the accounting industry has ever seen. The Act forced public accounting firms to drastically change the way they do business and forced public companies to spend great sums of money to become compliant with the law. The Act provided for much more regulation of the public accounting industry. In addition, the Act increased the responsibility of management when it came to financial reporting. Because of the high transition costs and additional costs to remain compliant and pay for longer audits, the Act was viewed in a very negative light, especially in the first few years of its existence. However, following the release of Auditing Standard 5 by the PCAOB, public companies, which had previously viewed the additional costs as having no tangible benefit, began to realize some incentives to complying with the Act. Most notably, companies saw an improved quality of financial reporting accuracy and reliability, improved quality of the financial reporting process and audit process, and improved efficiency and effectiveness of other business processes.

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CHAPTER 1: THE SARBANES-OXLEY ACT OF 2002 IN CONTEXT

Introduction

Following the accounting scandals of the early 2000s, Congress passed one of the most controversial laws the business world has ever seen, the Sarbanes-Oxley Act of 2002 (SOX). Perhaps only second to the IFRS convergence, the Sarbanes-Oxley Act has been one of the most talked about topics in the field of accounting during recent years. The set of regulations in the bill was designed to restore faith in public accounting firms and the financial information reported by public companies that they audit. In a recent talk he gave, Represented Michael Oxley, co-sponsor of the bill, said that the Act was intended to "restore investor confidence… through transparency and accountability."

This set of regulations put a lot of hardships on both public accounting firms and the public companies they audit. In the nine years that has followed the passage and implementation of SOX, there have already been numerous studies conducted around the Act. Most studies have tried to estimate the true cost of compliance for America's corporations. These studies paint the Sarbanes-Oxley Act in a negative light by only examining costs incurred for corporate America to become SOX compliant and the subsequent increase in audit fees.

The purpose of this research project is to put the Act in context by examining what it did and the perceived negative impacts of the Act, and then attempt to look at SOX as an Act that has provided benefits for the public accounting firms and their public

clients. While it is true that companies were forced to spend a large amount of time and money to become SOX compliant, especially in the realm of internal control to comply with Section 404, numerous benefits may have been reaped. In developing this thesis, preliminary research of existing studies was conducted. This preliminary research provided context for the surveying of four partners who worked at Big Four firms and three executives who worked at public U. S. companies. These partners were able to provide specific examples to corroborate the publicly available research by sharing how SOX impacted their particular audit firms and clients. The executives were also instrumental in detailing how SOX has impacted their respective companies. These partners and executives agreed to be part of this research on the condition that they and their firms would remain unnamed.

This thesis will first provide a brief overview on SOX and its major highlights. Then, this thesis will examine how Sarbanes-Oxley went from being a drag on American business that provided few realizable benefits to how SOX has provided benefits to audit firms and their clients beginning around the introduction of Auditing Standard 5, which acted as an inflection point in the way SOX was viewed in terms of its costs and perceived benefits. Specifically, this thesis will analyze how the quality of financial reporting has been improved, how the quality of the financial reporting and audit processes have been improved, and how the efficiency and effectiveness of other business processes have been improved. This thesis will accomplish this by citing research already conducted and specific examples from partners and executives who went through the SOX implementation and continue to experience the ramifications of SOX on a day-to-day basis.

Sarbanes-Oxley: A Brief Overview

While the goal of this paper is not to provide a thorough analysis of the Sarbanes-Oxley Act of 2002, it is important to provide some context to the research by briefly discussing some of the major parts of SOX. Specifically, there will be brief discussion in regards to the creation of the Public Company Accounting Oversight Board, enhanced standards of auditor independence, increased responsibility for financial statements by top management, and the requirement for management and auditor to provide an opinion on internal controls. The focus of the discussion on each of these topics will be on areas where research of this thesis has proved these major parts of SOX have led to benefits.

Public Company Accounting Oversight Board

To help provide regulation and guidance for public accounting firms who audit public companies, SOX provided for the establishment of the Public Company Accounting Oversight Board, known as the PCAOB. This board was primarily created to assist public accounting firms by promulgating standards that would assist the firms in performing better quality audits (H.R. 3763). Under Section 104 of Sarbanes-Oxley, the PCAOB was also mandated with the following:

> The [Public Company Accounting Oversight] Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this [Sarbanes-Oxley] Act, the rules of the Board, the rules of the [Securities and Exchange] Commission, or professional standards, in connection with its performance of

audits, issuance of audit reports, and related matters involving issuers (H.R. 3763).

By charging the PCAOB to take over the regular reviewing of public accounting firms who audit SEC filers, peer reviews performed by member CPA firms in the American Institute of Certified Public Accountants (AICPA) were effectively phased out. Prior to SOX, the quality of the audits performed by CPA firms was ensured with these AICPA peer reviews.

Auditor Independence

One of the sections of the Act that had the greatest impact on the type of work that audit firms could do for their clients relates to the idea of increased auditor independence. This was because it greatly limited the non-audit services an auditor could perform for its audit clients (Chambers—Audit Quality, 2008). Section 201 of the Act specifically lists the types of non-audit services that, if performed for an audit client, would compromise independence.

According to Anandarajan et al. (2008), "The business failures of Enron, WorldCom, Global Crossing and other large firms and the subsequent admission of key officials that they had deliberately misled investors, led the public to question the role and integrity of these companies' auditors. The auditor of Enron, Arthur Andersen, suffered a criminal indictment (later overturned) that forced the firm's dissolution. These events led the public to strongly question the independence of the auditor." It is believed that "independent certifying public accountants act as more objective monitors of opportunistic actions by managers of public companies than a certifying public

accountant that is in some manner affiliated with that company" (Bureau of National Affairs website, 2011). This is in line with the overall stated goal of SOX being to improve financial reporting quality. The SEC and Congress assumed that audits performed by independent auditors is vital to the financial reporting quality because "[t]he independent nature of certifying auditors is presumed to furnish investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional" (Bureau of National Affairs website, 2011).

Increased Responsibility for Financial Statements by Management

Sarbanes-Oxley greatly increased the pressures on top executives of SEC filers. Section 302 required that the CEO and CFO—or those in positions that perform similar functions—certify the annual report. It forces these individuals to review the report, ensure that the report is not misleading, and that the financial information fairly presents the position of the company. The Act also makes the signers of the report responsible for the internal controls of the company and discovering any deficiencies or material weaknesses. Title VIII and IX of the Act go onto impose harsh penalties for these executives (any other management personnel) who knowingly falsify financial statements (H.R. 3763).

Management and Auditor Opinion on Internal Control Effectiveness

Section 404 of the Sarbanes-Oxley Act of 2002 deals with a company's internal controls. This section indicates that reports must:

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting (H.R. 3763).

Section 404 does not stop with management's responsibility in regards to ensuring the operating effectiveness of internal controls over financial reporting. It also demands that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board" (H.R. 3763). SOX 404 essentially forced management to ensure that their internal control frameworks were designed effectively and were in operating order so that management and the auditor could deliver assessments regarding internal controls.

Lacking Benefit: The Early Years

Before discussing the benefits that were discovered through the findings from research and the findings from discussions with partners in auditing firms and senior management in public companies, this thesis will first provide some context relative to the hardships endured by many corporations attempting to implement SOX. Much of this discussion of context comes from a large amount of existing published research that has already been done, most of which paints SOX in a negative light. In addition, some of

this discussion of context is derived from conversations held with audit partners and senior management of companies who personally experienced the implementation of the provisions required by the Act.

Much of the criticism of the Act has stemmed from three areas: corporate governance and regulation that is excessive and unnecessarily costly, high costs to implement the provisions required in the Act, and the increased costs incurred by companies to pay for longer audits and increased costs to remain SOX-compliant. For these reason, the discussion concerning difficulties faced by corporate America will focus on the issue of overregulation and corporate governance, transition costs to get compliant with the Act as well as the increased audit and continuing compliance costs.

Overregulation and Corporate Governance

Sarbanes-Oxley dramatically altered the way in which corporations were required to govern themselves as public companies. One of the most scathing scholarly articles regarding the overregulation in corporate governance was written by Roberta Romano (2005). This article blasts the Act and its law makers as being responsible for transforming the way that Americans control their businesses into "quack corporate governance." Three areas that are often cited as being examples of Congress overregulating corporate America deal with the way SOX transformed audit committees, restricted services that clients could hire their audit firms to perform, and transformed the CEO and CFO's attentions.

Under Section 301, audit committees had to be comprised completely of independent directors. The audit committee was also the party responsible for the hiring

of the independent audit firm (H.R. 3763). This meant that individuals completely independent of the public company being audited had the power to direct how management spent money when it came to paying the audit firm. This was believed to be in the best interest of the investors because independent members on the audit committee had no financial interest in the inflation of earnings, as management did (Romano, 2005). Audit firms were more concerned about making the audit committee happy, as opposed to management. Related to the audit committee and the board of directors as a whole, SOX has caused a great change in the process of preparing and running board meetings (Morgenstern, 2007). Romano suggests that this reorganizing of board structure has not led to an increased reliability of financial reporting, citing studies that conducted regression analyses that found no connection between independent audit committees and financial reporting accuracy and reliability.

Another area that has faced a great deal of criticism as being an example of overregulation has been in regards to auditor independence. While intended as a section aimed at public accounting firms as a directive to limit services offered to their audit clients, Romano argues that Section 201, which provides a list of what services an auditor cannot provide to audit clients, is an attempt by Congress to participate in corporate governance. She sees it as "Congress substituting its judgment regarding what services a company can purchase from its auditor for that of corporate boards or shareholders." Romano's feelings of frustrations are shared by an executive surveyed for this thesis. The executive indicated that the independence that was so emphasized by SOX led to tension between the audit firms and their clients. The executive had indicated that audit partners were encouraged by their firms not to work very closely with their clients on

accounting issues that arose for fear that the strict independence rules that were promulgated by SOX would be violated. Another executive indicated that there was a clear strain on the auditor-client relationship in the early years of SOX. This executive indicated that, especially in the early years, the client felt that it could not have a "collaborative relationship" with the auditor. The executive went on to say that the company, like other companies at the time, was forced to hire other firms to come in and assist with accounting issues because the auditor was so reluctant to offer any accounting advice for fear it would impair independence.

A third area that was initially viewed as being problematic for corporate America dealt with the increased responsibility on the CEO and CFO (or those in an equivalent position of another title). Section 302 requires that these executives certify the financial statements as being free from material misstatement. Sarbanes-Oxley essentially required these executives, specifically the CEO, to change their focus. As Genevieve Beyea, Assistant Professor at Texas Tech University School of Law, points out in an interview (Castellon, 2011), "the CEO [was pulled] away from the strategic vision and management of the company, and more toward ownership and oversight of finances. CEOs are now deeper in the nitty-gritty of financial reporting." Section 302 has proved to be a headache, especially for a particular executive who was required to certify the financial statements for his company. This executive was considered to be in a position performing similar functions as a CFO. However, the background of this individual was not financial in nature. Nonetheless, he was required to certify the financial statements so that his company would be compliant under the Section 302.

The Transition Costs

Ever since the Sarbanes-Oxley Act of 2002 was passed, much of the research conducted has attempted to criticize the massive costs the Act forced on corporate America. As Dennis Chambers et al. (2010) point out, "the costs associated with SOX were mostly front-loaded" meaning that most of the costs came as a result of the process companies had to undergo in order to effectively implement the provisions required by SOX. Most of these transition costs were associated particularly with one section: Section 404. This controversial section, of course, led to the requirement that management and auditors assess and opine on a company's internal control environment in place over financial reporting (H.R. 3763).

There have already been numerous studies conducted around SOX 404. Most of these studies heavily criticize this section. One of these studies, conducted by Jagan Krishnan et al. (2008), broke the costs of complying with SOX 404 into three categories: "additional audit fees, internal labor costs, and external consulting/technology expenses." In an effort to focus on the transition costs associated with Section 404, the focus in this section of the thesis is on the external consulting/technology expenses and the internal labor costs that were associated with becoming 404 compliant. In the following section, the focus will be on audit costs.

To determine a sample for finding compliance costs, this study analyzed SEC filings to determine which firms disclosed costs associated with Section 404 compliance. The sample was reliant upon the choice of firms to voluntarily disclose Section 404 compliance costs. Krishnan (2008) found that those firms who voluntarily disclosed

these costs tended to be smaller in size. Therefore, the firms used in the sample were not representative, in terms of size, of the total population.

Out of a sample of 266 companies, the study finds that the total initial compliance costs have a mean somewhere around $2.2 million and a median of $1.2 million, suggesting skewed results. The study, however, recognizes that there may be a bias in this number in that the majority of companies in the sample used to determine this number were small to mid-size companies. The study found that transition costs, as would probably be expected, was positively correlated to a firm's size. This indicates that the actual population mean, when taking into account more of the larger firms—which typically chose not to disclose compliance costs, could be even higher. In addition, transition costs were also increased due to material weaknesses existing in an internal control framework, which was typical in smaller firms. Therefore, the study concluded that while larger firms spent a larger total amount of money in compliance costs, smaller firms spent more money in terms of percentage of total sales and assets. Financial Executives International (2005) conducted a survey that perhaps better captured the costs of 404 compliance. The 217 companies used in its survey averaged revenues of $5 billion per year. The survey finds that compliance costs averaged $4.36 million.

A partner who worked at a Big Four firm during the years of SOX implementation has suggested that during the transition, many of the companies he worked with saw these dollars spent for something that was viewed as more of a "compliance exercise" instead of an exercise that was of any value to the company. One reason cited for compliance costs being so high was that Sarbanes-Oxley put so much emphasis on documenting and assessing controls. Although many companies had

somewhat decent controls, they still may have had to spend a lot of money to get 404 compliant.

The Increased Audit Costs

Once companies were finished spending large sums of money for the transition costs to implement Sarbanes-Oxley and become compliant, they were far from done spending money for items that they did not initially see as necessary. The Krishnan (2008) study that attempted to find a mean cost for initial compliance costs also focused on the increase in audit fees. That study suggests that the mean increase between FY 2003 audits and FY 2004 audits was $0.92 million. Again, this study recognizes that the sample seems to be biased because most respondents were from small to mid-size companies. One partner who worked for a Big Four firm—and therefore, probably working on larger-size clients—estimates that $1 million in audit fees pre-SOX resulted in $2 to $2.5 million in audit fees in the few years immediately following SOX implementation.

According to the audit partners that this thesis surveyed, there were two primary reasons for the high audit costs in the first few years of SOX: a steep learning curve for the auditors and Auditing Standard 2. One partner from a Big Four firm cited that in the early years, there was very little guidance on how to properly implement the COSO Framework for internal controls. While auditors have relied on controls as part of their audits prior to Sarbanes-Oxley, they were never mandated to specifically issue an opinion on the operating effectiveness of internal controls. Couple the inexperience of auditors with the introduction of Auditing Standard 2, and there was a recipe for high audit fees.

Auditing Standard 2 created a headache for auditors and their clients, according to the audit partners surveyed as part of this thesis. According to one of them, because of the length of Auditing Standard 2, auditors tested a great number of controls. The audit firms were concerned that if they did not test virtually all controls, the PCAOB would accuse the firms of not complying with SOX. The partner contends that firms were testing all controls, even if they would be considered non-key by today's standards and, therefore, not have an effect on preventing or detecting material misstatements. This view seems to be shared among the partners surveyed for this thesis: too much effort was being put into testing controls in the early years of SOX because of the mandate set by Auditing Standard 2. The lack of specific guidance was not very helpful either. One partner indicates that instead of using the typical top-down approach that is currently used to test an internal control environment, auditors started at controls at the lowest level and worked their way up to entity-level controls.

Executives that were surveyed as part of this thesis echo the partners' explanation of headaches in the early years. Aside from the concerns that executives had from the auditors' unwillingness to collaborate with them in the early years due to independence fears, audit clients were also concerned with the large increase in audit fees. One executive termed the early years of SOX as the "overboard period," meaning that clients recognized that the auditors were testing way too many controls and, therefore, charging higher audit fees. Another executive recognized how the early years of SOX was difficult for his auditor due to the lack of automated controls. This made early tests of controls more difficult and time-consuming for the auditor.

Chapter 2: An Analysis of Benefits from the Sarbanes-Oxley Act of 2002

Turning the Corner: Auditing Standard 5

While it is widely agreed that the early years of Sarbanes-Oxley were difficult for auditors and their clients, the years following the issuance of Auditing Standard 5 probably marked the first time when auditors and their clients could agree that perhaps SOX was not all bad. Auditing Standard 5 was issued by the PCAOB for all fiscal years following November 15, 2007. It was a clear signal that the Board had heard the frustrations of public companies who had felt that their audit fees had gone through the roof. Auditing Standard 5 was introduced in the hopes of lowering fees associated with SOX 404 (controls) testing.

Auditing Standard 2 vs. Auditing Standard 5

According to Jiang and Wu (2009), there are five key differences between Auditing Standard 2 and Auditing Standard 5 that have reduced the amount of work required of auditors when it comes to their mandate to assess and issue an opinion on the effectiveness of internal controls. These categories are "1) the degree of auditor discretion in identification of material weaknesses; 2) the top-down versus bottom-up approach in audit planning; 3) the scalability of the audit; 4) the ability to rely on the work of others; and 5) the requirement for walkthroughs of significant transactions."

Auditing Standard 2 removed a lot of professional judgment from the auditors by forcing them to be more rigid in determining control deficiencies and material

weaknesses. It specified eight "strong indicators" that auditors must report as control deficiencies and highly consider reporting a material weakness if one should exist. Auditing Standard 5 removes some of the rigidness that Auditing Standard 2 forced on the auditors by allowing for more professional judgment from them in their evaluation of internal controls and subsequent judgments of control deficiencies and material weaknesses (Jiang, 2009).

Auditing Standard 5 reversed the required approach that auditors took while evaluating a company's internal control environment. As Jiang and Wu (2009) indicate:

> [Auditing Standard] 2 adopted the bottom-up approach and focused on the transaction and account level tests. [Auditing Standard] 5, however, follows a topdown, holistic auditing approach in which auditors start from the financial statement level, perform risk assessments, and identify significant accounts and transactions on which to perform audit tests. The topdown approach increases audit efficiency by focusing on the most significant transactions and accounts.

One of the arguments associated with Auditing Standard 2—and SOX in general—is the unequal burden placed on smaller companies to be compliant according to Genevieve Beyea in an interview (Castellon, 2011). In other words, smaller companies have had to pay more costs relative to their sales to be compliant with SOX and more in the way of audit fees relative to their sales for auditors to evaluate their internal control environment. Auditing Standard 2 provided a clear approach that had to be followed on every audit of an internal control environment, regardless of the size of

the company. Auditing Standard 5 allows auditors to tailor their approach to assessing an internal control environment based on the client's size and complexity (Jiang, 2011).

Auditing Standard 2 put a lot of restrictions on using the work of others. It allowed auditors to use the work of others, but only if they repeated the steps performed by others. With Auditing Standard 5, auditors can use the work of internal auditors and other employees of the client, provided that there is evidence that their work can be relied on (i.e., they are competent) (Jiang, 2011). One of the executives who was surveyed for this thesis has seen how Auditing Standard 5 has led to an increase in the way her auditor uses the work of others. While impairment of independence is always an area of concern, there has been more collaborative work since Auditing Standard 5. Another executive indicated that her auditor now uses more of the client's internal audit work to assist with the independent year-end audit. She indicated that Auditing Standard 5 acted as a "catalyst" for helping to move the auditor-client relationship back towards a pre-SOX level.

According to Jiang, the final way that Auditing Standard 5 changed Auditing Standard 2 was by changing the requirements associated with walkthroughs. With Auditing Standard 2, auditors had to perform walkthroughs "for each major class of transactions that was considered significant to the company's financial statements" (Jiang, 2009). Auditing Standard 5 relaxed this requirement, which, in turn, lowered audit fees since auditors did not have to perform as many walkthroughs. Auditing Standard 5 indicates that alternative procedures can be used in place of a complete walkthrough in order to gain confidence over the operating effectiveness of a control.

Audit Fee Reduction

The big question about Auditing Standard 5 was whether or not it led to a reduction in audit fees associated with SOX 404 auditing. The Jiang and Wu (2009) study did not find a decrease in audit fees from the fiscal years at the end of Auditing Standard 2 guidance to the fiscal years at the beginning of Auditing Standard 5 guidance. According to the study, "The accelerated filers experienced a 4.79% increase in average audit fees from fiscal year 2005 to 2006, when [Auditing Standard] 2 was in effect. In comparison, there was only a marginal increase of 0.44% in average audit fees from fiscal year 2006 to 2007, when [Auditing Standard] 5 became effective." Jiang and Wu cite the former president and CEO of Financial Executives International, Michael Cangemi, for his explanation for the lack of decrease in audit fees. According to Cangemi, SOX 404 audit fees did, in fact, decrease with the introduction of Auditing Standard 5—by 5.4% in his estimation. However, due to his estimation of a 5% increase in the average hourly rate charged by auditors, the decrease in SOX 404 audit costs was not explicitly seen.

Partners surveyed for this thesis are in agreement that SOX 404 audit fees have decreased with the introduction of Auditing Standard 5. One partner in particular expressed his feeling that his firm was able to perform a more efficient audit with Auditing Standard 5's top-down approach. He also indicated that the firms have become better at 404 auditing through experience and, therefore, can audit more efficiently.

Another reason that auditors have turned the corner in being more efficient in reporting on internal controls may be due to the types of controls that companies have

implemented. Melissa Aguilar (2009) cites a study from KPMG's 404 Institute. The study found that "many companies are reporting fewer deficiencies (and much fewer material weaknesses) and expending fewer hours to conduct their internal control testing." The study goes on to say that control automation is at least one of the reasons for this.

Improved Quality of Financial Reporting Accuracy and Reliability

The Sarbanes-Oxley Act's primary goal as stated in the official House Resolution was "to protect investors by improving the accuracy and reliability of corporate disclosures" (H.R. 3763). In other words, the primary goal of SOX was to improve the quality of financial reporting. So with all the hardships that SOX imposed on audit firms and their clients, did it accomplish its primary objective of delivering more and higher quality information to investors? Three metrics can be used to determine whether or not SOX improved financial reporting accuracy and reliability: the perception of conservatism, the rate of restatements and material misstatements, and the increased focus on financial reporting accuracy and reliability by companies.

Increased Conservatism in Booking Accruals

There have been numerous studies that suggest that the enactment of Sarbanes-Oxley resulted in companies being more conservative when it comes to reporting accruals. Many of these studies evaluate this increased conservatism by analyzing companies for "abnormal accruals." Normal accruals for a company are calculated using

a regression model called the Jones model, which takes into account assets, revenues, and earnings. Abnormal accruals are those accruals that are outside the range of what would be considered normal (Chambers—Better Reporting, 2010).

Four of these studies cited by Chambers (2010) have found that abnormal accruals were higher in the pre-SOX years, especially around the turn of the century during the financial scandals, than in the post-SOX era. The studies attribute the increased reluctance to book accruals to Sarbanes-Oxley. It is believed that the deterrence to inflate earnings that was brought on by Section 302 caused executives to be more conservative.

It's not just academic studies that prove companies are taking a more conservative approach to booking accruals; executives surveyed for this thesis say their companies are taking steps to ensure improper accruals are not booked. One executive says that his company is more open to seeking the professional knowledge of its auditor before booking potential accruals. From his experience in applying SOX, he indicates that his company is more prudent in booking accruals. The executive adds that it is more efficient to take time in deciding whether or not to book an accrual than potentially going through the process to reverse the accrual. Another executive indicates that her company has a procedure for checking the logic behind accruals to ensure the accrual should, in fact, be booked prior to booking it. The third executive went a step further in discussing the steps her company took in verifying the accuracy and validity of accruals. She indicated that there is a process in place for dealing with "standard" accruals and a process for dealing with "nonstandard" accruals. The standard accruals—the ones made year after year—are reviewed yearly by management. However, nonstandard accruals are to be reviewed every time they take place. Following SOX, the executive says that

her company now scrutinizes nonstandard accruals much more. In addition, perhaps as a result of Section 404, there are quite a bit more controls in place to verify accruals.

Restatements and Material Misstatements

Calculating abnormal accruals may seem like an inexact science that involves a lot of theoretical models and estimations. However, the number of restatements pre-SOX and the number of restatements post-SOX are more concrete numbers. In an article by Yun and Kim (2011), research has shown "that forced financial restatements by the SEC and other external agencies were reduced to about one-fifth after the passage of SOX than before SOX." Their research suggests the "effectiveness of SOX for restatement announcement firms by the SEC's expanded filing requirement."

Furthermore, recent research has shown that SOX's most controversial section—Section 404, which requires the testing of a company's internal control environment by management and auditor—has been instrumental in preventing misstatement. According to a study done by Albert L. Nagy (2010), compliance with Section 404 of SOX "reduces the likelihood of issuing materially misstated financial statements, and suggests that the S404 regulation is meeting its objective of improving the quality of financial reports."

Increased Focus on Accuracy and Reliability

Since Sarbanes-Oxley was enacted, there appears to be an increased focus on improving the accuracy and reliability in corporations' financial reporting. All three executives surveyed for this thesis indicate that they have seen their financial reporting

accuracy and reliability improve after SOX. They all cited specific steps their companies took in the wake of SOX to assist in the improvement of accuracy and reliability.

One executive cited his company's changing focus on their enterprise resource planning (ERP) system that the company was implementing around the time SOX went into effect. He indicates that because of SOX's enactment, his company specifically tailored some of the customizable settings to improve accuracy and meet disclosure requirements. Another executive indicated the drastic overhaul of her company's closing process. After SOX, her company improved the closing process by using less estimates and more real data. She indicated that SOX encouraged her company to use more real data and less estimates to close the books at every month-end.

Improved Quality of the Financial Reporting Process and Audit Process

Research has shown that not only has the *accuracy* and *reliability* of financial information improved since the enactment of Sarbanes-Oxley, but the *process* of financial reporting and the related audit process has also shown improvement. All three executives surveyed for this thesis indicated their company's improved efficiency and effectiveness in their companies actually going through the financial reporting process. In addition, they, along with some of the partners surveyed, indicate a more effective and efficient audit since the enactment of SOX.

Financial Reporting Process Improvements

The effects from an improved financial reporting process seem to be less widespread and more varied than the effects from improved financial reporting accuracy and reliability. A good bit of the research indicates that the improvement seen in the financial reporting process is largely dependent upon the approach companies are taking to adhere to Section 404 in designing their internal control environments. Specifically, research has shown that improvements seen in the financial reporting process were affected by how aggressive a company was in automating their internal controls over financial reporting in light of Section 404's requirements.

The article by Melissa Aguilar (2009) cites a study by KPMG's 404 Institute that says most companies are not using automated controls and are instead relying on manual controls for 404 compliance. Lawrence Raff, a KPMG partner and executive director of the Institute was quoted in the article, saying, "Leading companies that had the forethought to invest early on in their internal controls processes have tended to emerge as leaders in terms of efficiency and effectiveness of their compliance efforts."

Two years since the KPMG study was conducted, companies are continuing to try to improve the efficiency and effectiveness of their financial reporting process in light of SOX compliance requirements. According to a survey of executives conducted by Protiviti (2011), companies can still make their greatest strides in the area of automating controls. In addition, the study found that it takes about four years for companies to realize the benefits from SOX compliance. The survey reports that by the fourth year of

SOX compliance, 94% of companies are "leveraging their compliance activities" to improve the financial reporting process.

Perhaps because all executives surveyed for this thesis work for companies who are well into their SOX compliance efforts, every executive surveyed for this thesis indicates that their companies have responded to the SOX requirements by taking action to improve the efficiency of their financial reporting process. Very much in line with the Protiviti survey, two of the executives surveyed indicate that their respective companies are realizing an improvement in their financial reporting process, but are still working towards optimizing their control systems. Both said that their respective companies realized that they had way too many manual controls and are still in the process of automating as many of them as possible.

The third executive, the one who indicated the improved accuracy in the closing process, also discussed the increased efficiency in the closing process. She had indicated that after SOX, her company was encouraged to go from a closing process that took three days down to a process that took only one day. She also indicated how the focus on the financial reporting process has become more permeable throughout the organization. According to her, leaders in the financial reporting process and other business leaders now work more closely together to ensure that the financial reporting process is the best it can be, and the other business processes are the best they can be.

Audit Process Improvements

Auditors and their clients have also seen improvements in the audit process. Research has shown that clients are seeing an improvement in audit quality and that the

PCAOB, the board created to oversee public accounting firms, is contributing to this improvement in audit quality. One such study, conducted by Chambers and Payne (Audit Quality, 2008), found that accruals are more persistent from year to year for clients of smaller audit firms after SOX than they were for those same clients prior to SOX. Chambers and Payne theorize that, because smaller audit firms tended to lack independence more than Big Four (or Six) firms prior to SOX, the audit quality of these small firms improved because of the increased independence requirements brought on by SOX.

Another study by Carcello et al. (2009) examined the PCAOB inspections of audit firms that were mandated by SOX. The study attempted to analyze the reduction in abnormal accruals that audit clients booked in the years following the initial PCAOB inspections. The study found that following the initial years of the inspections, abnormal accruals dropped significantly. The research showed that there was no such drop in the years of AICPA peer reviews, which was the way the profession monitored audit quality prior to SOX.

The clients of audit firms are also reporting seeing benefits from an improved audit process. One executive points out that after the initial strain on the audit-client relationship following the issuance of Auditing Standard 2, her company has seen an improvement in the audit process in the wake of the issuance of Auditing Standard 5. In particular, she notes that the quality and amount of documentation from her auditors have greatly increased post-SOX. Now, if her company experiences an accounting issue that they faced in prior years, it is easier to get guidance from its auditor's past work papers. Another executive indicates that despite the occasional "over-documentation" by the

auditor, there is value in the increased documentation. She says that she has seen the PCAOB reviews improve the audit process.

Improved Efficiency and Effectiveness of Other Business Processes

Obviously, the goal of SOX was to improve the quality of financial reporting that investors use to make decisions. Therefore, it should not be a big surprise that the quality of financial reporting and the reporting/audit process increased according to research. However, what may be more of a surprise is the improvement that corporations are seeing in other operational areas of the business outside of financial reporting.

Scot Glover (2010) discusses how having a "risk-oriented mindset," which was necessary to create an appropriate internal control environment over financial reporting, has led to taking a similar mindset in other areas of the business. According to him, executives have realized the benefits reaped from having a strong internal control environment for their financial reporting process and have attempted to "think more broadly and strategically about the comprehensive risk profile of their entire company." A partner who was surveyed for this thesis indicated that his clients were taking a SOX mindset to operational controls that are unrelated to financial reporting as they do take for controls over financial reporting.

The executives surveyed for this thesis corroborate the partner and Glover's findings. One executive discussed his company's focus on automating as many controls as possible both inside and outside of the financial reporting process. He said that SOX and the implementation of his company's ERP system forced process owners to

reexamine their business processes and look for ways to improve. He said that the message his company took from SOX was simple: "Standardized. Simplify. Automate." This executive, like Glover, indicated that he has seen the most improvement in the area of risk management. One of the things that his company realized, like many other companies, was that manual controls were not the way to go, primarily because the manual controls over financial reporting were expensive for the auditor to test. After choosing to automate more of those controls, the company realized that there is great benefit in automating as many other controls as possible.

Other executives discussed how the "SOX mentality" has really permeated the organization as a whole. One executive indicates that her company has found success in applying the SOX mentality to tackle projects not related to financial reporting. In addition, all process owners—not just ones who deal with matters related to financial reporting—are required to establish control objectives and minimum expectations for meeting those objectives. Specifically, the executive cited the improvements that self-assessments created in the areas of environmental compliance and safety standards. These self-assessments follow an approach that is similar to the control assessments required under Section 404 of SOX.

Summary of Significant Findings

The Sarbanes-Oxley Act of 2002 was one of the biggest pieces of legislations to hit the accounting world. Aside from perhaps the Securities Acts of the 1930s, no single piece of legislation transformed the public accounting field like this Act did. There is no

doubt that the Act, along with the promulgation of Auditing Standard 2, created a massive amount of headaches for the public accounting profession and its clients.

The Act imposed many costs and regulations that, at least in the early years, were seen as unnecessary, excessive, and lacking any benefit. The creation of the Public Company Accounting Oversight Board and the increased requirements for auditor independence really put a strain on the auditing profession. The increased responsibility that executives were forced to take on—including potential criminal liability—and the increased emphasis on companies' internal control environments put a strain on executives' job roles and their companies' bottom lines. The costs companies were forced to bear, especially those associated with compliance with Section 404, were quite large and seen as unnecessary, especially by those companies who already had adequate control systems. Furthermore, continuing compliance costs meant that public companies would continue to dish out funds to meet the requirements of SOX for years to come.

With the issuance of Auditing Standard 5 by the PCAOB, some headaches began to dissipate, and some benefits of the Act were beginning to show themselves. Auditing Standard 5 reduced audit costs that clients had to pay to their auditors and provided guidance to auditors to make audits more efficient. Research already done and discussions held with partners and executives for this thesis have shown that audit firms and their clients are seeing the primary objective of SOX being met: improved quality in financial reporting accuracy and reliability. In addition, the emphasis on internal controls brought on by Section 404 has proved to be beneficial for companies as they have seen improvements in their financial reporting process. SOX has even had some

consequences that were perhaps unintentional: improvement in other business processes outside of the financial reporting process.

All of the existing research available as well as the beliefs of the audit partners and executives surveyed for this thesis generally seem to be in agreement on a few things. First, with the initial rollout of SOX, it would have been difficult to find an audit partner or an executive who would have said SOX was a good thing for corporate America. Now, executives and partners seem to be in agreement that SOX was, at the very least, a necessary evil. Most executives and partners, however, would say that SOX has, as a whole, been a benefit to corporate America. There has been an increased emphasis on the role of internal controls, and that is making companies operate more effectively and efficiently. There also tends to be agreement that as costs of compliance continue to decline, benefits realized from the Act will only continue to grow.

Before addressing some of the benefits realized by corporations, this paper began with a brief background on the Sarbanes-Oxley Act and some of the criticisms associated with it. One criticism was the drastic regulations put in place by the Act. While research completed for this thesis has not shown much benefit to requiring audit committees to be independent, there have been findings that requiring CEOs to certify the financial reports provide some benefit. CEOs shifting their focus away from guiding the company towards a long-term vision may be detrimental in some respects. However, executives agree that making the CEOs more aware of the financial reporting has improved financial reporting accuracy and has made the process run more smoothly.

Another criticism of the Act dealt with the increased transition costs and subsequent increase in audit fees. It is still, and perhaps always will be, too difficult to attempt to quantify the benefit received from these costs. In a discussion held with Representative Oxley, he pointed to the market capitalization of firms when SOX went into effect versus the market capitalization after. He said that the drastic increase in market capitalization is a good measure of the benefit of the Act. The research of this thesis found that financial reporting accuracy and reliability have improved in a post-SOX world. In addition, research has shown that the financial reporting process has improved in addition to the audit process.

As companies expand their abilities in managing controls and their related processes with more years of experiencing SOX, perhaps SOX will be remembered as an Act that proved beneficial to America and the accounting profession, and not an Act that imposed a great deal of costs and regulations on America's public companies.

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Exhibit A: Schedule of Executives and Partners Surveyed

Partner / Executive	Description of Job Role and Firm*
Partner 1	Audit partner at regional firm who was previously with a Big Four firm where he went through the SOX implementation.
Partner 2	Audit partner at Big Four firm where he went through SOX implementation.
Partner 3	Audit partner at Big Four firm where he went through SOX implementation.
Partner 4	Audit partner at Big Four firm where he went through SOX implementation.
Executive 1	Former Big Four audit partner. Currently vice president at of a manufacturing company.
Executive 2	Formerly worked at a Big Four firm. Currently vice president and controller at an engineering company.
Executive 3	Current C-Suite officer at a chemical company.

*specific job titles and more detailed explanations of firms were intentionally withheld in order to ensure absolute anonymity

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EDUCATION

The Pennsylvania State University Fall 2007 – Fall 2011

B.S. in **Information Sciences and Technology**

B.S. in **Accounting**

WORK EXPERIENCE

PSUKnowHow January 2011 – December 2011

Private Instruction Tutor / Review Session Leader

- Improved students skills—individually or in small groups—in accounting, finance, and economics classes
- Developed packets listing important concepts and equations for accounting students to use in preparation for exams
- Led review sessions for each exam that included approximately 20 – 50 students

PricewaterhouseCoopers, LLP Summer 2009, Summer 2010

Systems and Process Assurance (SPA) Intern

- Developed understanding of complex accounting computer systems
- Tested systems to ensure companies' controls were appropriate
- Documented results in a professional format to assist financial audit process

Allegheny Conference on Community Development Summer 2008

French and Indian War 250—Special Projects Intern

- Managed, tracked, and processed online sales of the PA Forbes Trail book
- Designed and populated database to locate over 300 digital images used in book
- Planned and published wholesale catalog to distribute to over 240 gift shops

ACTIVITIES

Penn State IFC/Panhellenic Dance Marathon — Fall 2009 – Spring 2011

Entertainment Captain—Timeline / Logistics

- Collaborated with other Captains and Overalls to schedule all events during 46-hour Dance Marathon
- Leveraged MS Excel to create logical and organized presentation of all events

Penn State Lion Ambassadors — Spring 2009 – Fall 2011

IT Chair

- Maintained websites utilized by organization and by general public
- Trained membership on utilization of public site and intranet site

HONORS

Dean's List (all semesters)
Beta Gamma Sigma Junior Inductee
Schreyer Honors College Scholar
Penn State President's Freshman Award
PwC Leadership Adventure
Phi Kappa Phi Inductee
Penn State Pugh Senior Award