The Effects of the Sarbanes-Oxley Act:
A Deeper Look into its Impact on Small Companies

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Abstract
The following thesis was written by Jonathan W. Carlson and Leonard P. Basak, III for their Bachelor of Science in Business at Linkoping University, Sweden. The authors intend to determine the effects the Sarbanes-Oxley Act (SOX) has had on business. The paper outlines many possible costs of the act, with a focus on the adverse impacts it has on small companies. In order to combine new information with previous research, interviews were conducted. The purpose of these interviews is to compare and contrast the effects of SOX on firms of different sizes or structure. Through the combination of past studies and research, the authors agree that future changes to the Sarbanes-Oxley Act are needed to make it less invasive on small firms. The thesis recommends simple revisions be made that can explicate the types of firms the Act applies to. In the interviews conducted, the harmful effects of the Act are more extreme in small companies that large ones. These findings are consistent with the findings of previous research, allowing a reasonable proposal for additional revision of the Sarbanes-Oxley Act.
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Introduction

Large and small businesses operating within the United States are regulated by the government. Most of these regulations are put into effect by the federal government. Questions arise regarding whether there is too much government regulation, which is costing businesses money and countless work hours that could be spent in more productive ways. Carls (2004) estimates that the Federal Register chronicles more than 69,000 pages of federal regulations. Government estimates place the total cost of federal regulations at $300 billion per year, while other experts estimate the cost as closer to $700 billion. The concern related with these figures revolves around the belief that too much government regulation can be harmful to the success of businesses as well as the economy as a whole. Global firms that operate within the United States are also required to comply with rules set forth by government regulations. It is possible that these stringent regulations drive corporations away from U.S. markets. Regulations must be reviewed to insure that they do not interfere with trade among nations and economic growth in the global market.

The Sarbanes-Oxley Act was enacted as a bi-partisan legislation on July 30, 2002. The impact of the Sarbanes-Oxley Act has been vast. It has affected companies, investors and financial markets in various ways. The Sarbanes-Oxley Act (SOX) is named after its sponsors, U.S. Senator Paul Sarbanes and U.S. Representative Michael Oxley. The official name for this act is the Public Company Accounting Reform and Investor Protection Act of 2002. It has done a lot to ensure that the integrity of publicly traded companies is always upheld. The creation of this act was brought about to prevent future accounting fraud similar to those of Enron and WorldCom, and to restore the
American people’s trust in the public markets. Enron, an energy company in the United States, was accused and convicted of falsifying and destroying financial documents in order to hide the financial distress of their firm from investors. The Enron Scandal accelerated the demise of Arthur Andersen, one of the largest audit and accountancy partnerships in the world at that time. The auditors at Arthur Anderson failed to uphold professional accounting standard when auditing Enron’s records, and failed to make disclosures of irregular practices and transactions. Arthur Anderson remains as one of the largest bankruptcy reorganization and audit failures of all times. By using accounting loopholes, special purpose entities, and poor financial reporting, Enron managed to conceal billions (USD) in debt from failed deals and projects. Enron’s stock price had once been at a high of 90 dollars per share, and eventually dropped below 1 dollar because of the unethical decisions enacted by the company. This drop in share price lost company shareholders nearly 11 billion dollars (Lowengrub, 2005).

The Sarbanes-Oxley Act has been thought to help and hurt companies in different ways depending on the company at hand. It may have restored some faith to investors, but an analysis of the negative effects it has brought forth is required to see the bigger picture. The Act brings a lot of change to companies in terms of management’s reporting responsibilities and the complexity of auditor’s responsibilities. It can be very costly for companies to properly comply with the Act. Publicly listed firms are forced to deal with direct and indirect costs which include higher D&O insurance premiums, greater director’s fees because of increased time commitment and responsibility, and larger expenses resulting from internal control software and greater costs due to consulting fees. These costs can hurt many publicly owned companies because of the significant increase
in overhead, and can even deter smaller firms from entering the public market. Although corporate America and the federal government agree that restoring investors’ faith is crucial to ensuring the success of the U.S. economy, there are doubts and questions about whether the cost to comply with the Sarbanes-Oxley Act is appropriate for small companies.

With the increased regulation brought about by the Sarbanes-Oxley Act, it is difficult to obtain opinions about the act from public companies. Many companies simply cannot respond to questions regarding the act due to internal controls set forth by management. Because of this, it can be extremely difficult to obtain responses from companies meaning sample sizes may be small when regarding this topic. Additionally, the sheer size of the act causes confusion when talking about specific portions. There are many variables that alter the opinions of people regarding the act. Throughout this paper, we outline major issues that create differences in opinion regarding the act.

The Sarbanes-Oxley Act was created with the intention of revisions, additions, and possibly replacement in future years. Nearly ten years later, little has been done to improve upon SOX.

In the following sections, we attempt to (1) determine if the effects of the Sarbanes-Oxley Act significantly hinder the success of small companies, and (2) determine if further revisions of SOX are necessary to remedy this problem.

The findings of this paper will be extremely important because many view the regulations of SOX as burdensome constraints. The affects the Act has on businesses may inhibit economies as a whole. Regulation on business is an extremely controversial subject in capitalistic markets such as The United States of America.
Previous Findings:

The Negative Effects of the Sarbanes-Oxley Act

As illustrated in previous research and data collection, the Sarbanes-Oxley Act has definitely had an impact on companies in America. In 2002 SOX was passed by U.S. Congress to prevent any additional corporate scandals from occurring. Corporate America may agree that there are some benefits of SOX, but it finds SOX compliance requirements to be burdensome, vague, and frustrating (Montaria, 2007). The content of the following sections will include information and analysis of previous research in regards to the negative effects of the Sarbanes-Oxley Act.

Previous research regarding this topic has been conducted in different ways. Much of the data retrieved has been through the form of quantitative surveys. Other popular forms of research include the analysis of financial figures, the observation of the behavioral trends, and the questioning of executive management to determine hidden problems the act imposes.

One of the major complaints seems to be the lack of detailed recordkeeping requirements. Because the penalties for noncompliance are so punitive, companies spent enormous amounts of money and time and other resources developing SOX compliance manuals, processes for documenting financial activities and other data control activities. And still the corporations are not sure if they are sufficiently meeting the requirements. Independent audits of financial statements provide a deterrent to opportunistic
management behavior but this was ruined when auditors did not remain fully independent (Chambers and Crowley 2003).

The last provision of this Act which has an enormous impact on large companies is referred to as the “SOX 404 compliance”. This section requires publicly traded companies to set up a set of comprehensive internal controls of their finances and also have their policies reviewed by outside firms on a regular basis. This section alone can cause companies earning revenues of more than 5 billion to spend an average of 4.3 million to comply with “SOX 404” per year (What Is The Sarbanes-Oxley Act?).

U.S. companies spent an average 3.8 million each in fiscal 2005 to comply with SOX. Many researchers believe the cost discourages listings on US exchanges. Smaller companies are getting help from Treadway Commission and NASDAQs CEO to have guidelines changed so that they can implement section 404 of SOX. The Securities Exchange Commission is expected to make these changes. However, additional costs of SOX compliance may still be too high and smaller, publicly-listed companies could possibly get to choose to de-list from SEC-regulated exchanges to avoid the costs (Coustan, Leinicke, Rexroad, and Ostrosky 2004).

It is evident there is a need for additional research on the effectiveness of SOX as average total compliance costs dropped 23%, to about 2.9 million, in 2006 (Financial Executives International 2007). However, 70% of the 484 CFOs surveyed in 2007 believe SOX compliance costs outweigh its benefits (Grant 2007). Some suggest SOX compliance could reduce growth and/or lead to employee layoffs (CFO Executive Board 2005).

Business journals present evidence that the Sarbanes-Oxley Act affects more than
just U.S. based companies. Global firms that operate within the United States are required to comply with the rules set forth by the act as well. Keeping this in mind, it is possible that corporations could be driven away from the U.S. markets because of increased restrictions within the company. This deterrent will disrupt global trade and is slowing the progressive movement towards a free global market. Decreased trade among nations disrupts the competitive advantage of nations and can prevent significant economic growth. Some firms may choose to leave and be listed on exchanges not regulated by the SEC, such as European or Asian exchanges, or on so-called “pink sheets” that are not subject to SEC regulation; or they may choose to go private (Michelson, Stryker, & Thorne, 20010)

Shortly after the implementation of the Sarbanes-Oxley Act in 2002, it became clear there would be a severe impact on small and large companies alike. While the benefits of the act are quite clear and easily seen, the costs of the act are harder to determine. Therefore, it is difficult to determine whether the benefits are worth the cost.

**Direct Cost Increases SOX Imposes**

The most easily observed cost of the SOX is the increase in monetary expenditures companies need to audit their firm. A study recently performed by James A. Millar, a professor in the College of Business at the University of Arkansas, and B. Wade Bowen, shows a significant increase in the cost of audits from pre-regulation enactment to post-enactment. Their study included a sample size of over 150 small and large businesses all taken from either the S&P Smallcap 600 index or the S&P 500 index. During this study they determined that the average (mean) increase in the cost of audits
for both small large companies are as follows: small companies audit costs increased from 0.180% to 0.291% of their total revenues, and large companies audit costs increased from 0.0503% to 0.0855% of total revenues (Miller & Bowen, 2011). These numbers may appear insignificant and small, but it is important to remember these are percentages compared to total revenues. When compared with net income, the numbers are in fact much larger, and can cause a significant impact on the success of a company.

The reasons for increased auditing fees stem from a variety of reasons. Initially, companies who utilized both internal and external auditors needed the way they conduct their audits. This reason for cost increases was only temporary, but there are residual increases that will continue to be present for years to come. Additional compliance measurements will continue to be applied to companies internally. This adds a cost directly related to SOX that was not previously present for companies.

Psychological Effects of SOX

The Sarbanes-Oxley Act increased the fines and criminal penalties for willful and wanton misconduct when dealing with audits. This increase has caused auditors to perform extremely detailed and in-depth audits due to the fear of increased penalties. The methods for avoiding audit failures are described by the following, “Expanding the scale, scope and depth of the financial audit can potentially enhance audit quality and thereby reduce the probability of audit failure” (Hoi, Robin, & Tessoni, 2007). In addition to this trend, the Sarbanes-Oxley Act requires more detailed audits than were originally being performed. The audits performed after the enactment of SOX are simply more detailed. The cost of performing more in-depth audits has significantly increased,
and those costs are then transferred onto the company being audited. Furthermore, the cost of the Act for auditors does not end at the monetary issues previously stated. The company being audited is essentially given little choice about how much need to pay audits because of the difference in the perceived goals between the auditor and the company. The effect can often in a serious goal incongruence between the between the company being audited and the auditing team.

Section 802 in the Sarbanes-Oxley Act set forth serious criminal penalties for people who attempt to impede legal investigations regarding the finances of publicly traded companies. These penalties can best be summarized through the following statement: “This section imposes penalties of fines and/or up to 20 years imprisonment for altering, destroying, mutilating, concealing, falsifying records, documents or tangible objects with the intent to obstruct, impede or influence a legal investigation. This section also imposes penalties of fines and/or imprisonment up to 10 years on any accountant who knowingly and willfully violates the requirements of maintenance of all audit or review papers for a period of 5 years” (Addison-Hewitt Associates, 2006). It is often argued that the distinction between willful misconduct and accidental misconduct is difficult to discern. Regardless of the severity of this thought process, the possibility of wrongful conviction of guilt is certainly present in most management minds, even if only sub-consciously. The negative cost of this occurrence is most visible for companies that are actively hiring employees who this section pertains to. With increased risk, it is not unreasonable to hypothesize affected employees will seek increased compensation to counteract the additional risks. While the additional compensation for these employees
adds costs to publicly traded companies that cannot be easily linked to the Sarbanes-Oxley Act directly, they are certainly still present.

**Shortcomings and Inefficiencies of SOX**

The Sarbanes-Oxley Act only addresses intentional audit failure, but can actually be credited with causing increased accidental audit failures. The one-dimensional improvements created by the act are best examined in the academic work by the name of “Sarbanes-Oxley and Audit Failure: A critical examination,” by James Tackett, Fran Wolf, and Gregory Claypool of Youngstown State University. In their work, Tackett, Wolf, and Claypool astutely highlight the increased chance of accidental audit failure after the Sarbanes-Oxley Acts implementation. They accredit much of this increase due to the heightened workload during the first quarter of each year. The reason behind this is that approximately 70% of companies have a calendar year end resulting in about 70% of their auditing procedures being performed in the first quarter of the following year (Tackett, Wolf, & Claypool, 2004). This means that there is a large spike in the amount of workload needed during a small section of time during the year. It would be illogical and inefficient to hire additional staff for an entire year, when they are only needed for about three months of it. Being so, Tackett, Wolf, and Claypool explain that the additional work load is given to the auditing professionals who typically work 55-70 hour work weeks during the first quarter of the year. Longer weeks increase the occurrence of auditor fatigue and accidental error. In this sense, the regulations mandated by the SEC and the Sarbanes-Oxley Act actually increase the prevalence of unintended audit errors. Simple revisions of the act could be created to reduce the occurrence of these errors.
International Trends after SOX Enactment

There are also significant repercussions involving international companies. An academic paper by Zhu and Small (2007) suggest that SOX has a significant negative effect on non-U.S. companies listing on U.S. exchanges. Companies began delisting American Depository Receipts (ADRs) shortly after SOX passage, and the number of new ADRs offered also decreased. This happened significantly faster than the rate of U.S. firms delisting between 2002 and 2005. This increased rate of delisting suggests that SOX had a negative effect on the number of foreign companies remaining listed in the U.S. This suggests that companies will choose not to be listed on SEC-regulated exchanges if costs exceed benefits of being listed.

Closing Statement

The Sarbanes-Oxley Act was created with the intention of implementing extensive revisions down the road. Little has been done to correct the apparent faults, which have been listed previously. We propose that simple revisions to the Sarbanes-Oxley Act could make it less costly for publicly traded companies, and also increase its effectiveness in reducing auditing errors.

Research Problem and Questions

Our contribution will help determine if the Sarbanes-Oxley Act hinders the success of small firms and if it requires further revision. If the results of our research
show the Sarbanes-Oxley Act has significant adverse effects on the success of small firms, we will increase the amount of data supporting this claim, further verifying previous research. If the results of our study differ from previous studies, we will be able to indicate additional research is needed to determine the effects of SOX on small businesses. Because of this, the outcome of our research will benefit the arguments about SOX that is un-reliant on outcome. The people who should be interested with our results differ by result. If we determine a significant detrimental effect exists because of the SOX, the owners of small firms will have further proof to convince public officials revision of SOX is necessary. If the results show SOX to be unobtrusive, future researchers will be provided with additional cause to examine the efficiency of the Act.

**Contribution of Our Work**

The main contribution of this thesis is to demonstrate the effects of the Sarbanes-Oxley Act when applied to small firms. Previous research suggests a trend of decreased success for small firms that are affected by SOX. Because of this, many researchers have requested additional studies be performed to further solidify their results. In the conclusion of their study about the cost differences of SOX for small and large firms, J.A. Miller and B. W. Bowen write, “First, our study has been limited to the time immediately surrounding enactment of SOX. It would be interesting to examine cost differences for a longer period following enactment to see if they are maintained or whether these differences diminish/increase.” This shows that further study revolving around the cost difference between large and small firms is beneficial because it offers an extended scope about the subject.
As of now, there is still a considerable amount of debate about how much the Sarbanes-Oxley Act affects businesses. The questioning behind its affect on small firms compared to large firms is at even greater levels. By conducting our study, we hope to define the cost differences between the two different sizes of companies, as well as analyze if the cost SOX puts on smaller firms is too burdensome. We will be adding additional information about these subjects, in order to more clearly define what the costs of compliance are. We also hope to add insight about what executive management within companies feels about the additional regulations SOX sets forth.

**Significance of Possible Findings**

The findings of our study will be significant to determining how the Sarbanes-Oxley Act affects business, no matter the outcome. Each possible outcome will still add valuable insight that will contribute to different sides of the argument. If the findings of the study determine that small businesses are negatively impacted at an unacceptable level, while large businesses are not, then we will be able to add support to the claim revision of SOX is needed because its impact is too vast on those companies. If we determine the negative costs are significant for both sizes of companies, our reasons for claiming the need of further revision will be even greater. If we find the impact on the two types of companies is insignificant or acceptable, we will be able to conclude that previous research about this subject may not be accurate. By doing so, we will be contributing to the topic by stressing the importance of further research in this field. If large companies are affected more than small companies, we will be able to counter
previous research saying the opposite. In this scenario as well, we will be able to outline
the need for additional studies in this field.

Audience of Possible Findings

The audience of our thesis will vary depending on the outcome of our findings. The outcome will be significant to U.S. government officials in every case, however. If small businesses companies are too greatly impacted, such firms will have additional support to express the necessity for revision of SOX. If our findings contradict previous research, scholars will be interested in our work as it will discuss the need for further research in this field.

The Questions We Attempt to Answer Are:
1. Does the Sarbanes-Oxley Act negatively impact small companies more than large companies?
2. Do the negative impact SOX has on companies warrant future revisions of the Act?

Methodology

This chapter will summarize how we intend to prepare, test and evaluate the Sarbanes-Oxley Act and its impact on business in the United States.

In order to obtain new information regarding SOX, we created a series of interview questions. As in qualitative research, our theory on the effects of SOX will be the outcome of our investigation. We followed the main steps in qualitative research
The interview we conducted was comprised of six main questions which are listed later in this section. We believed these questions would help us determine the effects of the act. The questions were formulated by ourselves, and were created in a manner that would ensure the gain of valuable information. We would interview two different firms; one small business and another large company. The reason for doing so would be so we could compare and contrast the opinions of management at opposite ends of the SOX regulatory spectrum. It does appear that there has been plenty of academic research done on the effects of the SOX act. This research includes that of which supports the act and all of its effects but there is also plenty that has been done to prove there are significant flaws and negative effects. Interviewing is an excellent technique for gathering information and seems especially helpful in this line of research because the opinions from the people living and dealing with this Act everyday are what really matter. A structured interview is necessary in this case which generally in instance in which all interviewees are given identical context of questioning. This type of interview is the typical form of interview in social survey research (Bryman & Bell, 2007). However, some kind of mix may be used that involves qualitative and focused interviews in order to reach a wider range of information.

Our research began by first defining the Sarbanes-Oxley Act by reading past articles and academic journals regarding the contents of the Act. After extensive research on why the Act was put into effect and the controversial aspects of the Act, we chose to compile our own data from existing companies in the United States to determine the impact that the Act has had on them. We gathered this information through deductive research which works from the general to the specific (it is knowledge-driven).
The first step of this study was the formation of interview questions that would enable us to compare any differences in operating costs, company expansion, employee involvement, etc. that has been influenced by the Act. These interview questions were formulated to inspire the respondents to expound on all aspects of the Act. A formal interview form was then emailed to seven companies in the United States.

Qualitative data sources include observation and participant observation (fieldwork), interviews and open-ended questionnaires, and documents/texts. These interviews will be carried out in a qualitative manner for multiple reasons. We had already studied data collected in a quantitative manner by others in academic journals. We felt that the previously conducted surveys were done by people with more experience and more complex tools than us, thus their results were probably close to the best we could find. While reading the results of these earlier studies we noted that these authors described their results as being less useful than they had hoped. It occurred to us that we may be able to determine new or additional information if we properly executed interviews using effective open-ended questions. We also looked at this part of our research in a practical manner which led us to the choice of interviewing multiple insurance companies of similar size. In relation to the reliability and validity in our qualitative research, we applied two primary criteria for assessing our study: trustworthiness and authenticity (Bryman & Bell, 2007). We each had contacts associated to different insurance companies who we could send an interview by email. The interview process via email was appealing to us because it would give our respondents time to read over and think about the questions without a time restraint that might be involved with a long-distance telephone call.
Our Interview Questions Are As Follows:

1. What additional financial costs does the Sarbanes-Oxley Act put on your company? Please explain where and why these costs are incurred.

2. What amount of time is necessary for the management of accounting records and other data required for compliance as compared to how these tasks were done prior to the Act?

3. What are the benefits of the Act for your company?

4. Has the Act affected your decisions in hiring employees or working with other companies due to the grave implications of the SOX Act?

5. Section 404 of the Sarbanes-Oxley Act mandates audits of internal accounting controls. Do you believe the cost of this regulation outweighs the benefits? Why or why not?

6. If you believe the harmful effects of the SOX Act on your company are significant, what sections do you believe need to be changed and do you have any ideas of how those changes could be made?

Study Results

It became clear that obtaining quality interviews would be much more difficult than we had planned. Unfortunately, corporate officers and managers were barred by corporate communication policies from making any comment, disclosures, data or opinions regarding SOX and its impact on their companies. This problem significantly hindered the amount of data we were able to receive while conducting our study. While trying to obtain interviews from company representatives, we were turned down on over 7 occasions. It is possible that added restrictions from SOX have driven companies away
from discussing certain subjects with the public. We corresponded with Executive Vice-Presidents, Managing Directors, Public Relations Directors and legal departments. One large company indicated it likes to work with students writing thesis papers, but company collaboration must be pre-approved and time frames had to be compatible with staff schedules and workloads. On multiple occasions, our interview requests and questions went to Legal Departments after several email exchanges, and eventually were not approved for response. The seven-hour time zone differential made it extremely difficult for us to make telephone contact.

Our goal was then focused on obtaining at least two interviews, one from a larger publicly traded company and one from a smaller private company. After receiving our test results we would decide exactly what we wanted to prove. If we received negative feedback regarding SOX from both large and small companies, we would suggest the need for possible revisions to the Act. If we find negative results from only one type of company, we will be able to make a significant contribution in one of two ways. If the smaller company believes SOX to be detrimental to its success, we will have relatively strong support that smaller companies are affected more severely than large companies. We believe this to be the most likely outcome, because previous research supports this trend. If the larger company believes SOX has a negative impact on business and the smaller firm does not, we will be able to argue the findings of previous researchers. We would also create a larger interest about SOX because our findings would contrast the beliefs of others. We would recommend future studies be performed to further support or disprove our findings. It is important to note that our findings would still remain credible in this instance because our empirical findings will come directly from people who deal
with SOX. Last, if we retrieved positive feedback about SOX from both types of companies, we will be able to create a claim that counters the studies of others on this subject. This would be important because it could help ensure further research be conducted about the effects of SOX and could possibly prevent unnecessary revisions to the Act.

The purpose of researching the different types of companies this way is meant to make it easier to compare the effects of the Sarbanes-Oxley Act on both forms of companies. We read in previous research that SOX could affect different types of companies in many ways. However, we wanted to attempt to find something different on our own and possibly make new contributions using it along with previous research from others in order to come up with ideas for revision. These interviews were not only meant to seek out negative effects of the Sarbanes-Oxley act on companies, but also give the interviewees a chance to express positive effects. We were hoping to simply hear, in their opinions, where and how these effects were shown.

Answers to Our Questions

The following is the interview response from a risk manager who is responsible for the SOX compliance of a Fortune 1000 company:

1. What additional financial costs does the Sarbanes-Oxley Act put on your company? Please explain where and why these costs are incurred.

The additional cost to companies comes in the form of testing of the internal control structure to insure that it is operating effectively. This is required by the Act in order for the CEO and CFO to sign their certifications.
2. What amount of time is necessary for the management of accounting records and other data required for compliance as compared to how these tasks were done prior to the Act?

The additional time increase should be minimal (insuring that policies and procedures are kept current and are being followed) if the company had a fairly robust process in place (as most companies should have) prior to the enactment of the Act.

3. What are the benefits of the Act for your company?

The benefit of the Act to companies should be providing their shareholders with a level of comfort that the statements are fairly presented. The Act also re-implements a process that was in place in corporate America through the early 1990’s and then was lost.

4. Has the Act affected your decisions in hiring employees or working with other companies due to the grave implications of the SOX Act?

For most companies, the Act has created an increased interest in hiring individuals with CPA’s. This is especially true in key positions such as CFO and Controller.

5. Section 404 of the Sarbanes-Oxley Act mandates audits of internal accounting controls. Do you believe the cost of this regulation outweighs the benefits? Why or why not?

Companies with internal audit departments have always performed financial audits both independently and with the external auditors. The role of the Act was to put more structure around financial audits, coordinate the work with the external auditors and report the results to management.
6. If you believe the harmful effects of the SOX Act on your company are significant, what sections do you believe need to be changed and do you have any ideas of how those changes could be made?

The Act has not been harmful to any company. It has created some additional costs for companies but provides a benefit to the company, if structured correctly, in ensuring that financial statements are reasonably stated. The PCAOB move from AS2 to AS5 has helped companies decrease their ongoing costs of the Act to a manageable figure.

The following is an interview response from Daniel T. Saunders, Former Vice President of ISMIE Mutual Insurance Company, retired in 2009:

1. **What additional financial costs does the Sarbanes-Oxley act put on your company? Please explain where and why these costs are incurred.**

Even though the Sarbanes - Oxley Act (SOX) applies only to publicly traded companies and did not directly apply to ISMIE Mutual Insurance Company (ISMIE), there were still significant direct costs that ISMIE incurred. SOX was obviously a high profile piece of legislation which generated significant interest on the part of the ISMIE’s Board of Directors. This resulted in significant time and expense researching the provisions of the act and educating the Board members as to how SOX might affect ISMIE. Due to concern that SOX could be applied to mutual companies in the future, this is an ongoing expense. In addition, due to this concern, ISMIE's management has treated the provisions
of SOX as applying to the company. I believe that the SEC estimated direct cost of compliance would be $91,000 per company; however, the actual cost of compliance is much higher. In addition to the direct cost of compliance, management must now spend a significant amount of time solely to ensure technical compliance with the provisions of SOX. Even though SOX was specifically limited to publicly traded companies, the recent ruling by a Federal Judge extending the provisions of SOX to mutual companies shows that this concern and need for ongoing attention to compliance may be well placed.

2. **What amount of time is necessary for the management of accounting records and other data required for compliance is as compared to how these tasks were done prior to the Act?**

As an insurance company, ISMIE is required to maintain accounting records and other data as required by the various states in which ISMIE operates. SOX has added another layer of review to ensure specific compliance with SOX. In addition to the direct management of accounting records, there is time associated with ensuring that your auditing company is SOX compliant as well as an increase in the time needed to update Board members as to compliance.

3. **What are the benefits of the Act for your company?**

I am hard pressed to find a benefit to our company from SOX. Proper financial controls were already in place. SOX simply adds another expense that must be charged to our physician policyholders who then must pass the cost on to their patients.
4. **Has the Act affected your decisions in hiring employees or working with other companies due to the grave implications of the SOX Act?**

SOX has not affected our decisions in hiring employees or working with other companies. It has simply added an additional layer of cost to an already highly regulated business. There have been no personnel changes nor changes in relations to other companies as a result of SOX.

5. **Section 404 of the Sarbanes-Oxley Act mandates audits of internal accounting controls. Do you believe the cost of this regulation outweighs the benefits. Why or why not?**

I believe the benefits of SOX do not outweigh the costs. We were strictly regulated by the Department of Insurance. I do not believe that there was any increase in the level of confidence in our finances gained by the physician policyholders nor the public. It has simply resulted in increased cost to the physician policyholders which is then passed on to their patients.

6. **If you believe the harmful effects of the SOX Act on your company are significant, what sections do you believe need to be changed and do you have any ideas of how those changes could be made?**
I do not believe that SOX applies to mutual companies; however, one Federal Judge has ruled that SOX does apply to mutual companies. The SOX Act should be amended to clarify that it does not apply to mutual companies.

Research Analysis

Summary
In this chapter we will focus on our own personal study results that were gathered from qualitative interviews which were sent to a large, Fortune 1000 company and a smaller private company. We will attempt to analyze and interpret these results in order to explain what they mean to us, how we can use them, and what is significant about them.

First interview analysis
This interviewee’s opinion as a risk manager for a company did not give much support to any of the research we had completed using others’ academic work. This may have simply been one individual’s opinion being mixed in with truth. Unfortunately, it will not provide much support in confirming the need for additional revision of the Sarbanes-Oxley Act. After reading this interview, it is clear that this individual does not feel that SOX causes any significant negative effects to the company. He does not express that there are any large increases in time or money needed from the company in order to keep up with the requirements of SOX. However, the interviewee did explain that additional tests of internal controls are now performed, in addition to stricter hiring practices. Much of what is stated in this response was seen during our initial research on the Sarbanes-Oxley Act itself and was not very useful to support our purpose. It is
important to note that this interview was completed by a Risk Manager. With that in mind, it is possible the answers to our questions were answered with the intention of diverting attention away from the company. We were hoping to receive an interview from an executive manager working within a large public company who would express more of the possible issues SOX has caused the company. However, it was very difficult for us to get a response to these questions from anyone in that particular position. Thus, we must work as effectively as possible using both this interview and another from someone associated with a smaller private company. A concerning possibility we have construed is that the Risk Manager interviewed may have understated the severity of the negative effects SOX has had on his company. The most apparent factor that influenced this assertion resides in the Risk Manager’s statement, “The Act has not been harmful to any company. It has created some additional costs for companies but provides a benefit to the company, if structured correctly, in ensuring that financial statements are reasonably stated.” In this statement, the interviewee clearly acknowledges the existence of increased monetary burdens brought about by SOX, but firmly rejects the possibility that it could cause more harm than good for “any company.” In our opinion, this statement is so strong we have viewed it as carelessly presumptuous. When combined with the fact our request for an interview was deferred to a risk manager, we concluded that it is possible the severity of the burdens placed on companies by SOX may have been understated. Since the outcome of our research varied slightly from what was expected, we believe further interviews in this subject would be beneficial to determine if the information we obtained is parallel to similar companies. In this particular case, the
interviewee acknowledges the various costs of SOX, but he believes the benefits are worth the additional burdens.

2nd Interview Analysis

After reviewing this interview it was clear to us that there are some issues for this smaller mutual insurance company. The Sarbanes Oxley Act did end up adding additional costs and also caused extra time consumption. Mr. Saunders feels that the company has always been dealing with direct costs from SOX and explains that they believe the Act should not apply to their company.

Mr. Saunders’ response to Question Two discusses the significant increase in time spent making sure proper compliance is being carried out. Saunders explains the reasons SOX cost his firm additional time as, “In addition to the direct management of accounting records, there is time associated with ensuring that your auditing company is SOX compliant as well as an increase in the time needed to update Board members as to compliance.” These additional steps that needed to be performed added, in his mind, unnecessary precautions. Throughout the interview, he expresses his opinion that the regulations in place prior to the Sarbanes-Oxley act were sufficient in ensuring financial integrity. His answer to Question Three: “I am hard pressed to find a benefit to our company from SOX. Proper financial controls were already in place. SOX simply adds another expense that must be charged to our physician policyholders who then must pass the cost on to their patients,” summarizes his thoughts that the Act is adding unnecessary costs that are passed to their physician policyholders and then to the patients. He also believes that regulations by the state’s Department of Insurance were already effective enough before the implementation of SOX and that there are no new greater feelings of
security or trust in the eye of the public because of it. We were hoping to receive information that SOX had caused some issues with hiring employees or working with other companies because it was something we had seen in other academic research. Surprisingly, this was not the case as indicated in Saunders’s statement, “SOX has not affected our decisions in hiring employees or working with other companies.” Overall, this interview will be helpful to us while looking for possible changes or revisions that could be made within the Sarbanes Oxley Act itself.

When analyzing this interview as a whole, it is clear Mr. Saunders believes the Sarbanes-Oxley Act has caused more harm to his company than assistance. He makes his opinion quite explicit through the statement, “I believe the benefits of SOX do not outweigh the costs.” Furthermore, he outlines a few indirect repercussions the act has had in his response, “I do not believe that there was any increase in the level of confidence in our finances gained by the physician policyholders nor the public. It has simply resulted in increased cost to the physician policyholders which is then passed on to their patients.” This portion of the interview, in particular, is extremely fascinating because it coincides with the information and theories established in previous works.

While it is not expressly stated, it can be safely assumed that many clients of ISMIE Mutual Insurance Company were displeased with the increase in costs after the enactment of SOX. It is quite likely that some clients even chose to switch companies in search of lower costs. We believe the arrival at this conclusion to be very reasonable. In our opinion, it is very logical to assume a portion of clients may become upset with a sudden price increase in service. From that point, it is not unreasonable to believe a significant amount of clients would switch providers if unsatisfied with the server
provided. By formulating this analysis, it becomes clear the information gained through our research further supports the findings of Zhu and Small (2007), who pointed the trend of international companies delisting from United States exchanges after the implementation of SOX due to increasing costs and declining business success. Even more interestingly, we can now see an example of the causes and effects that directly relate to the trend discovered by Zhu and Small. By conducting interviews as opposed to quantitative research, we were able to determine a possible reason as to why international companies are delisting from U.S. exchanges. This offers tremendous insight and support to Zhu and Small’s findings about the international delisting, but only speculated about the reasons behind the trends.

What the Interviews Mean

Before obtaining the results of our interviews, we hypothesized the cost of a company’s compliance with the Sarbanes-Oxley Act would be proportionately greater in small firms than large ones, and that further changes to SOX may be necessary to relieve the financial burden on these companies. After analyzing the interviews we conducted, we have determined our hypothesis to be accurate.

Interestingly, the responses we received to our interview questions were extremely different. Daniel T. Saunders of ISMIE, the smaller company, believed the negative affects SOX created for his company to be severe. He could not determine a benefit of the Act for his company in any way. In contrast with this response, the risk
manager of the Fortune 1000 company explained his opinion that SOX could not have a negative effect on any firm and that it only created benefits for companies. Delving deeper into the reasons behind such drastic differences in responses, we arrived at the conclusion that it was possible the risk manager could not explicitly criticize SOX due to corporate policy. This conclusion was influenced by our knowledge of similar situations described previously in the study results section. The risk manager acknowledged the presence of additional costs required to ensure compliance of SOX, and increased costs of hiring employees with a CPA. Hiring additional employees with this professional certification is expensive, and surely these employees obtain higher salaries than previous personnel. While acknowledging the increases in cost, the risk manager refutes the possibility that they could negatively impact a company.

When first confronted with such contradicting opinions, we believed the results of our study to be unreliable. Through further analysis and examination we eventually arrived at the conclusion that our study results firmly support our hypothesis. As previous research has shown, larger companies have adapted to SOX more efficiently than smaller companies. We believe larger companies possess the resources necessary to adapt to the Sarbanes-Oxley Act in a way that makes their additional expenditures insignificant. Large companies are also more widely known than smaller ones. In a way, compliance with SOX acts as a public relations for these large companies. Since smaller firms reach a comparatively smaller number of people, the amount of positive public relations received from SOX compliance is much less. We have concluded that the ratios of benefits to cost of SOX are not as favorable for smaller companies for this reason. Supporting evidence for this conclusion is further described in the following statement
from Daniel T. Saunders, “I do not believe that there was any increase in the level of confidence in our finances gained by the physician policyholders nor the public. It has simply resulted in increased cost to the physician policyholders which is then passed on to their patients.” While additional research about this subject is needed to support this claim, we believe our conclusions to be logically formed and reasonable.

Daniel T. Saunders provided valuable insight about a major flaw within the Sarbanes-Oxley Act. Within recent years, a federal judge ruled that mutual companies be required to comply with SOX regulations regardless of public listing. We agree with Saunders that SOX was not intended to be implemented for this purpose. Minor modification to the Act could easily resolve a major issue that is creating major problems for mutual insurance firms. Most consider the previous standards and regulations enacted by a state’s Department of Insurance to be effective and efficient at thwarting financial dishonesty. Since the previous method of financial controls for mutual insurers was generally accepted, clarification of the purpose of SOX in regards to those firms should not have negative effects.

Although our findings were not consistent, we still received answers to interview questions that supported previous research and complaints about the Sarbanes-Oxley Act. While the smaller firm, ISMIE Mutual Insurance did not change its hiring policies, the Fortune 1000 company did. The Fortune 1000 firm also acknowledged additional time was necessary to comply with SOX. When this information is combined with the response of Daniel T. Saunders, each question we asked received an answer implying some sort of cost from one or more of the companies. The questions asked were created with the intention of being able to prove or disprove previous study results and analysis.
Amazingly, we received at least one response of support towards the previous claims from the two companies. The results of this research may not be able to certify the claims of previous researchers, but they do align with those claims and add a significant amount of credibility to them. Future studies about the negative effect of SOX should be able to express with relative certainty the need for revisions to the Act to better accommodate small companies.

By conducting interviews instead of quantitative research, we were able to obtain a form of empirical data unique to our study about the effects of the Sarbanes-Oxley Act. In doing so, we have been able to form insight as to why fewer domestic and international companies are incorporating within the United States, as well as why the rate of small firms listing on public exchanges has been decreasing. This contribution is important because it uses empirical data to indicate a reason why SOX has caused companies to delist from markets and deterred potential small firms from listing in the future. Past studies speculated about the reasons why market trends have been unfavorable for smaller firms, but we offer the first link as to why it is happening that is supported by empirical research. By adding our contribution to previous research, we have strengthened the proof that the Sarbanes-Oxley Act is impeding the success of small firms. Our additional proof of the hindrance SOX causes will probably not cause immediate revisions of the act, but we believe our contributions may serve as a catalyst for future studies that could cause prompt changes.

Conclusion
After looking into basic research on the Sarbanes Oxley Act itself and also the research done by others in the past we have found a path we would like to keep focus on. This became much clearer after finishing our interview process, narrowing down our options, and analyzing the data we collected. In our previous research we decided to center our attention on the costs and other negative effects that the SOX Act has on businesses. With our research and analysis complete, we hoped to contribute evidence supporting the fact that revisions could be made to the act in order to protect small companies from being hurt by it.

Many attempts were made in order to obtain information regarding the costs of compliance with the Sarbanes-Oxley Act from some larger companies but were all rejected by the interviewees. We feel that this is a major and unanticipated problem that we encountered when it came down to making a strong contribution.

The findings of our study were diminished due to limitations we encountered while attempting to obtain information. We were allotted a small amount of time to conduct research and analyze our findings (approximately 3 months). Studies spanning longer amounts of time should be able to obtain larger data samples to provide more substantial evidence to this subject. Lengthened amounts of time should allow further researchers to go through the necessary contacts of companies to conduct their interviews. We encountered unanticipated resistance from company representatives throughout our study. Unfortunately, the amount of time we had did not allow us to make additional modifications to our questions. Adjusting the questions asked to companies to make them less intrusive may also help procure larger data samples. We were not able to
compare the differences between large and small public companies with the differences between large and small public companies. Further research may be able to do this.

Still, the information we have found has proven to be significant. After conducting our study, we found further evidence to suggest the Sarbanes-Oxley Act hurts small companies more than large companies. We were also able to provide further support to the need for revision of SOX. By conducting interviews of different companies, we were able to provide empirical research that provides a direct reason why SOX can negatively affect small companies. This contributes a direct link between the trends described in previous research and the Sarbanes-Oxley Act, rather than just speculation. While we believe our contribution to be strong, we believe further studies should be conducted to further support our claims. Unfortunately, the scope of our interviews was small, but future research may be able to further confirm our claims by conducting a wider range of interviews.
Bibliography


