Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?

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Recent articles by Romano of Yale, Clark of Harvard, and Ribstein of Illinois have all surveyed the empirical academic literature and found Sarbanes-Oxley (SOX) wanting, Romano terming four of its key provisions "quack corporate governance." Using a slightly wider lens and considering an avalanche of more recent work, this Article demonstrates that the current dominant view that SOX is wholly unsupported by the academic literature is misguided. Rather, that literature gives substantial reason to view some of SOX's most important provisions with optimism.

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INTRODUCTION

In a recent article in the Yale Law Journal, Professor Roberta Romano savaged the Sarbanes-Oxley Act (SOX) of July 2002, characterizing it as “quack corporate governance,” based on two claims: (1) that Congress can do substantial harm when it legislates in haste and did so when passing SOX, and (2) that four key corporate governance provisions of SOX were unsupported by empirical academic literature. Romano’s critique has substantial company. Professors Clark, Ribstein, Butler, Bainbridge and others have also made these or similar points, which have become the received wisdom in legal academia. We, however, have important points of disagreement with both of these claims and engage them in this Article.

Regarding criticisms of the legislative process leading to SOX’s enactment, we concede Romano’s description of the events, just as we concede Bismarck’s bromide about laws and sausages. We find little comfort, but also nothing surprising or unusual, in her exegesis of the legislative birthing of SOX. On the other hand, we also agree with Churchill that democracy is the worst form of government except for all the others.

We shall suggest that in the absence of the periodic emergency situation,

3. Larry E. Ribstein, Sarbanes-Oxley After Three Years, 3 N.Z. L. Rev. 365, 376 (2005) (arguing that the empirical literature does not support SOX); Larry E. Ribstein, Sarbox: The Road to Nirvana, 2004 Mich. St. L. Rev. 279, 293 (arguing that SOX is an example of “Sudden Acute Regulatory Syndrome”).
8. Churchill, of course, famously stated that “democracy is the worst form of Government except all those other forms that have been tried from time to time.” Winston Churchill, Address Before the House of Commons (Nov. 11, 1947), in 7 Winston S. Churchill: His Complete Speeches 1897–1963, at 7566 (Robert Rhodes James ed., 1974).
media frenzy, investor outcry, and political pressure that lead to eruptions of reform such as the initial federal securities laws passed in the 1930s and SOX more recently, business interests would likely exert excessive influence over the political process in a manner that would prevent capital markets from realizing their full potential.

Regarding the substance of SOX’s corporate governance provisions, we concede that Congress did not examine the empirical academic literature as thoroughly as it might have (or perhaps at all). As academics who often cite and occasionally produce empirical studies, we are naturally sympathetic to the trumpeting of those studies. Still, it is overreaching to contend that statutory enactments that do not accord with the majority view of an array of disparate studies reaching a broad range of conclusions are automatically major gaffes. More significantly, we will demonstrate that a broader and more recent examination of the extant empirical academic literature actually supports several of the provisions that Romano and others critique. It turns out that “even a blind hog finds an acorn every now and again.”

This is definitely not a full-fledged defense of Sarbanes-Oxley. In order to be thorough yet keep the length of this Article manageable, we address only the selected provisions that Romano chose to attack. Whether judging those important provisions alone or SOX as a whole, it is too early to know with certainty whether, on balance, SOX’s passage will prove beneficial. Indeed, given that many of the statute’s costs and benefits will be impossible to measure precisely, we may never know with substantial certainty whether SOX produces more benefits than costs. However, we are confident that SOX deserves a kinder characterization than Professor Romano and some others have accorded it. The empirical literature regarding three of the four provisions assailed by Romano actually provides substantial grounds for optimism.

I. SARBANES-OXLEY AND THE LEGISLATIVE PROCESS

A. THE CRITICISMS

Professor Romano’s critique of SOX makes much of the fact that it was produced under enormous public pressure. SOX, she argues, was a rush job, and surely Congress would have made different policy choices than those made in SOX had it taken the time to do the job right. Perhaps Congress would have acted differently had it not been for public pressure; however, the presence of such pressure is not necessarily a bad thing. Much of the modern administrative state was created in response to popular calls for legislative action. It may be fair to say that Congress is less likely to enact major regulatory legislation (or

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10. We have our own criticisms of many of SOX’s other provisions, but they lay beyond the scope of this paper.
11. Romano, supra note 1, at 1549–68.
any legislation that benefits the broader public at the expense of business interests) in the absence of public pressure, but it is not fair to say that such pressure tends to produce bad legislation. Indeed, if we want our policy process to produce choices that represent popular preferences, then we are more likely to get good legislation (laws that represent median voter opinion) in the presence of public pressure.

The notion that business interests enjoy advantages in the legislative process permeates both popular opinion and the academic literature. Not surprisingly, tracking polls have long shown considerable public suspicion over the disproportionate influence exerted by business firms over the legislative process. Likewise, for more than four decades political scientists analyzing interest group influence have described a legislative process in which business interests use their superior resources to “capture” government and use it for their own ends, often to the detriment of non-business interests. Speaking long ago about the

12. This suspicion may be motivated in part by cynicism or worry about the role of corporate campaign contributions in the legislative process. However, as the remainder of this section illustrates, there are far fewer and far more innocuous reasons for concluding that business sometimes gets its way even when the general public might prefer a different outcome.


From the individual’s standpoint, much that happens seems the result of manipulation, of management, of blind drift; authority is often not explicit; those with power often feel no need to make it explicit and to justify it. That is one reason why ordinary men, when they are in trouble or when they sense that they are up against issues, cannot get clear targets for thought and for action; they cannot determine what it is that imperils the values they vaguely discern as theirs.


There are at least two different varieties of capture theory. Under one version, capture takes place with the complicity of congressional committees, via iron triangles, subgovernments, and the like. See Douglass Cater, Power in Washington 26–50 (1964); John Leiper Freeman, The Political Process: Executive Bureau-Legislative Committee Relations (1965); Stigler, supra, at 3. Another version of capture theory argues that after an initial burst of interest in regulation, the general public eventually loses interest in agency policymaking, leaving only regulated interest groups to participate in the process. Eventually, the agency is persuaded to adopt the policy preferences of the regulated industry, based in part upon the skewed information set with which the agency is presented. See generally Marver H. Bernstein, Regulating Business by Independent Commission (1955); Gabriel Kolko, Railroads and Regulation, 1877–1916, at 3–6 (1965); John A. Ferejohn, The Structure of Agency Decision Processes, in Congress: Structure and Policy 441 (Matthew D. McCubbins & Terry Sullivan eds., 1987); see also David B. Spence, Managing Delegation Ex Ante: Using Law to Steer Administrative Agencies, 28 J. Legal Stud. 417 n.19 (1999) (summarizing this literature); The Budget-Maximizing Bureaucrat: Appraisals and Evidence (André Blais & Stéphane Dion eds., 1991) (analyzing and testing via a collection of essays the self-interested models of bureaucratic behavior, specifically Niskanen’s arguments).
role of interest group pressure in the policy process, political scientist E.E. Schattschneider said, “The flaw in the pluralist heaven is that the heavenly chorus sings with a strong upper class accent. Probably about ninety percent of the people cannot get into the pressure system.”

Perhaps the best known explication of this view that business groups exert disproportionate influence over the policy process comes from Mancur Olson, who cast the problem as one of collective action. Olson argued that smaller groups will have an easier time being heard by government officials because they face fewer transaction costs when organizing and acting. Businesses, in particular, have a clear economic incentive to organize and pursue policies that will provide them with pecuniary benefits. Once organized, these groups influence regulators directly (by their disproportionately greater presence in agency proceedings) or indirectly (by exerting influence over the regulators’ legislative overseers). Olson’s work gave birth to a huge amount of literature that conceptualized interest group activity and the regulatory process as a prisoner’s dilemma game, one in which members of groups representing diffuse interests have much more of a temptation to free ride than members of groups representing tightly organized interests, further exacerbating the underrepresentation of non-business interests.

Yet somehow, some way, regulation happens. Congress manages to impose constraints on markets over the objections of business interests. How? The key is that group membership is only one avenue of influence in the modern political process, one that can be bypassed by “political entrepreneurs”—politicians who seize upon popular issues, assume the transaction costs of organizing, and thereby mobilize otherwise latent mass movements. In this way politicians can help themselves get elected or reelected by helping broader, less wealthy, mass interest groups to overcome Olsonian disadvantages, and this

16. Id. at 33–34.
17. Id. at 141.
18. See id. at 141–46.
20. The most cynical versions of capture theory posit that regulation happens when business wants it to—that is, when regulation offers businesses rent-seeking opportunities. According to this view, public utility regulation was enacted not to protect consumers but to guarantee chartered monopolies a return on their investments. See, e.g., Bernstein, supra note 13; Kolko, supra note 13, at 231–36. For a refutation of this dubious argument, see David B. Spence and Frank Cross, A Public Choice Case for the Administrative State, 89 Geo. L.J. 97, 121–23 (2000).
21. Professor Romano uses the term “policy entrepreneurs” to describe the securities experts who devised and championed the provisions that ultimately comprised SOX, people like Arthur Levitt and Lynn Turner of the Clinton Administration SEC. Romano, supra note 1, at 1563. As she uses the term, a policy entrepreneur is a champion of an idea rather than a political organizer. This is a different concept from the kind of political entrepreneur who bears the organizational costs of an otherwise latent group.
is most likely to happen in the context of higher-salience policy debates.\textsuperscript{22} This phenomenon goes by several different names: Anthony Downs called it the “issue-attention cycle,”\textsuperscript{23} while Chris Schroeder termed it the ‘republican moment’ explanation for major regulatory legislation.\textsuperscript{24}

Whatever one chooses to call it, the logic is simple. If a legislator’s first goal is reelection,\textsuperscript{25} she will tend to act so as to maximize the probability of being reelected. A legislator’s electoral vulnerability is a function of how her various actions on myriad policy issues sit with her constituents. If the constituents are too unhappy with too many of their representative’s choices, come November they will vote for her opponent. Therefore, for any given legislative choice, the legislator must attend to (i) the distribution of her constituents’ preferences over the issue, (ii) the intensity of those preferences, and (iii) the salience of the issue to her constituents. Of course, preference distribution is important: if more constituents prefer alternative X to alternative Y, that fact matters to the legislator. It is not dispositive, however. Preference intensity also matters; a weak constituent preference is less important to the legislator than a strong one, because the latter is more likely to affect the constituent’s vote on election day. Finally, the salience of the issue matters to the legislator because high profile votes are much more likely to generate significant electoral effects than votes on low-profile issues.\textsuperscript{26} In the context of debates over major new regulatory


\textsuperscript{23} Anthony Downs, \textit{Up and Down with Ecology—The “Issue-Attention Cycle,”} 28 PUB. INT. 38, 38 (1972) (noting that only during the times of intense public pressure for action is it possible to overcome the usual legislative inertia and produce major regulatory legislation).

\textsuperscript{24} See Schroeder, supra note 22, at 31. Politicians can tap into latent public interest groups in an effort to win support and, ultimately, to gain or retain office. In this way, politicians absorb many of the costs of collective action on an issue-by-issue basis. Without incurring any collective action costs beyond voting, a latent group can exert policy influence through its elected representative. Two well-known examples from environmental law include then-Representative Jim Florio’s leadership in the passage of the 1980 Superfund law and Representative Henry Waxman’s efforts on behalf of various clean air initiatives. For detailed discussions of political entrepreneurship, see HARDIN, supra note 19, at 35–37 and also MICHAEL TAYLOR, \textit{The Possibility of Cooperation} 223–36 (1987) (discussing rational choice theory).

\textsuperscript{25} This is the working assumption of most Congressional scholars in political science. See DAVID R. MAYHEW, \textit{Congress: The Electoral Connection} (2d ed. 2004), which is often credited as the best argument for this working assumption. This is not to suggest that re-election is legislators’ only goal—only that it is an overriding goal in that other goals (such as making voters aware of the policy issue in question) are secondary.

Political scientist Mark Smith has documented the tendency of legislators to be responsive to public opinion on the salient issues even when business interests are united against popular opinion. \textit{MARK A. SMITH, AMERICAN BUSINESS AND POLITICAL POWER: PUBLIC OPINION, ELECTIONS, AND DEMOCRACY} 114 (2000) (“Democracy does not cease to exist when business unifies. To the contrary, democracy begins to approach its potential during instances of business unity.”).

\textsuperscript{26} We distinguish here between preference intensity and “salience,” and use the latter term to refer to how aware voters are of the policy issue in question. Of course, these two will be related in many
legislation, these three factors enter into the legislator’s electoral calculus in predictable ways.

If Congress is considering new regulation of business, and the legislation is something most of a legislator’s constituents would favor, the legislator may nevertheless maximize her reelection chances by voting against it if: (a) constituents who would favor the law do not know about the bill, or (b) constituents who do favor the law do not feel strongly about it. In either of those cases, the legislator may do better to vote the way her business constituents want her to vote, since their preferences over the issue (the regulation of their industry) are likely to be intense and the issue will be salient to them. On the other hand, when popular preferences are intense or the issue is salient to the general public, siding with business entails far more electoral risk for the legislator. Stated more simply, legislators are more likely to vote for major regulatory legislation when the public favors it, cares about the issue, and is paying attention.27

Of course, these three aspects of popular preferences are not immutable. Politicians can try to influence constituent preferences over a policy issue. They can hold hearings, give speeches, and take other actions designed to move public opinion and draw attention to an issue. These efforts are more likely to be successful when events command the public’s attention. Indeed, politicians are more likely to engage in such efforts in order to “get out in front of” an issue or opinion shift. Many of the legislative pillars of our modern regulatory regime were enacted after these sorts of catalyzing events, which first moved public opinion (to notice and care about the issue) and then legislators (to act). There might never have been a 1980 Superfund law were it not for the discovery of buried hazardous chemicals at Love Canal and the election of Ronald Reagan in 1980.28

This is certainly the case with securities laws. The foundational securities laws—the Securities Act of 1933 and the Securities Exchange Act of 1934—were a response not only to the stock market crash of 1929 and the onset of the Great Depression, but also to a public that rejected Herbert Hoover in favor of Franklin Delano Roosevelt in the 1932 presidential election.29 In America,
"[f]ederal interest in corporate governance tends to be confined to reactions to particular scandals and notorious frauds...." 30 The same is true in the United Kingdom,31 and, indeed, in most of the developed nations.32 Charkham has noted that “[o]ne must sympathize with politicians’ difficulties in striking a sensible balance between competing pressure groups. Only when they can no longer avoid acting do they like to show that they care about the general interest.”33

In the case of Superfund, the 1933 and 1934 securities laws, and many other prominent pieces of legislation over the years, politicians reacted to the catalyzing event by mobilizing popular concern into legislative action.34 When it comes to regulation, Congress often acts under pressure.

As Professor Romano notes, such was the case with SOX.35 The collapse of Enron, the tech bubble, and WorldCom in succession preceded the enactment of SOX in mid-2002.36 In the summer of 2002, regulation of financial reporting and corporate governance were more salient and more important to the general public than at any time in recent history. A special edition of the USA Today “Money” section in June 2002 included an article entitled, How Did Business Get So Darn Dirty?, which cited “greed” as one of the primary answers to the title’s question.37 A Gallup poll taken in July of 2002 found that thirty-eight as well as SOX, “we had major scandals that coincided with the bursting of a stock market bubble that left investors licking their wounds and looking for someone to blame. Congressional hearings were held and there was a feeling that ‘something must be done.’ Congress felt pressure to act, and act it did”) (footnote omitted).


31. CHARKHAM, supra note 30, at 5 (pointing out that it took an unexpected collapse to stimulate appointment of the Cadbury Commission in 1992 that began the move toward modern governance in the United Kingdom).

32. See Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, 75 WASH. U. L.Q. 849, 850 (1997) (observing that “most of the major instances of new securities regulation in the past three hundred years of English and American history have come right after [stock market] crashes”); CHARKHAM, supra note 30, at 149 (noting that “[p]rogress in improving corporate governance in much of the Western world has not come by a considered programme of reform, but rather as a spasmodic reaction to scandal or incompetence”).

33. CHARKHAM, supra note 30, at 5.

34. The phenomenon is not limited to these examples. For examples from the Progressive Era, see infra notes 48–49.

35. See Romano, supra note 1, at 1523; see also Richard D. Cudahy & William D. Henderson, From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons, 26 ENERGY L.J. 35, 102 (2005) (noting that SOX “added more evidence in support of the well-established thesis that major movements in securities regulation only occur in the aftermath of a market bubble”).

36. The Adelphia, Tyco, and Global Crossing scandals—some of which involved extreme cases of extravagance and greed—were also contemporaneous events in this saga.

percent of Americans considered “big business” to be a major threat to America’s future, a jump of fourteen points from two years earlier.\textsuperscript{38} The popular call for action was a natural byproduct of well-publicized mismanagement and fraud. The collapsing stock market added true urgency to the deliberations.\textsuperscript{39}

Professor Romano’s is a highly stylized recounting of these undisputed facts. To Professor Romano, the story of SOX is a three-act play. In Act One, right-thinking Republicans fend off attempts by wrong-thinking Democrats to amend the securities laws in ways that (we are told) are bad, because they are inconsistent with “the empirical literature.” In Act Two, high-profile accounting and fraud scandals combine with the bursting of the stock market bubble. These events have little or nothing to do with the problems to which Democrats’ proposed amendments were aimed, but the public wrongly suspects that the two are connected. In Act Three, the legislative battle is rejoined, but this time misguided public pressure leads right-thinking Republicans to a hasty surrender to wrong-thinking Democrats (against their better judgment), and SOX is born. So while one might easily see in the passage of SOX a competition of ideas over time, with one set of ideas emerging victorious because public events lent more credence to them, Professor Romano sees instead only the triumph of wrongheadedness, which she implicitly defines as the set of proposals Democrats favored.

We do not find Romano’s argument convincing. First, the process of creating SOX was a fairly typical republican moment in our regulatory history. Second, as we describe in the rest of this Article, she has not made a convincing case for the wrongheadedness of most of the provisions she criticizes.

To be fair, Professor Romano anticipates (in a way) the kind of alternative explanation of the legislative process we offer here. But she does not answer or persuasively dismiss it. Thus, for example, she argues that Senate passage of SOX was hobbled by the extremely limited debate and amendment rules, which precluded careful consideration of the bill.\textsuperscript{40} Yet she also acknowledges that those restrictions were the product of a “Republican press for a cloture motion.”\textsuperscript{41} More importantly, she notes that the key provisions of SOX were not
cobbled together in a rush or pulled from a hat; rather, they were longstanding proposals favored by Democratic securities regulation experts. Oddly, she presents the Democratic policy ancestry of these proposals as if it were some kind of self-evident indictment of the proposals; in fact, the story of SOX's passage is nothing more than the story of one set of ideas winning out over a competing set. SEC head Arthur Levitt was an expert who had been warning of conflicts of interest and other structural problems in the accounting industry—the very sorts of problems that led (at least, in the minds of many sensible observers) to the scandals of 2001. It is hardly surprising or remarkable that those events would lead members of Congress to look at Levitt's proposals in a new light. Contrary to Romano's view, one might see those events as a vindication of his ideas, despite earlier Congressional resistance to them.

Similarly, Professor Romano makes much of the short debate in the House, noting that some of the key provisions of SOX were not even mentioned in the debate on the floor, and suggesting that Democrats' failure to raise those provisions (which were not in the House bill) reflects a lack of interest in those provisions. However, once again, she acknowledges that it was the Republican leadership that restricted debate in the House, though she infers far too much from House Democrats' failure to address those issues during the limited floor debate. As she notes herself, floor debate is not where real deliberation takes place in the U.S. Congress. How often have lawyers searched the legislative history in vain for a reference to a legislative provision of interest, even important provisions? Given the restricted debate rules employed for SOX in both houses of Congress, the failure to mention particular provisions on the floor is neither surprising nor indicative of a lack of support for those provisions.

42. She ascribes most of the credit (blame) for pushing SOX to former SEC Chair Arthur Levitt. Id. She sees the revival of Levitt's “agenda for accounting regulation” as “remarkable,” yet acknowledges that his proposals were at least two years old and “ready-made” for exactly the kind of problems that the Enron and other corporate scandals seemed to present. Id. at 1549–50.

43. Romano ably recounts this history. See id. at 1534–35.

44. Id. at 1551. Romano notes:

[A]t no point in the House debate did anyone mention audit committee independence or executive loans, the subjects of the SOX corporate governance mandates most intrusive on state law jurisdiction, nor did those mandates appear in the House Democrats’ bills. In fact, few representatives participated in the debate at all; of those who did, virtually all were members of the Financial Services Committee that had produced the bill. Id. (footnote omitted). Presumably, Professor Romano is suggesting that it was disingenuous of Democrats to support these provisions, which ended up in the bill produced by the conference committee, when the conference bill later came before the House.

45. Romano, supra note 1, at 1554.

46. Professor Romano poses and answers the question of why Republicans would force a rushed legislative process: like others, they believed (wrongly, says Professor Romano) that they were responding to an emergency. Id. at 1557. Legislators tend to impose restrictions on debate in emergencies because it is the best way to ensure that some legislative action is taken, where no action is the worst alternative politically in such situations. Id.
Indeed, Professor Romano ultimately acknowledges that the passage of SOX may be nothing more than the marketplace of ideas working efficiently. It was in part the culmination of a long debate between allies of Democratic and Republican SEC Chairs, Arthur Levitt and Harvey Pitt, respectively, over the need for further regulation of corporate financial auditing. Professor Romano’s description of the passage of the nonaudit services provision seems to fit this model nicely:

[T]he failure of Arthur Levitt’s regulatory effort a few years earlier was attributed to Pitt’s successful advocacy, as counsel to the accounting profession, which orchestrated political support for the industry against the SEC. No doubt Democrats’ displeasure with Pitt—and Republicans’ support for him—was a factor contributing to their differing position on both the organization of the entity regulating accounting and the nonaudit services provision. . . .

The debate over the nonaudit services prohibition was, therefore, in large part a replay of a battle over the regulation of the accounting industry fought two years earlier when Levitt was SEC Chair. But the environment this time was markedly different. There was a media frenzy, heightened by a sharply declining stock market and high-profile accounting frauds and business failures, in the middle of an election year. . . . In this charged atmosphere, Levitt’s earlier reform proposals now seemed prescient (at least to the Democrats for whom Levitt was a source of expertise), and the accounting industry had lost its public credibility with the audit failures.  

Apparently, a majority of Congress reached something like these conclusions, and it is not difficult to see why.

This is how most major regulatory legislation finds its way into the statute books. The regulatory state did not appear from whole cloth. Rather, it involved the reconsideration of ideas that had been rejected previously, after events made their proponents “seem prescient.” We usually consider such prescience to be a virtue, and rightly so. In these republican moments, some ideas win out over others. During the Progressive Era, the ideas of those prescient agitators for regulation of food safety  and antitrust law  won out. During the 1970s,
prescient agitators for environmental protection\textsuperscript{50} laws saw their ideas vindicated with the passage of environmental laws. Thus, there is nothing inherently damning about the previous rejection by Congress of some of the provisions of SOX. It seems that Professor Romano’s critique confuses criticism of the process of enacting SOX with criticism of its substance.

Finally, Romano seems to draw adverse inferences about SOX from the fact that the market fell after the statute’s passage.\textsuperscript{51} The notion that the market’s reaction after SOX tells us anything of value about the statute is deeply flawed on two grounds. First, there are myriad reasons why the market may have fallen after the passage of SOX, and Professor Romano does not make a sufficiently rigorous case for the notion that the latter caused the former. Second, and more fundamentally, even if SOX did precipitate a fall in stock prices, one might ask, “So what?”; this is neither surprising nor alarming. The price bubble of the 1990s was at least in part the product of Wall Street’s practice of relying on exaggerated earnings projections to value stocks. After SOX, Wall Street could expect to see more accurate but far less rosy projections. In that sense, falling stock prices may signal not a public policy problem, but a market problem.

Business rarely embraces intrusive or costly regulation. It is human nature to resist, or react negatively to, the imposition of constraints on one’s daily life. Romano seems at times to reason from assumption that the market should govern policy rather than the other way around, whereas we do not believe that businesses’ dissatisfaction with regulation—expressed before, during or after the process of enacting the regulation—necessarily tells us anything valuable about the wisdom or worth of that regulation.\textsuperscript{52} It may signal a problem, but not necessarily. Professor Romano repeatedly seems to credit implicitly the wisdom of opponents of the law and to discredit the law’s proponents, without making a

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50. These included writers, such as biologist Rachel Carson, author of the influential 1960s book on ecology, \textit{Silent Spring}; interest group leaders like David Brower, who championed the ideas of naturalist Aldo Leopold, who in turn had published his \textit{Sand County Almanac} in 1949; and mathematician Garrett Hardin, whose seminal 1968 article \textit{The Tragedy of the Commons} offered a straightforward, logical justification for regulation. For a summary of how these ideas found their way into American environmental law, see Spence, \textit{ supra} note 22, at 158–62.

51. Romano, \textit{ supra} note 1, at 1548–49.

52. \textit{See} NICOLAS VÉRON ET AL., SMOKE & MIRRORS, INC.: ACCOUNTING FOR CAPITALISM 149 (George Holoch trans., Cornell Univ. Press 2006) (2004) (noting that “[t]he capital markets are not generally known for their fondness for government intervention,” but observing that “[a] functioning public authority, however, is indispensable for the proper operation of the markets”).
persuasive case for doing either. After the corporate scandals of 2000–2001, the ideas of the law’s proponents prevailed in a fair public debate sufficiently so that a Republican Congress, which was not predisposed to regulate, decided to do so by enacting SOX. It is true enough that the law’s opponents and the market remained unhappy about this additional regulation. However, we remain baffled as to why Professor Romano finds significance in that unhappiness.

Ultimately, Romano’s criticisms of the process by which SOX was passed boils down to a simple point: she does not like four of its provisions. Whether she can convincingly criticize them on grounds that they do not accord with empirical academic literature is the subject of Part II of this Article.

B. A SUGGESTED REMEDY

Although Professor Romano’s disapproval of Sarbanes-Oxley seems complete, it is obvious that Congress must be able to pass emergency legislation to respond to an emergency. And very few people in America in July 2002 doubted that the capital markets faced a crisis. Romano suggests instead that the legislative process could be improved if emergency legislation were always made subject to some sort of sunset review by either Congress, the relevant agency, or a blue ribbon committee.\(^53\) Romano’s commitment to empiricism abandons her here, for she offers no evidence that laws enacted in a short time frame tend to have more problems than laws enacted over a longer period.\(^54\) This seems possible, but not necessarily the case, given the increased opportunity for political compromises, lobbyist influence, and other not-necessarily-beneficial factors to influence laws enacted over a longer time frame. The longer the legislative process drags on, the more unrelated earmarks are likely to be hung on the subject bill\(^55\) and, indeed, the more likely that businesses might prevent any remedial legislation at all from being passed.

In the best of all possible worlds, it might be beneficial for Congress to revisit all the laws it has previously enacted—emergency legislation and not—to see how they are performing and whether they should be amended. But diligently revisiting laws already passed or the recommendations of agencies and blue

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\(^53\) _Id._ at 1595, 1600–01. Professor Romano also suggests two fixes that are unrelated to the legislative process. First, she suggests that corporate governance be returned to the states who will govern via regulatory competition. _See id._ at 1597–99. Second, she suggests that corporate regulatory measures be voluntary rather than mandatory, so that corporations may opt out of them. _Id._ at 1595. These are important matters deserving article-length attention regarding their merits, and therefore will not be addressed here, although one of us has already written an article addressing state regulatory competition. _See Robert A. Prentice, Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred, 66 Ohio St. L.J. 1155 (2005)._

\(^54\) Romano, Ribstein and others are strong critics of the 1933 and 1934 securities acts. Although they were enacted in the aftermath of a scandal that activated the public, they were passed four and five years after the great stock market crash and pursuant to substantial legislative hearings. _See generally J.S. Ellenberger & Ellen P. Mahar, Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934 (1973) (compiling eleven volumes of legislative history)._

\(^55\) Gail Russell, _Pssst. K Street Delivers the Goods—For a Price_, CHRISTIAN SCI. MONITOR (Boston), Aug. 8, 2006, at 2 (noting that those who want an earmark should hire a lobbyist “and start early”).
ribbon committees about such laws might keep Congress constantly looking in
the rearview mirror and prevent it from addressing current or future problems.
Again, Romano offers no empirical evidence that sunshine provisions provide
any benefits on balance, and we remain dubious.

Whether or not sunshine provisions should be broadly applied, one can
certainly make the case that SOX’s § 404 provision for internal controls has
been so controversial and so much more expensive than Congress had foreseen,
that its impact should be reviewed. But keep in mind that the SEC has, in fact,
reviewed its impact and, as of this Article’s writing, has decided not to exempt
small firms from its coverage.\footnote{As this Article moved toward publication, the SEC extended further the
deadline for smaller firms to comply. In a December 2006 release, the Commission gave non-accelerated filers with less
than $75 million in market cap until December 15, 2007 to file a section 404 Management Report and a
year beyond that to file a 404 Auditor’s Attestation. \textit{See} Internal Control Over Financial Reporting in
Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies, Securities Act
Release No. 8760, Exchange Act Release No. 54,942, 17 C.F.R. 210, 228, 229, 240, 249 (Dec. 15, 2006).} The result might not please Romano, but the
process is much what she has advocated. If Congress revisits the issue, there is
no doubt that business interests will be listened to in a way they were not in July
2002 and that their lobbyists will have a much bigger impact than in the days
when their clients, such as Big Accounting, were radioactive. However, there is
substantial doubt as to whether this increased business influence will have
beneficial rather than detrimental effects.

Consider that anti-securities regulation policy entrepreneurs such as Romano,
Ribstein and Butler\footnote{\textit{See BUTLER \\& RIBSTEIN, supra note 4.}} appear to be sensing that the backlash against § 404 is
creating a climate where their preferred policy approaches, which appeared
infeasible in the aftermath of the Enron scandal and the dot-com bust, might
well now gain traction in the policy debate. This is especially true as business
lobbies battle to reassert their traditional degree of control over the political
process.\footnote{See Francis, \textit{supra} note 39, at 17 (noting that organizations such as the U.S. Chamber of
Commerce, the Business Roundtable, and the Financial Services Roundtable were leading the backlash
against SOX).} As just one measure of this campaign, a quick Lexis-Nexis search
reveals a score of references (including references in articles by conservative policy entrepreneurs such as John Tamny of the \textit{National Review},\footnote{\textit{See} Francis, \textit{supra} note 39, at 17 (noting that organizations such as the U.S. Chamber of
Commerce, the Business Roundtable, and the Financial Services Roundtable were leading the backlash
Institute\footnote{\textit{Presumed Guilty: The Injustice of Sarbanes-Oxley}, \textit{Bus. Press/Cal.}, Sept. 12, 2005, at 31.}) to Professor Zhang’s preliminary conclusion in her events study that,
as measured by investor reaction to various steps in the law’s passage, SOX’s
enactment cost the American economy $1.4 trillion dollars. A similar search finds almost no references to the fact that Zhang has backed off this conclusion or that three of four similar event studies reached the opposite conclusion—that investors expected SOX to benefit the economy.

If business reasserts its typical dominance over the legislative process, there is substantial reason to doubt that any overhaul of SOX will be more efficacious than the original version.


63. See Floyd Norris, Trusting Bosses Not to Cheat, N.Y. TIMES, June 23, 2006, at C1 (characterizing as disingenuous Zhang’s argument that when the stock market went down it was SOX’s fault and when it went up something else caused that and asking also how Zhang deals “with the fact that the market bottomed in the fall of 2002, about the time efforts to enforce Sarbanes-Oxley got under way, and has had a sustained rise since”).


II. SARBANES-OXLEY AND THE EMPIRICAL LITERATURE

Professor Romano’s substantive criticism is that SOX’s “corporate governance provisions” regarding (1) independent audit committees, (2) auditor provision of nonaudit services (NAS), (3) executive loans, and (4) executive certification of financial statements are unsupported by the empirical academic literature.65 We concede that Congress does not seem to have perused in any great detail the Journal of Finance and perhaps allowed its subscription to the Accounting Review to lapse. Nonetheless, we believe that another look at that body of empirical literature is revealing, especially in light of new developments.66 By looking through a slightly broader lens and accessing newer studies that were unavailable to Professor Romano, we hope to demonstrate that SOX rests on a much more solid empirical foundation than many have believed.

A. INDEPENDENT AUDIT COMMITTEES

1. Background

Because she supports replacing federal securities regulation with a system of state regulatory competition,67 Professor Romano naturally objects strongly to SOX’s federal intrusion into matters of corporate governance. She characterizes SOX’s corporate governance provisions as “recycled ideas advocated for quite some time by corporate governance entrepreneurs.”68 However, many of those “recycled ideas” are consistent with “best practices” that have gained substantial world-wide acceptance over the past quarter century. Rather than reinvent the wheel in an emergency situation, it appears that Congress chose to act consistently with an evolving global consensus regarding the proper way to develop and preserve capital markets.

Empirical academic literature indicates that capital markets are improved by vigorous securities regulation featuring mandatory disclosure requirements,69

65. Romano, supra note 1, at 1529–43.
66. Just as Romano did not limit her review to only academic literature available when Congress acted in July of 2002, we shall not limit ourselves to the literature available when she wrote her article. We believe the empirical literature on at least a couple of the key issues has shifted dramatically in the last couple of years and now provides substantially more support for some of SOX’s provisions. We realize that the tide could shift yet again. We have attempted to be thorough in our literature search, yet we realize we probably have missed some of the avalanche of relevant empirical pieces to appear in the last few years. However, we cite only papers available before SOX’s fourth anniversary in order to keep this Article within reasonable page constraints.

68. Romano, supra note 1, at 1523.
insider trading prohibitions,\textsuperscript{70} strong public enforcement,\textsuperscript{71} and provision of private remedies for defrauded investors.\textsuperscript{72} Cross and Prentice recently surveyed the academic literature, added their own study, and then concluded that “[w]hen these results are combined with the prior cross-country research, the historical research, and other empirical studies . . ., the case for strong securities regulation, particularly mandatory disclosure rules, seems exceedingly strong.”\textsuperscript{73} A leading empiricist, Bernard Black, made the same point more eloquently: “It’s magical in a way. People pay enormous amounts of money for completely intangible rights. Internationally, this magic is pretty rare. It does


\textsuperscript{73.} \textit{Cross & Prentice, supra note 72, at 387. See also Frank B. Cross & Robert A. Prentice, LAW AND CORPORATE FINANCE} 152-89 (2007) (summarizing relevant empirical studies on value of securities regulation and present new findings).
not appear in unregulated markets.”

Over the past decade or so, the success of U.S. markets has persuaded most developed nations to increase mandatory disclosure, impose more serious punishments for securities fraud, enact insider trading bans, create central securities enforcement agencies, and consider strengthening private rights to sue by defrauded investors. In broad outline, Sarbanes-Oxley’s corporate governance provisions may be persuasively viewed not as a reckless enactment of the crackpot ideas of “corporate governance entrepreneurs,” but as a series of reforms that seek to strengthen the conditions that are a predicate for the optimization of modern capital markets that, in turn, are key to the development of national economies.

2. Corporate Governance Generally

Although the empirical evidence indicates that securities laws are generally more important than corporation laws for capital market development, in the United States the line between securities law (traditionally within the realm of federal regulation) and corporate law (traditionally within the purview of the states) has never been etched in stone, and indeed, those who claim that there is

74. Bernard S. Black, Information Asymmetry, the Internet, and Securities Offerings, 2 J. SMALL & EMERGING BUS. L. 91, 92–93 (1998); see also La Porta et al., supra note 72, at 27 (“Financial markets do not prosper when left to market forces alone.”).

75. Prentice, supra note 69, at 832–37 (summarizing this convergence); cf. Charkham, supra note 30, at 6 (noting increased global awareness of the need for good corporate governance).

76. Romano, supra note 1, at 1523.


Romano observes that the fifty states have not enacted the SOX corporate governance provisions and argues that “[t]he message of the empirical finance and accounting literature is that this absence is not fortuitous, because the literature suggests that the mandates will not provide much in the way of benefit to investors.” Romano, supra note 1, at 1528. Although Romano implies state legislatures read the empirical financial and accounting journals and Congress does not, it is helpful to recall that no state has ever mandated financial disclosure or banned insider trading, see Mark J. Roe, Delaware’s Competition, 117 Harv. L. Rev. 583, 611–26 (2004), despite the very persuasive body of empirical evidence indicating the benefits that flow from such mandates. In the area of general corporate governance practices, it is Congress and not the states that has acted consistently with the empirical accounting and finance literature that Romano touts.

78. See, e.g., Ross Levine, Finance and Growth: Theory and Evidence, in 1A HANDBOOK OF ECONOMIC GROWTH 865, 921 (Philippe Aghion & Steven N. Durlauf eds., 2005) (summarizing a very strong body of empirical evidence demonstrating a strong positive link between the development of a country’s capital markets and its overall economic growth).

such a line have typically been disguising deregulatory arguments.\(^8\) Most of SOX’s corporate governance provisions, including those related to audit committees, are aimed at strengthening the reliability of federally-mandated corporate financial reporting that lies at the heart of the federal scheme of securities regulation. SOX, therefore, embodies not a wanton congressional incursion into a clearly delineated state prerogative,\(^8\) but instead a congressional attempt to shore up a federal system of securities regulation that has generally served the nation well but demonstrated obvious weaknesses during the dot-com boom.\(^8\)

SOX’s audit committee provisions are consonant with an accelerating worldwide trend to improve corporate governance practices that is supported by strong empirical evidence.\(^8\) The basic and simple notion is that if a country’s legal regime provides more investor protection, investors will be more willing to invest. That willingness will, in turn, translate into: companies being able to raise more money, more quickly and cheaply; into deeper and more liquid capital markets; and ultimately into greater economic growth.

Studies show that companies located in countries with higher corporate governance standards tend to perform better than companies located in countries with lower standards. In recent cross-national empirical studies, La Porta

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81. Bratton and McCahery have accurately noted that in America “[w]hen a problem with national market implications arises, all parties expect the national system to address it.” William W. Bratton & Joseph A. McCahery, The Equilibrium Content of Corporate Federalism 12 (European Corp. Governance Inst. Law Working Paper Series, Working Paper No. 23, 2004), available at http://ssrn.com/abstract=606481. The Enron era scandals, intertwined with the dot-com bust, created a national calamity in the form of a plummeting stock market, deep investor suspicion, and a hobbling economy. Congress was expected to provide an immediate remedy. Had it stood on the sidelines and left things for the states to clean up, public outrage would have justifiably matched the criticism that the federal government received for FEMA’s late and lame response to Hurricane Katrina.

82. Despite its problems, it is worth remembering that the U.S. system is quite arguably the best in the world. See Bengt Holmstrom & Steven N. Kaplan, The State of U.S. Corporate Governance: What’s Right and What’s Wrong?, J. APPLIED CORP. FIN., Spring 2003, at 8 (noting that “both on an absolute basis and particularly relative to other countries,” the U.S. economy has performed well over the past decade, even during the post-Enron period, “suggest[ing] a system that is well above average”).

83. There are many limitations, naturally. For example, common law nations and civil law nations go about things differently; features that work especially well in countries of one legal tradition do not work as well in countries of another. Cultural differences, path dependency, and entrenched interests fighting to preserve their power to exploit minority shareholders are other factors that will prevent complete cross-national legal convergence from occurring any time soon. Also, in some nations enterprises are funded primarily by banks rather than equity investors, so needs are different. In others, it is more common to have ownership concentrated in fewer hands so that the role of major shareholders is more important than in the United States, for example. In all nations, legal provisions must be applied effectively, so if a country adopts requirements but cannot enforce them because of the primitive state of its judicial system, a lack of trained lawyers or other problems, then a law on the books will mean little.
and colleagues, and Klapper and Love, and Bauer et al have all found evidence of improved corporate performance or value stemming from better governance practices. Although several of these cross-national studies are controversial, it is telling that within-nation studies produce consistent results. Companies within the same nation tend to perform better than their peers or enjoy higher valuation if they demonstrate better corporate governance, according to studies performed in the United States, China, Germany, the United


85. Leora F. Klapper & Inessa Love, *Corporate Governance, Investor Protection and Performance in Emerging Markets*, 10 J. Corp. Fin. 703, 705, 718 (2004) (citing Credit Lyonnais Securities Asia report finding in study of 495 firms across 25 emerging markets that companies ranked high on the governance index had better operating performance and higher stock returns, and finding similar results themselves in terms of better corporate governance being associated with higher return on assets and higher Tobin’s-Q).

86. Rob Bauer et al., *Empirical Evidence on Corporate Governance in Europe: The Effect on Stock Returns, Firm Value and Performance*, 5 J. Asset Mgmt. 91, 95 (2004) (finding in study of EU companies a positive relationship between good corporate governance and common stock returns and market value, but, surprising to the authors, not between good governance and firm performance (although they had only two years’ data)).

87. See also Joel Kurtzman et al., *The Global Costs of Opacity*, MIT Sloan Mgmt. Rev., Fall 2004, at 38, 41 (finding that countries that are more transparent, including in accounting and governance practices, allow their companies to raise capital at a lower cost than companies located in more opaque countries). But see Davide Lombardo & Marco Pagano, *Legal Determinants of the Return on Equity, in Corporate and Institutional Transparency for Economic Growth in Europe* 235, 252 (Lars Oxelheim ed., 2006) (finding that although one shareholder rights protection mechanism—one-share/one-vote provision—seems to reduce the scope of managerial opportunism and thereby reduces monitoring costs borne by outside shareholders, no such benefit was found with another shareholder protection mechanism—La Porta and colleagues’ anti-director rights index).

88. See, e.g., Jordan, supra note 79, at 31–32 & n.99 (noting flaws in La Porta et al. papers).

89. John E. Core et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors’ Expectations*, 61 J. Fin. 655, 684–85 (2006) (finding that “firms with weak shareholder rights have lower operating performance”); Amy Dittmar & Jan Mahrt-Smith, *Corporate Governance and the Value of Cash Holdings*, 83 J. Fin. Econ. 599, 599 (2007) (finding that good governance doubles the value of cash held by firms and that “firms with poor corporate governance dissipate cash quickly in ways that significantly reduce operating performance”); Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. Econ. 107, 107 (2003) (finding in study of 1500 large firms that “firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions”); Deon Strickland et al., *A Requiem for the USA: Is Small Shareholder Monitoring Effective?*, 40 J. Fin. Econ. 319, 336 (1996) (finding that a shareholder activist movement that targeted poorly performing firms with shareholder proposals to improve corporate governance by minimizing poison pills, increasing independence of directors and the like, which resulted in fifty-three negotiated agreements with management, resulted in total shareholder wealth gain of $1.3 billion).


Kingdom, Switzerland, Brazil (and Chile), Russia, Ukraine, Korea, and various Asian and Eastern European nations. Ninety-four percent of institutional investors around the globe say that corporate governance is important when their firms make investment decisions, and such investors are willing to pay a premium of up to twenty-seven percent.

92. Carol Padgett & Amama Shabbir, The UK Code of Corporate Governance: Link Between Compliance and Firm Performance 2 (ICMA Centre Discussion Paper in Finance No. DP2005-17, 2005), available at http://ssrn.com/abstract=934313 (finding that U.K. firms that comply with the United Kingdom’s code of corporate governance provide greater total shareholder return than those that do not, suggesting that “compliance matters not just as a box ticking exercise but as a real change in the governance of large listed companies, for which [investors] are willing to pay a premium”).

93. Stefan Beiner et al., An Integrated Framework of Corporate Governance and Firm Valuation, 12 EUR. FIN. MGMT. 249, 277–78 (2006) (finding that “the widespread hypothesis of a positive relationship between firm-specific corporate governance and Tobin’s Q” is confirmed by a study of Swiss firms, and noting that given the benefits of good corporate governance, it should be viewed by executives as an opportunity rather than an obligation).


96. Valentin Zelenyuk & Vitaliy Zheka, Corporate Governance and Firm’s Efficiency: The Case of a Transitional Country, Ukraine, 25 J. PRODUCTIVITY ANALYSIS 143, 154 (2006) (finding in an empirical study of Ukraine’s transitional economy that “there is a positive relationship between the levels of corporate governance quality across firms and the relative efficiency levels of these firms”).

97. Bernard S. Black et al., Does Corporate Governance Affect Firms’ Market Values? Evidence from Korea, 22 J.L. ECON. & ORG. 366, 366, 410–11 (2006) (finding that better corporate governance resulted in higher valuation of firms listed on the Korean Stock Exchange); Bernard S. Black et al., Predicting Firms’ Corporate Governance Choices: Evidence from Korea, 12 J. CORP. FIN. 660, 690 (2006) [hereinafter Black et al., Predicting Corporate Governance] (noting that insiders of some Korean firms may not be paying sufficient attention to corporate governance because they “do not yet understand that governance can pay off in higher share prices”).


100. INSTITUTIONAL S’HOLDER SERVS., CORPORATE GOVERNANCE: FROM COMPLIANCE OBLIGATION TO BUSINESS IMPERATIVE 5 (2006).
for shares in companies with good corporate governance.\textsuperscript{101} The recent empirical work cumulatively “documents a significant relation between a country’s protection of investors against expropriation by corporate insiders and the domestic development and efficiency of financial markets, costs of external capital, and economic growth and efficiency.”\textsuperscript{102}

3. Boards of Directors Specifically

The board of directors serves a key role in investor protection and good corporate governance by, in part, monitoring management in order to mitigate the agency problems that derive from the divorce of ownership from control that exists in modern public corporations.\textsuperscript{103} Experts around the world have reached a near consensus that corporate governance “best practices” must include a trend toward more independent boards of directors. In the United Kingdom, the Cadbury Committee called for more independent directors on corporate boards,\textsuperscript{104} as did the Peters Committee in the Netherlands,\textsuperscript{105} and at least three separate task force committees in Australia.\textsuperscript{106} In the 1990s, at least eighteen different nations appointed public or private committees that issued reports calling for increased independence in boards of directors.\textsuperscript{107}

\textit{a. Board Independence and Performance.} Despite the near unanimity among both private and public experts who have studied the issue that more independence is generally better, it is true that the academic evidence for the proposition that more independence on a board of directors translates into higher firm value or more profitability is decidedly mixed. In 1983, Fama and Jensen theorized that more outside directors on a board would improve monitoring

\textsuperscript{101} See Paul Coombes & Mark Watson, \textit{Three Surveys on Corporate Governance}, 4 McKinsey Q. (SPECIAL ISSUE) (2000). One good reason that investors are willing to pay a premium may be that in firms with strong shareholder rights, executives are less likely to receive excessive compensation. See Ruediger Fahlenbrach, \textit{Shareholder Rights and CEO Compensation} 29 (Univ. Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 03-05, 2003), available at http://ssrn.com/abstract=390144 (finding that “companies with weak shareholder rights pay their executives more, increase annual compensation more, and require substantially less equity incentives from their executives than firms with strong shareholder rights do”).


\textsuperscript{103} See generally Adolph A. Berle, Jr. & Gardiner C. Means, \textit{The Modern Corporation and Private Property} (1933) (explicating the dichotomy between ownership and control of public corporations).


\textsuperscript{105} Comm. on Corp. Governance, Recommendations on Corporate Governance in the Netherlands (1997) (recommendation 2.6).


effectiveness, and the empirical literature indicates that certain beneficial practices do seem to accompany increased board independence. For example, studies show that outsider-dominated boards are more likely to increase firm value by: removing ineffective managers, replacing ineffective CEOs with more effective CEOs, preventing overinvestment of cash, more efficiently managing write-offs, and making more effective restructuring moves when their firms are struggling. And numerous studies show that more independent boards create value in numerous ways during corporate control transactions.


Independent boards on which outsiders are not too busy serving on other boards do a much better job of turning over ineffective CEOs than do insider-dominated boards. However, if independent directors are too busy serving on other boards, then they do only a slightly better job. See Eliezer M. Fich & Anil Shidivasani, *Are Busy Boards Effective Monitors?*, 61 J. Fin. 689, 722 (2006). Of course, one impact of SOX is that directors are serving on fewer boards than before, see Linck et al., supra note 64, at 16–17 (finding that the average number of directorships held by a director in a large firm decreased after SOX), which should help independent boards maintain a performance advantage.

110. See, e.g., Kenneth A. Borokhovich et al., *Outside Directors and CEO Selection*, 31 J. Fin. & QUANTITATIVE ANALYSIS 337, 353–54 (1996) (finding that more outside directors mean that CEOs are more likely to be replaced from outside the firm and that stock returns indicate this benefits shareholders); Dahya & McConnell, supra note 107, at 59 (finding that after Cadbury Report firms that were compliant with recommendations, including those regarding increased board independence, were more likely to appoint outside CEOs and that this was a good thing, concluding that “[o]ur data appear to indicate that the global movement toward greater outside director representation will lead to different and, perhaps, better board decisions”).

111. See Scott Richardson, *Over-investment of Free Cash Flow*, 11 REV. ACCT. STUD. 159, 186 (2006) (finding weak evidence that companies with positive free cash flows overinvest less when their boards have a higher percentage of independent directors).


113. Tod Perry & Anil Shidivasani, *Do Boards Affect Performance? Evidence from Corporate Restructuring*, 78 J. BUS. 1403, 1430 (2005) (finding that boards with a majority of outside directors are more likely to initiate restructuring changes to turn the company around and to produce subsequent improvements in operating performance by those changes).

114. See, e.g., James A. Brickley et al., *Outside Directors and the Adoption of Poison Pills*, 35 J. Fin. Econ. 371, 388–89 (1994) (finding that the average stock market reaction to announcement of poison pills is positive when the board has a majority of outside directors and negative when it does not, suggesting that outside directors better serve the interests of shareholders); John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. Fin. Econ. 195, 217 (1992) (finding that bidding firms on which independent outside directors hold at least 50% of the seats have significantly higher announcement date abnormal returns than other bidders); James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. Fin. Econ. 195, 216 (1997) (finding that an independent target board enhances shareholder value in many ways during a tender offer attempt); Wallace N. Davidson III et al., *Golden Parachutes, Board and Committee Composition, and Shareholder Wealth*, 33 Fin. Rev. 17, 29–30 (1998) (finding that adoption of golden parachutes is more likely to hurt shareholders when insiders dominate the board of directors and key committees); Rita D. Kosnik, *Greenmail: A Study of Board Performance in Corpor-
Overall, there are many empirical studies that support the notion that more board independence creates firm value or improves company performance, both in the United States\textsuperscript{115} and in other nations.\textsuperscript{116} However, there are also many studies that do not find these positive effects from increased board independence.\textsuperscript{117} Although Fields and Keys recently observed that “there appears to be rate Governance, 32 Admin. Sci. Q. 163, 180 (1987) (finding that boards that protected shareholders by resisting greenmail attempts had more outside directors than companies that paid greenmail); Chun I. Lee et al., Board Composition and Shareholder Wealth: The Case of Management Buyouts, 21 Fin. Mgmt. 58, 71 (1992) (finding that “boards dominated by independent members are associated with larger abnormal returns” in management buyout transactions). But see Vijaya Subrahmanyam et al., The Role of Outside Directors in Bank Acquisitions, Fin. Mgmt., Autumn 1997, at 23, 35 (finding that in the banking industry, the presence of a large proportion of independent directors on the board is not adequate to ensure that bank acquisitions occur in the shareholders’ best interests).

115. See, e.g., Seoungpil Ahn & Mark D. Walker, Corporate Governance and the Spinoff Decision, 13 J. Corp. Fin. 76, 92 (2007) (finding that firms with better corporate governance, including more independent boards, tend to be associated with more value-creating spinoffs); Barry D. Baysinger & Henry N. Butler, Corporate Governance and the Board of Directors: Performance Effects of Changes in Composition, 1 J.L. & Econ. 101, 116 (1985) (finding that firms with more independent directors in the 1970s performed better (with a lag) than firms with fewer independent directors, but arguing that the benefits could be gained without a majority of independent directors); Catherine M. Daily & Dan R. Dalton, Bankruptcy and Corporate Governance: The Impact of Board Composition and Structure, 37 Acad. Mgmt. J. 1603, 1613 (1994) (finding that firms with a majority of independent directors are less likely to go bankrupt); Paul W. MacAvoy & Ira M. Millstein, The Active Board of Directors and Its Effect on the Performance of the Large Publicly Traded Corporation, J. Applied Corp. Fin., Winter 1999, at 8, 19 (noting that “[f]or the period 1991–1995, both of these governance metrics [director activism and independence] were statistically significant determinants of superior corporate performance as measured by a company’s earnings in excess of the cost of its capital net of the industry average”).

116. See, e.g., Asish K. Bhattacharyya & Sadhalaxmi Vivek Rao, Agency Costs and Foreign Institutional Investors in India 1, 15 (Indian Inst. of Mgmt. Calcutta, Working Paper No. 548, 2005), available at http://ssrn.com/abstract=773845 (studying a series of reforms that improved corporate governance and stimulated foreign investment and finding that operating costs were negatively correlated to the proportion of independent directors); Black et al., Predicting Corporate Governance, supra note 97, at 690–91 (finding that better corporate governance, including board independence, is causally related to higher share prices in South Korea’s capital market); Marek Gruszczynski, Corporate Governance and Financial Performance of Companies in Poland, Int’l Advances Econ. Res., May 2006, at 251, 258 (finding a significant association between governance rating (including independence of board) and the operating profit margin of Polish firms); Ping-Sheng Koh et al., Accountability and Value Enhancement Roles of Corporate Governance 23–26 (May 31, 2006) (unpublished manuscript, available at http://ssrn.com/abstract=664184) (finding in Australia that board independence was value enhancing); Lynda W.Q. Zhou, Do Investors Really Value Corporate Governance? Evidence from Hong Kong Market 13 (unpublished manuscript, available at http://ssrn.com/abstract=680221) (finding that investors in the Hong Kong market reward good governance, including board independence).

117. See, e.g., Anup Agrawal & Charles R. Knoebel, Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders, 31 J. Fin. & Quantitative Analysis 377, 394 (1996) (finding a negative relationship between firm performance and more outsiders on the board); Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921, 956 (1999) (surveying the literature and concluding, in part, that “board independence may simply not be very important, on average”); Richard Bozec, Boards of Directors, Market Discipline and Firm Performance, 32 J. Bus. Fin. & Acct. 1921, 1954 (2005) (finding in a study of Canadian state-owned enterprises that board independence is negatively related to firm profitability under circumstances where the firms are exposed to highly competitive markets); Julie Cotter & Mark Silvester, Board and Monitoring Committee Independence, 39 Abacus 211, 230 (2003) (concluding that “[w]e are unable to provide evidence that firm value is enhanced through stronger
overwhelming support among financial researchers for outside directors providing beneficial monitoring and advisory functions to firm shareholders, one cannot claim the empirical evidence clearly indicates that more independent boards will produce better financial results.

Regarding this unsettled debate, note five points. First, Jeffrey Gordon has offered several reasons why the benefits of board independence may exist but not show up in the empirical studies. Second, the recent empirical evidence also does not seriously support the claim that more independence will hurt corporate performance. Third, the market seems to have decided this debate in favor of independence. Investors, for example, tend to reward firms for improving corporate governance practices; the appointment of independent directors tends to raise stock prices in a way that appointment of inside directors does not. Creditors also recognize the value of independent directors by


118. M. Andrew Fields & Phyllis Y. Keys, The Emergence of Corporate Governance from Wall St. to Main St.: Outside Directors, Board Diversity, Earnings Management, and Managerial Incentives to Bear Risk, 38 Fin. Rev. 1, 5 (2003); see also Wendy Beekes et al., The Link Between Earnings Timeliness, Earnings Conservatism and Board Composition: Evidence from the UK, 12 Corp. Governance: An Int'l Rev. 47, 49 (2004) (stating that “[e]xisting empirical evidence generally supports the prediction that outside directors play an important part in protecting shareholders’ wealth in situations where the interests of managers and outside owners diverge”); Nikos Vafeas, Audit Committees, Boards, and the Quality of Reported Earnings, 22 Contemp. Acct. Res. 1093, 1101 (2005) (noting that “there is a vast body of literature suggesting that a greater proportion of outsiders serving on corporate boards is associated with improved board monitoring over shareholders”).

119. See Gordon, supra note 69, at 39–42. Gordon’s explanations include the tradeoffs between the benefits of insiders and independents, the idea that firms are finding their optimal mix, the idea that director independence is only beneficial up to a point, and the difficulty of isolating firm-specific effects.

120. Roberta Romano, Corporate Law and Corporate Governance, 5 Indus. & Corp. Change 277, 287 (1996) (“[V]irtually all studies find that there is no significant relation between performance and board composition. . . .”).

121. See, e.g., Baysinger & Butler, supra note 115, at 101 (finding that the market rewards firms that add independent directors); Steve Lin et al., Stock Market Reaction to the Appointment of Outside Directors, 30 J. Bus. Fin. & Acct. 351, 376 (2003) (reporting results of U.K. study finding that market was most likely to respond positively to appointment of outside director if firm was perceived to have agency problems); Stuart Rosenstein & Jeffrey G. Wyatt, Outside Directors, Board Independence and
extending credit on cheaper terms to firms with more independent boards.122

Fourth, virtually all studies looking at whether firms with more independent boards perform better have used financial numbers unadjusted for the fact that boards with more insiders tend to fudge the numbers more than boards with more outsiders.123 In other words, it is quite possible that the reason many studies have not found that firms with more outsiders do not perform better than firms with fewer outsiders is the latter are more likely to falsely represent their performance. Cornett and colleagues recently controlled for that fact, demonstrating that earnings management is reduced when there is more monitoring of management discretion from such sources as independent outside directors and institutional representation on the boards, and finding that once the likely impact of earnings management is removed from profitability estimates, “the estimated impact of corporate governance variables on firm performance more than doubles.”124

Fifth, regardless of the resolution of the debate regarding the effect of independence on firm performance, it is critical to remember that when it enacted SOX, Congress was not directly attempting to assist firms’ economic performance or to increase their value. Rather, SOX’s corporate governance provisions were aimed at restoring faith in the capital markets by protecting investors, primarily by improving the accuracy and reliability of financial reporting and by preventing corporate frauds.125 When studies focusing on

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122. See, e.g., Ronald C. Anderson et al., Board Characteristics, Accounting Report Integrity, and the Cost of Debt, 37 J. ACCT. & ECON. 315, 340 (2004) (finding that the cost of debt, as proxied by bond yield spreads, is inversely related to board independence); Hollis Ashbaugh-Skaife et al., The Effects of Corporate Governance on Firms’ Credit Ratings, 42 J. ACCT. & ECON. 203, 240 (2006) (finding that credit ratings are positively related to overall board independence); Sanjeev Bhojraj & Partha Sengupta, Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors, 76 J. BUS. 455, 459 (2003) (finding that firms that had stronger outside control of the board and greater institutional ownership had lower bond yields and higher ratings on their new bond issues).

123. See infra note 127 and accompanying text.


accurate financial reporting are segregated from those focusing on value creation, it becomes clear that the vast bulk of existing empirical studies indicates that more board independence does translate into more accurate financial reporting and thereby bolsters the federal mandatory disclosure system. Noting this fact, Gordon argues that the real benefits of independence are systemic. They do not necessarily accrue to individual firms and thereby show up in cross-sectional studies. Rather, more independence translates into a culture of better governance, more reliable financial disclosure, and less fraud that benefits all firms and the entire economy.\textsuperscript{126}

\textit{b. Board Independence and Financial Reporting.} Congress’s main purpose in enacting SOX was not to directly improve corporate performance but to assist the capital markets more broadly by reestablishing investor confidence through more accurate financial reporting and better fraud avoidance. It turns out that most evidence supports the Cornett conclusion that more independence means less financial monkey business.

Earnings management was a major concern of Congress when it passed SOX, and a brace of recent studies indicates that increased board independence reduces earnings management.\textsuperscript{127} Several other empirical studies, undertaken in

\begin{quote}
\url{http://ssrn.com/abstract=895520} (noting that the primary motivation for passing SOX “was to prevent future instances of massive financial fraud” that shocked the economy).
\textsuperscript{126} Gordon, supra note 69, at 42.
\textsuperscript{127} See, e.g., Ryan Davidson et al., \textit{Internal Governance Structures and Earnings Management}, 45 Acct. & Fin. 241, 243 (2005) (finding in study of Australian firms that earnings management is reduced if a board of directors has a majority of non-executive directors); Patricia Dechow et al., \textit{Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC}, 13 Contemp. Acct. Res. 1, 3 (1996) (finding that firms that manipulate earnings are more likely to have board of directors dominated by managers); Koh et al., supra note 116, at 23 (finding in Australian study that board independence minimized earnings management); Sarah E. McVay et al., \textit{Trading Incentives to Meet the Analyst Forecast}, 11 Rev. Acct. Stud. 575, 575 (2006) (finding that earnings management “is weaker in the presence of an independent board, suggesting that good corporate governance mitigates this strategic behavior.”); Kenneth V. Peasnell et al., \textit{Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?}, 32 J. Bus. Fin. & Acct. 1311, 1313 (2005) [hereinafter Peasnell et al., \textit{Board Monitoring}] (finding in U.K. study, “consistent with the prediction that outside directors contribute towards the integrity of financial statements,” that managers are less likely to make income-increasing abnormal accruals to avoid reporting losses and earnings reductions if there is a higher proportion of outside directors on the board); Kenneth V. Peasnell et al., \textit{Accrual Management to Meet Earnings Targets: UK Evidence Pre- and Post-Cadbury}, 32 Brt. Acct. Rev. 415, 440 (2000) (finding in the United Kingdom that many firms responded to the Cadbury Report recommendations by increasing the percentage of nonexecutive directors on their boards and that when this happened earnings management declined); Biao Xie et al., \textit{Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee}, 9 J. Corp. Fin. 295, 296 (2003) (finding that “a lower level of earnings management is associated with greater independent outside representation on the board”); Anwer S. Ahmed et al., \textit{The Sarbanes Oxley Act, Auditor Independence and Accounting Accruals: An Empirical Analysis} 2–3 (Nov. 13, 2006) (unpublished manuscript, available at \url{http://ssrn.com/abstract=887364}) (finding that auditors tend to allow their more important clients to engage in more aggressive accounting except for “strong governance firms” that have more outside directors and institutional shareholdings); Marcia M. Cornett et al., \textit{Earnings Management at Large U.S. Bank Holding Companies} 23 (Jan. 2006) (unpublished manuscript, available at \url{http://ssrn.com/abstract=886115}) (finding that earnings management at publicly traded
the United States and abroad, find that increased independence of boards lowers financial reporting fraud by firms. Still other studies find that more board independence is correlated with fewer SEC enforcement actions, fewer shareholder lawsuits, more informative financial disclosures, higher quality

bank holding companies is “significantly reduced when the board of directors is composed of more independent outside directors”). But see Yun W. Park & Hyun-Han Shin, Board Composition and Earnings Management in Canada, 10 J. Corp. Fin. 431, 433, 455 (2004) (finding that in Canada where ownership is more concentrated, dominant shareholder CEOs more prevalent, and the market for outside directors less developed than in the United States, outside directors do not help minimize earnings management).

128. See, e.g., Mark S. Beasley, An Empirical Analysis of the Relations Between the Board of Director Composition and Financial Statement Fraud, 71 Acct. Rev. 443, 445 (1996) (finding that “no-fraud firms have significantly . . . higher percentages of outside directors than fraud firms”); Mark S. Beasley et al., Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, 14 Acct. Horizons 441, 441 (2000) [hereinafter Beasley, Fraudulent Financial Reporting] (finding that as compared to no-fraud industry benchmarks, fraud companies in three volatile industries had less independent boards of directors); Gongmeng Chen et al., Ownership Structure, Corporate Governance, and Fraud: Evidence from China, 12 J. Corp. Fin. 424, 446 (2006) (finding that “[i]ncreasing the proportion of outside directors will help deter fraud [in China]”); Sharma, supra note 106, at 115 (finding in Australian study that “as the percentage of independent directors on the board and the percentage of institutional shareholders increase, the likelihood of fraud decreases”); Hatice Uzun et al., Board Composition and Corporate Fraud, Fin. Analysts J., May/June 2004, at 34, 41–42 (finding that as the number of independent outside directors on a firm’s board increased, and as the number of independent outside directors on a firm’s audit and compensation committees increased, the likelihood of corporate wrongdoing decreased). But see Lawrence J. Abbott et al., The Effects of Audit Committee Activity and Independence on Corporate Fraud, Managerial Fin., Nov. 2000, at 55, 61 (not finding a significant relation between fraud and the proportion of outside directors on the entire board, although finding that an audit committee meeting a minimum threshold of independence and activity is associated with decreased fraud).

129. See, e.g., David W. Wright, Evidence on the Relation Between Corporate Governance Characteristics and the Quality of Financial Reporting 2–3 (May 1996) (unpublished manuscript, available at http://ssrn.com/abstract=10138) (finding that “firms violating SEC reporting standards [and therefore subject to SEC Accounting and Auditing Enforcement Releases (AAERs)] have a significantly higher percentage of insiders and ‘grey’ area directors on their audit committee (or entire board in the absence of an audit committee) than firms in an industry/size matched control sample”).


131. See, e.g., Bipin Ajinkya et al., The Association Between outside Directors, Institutional Investors and the Properties of Management Earnings Forecasts, 43 J. Acct. Res. 343, 371 (2005) (finding that firms with a greater proportion of outside directors voluntarily issue more earnings forecasts and those forecasts tend to be more specific, accurate, and unbiased); Anderson et al., supra note 125, at 2 (finding that “earnings response coefficients increase as corporate boards become more independent”); Beekes et al., supra note 118, at 57–58 (2004) (finding that U.K. firms with a higher proportion of outside directors are more likely to recognize bad news in earnings in a timely basis); Wendy Beekes & Philip Brown, Do Better-Governed Australian Firms Make More Informative Disclosures?, 33 J. Bus. Fin & Acct. 422, 441 (2006) (finding that well-governed Australian firms, with independent boards as a key factor in governance quality, do make more informative disclosures); Simon S.M. Ho & Kar Shun Wong, A Study of the Relationship Between Corporate Governance Structures and the Extent of Voluntary Disclosure, 10 J. Int’l Acct. Auditing & Tax’n 139, 153 (2001) (finding in study of listed firms in Hong Kong that the existence of more family members on a board of directors was significantly and negatively related to the extent of a firm’s voluntary disclosure, thus “provid[ing] empirical evidence to support Hong Kong regulatory bodies’ new requirements on board
Klein also finds that more independence results in fewer earnings restatements, although more studies fail to find such a relationship. Whereas post-SOX one may view the restatement of financials as an indication that a company is trying to get it right, before SOX it was more likely a sign that management had been busted by its auditor for stretching numbers beyond all bounds of plausibility. Restatements aside, the strong message from the empirical literature is that more board independence is associated with more accurate financial reporting as measured by virtually every indicator.

4. Audit Committees

SOX’s provisions, while consistent with the theory behind independent boards of directors, focus not on the entire board, but upon audit committees. SOX

composition”); Irene Karamanou & Nikos Vafeas, The Association Between Corporate Boards, Audit Committees, and Management Earnings Forecasts: An Empirical Analysis, 43 J. Acct. Res. 453, 480 (2005) (finding that features of good governance, such as more independent boards, are related to more voluntary and more accurate earnings forecasts by firms); Koh et al., supra note 116 (finding that board independence is a governance attribute that is important to financial reporting). But see Nikos Vafeas, Board Structure and Informativeness of Earnings, 18 J. Acct. & Pub. Pol’y 139, 157 (2000) (finding no evidence that market participants perceived that more independent directors led to increased earnings informativeness).

132. Joseph V. Carcello et al., Board Characteristics and Audit Fees, 19 Contemp. Acct. Res. 365, 380–81 (2002) (finding that boards with more outside directors demand differentially higher auditor quality); Ho Young Lee et al., The Effect of Audit Committee and Board of Director Independence on Auditor Resignation, Auditing: J. Prac. & Theory, Sept. 2004, at 131, 143 (finding independent boards of directors reduce the likelihood of auditor resignation and “are more likely to exert greater effort working with the firm’s auditor, thus reducing hidden audit risks”).

133. See Krishnagopal Menon & Joanne D. Williams, The Use of Audit Committees for Monitoring, 13 J. Acct. & Pub. Pol’y 121, 137 (1994) (finding that “boards with higher outsider participation assert themselves as representatives of owners, and are more likely to employ mechanisms [such as audit committees] to monitor managers”). But see David Malone et al., An Empirical Investigation of the Extent of Corporate Financial Disclosure in the Oil and Gas Industry, 8 J. Acct. Auditing & Fin. 249 (1993) (failing to find a relationship between outside directors on board and extent of financial disclosure by oil and gas firms).

134. April Klein, Audit Committee, Board of Director Characteristics, and Earnings Management, 33 J. Acct. & Econ. 375, 376 (2002) (finding that “[f]irms that change their boards and/or audit committees from majority-independent to minority-independent have significantly larger increases in abnormal accruals [signaling earnings management] vis-à-vis their counterparts”).


136. Paul Sarbanes, Living Up to Its Promise; Sarbanes-Oxley Pays Dividends by Keeping Companies Honest, Rocky Mountain News (Denver), Apr. 8, 2006, at 2C (“Whereas before the passage of the legislation the escalating number of restatements was a danger sign, the numbers today indicate that the internal control requirements are having the desired effect. As the controls increasingly take effect, the number will decline.”). The market realizes this change, because restatements before SOX were typically punished by stock market drops of 10%, whereas post-SOX the drop averages only 2%.
substantially increases the authority and power of the audit committee, and section 301 requires that all listed companies have audit committees composed entirely of independent directors. This attention to audit committees is consistent with the conclusions of many recent studies that audit committees must play a more central role in corporate governance and in ensuring the quality of financial reporting. The Treadway Commission, the Kirk Panel, the Australian Treasury, the United Kingdom’s Smith Committee and Higgs Review, and other studies all emphasize the important role that audit committees should play in the financial reporting function for firms that wish to embrace “best practices.” In Europe there has been a substantial trend toward increasing the power and responsibility of audit committees.

In Enron’s wake, the U.K. government did exactly what so many SOX critics believe Congress should have done rather than act in the heat of passion—it set up a high level group of regulators and ministers to coordinate a review of the U.K. regulatory framework, which included substantial involvement by British academics. This “evidence-based policy making” led to exactly the same broad conclusions that Congress reached more precipitously in July 2002—that there was a need for “a wider role for the company audit committee in managing the relationship between the company and the auditor.”

Empirical evidence supports both the U.K. report’s conclusions and SOX’s policy prescriptions. Numerous studies support the notion that more indepen-
dence on audit committees improves financial reporting, just as does more independence on the board as a whole. For example, Krishnan finds that increasing the independence of audit committees reduces internal control problems. At least six other studies conclude that more independent audit committees tend to reduce earnings management. Other studies find that more volatile industries were less likely to have audit committees); Vivien Beattie et al., Perceptions of Auditor Independence: U.K. Evidence, 8 J. Int'l. Acct., Auditing & Tax’n 67, 103 (1999) (finding in U.K. study that the presence of an audit committee is a significant factor in enhancing third party perceptions of auditor independence); Dechow et al., supra note 127, at 1 (finding that firms that manipulate earnings are more likely to have board of directors dominated by managers and less likely to have an audit committee); Mark L. DeFond & James Jiambalvo, Incidence and Circumstances of Accounting Errors, 66 Acct. Rev. 643, 653 (1991) (finding that overstatements of earnings are less likely among firms that have an audit committee); Jenny Goodwin-Stewart & Pamela Kent, Relation Between External Audit Fees, Audit Committee Characteristics and Internal Audit, 46 Acct. & Fin. 387, 388 (2006) (finding that the existence of an audit committee is associated with higher quality audits); Ho & Wong, supra note 131, at 153 (finding in study of listed firms in Hong Kong that the existence of an audit committee was significantly and positively related to the extent of a firm’s voluntary disclosure, “provid[ing] empirical evidence to support Hong Kong regulatory bodies’ [] new requirements on . . . the formation of an audit committee”); Michael C. Knapp, An Empirical Study of Audit Committee Support for Auditors Involved in Technical Disputes with Client Management, 62 Acct. Rev. 578, 585 (1987) (finding that audit committees can improve auditing because “audit committee members tend to support auditors rather than management when audit disputes occur”); John J. Wild, The Audit Committee and Earnings Quality, 11 J. Acct., Auditing & Fin. 247, 274 (finding evidence that establishment of an audit committee enhances earnings quality).

Some studies do not find a positive impact from the existence of an audit committee, but most of them do not test to see if the audit committee is independent or not. See, e.g., Beasley, supra note 128, at 463 (not finding that the presence of an audit committee reduced fraud likelihood); Peasnell et al., Board Monitoring, supra note 127, at 1313 (finding that in the United Kingdom although board independence reduces the likelihood of earnings management, presence of an audit committee does not, but noting that 84% of firms in the sample had an audit committee, which might account for this null result).


149. See, e.g., Jean Bédard et al., The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management, 23 Auditing: J. Prac. & Theory 13, 32 (2004) (finding that a unanimously independent audit committee is negatively related to aggressive earnings management); Davidson et al., supra note 127, at 243, 262 (finding in a study of Australian firms that earnings management is negatively associated with an audit committee with a majority of non-executive directors); Klein, supra note 134, at 376 (finding more earnings management as measured by abnormal accruals in firms with audit committees comprised of less than a majority of independent directors, and that firms changing their audit committee from majority-independent to minority-independent sustained significantly larger increases in abnormal accruals); Hollis Ashbaugh et al., Corporate Governance and the Cost of Equity Capital 35 (Dec. 2004) (unpublished manuscript, available at http://ssrn.com/abstract=639681) (finding that firms with more independent audit committees have lower abnormal accruals); Daniel Bryan et al., The Influence of Independent and Effective Audit Committees on Earnings Quality 28 (Jan. 6, 2004) (unpublished manuscript, available at http://ssrn.com/abstract=488082) (finding that independent and active audit committees result in increased earning informativeness and transparency); Sonda Marrakchi Chtourou et al., Corporate Governance and Earnings Management 26 (April 21, 2001) (unpublished manuscript, available at http://ssrn.com/abstract=275053) (finding that audit committees with a higher proportion of outside members who are not managers in other firms, or with at least one financial expert are significantly less likely to have high levels of earnings management). But see Joon S. Yang & Jagan Krishnan, Audit Committees and
independence on an audit committee tends to translate into fewer earnings restatements, less fraud, fewer SEC enforcement actions, and less illicit opinion shopping. Bryan and colleagues find that firms with active and independent audit committees tend to have greater earnings transparency and informativeness, consistent with the theory and requirements of SOX. Overall, more independent audit committees tend to translate into better auditing.

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150. See, e.g., Lawrence J. Abbott et al., Audit Committee Characteristics and Restatements, Auditing: J. Prac. & Theory, Mar. 2004, at 69, 70 (2004) (finding that companies with completely independent audit committees that meet at least four times a year have fewer financial restatements); Joseph V. Carcello et al., CEO Involvement in Selecting Board Members and Audit Committee Effectiveness 27 (Aug. 2006) (unpublished manuscript, available at http://ssrn.com/abstract=927737) (finding that audit committee independence is correlated to fewer restatements but only when the CEO is not formally involved in selecting board members, concluding that their findings “provide[] support for various post-SOX changes, which enhanced audit and nominating committee independence”). But see Agrawal & Chadha, supra note 135, at 403 (not finding an association between the probability of restatement of earnings and the independence of the audit committee).

151. See, e.g., Beasley et al., Fraudulent Financial Reporting, supra note 128, at 441 (finding that as compared to no-fraud industry benchmarks, fraud companies in three volatile industries had less independent audit committees); David B. Farber, Restoring Trust after Fraud: Does Corporate Governance Matter?, 80 Acct. Rev. 539, 560 (2005) (finding that firms identified by the SEC as fraudulently manipulating their financial statements have lesser percentages of outside board members); Uzun et al., supra note 128, at 41–42 (finding that as the number of independent outside directors on a firm’s board increased, and as the number of independent outside directors on a firm’s audit and compensation committees increased, the likelihood of corporate wrongdoing decreased); Laurel Gordon Cobb, An Investigation into the Effect of Selected Audit Committee Characteristics on Fraudulent Financial Reporting, (Apr. 1993) (unpublished Ph.D. dissertation, University of South Florida) (finding a negative relation between the percentage of outside directors on the audit committee and the incidence of fraudulent financial reporting).

152. See, e.g., Abbott et al., supra note 128, at 55 (finding that “firms with audit committees which meet minimum thresholds of both activity and independence are less likely to be sanctioned by the SEC” for fraudulent or misleading reporting); Wright, supra note 129, at 2–3 (reporting results demonstrating that firms violating SEC reporting standards and therefore subject to SEC Accounting and Auditing Enforcement Releases (AAERs) have a significantly higher percentage of insiders and “grey” area directors on their audit committees than do matched firms in a control sample). In a study of firms that were punished by the U.K. Financial Reporting Review Panel for substandard financial reporting, Song and Windram found that “director independence increases audit committee effectiveness.” Jill Song & Brian Windram, Benchmarking Audit Committee Effectiveness in Financial Reporting, 8 Int’l J. Auditing 195, 203 (2004).


154. Bryan et al., supra note 149, at 28 (finding that independent and effective audit committees do enhance the quality of earnings reporting, in accordance with SOX’s theories and requirements).

155. See, e.g., Lawrence J. Abbott & Susan Parker, Auditor Selection and Audit Committee Characteristics, 19 Auditing: J. Prac. & Theory 47, 48, 61 (2002) (finding that independent and active audit committees are more likely to demand a high quality audit and toward that end are more likely to hire auditors that specialize in the relevant industry); Vivien Beattie et al., Behind the Audit Report: A Descriptive Study of Discussions and Negotiations Between Auditors and Directors, 4 Int’l J. Auditing 177, 199–200 (2000) (finding in U.K. study that among the most influential factors enhancing auditor independence are audit committees with independent directors); Joseph V. Carcello & Terry L. Neal, Audit Committee Characteristics and Auditor Dismissals Following “New” Going-Concern Reports,
more informative and credible earnings disclosure,\textsuperscript{156} and other benefits.\textsuperscript{157}

As with boards in general, the studies regarding the independence of audit committees are not unanimous; neither, however, are they closely divided. The

\textsuperscript{78} ACCT. REV. 95, 113–14 (2003) (finding that companies with more independent directors on their audit committee have fewer auditor dismissals following issuance of going-concern opinions which should strengthen the auditor’s hand in negotiations with management and thereby “improve the quality of auditor communications with investors and creditors for companies experiencing financial distress”); Joseph V. Carcello et al., supra note 132, at 365, 378–79, 381 (finding that audit committees with more outside directors tend to demand differentially higher auditor quality); Yi Meng Chen et al., Audit Committee Composition and the Use of an Industry Specialist Audit Firm, 45 ACCT. & FIN. 217, 236 (2005) (finding that the more independence on an audit committee, the more likely a firm will use an industry specialist auditor of presumably higher quality); Ho Young Lee et al., supra note 132, at 143 (finding that that with an independent audit committee, outside audit firms are less likely to resign and if they do, the successor auditor is more likely to be of high quality); Lawrence J. Abbott et al., The Effect of Audit Committee Characteristics and Non-Audit Fees on Audit Fees 13 (June 29, 2001) (unpublished manuscript, available at http://ssrn.com/abstract=275808) (finding that an active and independent audit committee will be more concerned about audit quality which will be reflected in higher audit fees).  

156. See, e.g., Joseph V. Carcello & Terry L. Neal, Audit Committee Independence and Disclosure: Choice for Financially Distressed Firms, 11 CORP. GOVERNANCE: AN INT’L REV. 289, 296 (2003) (finding significant positive relation between percentage of nonindependent directors on “the audit committee and the optimism of firms’ going-concern disclosures,” thus “provid[ing] additional support for continuing regulatory efforts throughout the world to increase the independence of the board of directors and its key committees [including audit]”); Karamanou & Vafeas, supra note 131, at 480 (finding that good governance, such as more independence on audit committees, is associated with more voluntary earnings forecast disclosure and greater accuracy of those disclosures “consistent with the notion that governance matters and that better governance in public corporations is associated with less information asymmetry between management and shareholders”); Vafeas, supra note 118, at 1118 (finding that more insiders on an audit committee are associated with lower earnings quality); Gopal V. Krishnan & Gnanakumar Visvanathan, Does the SOX Definition of an Accounting Expert Matter? The Association Between Audit Committee Directors’ Expertise and Conservatism 6 (Dec. 1, 2005) (unpublished manuscript, available at http://ssrn.com/abstract=866884) (“Our evidence suggests that financially sophisticated and independent audit committees contribute to [accounting] conservatism.”); Wright, supra note 129, at 2 (finding “that higher analyst ratings of financial reporting quality are associated with firms with lower percentages of directors, particularly audit committee members, who are either relatives of officers or have some business relationship with the firm (so-called ‘grey’ area outside directors”). But see Anderson et al., supra note 125, at 24 (finding “that the information content of earnings increases with audit committee independence,” but also finding that independence of the audit committee does not add meaningfully to the beneficial impact of independence of the entire board); Andrew J. Felo et al., Audit Committee Characteristics and the Perceived Quality of Financial Reporting: An Empirical Analysis 29 (Apr. 2003) (unpublished manuscript, available at http://ssrn.com/abstract=401240) (finding that the percentage of audit committee members having expertise in accounting or financial management is positively related to financial reporting quality but audit committee independence is not).

157. See, e.g., Anderson et al., supra note 122, at 340 (finding that the cost of debt, as proxied by bond yield spreads, is inversely related to audit committee independence); Georges Dionne & Thouraya Triki, Risk Management and Corporate Governance: The Importance of Independence and Financial Knowledge for the Board and the Audit Committee 29 (HEC Montreal, Working Paper No. 05-03, 2005), available at http://ssrn.com/abstract=730743 (finding that firms with all independent audit committees are more likely to effectively hedge risk, which benefits shareholders); Ashbaugh et al., supra note 149, at 35 (finding that firms with more independent audit committees have a lower cost of equity); Koh et al., supra note 116, at 23 (finding that audit related governance structures such as independent audit committees were not only helpful in improving financial reporting but were also value-creating for shareholders).
large majority supports the positions of the corporate governance entrepreneurs whom Romano disparages. As Turley and Zaman recently observed, “the independence of [audit committee] members [has] consistently been found to be associated with a lower likelihood of problems in financial reporting quality.”

SOX critics might well point out that up to this point, we are just wandering around in the neighborhood but have still not addressed SOX’s specific requirement that all members of the audit committee be independent. This would be a fair objection, but many experts and committees in America and around the world have suggested that audit committees should indeed be comprised totally of independent directors. Furthermore, substantial empirical evidence supports the conclusion that it is beneficial to require all members (and not just a majority) of the audit committee to be independent.

Four studies of how auditors interact with audit committees, undertaken in the United States, Canada, Singapore, and Australia and New Zealand, all find better performance when audit committees are composed solely of independent directors. Several studies indicate that audit committees composed entirely of independent directors are more likely to take their financial reporting responsibilities more seriously and to be more active. This greater activity translates into...
better performance. Abbott and colleagues find fewer restatements when audit committees are completely independent.162 Bédard and colleagues determine that “a majority of outside members [of the audit committee] is not sufficient to decrease the likelihood of aggressive earnings management and that 100 percent is the critical threshold.”163 Chourou and colleagues also find reduced earnings management with audit committees composed only of outside directors.164 McMullen and Raghunandan find that firms subject to SEC enforcement actions or restating their earnings are less likely to have all independent directors on their audit committees than firms not engaged in similar misconduct.165 Carcello and colleagues find that firms with more active and independent audit committees are associated with higher audit fees—presumably reflecting higher audit quality.166 In another study they conclude that these firms reduce purchases of nonaudit services from their auditors in order to improve the appearance and reality of auditor independence and thereby increase the credibility of their financial statements.167 The benefits of an entirely independent audit committee are clear enough to creditors that firms with such entirely independent committees enjoy lower debt financing costs.168

Although not all studies find advantages from raising the requirement from a majority independent audit committee to a fully independent audit committee,169 the empirical evidence supporting SOX’s requirement that audit commit-

accounting or financial background are more likely to (1) have longer meetings with the chief internal auditor; (2) provide private access to the chief internal auditor; and (3) review internal audit proposals and results of internal auditing”); Scarbrough et al., supra note 160, at 61 (finding that audit committees composed solely of independent directors were more active and engaged with internal auditing quality).

162. Abbott et al., supra note 150, at 70 (finding that companies with completely independent audit committees that meet at least four times a year have fewer financial restatements).

163. Bédard et al., supra note 149, at 29.

164. Chourou et al., supra note 149, at 26–27 (finding that among the audit committee characteristics that are negatively associated with earnings management is “the presence on the committee of only independent directors who meet more than twice a year”) (emphasis added).

165. Dorothy A. McMullen & K. Raghunandan, Enhancing Audit Committee Effectiveness, J. ACCT., Aug. 1996, at 79, 79–80 (finding firms subject to SEC enforcement actions or materially restating their quarterly reports are less likely to have an audit committee composed entirely of non-executive directors than firms with audit committees consisting solely of outside directors).

166. Carcello et al., supra note 132, at 365, 378–81.

167. Lawrence J. Abbott et al., An Empirical Investigation of Audit Fees, Nonaudit Fees, and Audit Committees, 20 CONTEMP. ACCT. RES. 215, 230 (2003) (“Our results indicate that companies with audit committees that consist of solely independent directors and that meet at least four times a year are likely to have lower NAS fee ratios[, supporting] the actions of the SEC and others, who have argued for a heightened role of the audit committee in matters related to accounting and auditing.”).

168. See Anderson et al., supra note 132, at 335.

169. See, e.g., Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Valuation, 25 J. ACCT. & PUB. POL’Y 409, 428 (2006) (not finding any link between firm value and audit committees composed solely of independent outsiders); Davidson et al., supra note 127, at 243 (finding “a negative association between earnings management and audit committees comprising a majority of non-executives, but no relationship between earnings management and committees comprised solely of non-executives”); Klein, supra note 134, at 398 (finding that although a majority of independent directors on the audit committee minimizes earnings management, there is no difference when the audit
Whether accidentally or not, Congress seems to have made the right call regarding audit committees.

Post-SOX impact studies should be particularly persuasive, and their results tend to support SOX’s audit committee requirements. In 2006, Aggarwal and Williamson studied six corporate governance requirements imposed by SOX and by the stock exchanges as a response to the Enron scandal, including the requirement that the board consist of a majority of independent directors and the audit committee consist of only independent directors. They concluded that firms that had voluntarily adopted those requirements between 2001 and 2005 were rewarded by the marketplace in an economically and statistically significant manner and that these corporate governance provisions “did target relevant governance attributes.”

Institutional Shareholder Services found that throughout most of the world, corporate governance reforms were viewed as important priorities by most institutional investors who thought about needed reforms in the capital markets. Because SOX’s governance reforms had already instituted the needed changes, corporate governance reform was not found to be an important priority in the United States. A study by GovernanceMetrics International found SOX reform had led to a 10% improvement in the corporate governance performance committees are entirely independent and concluding that the new rules “are reasonable, although maintaining a wholly independent audit committee may not be necessary”).

170. See supra notes 160–167 and accompanying text; see also F. Todd DeZoort & Steven E. Salterio, The Effects of Corporate Governance Experience and Financial-Reporting and Audit Knowledge on Audit Committee Members’ Judgments, 20 AUDITING: J. PRAC. & THEORY 31, 43–44 (2001) (reporting results of an experiment indicating that greater independent director experience and greater audit knowledge were associated with higher audit committee member support for a “substance over form” approach to auditing and concluding that the “results indicate that calls for audit committees to be completely composed of independent directors . . . appear justified”).

171. Aggarwal & Williamson, supra note 125, at 1, 26–27.

172. Id. at 28. Aggarwal and Williamson state reservations. First, they correctly note that the requirements are disproportionately costly for small firms. Second, they suggest that because some firms were “voluntarily” adopting the provisions and were rewarded, the markets were already doing their jobs. Id. at 27–28. During most of the time period they studied, however, firms were adopting these provisions because it was clear that SOX and the stock exchanges were already going to require such changes or because they were motivated to head off regulation by voluntarily making needed reforms. Voluntarily making reforms in attempts to forestall government regulation is a time-honored tactic. See Robert Prentice, Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future, 51 DUKE L.J. 1397, 1438–39 (2002) (explaining how Wall Street fended off government regulation in the 1920s via voluntary reforms); David Boyce et al., United States: Best Practices in Nonprofit Governance: Dealing with “Voluntary” Reforms, MONTAQ BUS. BRIEFING, Feb. 26, 2007 (recommending that nonprofits “voluntarily” adopt IRS regulation); Dan Jamieson, NASD, NYSE Urge Firms To Comply on Bonds; Stiffer Research Rules Could Be Imposed if Scrutiny Is Lax, INVESTMENT NEWS, Aug. 21, 2006, at 28 (noting that firms are being urged to voluntarily make changes so that governing bodies do not impose them).

173. See INSTITUTIONAL SHAREHOLDER SERVICES, CORPORATE GOVERNANCE: FROM COMPLIANCE OBLIGATION TO BUSINESS IMPERATIVE 31 (2006).

174. The study found that improved corporate governance was the number one priority for institutional investors in Continental Europe, the United Kingdom, Australia/New Zealand, and China, as well as the number two priority in Canada and the number three priority in Japan:
of large U.S. companies and to a 40% rebound in the stock market, concluding that SOX’s benefits outweigh its costs, even if those costs are substantial.\textsuperscript{175}

Chhaochharia and Grinstein’s recent study found that several of SOX’s provisions, including those relating to independence of boards and board committees, created abnormal positive returns for large and medium-sized firms that had not been in compliance with the requirements but would benefit when forced to comply by SOX.\textsuperscript{176} Their results suggested “that the corporate governance rules had an economically significant impact on firm value, and that firms that [were] less compliant with the rules realize[d] a greater value improvement compared to firms that are more compliant with the rules.”\textsuperscript{177}

The accumulated empirical evidence establishes that there is no credible basis to claim that SOX’s audit committee provisions amount to “quack corporate governance.”

\section*{B. PROVISION OF NONAUDIT SERVICES}

1. Background

Part of the reason that the numerous empirical studies supporting vigorous securities regulation and corporate governance “best practices” ring true is that they are consistent with a very common sense body of logic. An agency problem arises when one group (officers) manage assets belonging to another group (investors). Both economic reasoning (which suggests that a rational manager will try to advance his self-interest when handling others’ money) and behavioral psychology (which indicates that even managers consciously trying to act in their principals’ best interests will unconsciously tend to act in their own best interests)\textsuperscript{178} indicate that effective monitoring of those agents will generally be a good idea.

Overall, the empirical evidence supporting accountant self-serving bias is

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\item In the U.S., however, investors apparently believe that recent American laws and regulations have resolved specific issues of board independence and structure. The U.S. Sarbanes-Oxley Act, for instance, sets higher requirements for audit committees, and U.S. stock markets have adopted higher standards mandating majority-independent boards and all-independent key committees. These reforms probably explain why U.S. investors relegate the issue of board structure, composition, and independence to number five on their list of priorities.\textsuperscript{Id.}
\item 176. Chhaochharia & Grinstein, \textit{supra} note 64, at 22, 29, 34 (finding, however, adverse impact for small firms for which costs might outweigh benefits).
\item 177. \textit{Id.} at 34.
\end{itemize}
substantial and has been documented in numerous areas of endeavor—for example, tax, auditing, and consulting. The common sense story regarding excessive provision of nonaudit services (NAS) goes like this: During the 1990s, audit firms became intensely interested in selling NAS beyond the tax services they had traditionally provided. These large accounting firms may have used audit services as a loss leader. Whether or not they did, “Big Accounting” saw consulting fees skyrocket. In order to keep audit clients happy and purchasing consulting services, auditors often looked the other way when clients wished to be too aggressive in their accounting.

The auditing profession initially opposed limits on NAS on grounds that despite many high-profile audit failures, none could be tied directly to attempts

179. See, e.g., Allen D. Blay, Independence Threats, Litigation Risk, and the Auditor’s Decision Process, 22 Contemp. Acct. Res. 759, 759 (2005) (finding in web-based experiment that “auditors facing high independence threats (fear of losing the client) evaluated [going-concern] information as more indicative of a surviving client and were more likely to suggest an unmodified audit report, consistent with client preferences[,] whereas auditors faced with high litigation risk evaluated information as more indicative of a failing client and were more likely to suggest a modified audit report”); C. Bryan Cloyd & Brian C. Spilker, The Influence of Client Preferences on Tax Professionals’ Search for Judicial Precedents, Subsequent Judgments and Recommendations, 74 Acct. Rev. 299, 301 (1999) (finding that after studying certain provided precedents, one-half of accountant subjects recommended a position known to be favored by their clients, even though a panel of experts concluded that there was only a 14% chance that the position would be sustained if challenged); Andrew D. Cuccia et al., The Ability of Professional Standards to Mitigate Aggressive Reporting, 70 Acct. Rev. 227, 243–44 (1995) (finding self-serving bias affects tax accountants); Michael C. Knapp, Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure, 60 Acct. Rev. 202, 208 (1985) (finding that if auditor and client clash as to proper financial treatment, the client is more likely to get its way if it is in good financial shape so that litigation risk to the auditor is minimized); Lawrence A. Ponemon, The Objectivity of Accountants’ Litigation Support Judgments, 70 Acct. Rev. 467, 474, 478, 484 (1995) (finding that when accountants act in a litigation support role, notwithstanding a professional responsibility to act objectively, they tend to favor their clients’ economic interests by, for instance, providing a higher estimate of an inventory destroyed by fire if hired by the plaintiff and a lower estimate if hired by the defendant); Steve Salterio & Lisa Koonce, The Persuasiveness of Audit Evidence: The Case of Accounting Policy Decisions, 22 Acct. Orgs. & Soc’y 573, 583–85 (1997) (finding that if precedents are quite clear, the auditor will follow them, but if they are unsettled auditors will tend strongly to favor client’s preferred position); Carolyn A. Windsor & Neil M. Ashkanasy, The Effect of Client Management Bargaining Power, Moral Reasoning Development, and Belief in a Just World on Auditor Independence, 20 Acct. Orgs. & Soc’y 701, 711 (1995) (finding more acquiescence to client pressure by auditors if client is in strong financial shape among auditors with low moral reasoning). But see John C. Corless & Larry M. Parker, The Impact of MAS on Auditor Independence: An Experiment, Acct. Horizons, Sept. 1987, at 25, 25 (finding in an experiment that there was no evidence that auditors who were asked to evaluate an internal control system were significantly affected by whether their own or another firm had established the system).


to sell consulting services. Absent an ability to read auditors' minds, it will always be difficult to prove with certainty why they looked the other way in the face of improper accounting by audit clients. Despite this difficulty, plausible cases can be made that accounting scandals surrounding Just for Feet, Oxford Health Plans, Colonial Realty, BCCI, DeLorean Motor Co., and even Enron itself involved auditors who wished too fervently to sell consulting services to clients.

After all, during much of the 1990s, many of the largest audit firms compensated and promoted audit partners based substantially on how much consulting revenue they could generate from the firms they audited. Audit partners could be terminated for failing to cross-sell enough consulting services. Accounting "firm leadership roles were more likely to be bestowed on those who were successful marketers rather than the most talented and diligent auditors." Common sense and the psychology of motivated reasoning make it clear that auditors whose compensation is slanted in this way will have difficulty being objective about auditing decisions. Moreover, firms that fired their auditors had to report that fact publicly, opening themselves up to suspicion by investors. However, an issuer could exert leverage upon an audit firm that was also providing consulting services by threatening to reduce or eliminate purchase of those services because that sort of a change was not required to be publicly reported.

Therefore, in the wake of a huge scandal involving numerous busted audits, Congress in SOX prohibited accounting firms from providing specified types of

182. See Feeling the Heat, ACCOUNTANT, May 1, 1998, at 17 (quoting AICPA report contending that there existed "no evidence" that provision of NAS impaired independence).

183. See Elizabeth MacDonald, Was That Auditor's Opinion Really Independent?, FORBES, March 19, 2001, at 109 (addressing these first five examples).


185. See Ken Brown & Ianchele J. Dugan, Sad Account: Andersen's Fall from Grace Is a Sad Tale of Greed and Miscues, WALL ST. J., June 7, 2002, at A1 (reporting that beginning in 1998, Arthur Andersen had internal targets requiring partners to bring in twice as much consulting revenue as audit revenue); Jere R. Francis, What Do We Know About Audit Quality?, 36 BRIT. ACCT. REV. 345, 362 (2004) (“Apparently it was common to reward audit partners based on the amount of non-audit services purchased by audit clients.”).


187. Cox, supra note 180, at 309.


190. See Coffee, supra note 189, at 1412.
NAS to public company audit clients.\textsuperscript{191} Although on its face this reform makes common sense and does not seem quack-like, Romano properly demands that we examine the evidence.

2. Independence in Appearance

Before we examine the evidence in detail, note that Romano focuses solely on independence in fact (also known as independence in mind), which refers to whether actual decisions of audit firms and audit partners are affected by their desire to sell auditing services.\textsuperscript{192} Courts, standard-setting bodies, the SEC, and the accounting profession itself all agree that independence in appearance is just as important for the capital markets as independence in fact.\textsuperscript{193} And a large body of empirical evidence shows that audit firm provision of consulting services to audit clients tends to substantially undermine the appearance of independence in the eyes of financial statement consumers such as banks, stock analysts, and lay and institutional investors.\textsuperscript{194}

For example, in 1999, Beattie and colleagues surveyed finance directors, audit partners and financial journalists in the United Kingdom and found that a high level of NAS relative to audit fees was one of the strongest factors undermining perceived independence of auditors.\textsuperscript{195} Several studies done between 1989 and 1999 in other nations,\textsuperscript{196} as well as in the United States,\textsuperscript{197} also

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\textsuperscript{191} Sarbanes-Oxley § 201(a), 15 U.S.C. § 78j-1(g) (Supp. II 2002).
\textsuperscript{192} See Ann Morales Olazabal & Elizabeth Dreike Almer, Independence and Public Perception: Why We Need to Care, J. Acct., Apr. 2001, at 69, 70 (noting the distinction between independence in fact and independence in appearance and emphasizing the importance of the latter).
\textsuperscript{194} Many relevant studies are from 1989 and earlier. That was a more innocent time, when NAS fees were typically just a small fraction of audit fees. Although results are mixed, even in that world before NAS fees came to dwarf audit fees and when audit partners were not yet compensated on the basis of how much consulting services they could foist off on an audit client, most studies found that a substantial percentage of financial statement users believed independence would be impaired by provision of various forms of NAS by an auditor. See, e.g., Abraham J. Briloff, Old Myths and New Realities in Accountancy, 41 Acct. Rev. 484, 491 (1966) (reporting results of survey finding that a majority of users of financial statements thought that provision of NAS would be incompatible with independence and would detract from the significance of the auditor’s opinion); Michael Firth, Perceptions of Auditor Independence and Official Ethical Guidelines, 55 Acct. Rev. 451, 465 (1980) (finding in U.K. survey that users of financial statements—financial analysts and loan officers—perceived that provision of NAS impaired independence).
\textsuperscript{195} Beattie et al., supra note 147, at 89.
\textsuperscript{196} See, e.g., Daryl Lindsay, An Investigation of the Impact of Contextual Factors on Canadian Bankers’ Perceptions of Auditors’ Ability to Resist Management Pressure, 3 Advances Int’l Acct. 71, 83 (1990) (finding that bankers in Canada perceived that auditor provision of NAS services to audit clients tended to impair independence); Hai Yap Teho & Chui Choo Lim, An Empirical Study of the Effects of Audit Committees, Disclosure of Nonaudit Fees, and Other Issues on Audit Independence: Malaysian Evidence, 5 J. Int’l Acct. Auditing & Tax’n 231, 231, 245 (1996) (finding that provision of
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found that NAS provision damaged perceptions of auditor independence.

Although there are a few (mostly pre-1985) studies that do not demonstrate significant third party reservations about the impact of NAS provision upon independence, it is unlikely that those results could be replicated in the post-Enron era. Following Enron, the U.K. government did exactly what Romano suggests Congress should have done—it consulted academics and studied the issue, instead of acting in haste. All three commissioned studies provided “clear evidence that the provision of non-audit services, particularly at a significant level, undermines independence in appearance and threatens the credibility of audit.”

That the prospect of earning $100 million per year in mostly consulting revenue caused Arthur Andersen’s top brass to make the conscious decision to continue allowing Enron to engage in overly aggressive accounting is too widely known for many financial statement users to display equanimity in the face of substantial NAS provision by external audit firms. Certainly in July of 2002, as people wondered how the auditors at WorldCom had missed billions and billions of dollars worth of improperly booked transactions, it would have been hard to find many users of financial statements willing to take a “What, me worry?” view of NAS provision. With measures of investor NAS was the second most important factor leading to impairment of perceptions of auditor independence in Malaysian survey). However, there is evidence that in some small nations with close audit markets, provision of NAS is not seen as impairing independence. See Mary Canning & David Gwilliam, Non-Audit Services and Auditor Independence: Some Evidence from Ireland, 8 EUR. ACCT. REV. 401 (1999) (Ireland); Ferdinand A. Gul, Bankers’ Perceptions of Factors Affecting Auditor Independence, 2 ACCOUNTING & ACCOUNTABILITY J. 40, 48-49 (1989) (New Zealand).

197. See, e.g., Roger W. Bartlett, A Scale of Perceived Independence: New Evidence on an Old Concept, 42 ACCT., AUDITING & ACCOUNTABILITY J. 52, 62 (1993); D. Jordan Lowe & Kurt Pany, CPA Performance of Consulting Engagements with Audit Clients: Effects on Financial Statement Users’ Perceptions and Decisions, 14 AUDITING: J. PRAC. & THEORY 35, 49 (1995) (finding that financial statement users perceived greater independence and financial statement reliability when outside auditors did not provide material amounts of NAS to audit clients, although these perceptions could be substantially mitigated by using separate personnel to provide the audit and consulting services); Lydia L. F. Schleifer & Randolph A. Shockley, Policies to Promote Auditor Independence: More Evidence on the Perception Gap, 7 J. APPLIED BUS. RES. 10, 15 (1990) (finding that users of financial statements agreed with proposed policies to restrict NAS provided by auditors); Susan L. Swanger & Eugene G. Chewning, Jr., The Effect of Internal Audit Outsourcing on Financial Analysts’ Perceptions of External Auditor Independence, 20 AUDITING: J. PRAC. & THEORY 115, 116 (2001) (finding that “financial analysts’ perceptions of external auditing independence are greater when the client employs its own internal audit staff or outsources to a different CPA firm, compared to the situation in which the external auditor performs all internal audit duties” but finding also that the perception could be largely mitigated by segregating external and internal audit staffs).

198. Fearnley & Beattie, supra note 145, at 123–24 (referring to studies done by Mori, Canning and Gwilliam, and Beattie and Fearnley).


200. See generally LYNN W. JETER, DISCONNECTED: DECEIT AND BETRAYAL AT WORLDCOM 184 (2003) (noting that auditors did not notice that $3.8 billion was missing at WorldCom).

201. A 1999 study found that loan officers’ views of independence diminished if the outside auditor provided internal audit services and diminished again if in so doing the outside auditor performed...
sentiment reaching all-time lows, a Congress concerned with restoring investor faith in the capital markets sensibly paid attention to investor perceptions. In post-Enron studies in the United States, Krishnan and colleagues, Mishra et al., Higgs and Skantz, and Krishnamurthy et al. all found that investors believe that provision of nonaudit services impairs auditor independence.

These perceptions have real impacts. Gul and colleagues found that investors perceive more auditor bias when higher levels of NAS are provided, thereby reducing their perception of the quality of a firm’s reported earnings.

management functions. Strangely, the effect reversed if it was stipulated that different personnel from the outside auditor performed the external audit and the internal audit function. D. Jordan Lowe et al., The Effects of Internal Audit Outsourcing on Perceived External Auditor Independence, AUDITING: J. PRAC. & THEORY, Supp. 1999, at 7, 18. Given that Enron was one of the issuers that Lowe et al. highlighted as being a pioneer in outsourcing its entire audit function to its external auditor, it seems unlikely that this effect reversal manifested before 1999 would have survived the Enron scandal.

202. Romano points out that in June and July of 2002, “one well-known measure of investor sentiment, which was inaugurated in 1996, was at its lowest recorded level.” Romano, supra note 1, at 1546.


204. Suchismita Mishra et al., Do Investors’ Perceptions Vary with Types of Nonaudit Fees? Evidence from Auditor Ratification Voting, AUDITING: J. PRAC. & THEORY, Nov. 2005, at 9, 9 (finding evidence in shareholder auditor ratification voting that investors view both tax fees and other consulting fees more negatively than audit fees).

205. Julia L. Higgs & Terrance R. Skantz, Audit and Nonaudit Fees and the Market’s Reaction to Earnings Announcements, AUDITING: J. PRAC. & THEORY, May 2006, at 1, 20-21 (finding support for this proposition, but only “weak” support); see also Kannan Raghunandan, Non-Audit Services and Shareholder Ratification of Auditors, AUDITING: J. PRAC. & THEORY, Mar. 2003, at 155, 162. Raghunandan finds that the higher the relative magnitude of NAS fees, the higher the shareholder vote against auditor ratification. This fact, coupled with a recent large increase in shareholder proposals calling for a reduction in auditor provision of NAS, seems to also indicate shareholder concern about NAS impact on independence. That said, most outside auditors are overwhelmingly approved even when they provide substantial NAS, but this is probably just emblematic of the fact that shareholders routinely approve extremely high percentages of virtually all proposals that managers ask them to vote for, even when they undermine the shareholders’ best interests. For example, shareholders virtually never fail to approve even the most excessive proposals for officer pay. See Randall S. Thomas & Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 WAKE FOREST L. REV. 31, 58 (2000). See generally Prentice, supra note 53, at 1218–23 (discussing severe limits to effectiveness of shareholder voting in public corporations).

206. Srinivasan Krishnamurthy et al., Auditor Reputation, Auditor Independence, and the Stock-Market Impact of Andersen’s Indictment on Its Client Firms, 23 CONTEMP. ACCT. RES. 465, 465, 484 (2006) (finding that stock market reaction to the stock price of Arthur Andersen clients was “significantly more negative when the market perceived Andersen’s independence to be threatened”).

207. There is some evidence that firms with particular agency problems sometimes realize how badly they need to gain credibility by appearing to have independent auditors and will therefore restrict the NAS they purchase from their auditors. See, e.g., Michael Firth, The Provision of Nonaudit Services by Accounting Firms to Their Audit Clients, 14 CONTEMP. ACCT. RES. (SUMMER ISSUE) 1, 1 (1997); Mohinder Parkash & Carol F. Venable, Auditee Incentives for Auditor Independence: The Case of Nonaudit Services, 68 ACCT. REV. 113, 131 (1993) (concluding that “[o]verall, the results of this study suggest that auditees recognize the potential for perceptions of independence impairment and voluntarily manage the amount of recurring nonaudit services that are purchased from their auditor”).

208. Ferdinand A. Gul et al., Non-Audit Services, Auditor Quality and the Value Relevance of Earnings, 46 ACCT. & FIN. 797, 814 (2006) (finding in Australian study that “the value relevance of earnings is weaker for firms that receive a higher proportion of NAS from the external auditor”).
Francis and Ke recently found that investors perceive that high levels of NAS fees compromise auditor independence and that this conclusion affects their investment decisions.\textsuperscript{209} Davis and Hollie discovered that when investors perceive that auditor independence is impaired because of a high level of NAS, they invest less confidently and pricing becomes less efficient.\textsuperscript{210} Brandon and colleagues learned that bond analysts punish firms that pay too much in the way of consulting fees to their auditors.\textsuperscript{211} Amir and colleagues also found that “when non-audit services outweigh the auditing service at the client level, auditor’s independence is questioned and bond ratings are negatively affected.”\textsuperscript{212}

A Congress acting with the primary goal of restoring the market’s faith in public companies’ financial disclosures could not afford to ignore appearances. There is substantial evidence that Sarbanes-Oxley as a whole did effectively restore investors’ confidence in the capital markets,\textsuperscript{213} and it is quite likely that the provision relating to consulting services played an important role. Because the capital markets are deeply and concretely affected by appearances, and because “even placebos can really alleviate illness,”\textsuperscript{214} it was not quackery for


\textsuperscript{210} Shawn M. Davis & Dana Hollie, The Impact of Nonaudit Services Fee Levels on Investor Perceptions of Auditor Independence, BEHAV. RES. ACCT. (forthcoming) (finding that “when investors perceive auditor independence is impaired as a result of the level of nonaudit fees, they are more likely to invest less confidently, pricing is less efficient and profits are less uniformly distributed across investors”).

\textsuperscript{211} Duane M. Brandon et al., Nonaudit Fees, Auditor Independence, and Bond Ratings, AUDITING: J. PRACT. & THEORY, Sept. 2004, at 89, 101 (finding “that the magnitude of nonaudit fees paid to the external auditors is negatively associated with a firm’s bond rating”).

\textsuperscript{212} Eli Amir et al., The Effects of Auditor Independence on Cost of Public Debt 22 (Sept. 2005) (unpublished manuscript, available at http://ssrn.com/abstract=781844) (finding generally that higher external auditor independence as promoted by Sarbanes-Oxley is associated with better bond ratings and lower yield premium in the primary corporate bond market); see also Inder K. Khurana & K.K. Raman, Do Investors Care About the Auditor’s Economic Dependence on the Client?, 23 CONTEMP. ACCT. RES. 977, 1007 (2006) (using client-specific ex ante cost of equity capital as a proxy for investor perceptions and finding that both audit and nonaudit fees are perceived as threats to independence by investors, meaning that SOX may have not gone far enough to minimize accounting firms’ economic ties to audit clients, rather than too far).

\textsuperscript{213} Given record budget deficits, record trade deficits, record gasoline prices, unprecedented job outsourcing, the impact of Hurricane Katrina, and the burdens of fighting both terrorism and the war in Iraq, American capital markets have performed remarkably well since July 2002. See, e.g., Edward Cone, Compliance: Is Sarbanes-Oxley Working?, CIO INSIGHT, June 12, 2006 (noting that the DJIA is up more than 50% above its 2002 lows); Jed Graham, SEC Mulls Fresh Sarbanes-Oxley Fixes to Ease Small Firms’ Compliance Costs, INVESTOR’S BUS. DAILY, May 11, 2006, at A1 (noting that “with stock indexes near multiyear or all-time highs, investors seem to have regained confidence in corporate books”); Andy Serwer, Stop Whining About SarbOx!: Critics Want to Repeal the Law, but It’s Been a Boon to the Market, FORTUNE, Aug. 7, 2006, at 39 (noting that the market value of the Wilshire 5000 index, a proxy for all public companies in the United States increased 54% in the four years after SOX was signed).

\textsuperscript{214} Clark, supra note 2, at 6.
Congress to legislate with independence in appearance in mind.\textsuperscript{215}

3. Independence in Fact

Turning to independence in fact, it is true that a large number of studies have failed to find convincing evidence that provision of nonaudit services (NAS) significantly impairs independence.\textsuperscript{216} However, many studies have found at least some evidence that NAS provision may impair independence in fact.

Looking at restatements, Kinney and colleagues recently found mixed results. They found a significant positive association between unspecified non-audit services and restatements, but they found no significant association between either financial information systems design and implementation or internal audit services and restatements, providing some evidence that provision of “NAS may create an economic dependence that leads to more restatements and that there are insufficient compensating financial reporting quality enhancements to offset the dependence.”\textsuperscript{217} On the other hand, the authors found that provision of tax services (which SOX does not outlaw) specifically was correlated to fewer restatements.\textsuperscript{218} Admittedly, most studies have failed to find a solid link between NAS provision and earnings restatements.\textsuperscript{219}

Other academics have studied the impact of NAS provision on auditors’ willingness to issue qualified opinions for clients. Wines found evidence indicating that Australian auditors are less likely to issue qualified opinions for clients.
to whom they provide higher levels of NAS. Sharma and Sidhu found in Australia that auditors providing more NAS were less likely to issue a going concern opinion, indicating an impairment of independence. Firth did a similar study in Great Britain and uncovered evidence that “the higher the consultancy fees paid to the auditor, the more likely the audit report will be clean.” However, more studies have not found such an impact.

Focusing on the relationship between NAS provision and accrual quality, Srinidhi and Gul found a significant negative relationship between the magnitude of NAS and accrual quality, concluding that their results suggest that “non-audit fees result in economic bonding and consequent loss of audit quality.”

Looking at audit failure as measured by litigation, Bajaj and colleagues found

220. Graeme Wines, Auditor Independence, Audit Qualifications and the Provision of Non-Audit Services: A Note, 34 ACCT. & FIN. 75, 83 (1994) (finding in an Australian study that auditors providing higher levels of NAS were less likely to issue qualified reports on clients, which could suggest to users of financial statements an impairment of independence).

221. Divesh S. Sharma & Jagdish Sidhu, Professionalism vs Commercialism: The Association Between Non-Audit Services (NAS) and Audit Independence, 28 J. BUS. FIN & ACCT. 595, 623 (2001) (“The results of this research are consistent with the proposition that auditors may be tempted to impair their independence when their audit clients generate higher proportions of NAS fees to total fees.”).

222. Michael Firth, Auditor-Provided Consultancy Services and Their Associations with Audit Fees and Audit Opinions, 29 J. BUS. FIN & ACCT. 661, 683 (2002).

223. See, e.g., Lynn Barkess & Roger Simnett, The Provision of Other Services by Auditors: Independence and Pricing Issues, 24 ACCT. & BUS. RES. 99, 107 (1994) (finding no relationship between dollar volume of NAS and audit qualification in Australian study); Allen Craswell et al., Auditor Independence and Fee Dependence, 33 J. ACCT. & ECON. 253, 273 (2002) (reporting results of Australian study on audit fee independence, finding no impact on auditors’ propensity to issue qualified opinions from higher level of audit fees); Alan T. Craswell, Does the Provision of Non-Audit Services Impair Auditor Independence?, 3 INT’L J. AUDITING 29, 36–38 (1999) (finding in Australian study that the level of NAS fees paid did not differ between firms receiving clean opinions and those receiving qualified opinions); Mark L. DeFond et al., Do Non-Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions, 40 J. ACCT. RES. 1247, 1271 (2002) (finding “no significant association between non-audit service fees and impaired auditor independence, where auditor independence is surrogated by auditors’ propensity to issue going concern audit opinions”); Clive S. Lennox, Non-audit Fees, Disclosure and Audit Quality, 8 EUR. ACCT. REV. 239, 248 (1999) (finding in a U.K. study a positive relationship between non-audit fees and audit qualifications, although the relationship was not significant); David Hay et al., Non-audit Services and Auditor Independence: New Zealand Evidence, 33 J. BUS. FIN. & ACCT. 715, 732 (2006) (reporting results of New Zealand study not finding evidence that increased NAS fees were associated with fewer qualified audit opinions; also finding that more NAS fees were not associated with longer auditor tenure although they were associated with higher levels of audit fees “which indicate lack of independence in appearance, but [is not] evidence of lack of independence of mind”); see also Paul J. Beck et al., An Empirical Analysis of the Relationship Between MAS Involvement and Auditor Tenure: Implications for Auditor Independence, 7 J. ACCT. LITERATURE 65, 82–83 (1988) (finding only some evidence that auditor tenure is longer when high levels of management advisory services (MAS) are provided by auditor, and concluding that because audit tenure for most firms in the study was lengthy, the “results do not provide evidence that auditor independence is impaired substantially by MAS involvement”); Curtis L. DeBerg et al., An Examination of Some Relationships Between Non-Audit Services and Auditor Change, ACCT. HORIZONS, Mar. 1991, at 17, 28 (finding no relationship between NAS purchases and client tendency to switch auditors).

224. Bin N. Srinidhi & Ferdinand A. Gul, The Differential Effects of Auditors’ Non-audit and Audit Fees on Accrual Quality, 24 CONTEMP. ACCT. RES. (forthcoming June 2007) (manuscript at 4, 19,
that “nonaudit fees are indeed higher than normal in cases for which there was a severe audit failure . . .”; however, because of various limitations in their study they refused to interpret higher compensation for consulting activities as evidence of lack of auditor independence.225 On the other hand, a different study failed to find that increased NAS is associated with less conservative financial reporting.226

The largest number of studies on the effect of NAS provision on independence has examined the impact on earnings management. Logically, if NAS provision causes independence problems, then one should see more earnings management by firms purchasing substantial amounts of NAS from their auditors. Frankel and colleagues did find more earnings management where audit firms provided more NAS.227 Gore and colleagues found similar results in a U.K. study, especially where non-Big 5 firms were involved.228 Dee and colleagues also reported significant associations between measures of earnings management and provision of NAS, concluding that their findings “suggest that auditors that earn a higher proportion of their fees from the provision of non-audit services to their clients allow more income increasing accruals.”229 Ferguson and colleagues, in another U.K. study, found positive and significant associations between three measures of NAS provision and three distinct indicators of earnings management, concluding that “[o]verall, these results are consistent with the proposition that higher levels of economic bonding between auditor and client resulting from the joint provision of NAS may reduce auditors’ willingness to restrain clients’ opportunistic accounting practices and may, in turn, reduce the quality of financial reporting.”230 This substantial body of work provides a reasonable empirical basis for Congress’s ban on many types

available at http://ssrn.com/abstract=920776 (but finding a positive relationship between accrual quality and audit fees, indicating that higher audit fees reflect higher audit effort).


226. Caitlin Ruddock et al., Nonaudit Services and Earnings Conservatism: Is Auditor Independence Impaired?, 23 CONTEMP. ACCT. RES. 701, 701–02, 741 (2006) (finding in an Australian study no evidence that high levels of NAS are associated with reduced earnings conservatism and concluding that litigation risk, threat of lost reputation, and alternative governance mechanism are sufficient to preserve actual auditor independence, although noting that restrictions on NAS provision may improve the appearance of independence).


230. Michael J. Ferguson et al., Nonaudit Services and Earnings Management: UK Evidence, 21 CONTEMP. ACCT. RES. 813, 836 (2004). Larcker and Richardson found a similar statistically positive association between NAS provision and signs of earnings management, but only for the firms in their
of NAS, even though many other studies have not concluded that auditor provision of NAS tends to increase earnings management and several of them rejected the conclusions of Frankel and colleagues.231

One reason these studies conflict may be that academics have yet to figure out how to tease out the real causal factors. For example, many of the studies on both sides of the issue worked from the assumption that if auditors are willing to accede to client demands for a clean opinion in order to sell a million dollars worth of consulting services to a client, then they must be twice as willing to do so in order to sell two million dollars worth of consulting fees. Unfortunately, it is unrealistic to expect the lock-step relationship some studies presume.232 Brown and colleagues note that “research designs that a priori restrict that relationship [between earnings quality and dependence on NAS fees] to being linear can spuriously produce evidence against the hypothesis that NAS matters.”233 Who is more likely to accommodate an aggressive client by fudging the numbers—CPA Joe who has already met his quota of $4 million in consulting revenue or CPA Mary who has not yet met her quota of $2 million in consulting revenue? The point is that even if Congress’s assumption that auditors might be willing to allow clients to engage in improperly aggressive reporting in order to keep them happy so that they will buy NAS is accurate, that does not necessarily mean that it will show up in a direct correlation between the level of NAS fees and measures of earnings management or opinion qualifications.

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231. See, e.g., Hollis Ashbaugh et al., Do Non-Audit Services Compromise Auditor Independence? Further Evidence, 78 ACC. REV. 611, 634 (2003) (finding no systematic evidence supporting the claim that auditors violate their independence by allowing earnings management as a result of clients purchasing relatively more nonaudit services); Hyeesoo Chung & Sanjay Kallapur, Client Importance, Non-Audit Fees, and Abnormal Accruals, 78 ACC. REV. 931 (2003) (not finding a statistically significant association between measures of earnings management and measures of client importance, including ratio of nonaudit fees to total revenues); Rick Antle et al., The Joint Determination of Audit Fees, Non-Audit Fees, and Abnormal Accruals 26 (Yale ICF, Working Paper No. 02-21, 2004), available at http://ssrn.com/abstract=318943 (finding that audit fees may increase abnormal accruals, evidencing unconscious bias in the auditor-client relationship, but finding no evidence that NAS fees increase signs of earnings management); Jong-Hag Choi et al., The Association Between Audit Quality and Abnormal Audit Fees 34–35 (Nov. 2005) (unpublished manuscript, available at http://ssrn.com/abstract=848067) (finding that it is positive abnormal audit fees, rather than NAS fees, that are associated with evidence of poor audit quality).

232. For example, studies do not indicate that if 25% of people will lie to receive a payoff of $1,000, 50% will lie for a payoff of $2,000. See Steve E. Salterio & Alan Webb, Honesty in Accounting and Control: A Discussion of “The Effect of Information Systems on Honesty in Managerial Reporting: A Behavioral Perspective,” 23 CONTEMP. ACC. RES. 919, 923 (2006) (noting that “[t]he level of honesty does not differ significantly between the two experiments [involving different payoffs], which is inconsistent with the economics-based prediction . . . that increasing the payoff for lying results in more lying”).

Another complication is that most studies look at overall firm revenues. This approach is problematic because key decisions are more often made at local offices by an audit partner whose career, like that of David Duncan of Arthur Andersen (the engagement partner on the Enron account), may depend upon keeping just one or two clients happy.234

Romano points out that the SEC has stated that “[s]tudies cannot always confirm what common sense makes clear.”235 She notes that this observation was made by a group created at former SEC chief Arthur Levitt’s request and observes: “Not surprisingly, a statute informed by Levitt’s perspective would not be responsive to the concerns of a literature that did not fit with his preconceptions.”236 This is a fair criticism, but it proves too much. To conclude, as defenders of provision of NAS do, that the opportunity to provide millions of dollars of such services does not affect audit judgment is inconsistent with common sense, the rational man theory of economics, and scores of studies done in the field of psychology on the self-serving bias (many studying auditors specifically).237 Of course auditors must be concerned with their reputation and litigation exposure and these factors will restrain wrongdoing. But does it truly make sense to conclude that auditors’ judgments are not affected when millions and millions of dollars of consulting revenue are placed on the other side of the scale? Just as studies commissioned by Arthur Levitt will be affected by his preconceived notions, conclusions reached by auditors will necessarily be influenced by their economic interests even if academics have not yet found a way to precisely measure that impact.238

234. See Macey & Sale, supra note 189, at 1168 (noting that lead “audit partners inevitably become captured by their client and are unwilling to report anything negative about those clients back to their firms”). Romano cites the Reynolds and Francis study that attempted to analyze revenues at an office-level. See J. Kenneth Reynolds & Jere R. Francis, Does Size Matter? The Influence of Large Clients on Office-Level Auditor Reporting Decisions, 30 J. ACCT. & ECON. 375 (2001). This study did not find that Big 5 auditors treat larger clients in their practice offices more favorably than smaller clients either with respect to going concern reports or earnings management. However, this study did not look at NAS revenue specifically. Id. at 396–97.

In a more recent study, Ahmed and colleagues, like Reynolds and Francis, looked at the office-level and focused solely on total revenue rather than NAS revenue. Focusing on earnings management, they found a positive relation between office-level measures of client importance and abnormal accruals that for their overall sample weakened in the post-SOX era (although not for firms with weak governance). See Anwer S. Ahmed et al., supra note 127, at 3, 23. In other words, Ahmed and colleagues, consistent with the economic theory that underlies this portion of SOX, found that auditors are more likely to fudge the numbers for important clients and that SOX improved, but did not completely remedy, the problem.

235. See Romano, supra note 1, at 1564 (quoting Revision of the Commission’s Auditor Requirements, 65 Fed. Reg. 43,148, 43,155 (July 12, 2000)).

236. Id.


238. See Macey & Sale, supra note 189, at 1175–76 (noting that pre-SOX rules allowing auditors to provide a wide range of consulting services “appear to have been premised on the faulty assumption
The debate over whether NAS provision impairs independence in fact remains unresolved, although the majority of academic studies fail to find direct evidence of impairment. Nonetheless, respected academics, experienced regulators, and various boards and commissions have believed that NAS provision impairs auditor independence. The evidence has been sufficiently persuasive that Japan, France, Belgium, and Italy have prohibited auditors from supplying NAS to audit clients, and other E.U. nations severely restrict or discourage the joint provision of audit and nonaudit services. Before heavy lobbying by the Anglo-American accounting profession successfully intervened, the European Commission’s proposed Eighth Directive on Company Law would have prohibited auditors from rendering any additional services to their audit clients. Perhaps these agencies were willing to ban NAS because it is also true that few empirical studies demonstrate any meaningful benefit from joint provision of auditing and NAS, so even an unjustified separation “should generate no great concern.”

Again let us conclude with studies of SOX’s actual impact. Hoitash and colleagues discovered a statistically positive association between audit fees and

that auditors and their clients had a shared incentive to maintain their independence from one another and to perform high quality work’’); see also Robert A. Prentice, The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing, 61 Ohio St. L.J. 1597, 1629–53 (2000) (citing scores of studies demonstrating that auditors’ judgments are affected by the self-serving bias).

239. Briloff, supra note 194, at 491–94 (criticizing provision of NAS by auditors); Cox, supra note 180, at 305 (noting that “[t]he prime suspect for the accounting profession’s recent sorrowful performance as a gatekeeper against financial frauds is the rising importance of non-audit services in overall operations of the major accounting firms”); Francis, supra note 185, at 364 (“To restore public confidence in auditing, and to possibly increase actual audit quality as well [as] the public’s perception of quality, accounting firms can signal their unambiguous commitment to audit quality by voluntarily stopping the provision of other (non-audit) services to audit clients in order to convey in the clearest possible manner that independent auditing is the core value and the core business of public accounting firms.”); Arieh Goldman & Benzion Barlev, The Auditor–Firm Conflict of Interests: Its Implications for Independence, 49 Acct. Rev. 707, 715 (1974) (noting that if NAS provision becomes widespread (as it since has), “the current basis of auditor’s professional uniqueness will be eroded,” though stopping short of calling for elimination of these services).

240. For example, Arthur Levitt, who headed the SEC for many years, strongly believed that provision of audit services impaired independence. See Arthur Levitt, Renewing the Covenant with Investors, Remarks delivered at the New York University Center for Law and Business (May 10, 2000).

241. For example, the staff of the Metcalf Committee, the Public Oversight Board, and the Commission on Auditors’ Responsibility have all expressed concern about the impact of NAS provision upon auditor independence. See, e.g., Survey Div., Audits & Surveys, Inc., Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients: A Research Report Prepared for Pub. Oversight Bd., SEC Practitioner Section—Div. for CPA Firms—AICPA (1986); Comm’n on Auditors’ Responsibilities, Report, Conclusions, and Recommendations (1978).


243. See Firth, supra note 222, at 665.

244. Clark, supra note 2, at 297.
evidence of earnings management from 2000 through 2003, and a significantly positive association between NAS fees and earnings management indicators in 2000 and 2001, but not after SOX was enacted.\textsuperscript{245} They conjecture that SOX was the reason for the lack of association between NAS fees and discretionary accruals after its passage,\textsuperscript{246} indicating not only that SOX’s positive results prove that it is hardly quack corporate governance in this regard, but also that if there is an argument to be made, it may be that SOX went not far enough (rather than too far) in minimizing auditors’ economic bonds with clients. Similarly, Lai, who hesitates to conclude that audit firms lacked independence before SOX, concludes that after SOX audit firms are more likely to issue modified audit opinions and auditees are likely to manage earnings less than before.\textsuperscript{247} Lai concludes that his “results suggest that the Sarbanes-Oxley Act is associated with improved auditor independence.”\textsuperscript{248}

The empirical literature fails to indicate that SOX’s prohibition of certain types of NAS is quack corporate governance.

C. EXECUTIVE LOANS

McDonnell notes that in passing SOX:

\begin{quote}
[A]lthough Congress has made a highly visible show of action, it has actually left it up to better-informed regulators and private actors to determine the detailed response to the scandals. This process has left much discretion in the hands of the best-informed parties, while inducing them to make needed reforms out of fear that if they do not, worse laws will follow.\textsuperscript{249}
\end{quote}

Thus, much of SOX works just the way Romano suggests, but section 402, which baldly prohibits companies from making loans to their officers and directors (with narrow exceptions), does not.

In evaluating section 402, it is worth remembering that the provocation for action on executive loans was great because in July 2002 a litany of abuses was rapidly coming to light. Executives of many companies had been using their firms’ treasuries as personal piggy banks, taking compensation that was largely independent of performance, disguising that compensation, and often not paying

\textsuperscript{245} Rani Hoitash et al., Auditor Fees, Abnormal Fees and Audit Quality Before and After the Sarbanes-Oxley Act 22–23 (Feb. 7, 2005) (unpublished manuscript, available at http://ssrn.com/abstract=646681) (also noting that their “results are most consistent with economic bonding being the primary determinant of auditor behavior rather then [sic] auditor reputation concerns”).
\textsuperscript{246} See id. at 1.
\textsuperscript{248} Id. at 14.
loans back when the going got tough. Bernie Ebbers, CEO of WorldCom, borrowed $408 million from his firm, using significant amounts of it for personal purposes. Ken Lay, in his final year at Enron, received $67 million in compensation and $70 million in loans. He enjoyed a $7.5 million line of credit, which he would sometimes draw down completely several days in a row, always repaying Enron with its own stock. CEO Dennis Kozlowski borrowed around $270 million from Tyco, most of which he used to buy a yacht, jewelry, art, and real estate. The potential for disaster was widespread; nearly 75% of the nation’s largest 1,500 companies loaned large sums of cash to top executives. Of those firms that disclosed their loans in 2002, the average size of the cash loans was about $11 million, with total insider indebtedness of $4.5 billion.

Approximately forty percent of these loans were purportedly made so that executives could purchase company stock, theoretically aligning their interests with shareholders’. Unfortunately, executives could sell those shares as quickly as they bought them, minimizing any benefits of the loan. Indeed, a study by Kahle and Shastri found that although loans can be helpful in increasing stock ownership of low ownership officers, on average “[a] loan that enables a manager to buy 100 shares of stock results in only an eight-share increase in ownership.” Furthermore, the empirical academic literature does not clearly demonstrate that increased executive ownership produces increased corporate value.

Not only did these loans not achieve their stated purpose, a substantial


251. See Dana Cimilluca, Former WorldCom CEO Ebbers Misses Loan Payment, Toronto Star, May 17, 2003, at C4 (noting that although the company extended Ebbers credit to help him repay bank loans without selling his WorldCom stock, Ebbers used some of the money to buy timberlands, to make donations to his alma mater, and the like).


255. See Ralph King, Forgotten, Bus. 2.0, Nov. 2002, at 82.


257. Id.


259. See id. at 792 (citing conflicting studies).
proportion of them were secured only by the stock itself, meaning that if the stock price dropped, the board of directors was almost inevitably forced either to loan additional sums or to forgive the loans so that investor confidence in the company’s stock would not be torpedoed by executives being forced to sell large chunks of stock at a time when the firm was struggling.\textsuperscript{260} The WorldCom board learned this lesson with Bernie Ebbers, who ultimately could repay almost none of the $400 million he borrowed.\textsuperscript{261} Conseco nearly went bankrupt after providing $575 million in loans to top executives to enable them to buy company stock; the executives could not repay the loans when the company’s stock tanked.\textsuperscript{262} Among other companies whose executives never repaid loans, Golf Trust of America forgave $2.1 million owed by its CEO.\textsuperscript{263} It has been estimated that as much as one billion dollars of pre-SOX loans will ultimately be forgiven.\textsuperscript{264}

These loans allowed executives to disguise huge amounts of compensation,\textsuperscript{265} often forced executives to either take unduly risky strategies to prop up share prices\textsuperscript{266} or to resort to outright fraud in order to do so, and were often used by insiders to siphon funds away from firms facing insolvency such as at Adelphia (where $3.2 billion disappeared into the pockets of the controlling Rigas family).\textsuperscript{267}

Romano does not assert that the academic literature is inconsistent with the loan provision. Indeed, the few existing studies of the subject support Congress’s decision to take action. Kahle and Shastri found that loans to buy securities tended to be made more to executives with high stock ownership, high cash compensation, and a large number of options exercised and granted; they, therefore, concluded that “option exercise loans enable entrenched managers to further increase ownership. . . . consistent with [commentators] who propose that options are less an incentive device than a mechanism for self-dealing by managers.”\textsuperscript{268} Cullinan et al. found a “significant association be-

\begin{itemize}
\item \textsuperscript{260} See Barnard, \textit{supra} note 250, at 330 (noting how WorldCom directors worried that if they did not loan money to CEO Ebbers, he would have to keep selling WorldCom stock and if the fact of his sales became public WorldCom’s stock price would drop).
\item \textsuperscript{261} See Cimilluca, \textit{supra} note 251, at C4; see also David Leonhardt, \textit{It's Called a 'Loan,' But It's Far Sweeter}, N.Y. \textsc{Times}, Feb. 3, 2002, at BU1.
\item \textsuperscript{262} See Gary Strauss, \textit{Don't Bother Paying Us Back, Many Boards Tell CEOs}, \textsc{USA Today}, Nov. 13, 2001, at 1B.
\item \textsuperscript{263} \textit{Id.}
\item \textsuperscript{264} BEBCHUK & FRIED, \textit{supra} note 256, at 116.
\item \textsuperscript{265} See, e.g., \textit{Id.} at 115–17.
\item \textsuperscript{266} See Leonhardt, \textit{supra} note 261, at BU1 (quoting pay consultant Russell Miller).
\item \textsuperscript{267} Adelphia Says '03 Loss Smaller, L.A. \textsc{Times}, Dec. 24, 2004, at C9 (noting that Rigas family members had been convicted of looting $3.2 billion from the company).
\item \textsuperscript{268} Kahle & Shastri, \textit{supra} note 258, at 794–95 (referencing Andrei Shleifer & Robert W. Vishny, \textit{A Survey of Corporate Governance}, 52 J. \textsc{Fin.} 737 (1997); David Yermack, \textit{Good Timing: CEO Stock Option Awards and Company News Announcements}, 52 J. \textsc{Fin.} 449 (1997)).
\end{itemize}
between executive loans and financial misstatements.269 And Elizabeth Gordon et al. found “a strong negative relationship between industry-adjusted returns and [the presence of insider] loans.”270

Clearly, Congress’s decision to reform executive loan practices enjoys significant support from salient examples of extreme abuse, as well as from academic literature indicating that executive loans (a) did not accomplish their main purpose, (b) contributed to inaccurate reporting, and (c) were associated with poor performance. Nonetheless, Romano and other critics suggest that section 402 was drafted in haste and poorly done. We agree, although we think some criticisms of the provision overreach.

Cunningham calls section 402’s ban on executive loans underinclusive because many of the abuses stemming from loan practices can be accomplished in other ways.271 This is a fair criticism, but no abuses would ever be outlawed if a decisive objection lay in the fact that other abuses would remain. Can not the other abuses be addressed in their turn?

Lowenstein also complains that of various forms of insider compensation that were abused, loans were not the most egregious,272 but again the fact that Congress might profitably have addressed other problems as well does not mean it should not have reformed loan abuses, which were themselves hardly minor.

Cunningham also objects that the ban will drive companies from using loans to other, less optimal tools of compensation.273 Possibly, but if the last decade has demonstrated anything it is that there are too many, not too few, mechanisms for shifting shareholder wealth into the pockets of executives.274 And Gordon et al.’s empirical study found insider loans and other forms of related-party transactions were indications of agency problems rather than efficient transactions.275

Although using loans as a form of compensation carries certain advantages in various contexts, most strong defenses of the practice assume that loans are used in place of other, less efficient, forms of compensation. Romano, for example, argues that stopping loans is not likely to result in reduction in total pay, but will instead force firms to compensate officers using less efficient forms of recompense.276 She and the other critics of section 402 apparently are wrong.

271. Lawrence A. Cunningham, Congress Overreacts on Audit Reform, DAILY DEAL, Nov. 5, 2002.
273. Cunningham, supra note 271.
274. See generally BERCHUK & FRIED, supra note 256.
276. See Romano, supra note 1, at 1539.
in this regard; Kahle and Shastri found that “executives who receive loans are not giving up other forms of compensation in return for receiving these loans.”

The most common criticism is that section 402 lacks clarity and leaves it unclear as to whether several widely practiced forms of executive compensation such as split-dollar life insurance policies, broker-assisted cashless option exercises, travel advances, relocation loans, and retention loans are still permissible. This is a legitimate complaint, even though many of these types of loans were the subject of abuse.

On the other hand, it is not clear how much injury SOX’s broad prohibition has truly caused, especially because the SEC clearly signaled an intent not to enforce the broad ban strictly and even its inexcusable failure to give specific guidance in the area has been mitigated by twenty-five major law firms that banded together to give consensus guidance, to which the SEC has acceded.

At the end of the day, there is little doubt that enactment of this broad ban disrupted many common and harmless loan arrangements at many firms. Companies have had to seek substitutes for legitimate loans as well as for illegitimate loans, and substantial time and money have been spent in various efforts to interpret section 402’s provisions.

How did this broad, disruptive (though hardly disastrous) executive loan ban become law? One may well argue that the problem, contrary to Romano’s

279. See, e.g., Maremont & Markon, supra note 254, at A3 (noting prosecutors’ charges that Tyco CEO Kozlowski used a $46 million interest-free “relocation loan” to buy four luxury properties); Tracie Rozhon & Joseph B. Treaster, Insurance Plans of Top Executives May Violate Law, N.Y. TIMES, Aug. 29, 2002, at A1 (quoting compensation consultant Graef Crystal as noting that split-dollar insurance deals are “a waste of assets” that end up being “a no-interest loan, when the money could have been used to invest in a plant or new equipment”).
280. See McDonnell, supra note 249, at 515 (noting that section 402’s “impact is relatively confined”).
primary complaint, was largely a lack of policy entrepreneurs to guide congressional action. Barnard has traced the legislative history of this provision, pointing out that even Democrats initially pushed only for hortatory legislation that would have merely urged directors to rein in the more abusive loan practices; disclosure rather than prohibition was to be the remedy. However, in July 2002 when the stock market was dropping like a stone, investor confidence was cratering, and abusive loan practices were in the headlines daily, it came to light that a decade earlier President Bush had taken loans from Harken Energy Corporation while a director of that firm. This disclosure embarrassed the President politically, especially because in a speech at the New York Stock Exchange he had just publicly “challenge[d] compensation committees to put an end to all company loans to corporate officers.” President Bush’s call for a total ban on such loans was, as Romano notes, “a decisive factor” in the prohibition being included in SOX. Bush’s statement, actuated by his acute political plight, emboldened Democrats to insert a total ban into the pending Senate reform bill, claiming that the White House supported the provision. SOX passed almost immediately, containing the loan ban even though the matter “was proposed and adopted without so much as an intelligent conversation.”

The process by which the loan ban became law emphasizes Romano’s point, which we do not contest, that in a time of intense political pressure, laws can be enacted with little deliberation. However, it undermines any broadside against “policy entrepreneurs,” for it was the very lack of such entrepreneurs with pre-developed solutions that caused the problem here. Under intense political pressure, with no nuanced remedy having been developed by policy entrepreneurs and no academic literature to study (or ignore), Congress acted with a meat ax rather than a scalpel. In the words of one commentator, “[i]n applying Draconian penalties, Congress made no apparent attempt to distinguish between the outrageous on [the] one hand, and the immaterial and customary on the other hand.” We agree that Congress should have taken a more nuanced approach.

It is inevitable in the passage of every sweeping reform statute that some

287. Id. at 336.
290. Romano, supra note 1, at 1562.
291. Barnard, supra note 250, at 328.
292. Romano makes the point that the loan ban was not on the radar screen of the “policy entrepreneurs” of which she complains. See Romano, supra note 1, at 1563.
provisions will receive more attention than others. That section 402 was inserted into SOX in the eleventh hour is not optimal, but it is scarcely a damning indictment of the overall statute. In hindsight, one hopes that Congress would have done a better job on section 402 had it taken a little more time. Of course, had Congress taken a little more time, corporate lobbyists might have ended up writing their own regulations, as happened often in the Tom DeLay era.294 Had Congress taken more time, who knows how many eviscerating amendments might have been tacked onto the bill before it was enacted into law? And then nothing would have been done about real problems associated with executive loans.

D. EXECUTIVE CERTIFICATION

Romano’s final assault on the substantive provisions of SOX focuses on section 302’s requirement that CEOs and CFOs of public companies certify that the company’s periodic reports do not contain material misstatements or omissions and “fairly present” the firm’s financial condition and results of operations.295 This is part of a trio of executive certification provisions, some would say an evil triumvirate, aimed at improving the accuracy and reliability of financial statements. The second leg of the stool is section 906(a)’s criminal penalty for officers who knowingly certify an inaccurate financial statement.296 The third is the now infamous section 404, which requires the filing of a management report attested to by the external auditor assessing the reliability of the issuer’s internal financial controls.297

Romano could not attack section 302 too vigorously, for at the time she wrote only two studies had been done regarding its impact and one of them indicated that it beneficially provided useful information to investors.298 Still, she sensibly called for more research, suggested that the certification regime be made optional, and presciently worried about the costs associated with the certification requirement.299

Recent developments demand that primary attention shift from section 302 to its companion, section 404. Today there are few major complaints about SOX apart from section 404.300 But because of the tremendous and unforeseen (by Congress and the SEC) costs imposed by section 404, it has become in the minds of many so synonymous with SOX that even if SOX’s other provisions

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298. See infra notes 310–312 and accompanying text.
299. Romano, supra note 1, at 1542–43.
do, on balance, produce benefits, SOX may be deemed a failure.

1. Section 302

Section 302 requires CEOs and CFOs to certify their firms’ quarterly and annual reports. Part of section 302’s purpose is to send a message to remind CEOs and CFOs that their responsibility is not to look the other way when financial shenanigans are occurring, as so many CEOs apparently did during the dot-com boom, or to issue numbers that are as optimistic as the auditors can be coerced into certifying, as so many CFOs did during the same time period.

In part, section 302 aims to take away the “plausible deniability” that Jeff Skilling, Richard Scrushy and other CEOs proclaimed when their houses of cards came crashing down. This is particularly important given that a large percentage of financial frauds involve the company’s CEO or CFO. It is likely not a coincidence that HealthSouth’s CFO resigned in August of 2002 rather than sign the section 302 certification; that resignation led directly to the unraveling of HealthSouth’s multibillion dollar fraud.

Thus, there is both logic and anecdotal evidence to support section 302’s certification requirement. Instead of acting hastily as Congress did in passing

301. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (Supp. II 2002). The officers must certify that: (a) they reviewed the report, (b) the report contains no misrepresentations, (c) the financial information is fairly presented, (d) they have reported any known internal weaknesses to the audit committee, and (e) they have reported any material changes in internal controls. Id.

302. See Manuel A. Utset, Time-Inconsistent Management & the Sarbanes-Oxley Act, 31 OHIO N.U. L. REV. 417, 442 (2005) (arguing that certification requirements of sections 302, 906, and 404 “provide value by targeting the short-term preferences of managers who might be tempted to repeatedly procrastinate in addressing problems that they are aware of but whose resolution would require managers to incur an immediate cost (even if the cost is merely the exertion of effort). The certification requirements make salient the costs associated with each one-period delay in addressing the problem”).


304. Of course, it is not only section 302 that is helping in this regard. See GLASS, LEWIS & CO., RESTATEMENTS TREND ALERTS: GETTING IT WRONG THE FIRST TIME 11 (2006) (noting that “[n]ot long ago, companies often could count on their outside auditors to help them rationalize aggressive—or even just plain wrong—accounting practices. Now, audit firms know the PCAOB will be second-guessing their work if it appears substandard”).

305. Geiger & Taylor, supra note 303, at 357 (noting that in front of Congress, “Mr. Skilling claimed to be totally ignorant about the details of Enron’s accounting”).

306. Roberto Ceniceros, Interest in Governance Drives Director Scrutiny, BUS. INS., Jan. 27, 2003, at 10 (citing John Tonsick, managing director in Los Angeles for Citigate Global Intelligence & Security, a global business intelligence firm); see also Merle Erickson et al., Is There a Link Between Executive Incentives and Accounting Fraud?, 44 J. ACCT. RES. 113, 123 (2006) (“[W]e find that the highest levels of management are most often accused of involvement in the accounting fraud. In more than 50% of the cases, the CEO or the CFO was accused of perpetrating the accounting fraud that led to the AAER.”).

SOX, Australia’s Parliament studied proposed corporate reforms slowly and carefully yet came to a similar conclusion in requiring officers and directors to certify required financial filings. But does the empirical evidence indicate that the certifications provide useful information to the market as Congress intended?

As noted, at the time Romano wrote, only two studies had been done. Bhattacharya et al. found that the market had already separated firms with good earnings transparency from those with bad transparency so that the SEC’s initial required certification by selected firms in August of 2002 was a “non-event,” concluding that “[t]he SEC order did not help, but neither did it hinder, the market’s ability to differentiate further between these two types of firms.” Hirtle, on the other hand, looked only at bank holding companies and found that “BHCs subject to the SEC’s order experienced positive and statistically significant abnormal returns from certification,” which would indicate that the certification provided valuable information to investors.

Most newer studies have found positive results flowing from the certification, consistent with Hirtle’s findings, and contradicting the “neither helped nor hindered” conclusion of Bhattacharya et al. These newer studies have tended to find that the disclosures have provided useful information to investors, restored investors’ confidence in the market, and rewarded firms with better internal controls, as intended by Congress.

For example, Vermeer studied firms that voluntarily certified financial statements and found that such firms were less likely to engage in earnings management, concluding that “[s]ection 302 may provide value by enhancing the credibility of those companies that did not provide certification under a voluntary system.” Chang et al. examined the impact on share prices of firms that certified; they found evidence that the provision advanced SOX’s goal of decreasing investor mistrust of corporate disclosures, concluding that “[t]aken together, our results suggest that the SEC order requiring filing of sworn

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309. See Michael Hill, Sustaining Compliance, 57 Keeping Good Companies 460, 460 (2005) (noting that CLERP 9 “stipulates that CEOs sign off on the veracity of company accounts and the accompanying internal controls around business financial systems”).
310. Both studies, and some others since, looked at the SEC’s June 27, 2002 order which, anticipating the later SOX rules, required CEOs and CFOs of certain large public companies to begin certifying their firms’ financial statements by August 14, 2002.
312. Beverly Hirtle, Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs, 38 J. Money Credit & Banking 1263, 1264 (2006). Hirtle also found that “certification resulted in a lasting decline in uncertainty concerning these banks’ future earnings streams, as the variance of analysts’ earnings forecasts for certifying BHCs declined significantly in the year following certification.” Id.
statements by CEOs and CFOs had a positive effect on the market value of certifying firms, consistent with the notion that certification improved investors’ confidence in corporate disclosures.314

Hammersley and colleagues studied cases where section 302 certifications revealed material weaknesses and concluded that the market reaction in terms of volume and direction suggested that the disclosures provide investors “with much more timely information about the quality of a company’s internal control system than was previously available.”315 Beneish et al. looked at stock returns and cost of capital effects in the wake of section 302 disclosures of internal control weaknesses and found significantly negative abnormal returns as well as positive abnormal increases in implied cost of capital, indicating that “these disclosures inform investors about the financial reporting quality of disclosing firms.”316 Ashbaugh-Skaife et al. studied Section 302 (and 404) reports and found that firms disclosing an internal control problem experienced large increases in costs of capital, indicating “that internal control risk matters to investors and that firms reporting strong internal controls or firms that correct prior internal control problems benefit from lower costs of equity capital beyond that predicted by other internal control risk factors.”317

Clearly, today a strong empirical case indicates that section 302 certifications not only warn CEOs and CFOs to take their responsibilities seriously, but also provide valuable information to the capital markets.318

2. Section 404

Congress thought it sensible to back up section 302’s certification requirement with provisions aimed at ensuring that internal financial controls were in


318. See also Paul A. Griffin & David H. Lont, Taking the Oath: Investor Response to SEC Certification Under Sarbanes-Oxley, 1 J. CONTEMP. ACCT. & ECON. 27 (2005) (finding that “investors did, in fact, respond to the events associated with SEC certification”). Wilkinson and Clements assumed that an early filing of CEO certifications might represent an attempt to signal financial reporting quality to the market but found no effect. Their assumption is only that, an assumption. It is just as reasonable to assume that these firms filed early because they finished early or that they filed early in an attempt to “get out in front” of a controversy. Overall, the results seem irrelevant to the question of whether the certification provides useful information to the market. See Brett R. Wilkinson & Curtis E. Clements, Corporate Governance Mechanisms and the Early-Filing of CEO Certification, 25 J. ACCT. & PUB. POL’Y 121 (2006).
place and effective so that CEOs and CFOs could have confidence in the numbers they were certifying, and required auditor certification so that the investing public could also have confidence.319

Congress’s attention to internal financial controls was consistent with preexisting theoretical work. Before SOX was passed, experts had emphasized the importance of internal controls to corporate managers, external auditors, investors, the government, and society as a whole because of their important effect upon long-term confidence in corporate financial reporting.320 Theoretically, firms with poor internal controls should have to pay more for capital because of the increased risk they present to investors.321 Empirical evidence supports this theory, showing that firms with poor internal controls tend to restate earnings more often.322 Such restating firms are typically punished by the market.323 Consistent with SOX, empirical studies also show that poor internal controls are associated with problems such as poor quality accruals.324 Overall, companies with poor internal controls tend to be worse performers and systematically riskier than comparable firms.325

319. After implementation of PCAOB Auditing Standard No. 2, material weaknesses in internal controls are to be disclosed to the public in three ways: (1) management’s report on the effectiveness of internal controls; (2) the auditor’s opinion on management’s assessment of internal controls; and (3) the auditor’s opinion on the effectiveness of internal controls. See William R. Kinney, Jr. et al., Assertions-Based Standards for Integrated Internal Control, ACCT. HORIZONS, Dec. 1990, at 1, 3 (noting that “since management designs and operates the internal control system, the system cannot be relied upon to prevent or detect fraudulent acts by management itself”).

320. See id. at 1.


323. Hemang Desai et al., The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Management Turnover, 81 ACCT. REV. 83 (2006) (finding that the market imposes a substantial penalty on those firms that engage in earnings manipulation and have to restate financials); Kinney & McDaniel, supra note 322, at 71 (finding that firm profitability is negatively associated with restatements).

324. Jeffrey Doyle et al., Accruals Quality and Internal Control over Financial Reporting, ACCT. REV. (forthcoming) (finding that firms that disclosed at least one material weakness in internal controls between August 2002 and November 2005 tended to have lower quality accruals). Doyle et al. note that their study provides empirical support for previous theoretical arguments linking internal controls and earnings reporting quality. Id.; see William R. Kinney, Jr., Research Opportunities in Internal Control Quality and Quality Assurance, AUDITING: J. PRAC. & THEORY, Supp. 2000, at 83, 84; see also Kinney & McDaniel, supra note 322, at 72.

Thus, both theoretical and empirical scholarship supports Congress’s focus on internal financial controls. This focus scarcely seems radical as it was simply an extension of Foreign Corrupt Practices Act rules on internal accounting controls, based largely on section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which had without any significant controversy already required insured depositary institutions to report on their internal controls and required the institutions’ independent accountant to attest to managements’ assertions.

Interestingly, France has similar internal control requirements, and Japan’s new Company Law also requires directors to “set up internal controls and monitor their effectiveness.” Congress’s decision to back up section 302 reports with section 404 auditor verification is also vindicated by post-SOX empirical studies showing that it is only after independent audits of internal controls come into the picture that companies tend to self report deficiencies under section 302. Auditing is arguably a critical component if we are to be serious about improving internal financial controls.

Furthermore, like section 302 certifications, section 404 reports have generally (but not universally) been found to provide useful information to the capital markets. De Franco et al., for example, studied firms that reported a deficiency that firms disclosing material weaknesses after SOX tended to be “smaller, younger, financially weaker, growing rapidly, or undergoing restructuring”).


328. See Chrystia Freeland & Jeremy Grant, Brokering Change: How Cox is Building a Consensus as Regulation Goes Global, Fin. Times (London), Aug. 4, 2006, at 11 (noting that SEC Chair Christopher Cox has pointed out that section 404 was based “almost word for word” on the FDICIA rule which the banking industry has “‘taken in (its) stride’”).


330. Charkham, supra note 30, at 152.

331. Glass, Lewis & Co., supra note 304, at 6 (noting that in the first years of SOX the vast majority of CEOs and CFOs certified their financial controls as free of material weaknesses, and only when outside audits commenced did the extent of internal control problems become known); Lord & Benoit, The Lord & Benoit Report: Bridging the Sarbanes-Oxley Disclosure Control Gap 8–9 (2006), available at http://www.section404.org/pdf/Lord_Benoit_Report_1_.pdf (same).

332. Boritz, supra note 329, at 28 (noting that “[a]uditing provides the highest level of assurance because it involves searching for evidence in support of or contradicting management’s assertions”).
in internal controls between November 1, 2003 and December 31, 2004 and found that the market reacted negatively to such disclosure, “support[ing] the idea that investors react to internal control news, that they are not fully aware [before disclosure] of the internal control deficiencies, and that internal control deficiencies are economically significant phenomena.”333 They also found that investors used this information to allocate their investment resources and thereby increase the efficiency of the capital markets, as the SEC had argued,334 and that the greatest benefit of the law flowed to small investors, as regulators had conjectured.335

Ettredge and colleagues found that auditors’ adverse 404 opinions on clients’ internal controls “are the most consistently significant determinant of [auditor] dismissals and resignations across our numerous regressions,”336 and concluded that such opinions “are consequential to clients and provide a new measure of audit or business risk that is meaningful to auditors.”337 And certainly the information is valuable to investors as well, especially given that more than half of all restatements in 2005 were by companies that had disclosed at least one material weakness.338

Doyle and colleagues studied the relationship between weak internal controls in firms identified by SOX-required disclosures under sections 302 and 404 and accruals quality (a measure of the accuracy of reported earnings). They learned that, consistent with sections 302 and 404, “the internal control environment is a fundamental element in the production of high quality accruals . . . .”339 This suggests that SOX’s mandated disclosures on company-level material weaknesses are “at least in part, appropriately identifying ‘poor quality’ firms—specifically those with poor accruals quality.”340 More specifically, they found that poor internal controls in their subject population were positively associated with several different measures of earnings management, including discretionary accruals, average accruals quality, and historical restatements.341

Ashbaugh-Skaife and colleagues used unaudited pre-SOX 404 disclosures and SOX 404 audit opinions in order to gauge how changes in internal quality

334. Id.
335. Id. at 1, 6–7.
337. Id. at 32.
338. GLASS, LEWIS & CO., supra note 304.
340. Id. at 31.
341. Id. at 2. This study did find that section 302 reports were more strongly associated with earnings management than section 404 reports, perhaps because auditors were pickier and more likely to highlight not only the significant internal control problems that management reported voluntarily but also more picayune problems that did not have significant impact on earnings quality. Id. at 3.
control affect risk and, importantly, the cost of equity capital. They determined that firms with internal control deficiencies have higher idiosyncratic risk, higher systemic risk, and higher cost of equity capital. When firms disclose an internal control problem, their costs of capital rise significantly, but when they subsequently improve their internal controls and receive an unqualified SOX 404 opinion, their costs of capital decrease. The results indicate that strong internal controls are valued by the capital markets and that SOX 404 helps inform the markets in important ways.

In a separate study, Ashbaugh-Skaife and colleagues studied the impact of the remediation of internal control deficiencies upon accrual quality. They found that firms with internal control deficiencies have higher total and abnormal working capital accruals (evidence of earnings management) compared to other firms. When those firms remedy their internal control deficiencies and earn an unqualified SOX 404 audit opinion, the accuracy of earnings reporting improves, “consistent with the notion expressed by then SEC Chairman Donaldson that strong internal controls provide a significant long-term benefit in improving the accuracy of financial reporting that leads to higher quality information for firms’ external stakeholders.”

Looking at the capital market reaction to section 404 from another angle, Lord and Benoit calculated average share price for 2,481 publicly held companies on March 31, 2004, 2005, and 2006. They determined that firms with effective internal controls in both years (3/1/04–3/1/05 and 3/1/05–3/1/06) had an average share price increase of 27.67% (compared to a market average of 18%), and firms with ineffective section 404 controls in the first year that were then remedied showed a 25.74% increase. However, those firms that reported ineffective controls in both years showed a 5.75% decrease over the two-year time period. These numbers indicate that internal controls are important to investors, that section 404 provides valuable information to investors, and that critics of section 404 who claim that it causes a dramatic drag on the economy “have some ‘splainin to do’” in light of these firms’ market performance in a time of 2% inflation, dramatically increasing energy costs, and record government budget deficits.

342. See generally Ashbaugh-Skaife et al., supra note 317.
343. Id. at 32–33.
344. Id. at 33.
345. Hollis Ashbaugh-Skaife et al., The Effect of Internal Control Deficiencies and Their Remedia-
346. Id. at 2.
347. Id.
349. Id.
350. Id. at 5.
Other studies by Emanuels and colleagues, Ogneva and colleagues, and Lopez and colleagues provide more mixed results, but at this time the stronger evidence indicates that certifications of financial statements and internal financial controls by CEOs, CFOs, and outside auditors provide useful information to the capital markets that will allow them to allocate capital more efficiently.

Lobo and Zhou have found that SOX’s certification requirements have improved financial reporting by making it more conservative than it was during the dot-com craze. Also, after SOX, empirical studies indicate that earnings management has decreased. This makes sense because, as noted earlier, other empirical studies indicate that firms with weak internal controls tend to engage

351. Emanuels and colleagues are not sold on the benefits of section 404 and agree with Romano that Congress should explore ways to encourage firms to voluntarily disclose information about internal controls, but their study indicated that “the capital markets appreciate the transparency required by SOX, as stock returns are positively influenced by even negative news.” Jim Emanuels et al., Abnormal Returns Around Disclosure of Problems in “Internal Control over Financial Reporting” 11 (Nov. 16, 2005) (unpublished manuscript, available at http://ssrn.com/abstract=848966).

352. Ogneva and colleagues, like Ashbaugh-Skaife et al., examined the relationship between internal controls and cost of equity. They also found modestly higher costs of equity for other weak internal control firms, but that difference disappeared when they controlled for other costs. See Maria Ogneva et al., Internal Control Weakness and Cost of Equity: Evidence from SOX Section 404 Disclosures 27–28 (July 2006) (unpublished manuscript, available at http://ssrn.com/abstract=766104). However, there were limitations with Ogneva et al.’s sample that makes it likely that Ashbaugh-Skaife et al.’s contrary conclusion that weak internal controls signal higher equity costs is more accurate. Ashbaugh-Skaife et al., supra note 317, at 31–32.

353. Lopez et al. studied the auditor’s opinion on management’s assessment of internal controls and the auditor’s opinion on the effectiveness of internal controls in an experimental setting. The experiment’s subjects reacted meaningfully to the latter reports, but not to the former, leading the authors to conclude that “investors value the internal control process by which the company arrives at its financial outcome; however, it is the auditor’s opinion of the system of internal controls that investors find most salient, rather than management’s.” Thomas J. Lopez et al., The Auditor’s Internal Control Opinions: An Experimental Investigation of Relevance 19–20 (Apr. 2006) (unpublished manuscript, available at http://ssrn.com/abstract=905796).


355. See Daniel A. Cohen et al., Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods 30 (Feb. 1, 2005) (unpublished manuscript, available at http://ssrn.com/abstract=658782) (finding that earnings management increased steadily from 1987 until SOX was enacted and declined substantially thereafter, but hesitating to attribute this development solely to SOX, noting “the nature of our analysis does not provide conclusive evidence whether this reversal was caused by SOX, a response to the publicity [of] the scandals, or other concurrent events”); Kevin Koh et al., Meeting or Beating Analyst Expectations in the Post-Scandals World: Changes in Stock Market Rewards and Managerial Actions (Oct. 5, 2006) (unpublished manuscript, available at http://ssrn.com/abstract=879831) (finding that earnings management has declined in the post-SOX era, without attributing causation).
in more earnings management. Heflin and Hsu also found less earnings management after SOX, and conclude that “our evidence suggests the regulations, on balance, have increased earnings informativeness.” A Canadian task force has concluded that “[t]ogether, these studies indicate that internal control assessments are useful to capital market participants because they convey information that can help them better assess information risks.” All this has led Professor Nelson to remind us:

[T]he costs of this reform [section 404] are high and immediate but the benefits are long-term. However, the benefits of this reform are real, with approximately 8% of SEC-listed companies having been forced to acknowledge and fix material control deficiencies and additional companies no doubt improving controls to avoid disclosure of deficiencies. The resulting improvements of internal controls should reduce the level of preaudit misstatement that auditors must detect and increase the amount of effort auditors expend on auditing. Sound controls and more auditing should prevent and detect many misstatements.

CONCLUSION

Ideally, Congress would always pass laws after consulting the academic literature and studying it thoroughly. It would be unaffected by media frenzy and not unduly influenced by either corporate governance entrepreneurs or business lobbyists. Ideally, Congress would always have time not only to tackle current pressing problems but also to continuously review all previous legislation to determine if it needed amendment or repeal. Unfortunately, this is not the world we live in.

SOX was passed in a frenzy. We have no quarrel with Professor Romano’s description of the messy process by which SOX was enacted. The speed of the

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356. See, e.g., Kam C. Chan et al., Earnings Management and Return-Earnings Association of Firms Reporting Material Internal Control Weaknesses Under Section 404 of the Sarbanes-Oxley Act 22–23 (Sept. 2006) (unpublished manuscript, on file with authors) (noting that “[p]rior studies suggest that poor internal control can lead to more opportunities for [earnings management],” reporting findings providing “mild evidence” of this fact and additional evidence that earnings management decreased after SOX 404 was implemented, and concluding that “[s]ince the findings of ineffective controls by auditors under Section 404 may cause firms to improve their internal controls, Section 404 has the potential benefits of reducing the opportunity of intentional and unintentional accounting errors and improving the quality of reported earnings”).


358. Boritz, supra note 329, at 66.

process did cause problems. But emergency situations demand emergency legislation, and even the fiercest critics concede that SOX was passed in a capital markets crisis.

SOX was also passed in what we have described as a republican moment. That various interest groups, media publicity, and public pressure all influenced the content of SOX is neither surprising nor troubling: it is called democracy. Usually, it is only when falling stock markets are coupled with major scandals that media attention creates a public uproar strong enough to break businesses’ grip upon the public policy process and enable securities reform legislation to be passed. It is not at all clear that we would be better off if such emergency legislation were never passed and we were left with a slow and deliberate system dominated by business lobbies.

The situation is ironic because the empirical evidence that SOX critics believe Congress ignored strongly indicates that vigorous securities regulation is necessary for capital markets to reach their potential. That does not mean, of course, that every securities law will be beneficial or that sound ideas such as mandatory disclosure and antifraud enforcement cannot be carried too far. Some provisions of SOX, for example, were probably unnecessary. Others, such as section 404, may have been counterproductive. SOX’s overall cost/benefit ratio is currently unknown and may never be measurable with any precision.

However, the empirical evidence that Professor Romano and others emphasize does not justify a description of SOX as “quack corporate governance.” SOX’s corporate governance provisions were enacted in large part to shore up a federal system of mandatory disclosure that a large body of empirical evidence indicates is extraordinarily beneficial in enabling modern capital markets to realize their potential. In broad outline, SOX is also consistent with the overwhelming empirical evidence that governance provisions that protect investors from exploitation by insiders benefit capital markets, that more independence on boards of directors and audit committees improves financial reporting, and that requiring, as SOX does, that audit committees be composed entirely of independent directors pays concrete benefits in terms of accurate financial reporting.

While the evidence does not clearly establish that allowing audit firms to provide nonaudit services to audit clients undermines independence in fact, there is substantial theoretical and empirical evidence to believe that it does. It may well be shortcomings in empirical models that have prevented this conclusion from being clearly established. In any event, the empirical evidence is clear that provision of NAS damages the appearance of independence and thereby undermines confidence in the capital markets. On that basis, it was reasonable for a Congress that was concerned about plummeting investor confidence to act to shore up that confidence by limiting the provision of NAS.

The best evidence indicates that Congress was well justified in acting to halt abuses in executive loans but, as Romano argues, botched the job by acting in a ham-fisted fashion. Although Romano strongly criticizes “policy entrepreneurs” who lurk in the background and bring forth their pet remedies when it is
politically viable to do so, it is the very lack of such entrepreneurs that may have caused Congress to legislate in an insufficiently nuanced manner regarding these loans.

Finally, the strongest empirical evidence supports the conclusion that the executive certification requirements—embodied in section 302 and reinforced by the internal financial control provisions of section 404—have provided the capital markets with useful information that has already improved their efficiency as allocators of capital and should provide increasing benefits in the future.

Will those benefits outweigh section 404’s substantial costs? Will the overall benefits of all SOX provisions, not just the four criticized by Romano, ultimately justify SOX’s costs? On those issues, we are agnostic, believing that we currently do not know and may never be able to measure the costs and benefits with accuracy. What we do know with some certainty is that if the political backlash against SOX 404 causes Congress to pass new legislation that damages severely any of the fundamental pillars of modern securities regulation, the empirical evidence indicates that damage to U.S. capital markets will surely follow.