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Compliance costs and disclosure requirement mandates: Some evidence

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ABSTRACT

This note contributes to the discussion on the compliance costs of disclosure requirements for publicly traded companies. Prior research tends to focus on audit cost increases when disclosure requirements are stricter. We add some evidence from the point of views of shareholders. Particularly, we contrast stock market reaction to the 2002 Sarbanes–Oxley (SOX) Act which significantly enhanced public company disclosure requirements, with the 2012 Jumpstart Our Business Startups (JOBS) Act which alleviated disclosure requirements for small firms. Contrary to popular belief that more disclosure rules impose regulatory burdens on firms and are costly to implement, we find that the stock market reacted positively toward rules that require more disclosure; whereas it reacted negatively toward rules that require less disclosure, even though those disclosure rules were initially designed to reduce the costs of compliance.

Introduction

This report contributes to the discussion of regulatory compliance costs to SEC's disclosure requirements. So far in the literature it is well documented that new or stricter disclosure requirements lead to higher costs of auditing and reporting. As the ultimate bearer of these costs, however, shareholders of these affected companies are not necessarily worse off. Instead, this report provides some evidence that, collectively, shareholders appreciate stricter disclosure requirements by pushing the stock prices higher, in the case of SOX in 2002, and on the contrary disliked loosening disclosure, in the case of JOBS Act in 2012, by sending the stock price lower.[1]

The results show that a median S&P 500 firm gains $704 million in market valuation when SOX was implemented and a median small firm (S&P Small Cap 400 Index member) loses an estimated $7.9 million when JOBS Act is signed into law. Our report contributes to the debate on the necessity of regulatory reforms by providing a well-rounded cost–benefit analysis, and it shows how taking measurements from different angles could produce very different results.

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[1] We acknowledge the presence of gross market inefficiency, especially in times of bubbles and crashes when market participants lose their independent judgment (Shiller, 2000; Sterling, 1975). However, our tests are not designed to test market efficiency. Instead, we follow Dee, Hillison, and Pacini (2010), Jain, Jain, and Rezaee (2010), and Webinger, Comer, and Bloom (2013) and assume that (1) Malkiel (2003) is right, that the presence of pricing irregularities "will not be an abandonment of the belief of many in the profession that the stock market is remarkably efficient in its utilization of information" (pp. 80) and (2) our time windows to estimate expected returns and to test market response are all outside of time periods of extremely market irrationality.

An overview of SOX and JOBS Act

The impact and consequences of SOX

The Public Company Accounting Reform and Investor Protection Act, otherwise known as SOX, was enacted in July 2002 after a series of notorious corporate scandals and auditing failures, such as Enron and WorldCom. SOX proponents believe that the law addresses investors' concerns about financial reporting frauds, while opponents feel that following these rules will be too costly, particularly for small businesses.

Among the most important sections of the legislation are Sections 302 and 906 which require the companies' chief executive officers (CEOs) and chief financial officers (CFOs) to personally certify the accuracy of the firms' financial statements. Furthermore, Section 404 is implemented to reinforce the internal control processes, which in turn play an important role in certifying the accuracy and the reliability of published financial statements, as documented by Franzen, Li, and Vargus (2013). SOX 404 and the Public Accounting Oversight Board (PCAOB) also require a company's independent auditors to report on the company's management's assessment and on the effectiveness of the company's internal controls. SOX 404 is generally considered the most costly aspect of the legislation for companies to implement.

Audit and non-audit fees

Academic researchers have conducted studies to quantify the costs of SOX compliance. For instance, Ahmed, McAnally, Rasmussen, and Weaver (2010) provide evidence on the net realized costs of SOX, these costs ranging from $6 million for smaller firms to $39 million for the largest firms. Small, Ionici, and Zhu (2007) find that the negative impact of SOX's passage decreases with firm size. Rising audit fees, among the most often cited costs of compliance, are mostly related to Section 404 of SOX.

To examine the impact of SOX on audit fees, we present audit fee data that are obtained from Audit Analytics in Table 1. Note that these fees include all fees disclosed by firms, not just fees incurred on SOX compliance. Dividing total audit and non-audit fees by the number of 2507 firms in the sample yields the average audit fee of $1.23 million and the average non-audit fee of $1.27 million in 2002. The average audit fees grew to $3.14 in 2011 whereas non-audit fees dropped to 0.82 million. Overall, as a percentage of revenue, total fees actually decreased from 0.08% at the beginning of SOX implementation to 0.06% in the most recent years. In addition, we hope to provide a simple "rule of thumb" for readers outside of finance and accounting to gauge the size of audit/non-audit fees. Table 1 therefore includes information on CEO and CFO compensations besides audit fees.

Table 1
Annual comparison of audit and non-audit fees to median CEO and CFO total compensation (in $ million). This table reports the average audit fees, non-audit fees, and total fees of S&P 1500 companies using data from Audit Analytics. To put audit costs in perspective, we compare them with executive compensations. We obtain CEO and CFO compensation data from Execucomp (based on the variable tdc1 in Execucomp, including total of salary, bonus, restricted stock and option grants, and long term incentive plans) and compare the median CEO and CFO compensation of S&P 1500 firms to the audit and non-audit fees of the companies. The comparison suggests the following: First, CEO compensations appear to be higher than audit fees throughout the sample time period, but lower than total fees in most years. Second, audit fees appear to be stable over time, after the initial jump of 2004. While the sizes of the firms grow steadily over the years, the costs per revenue actually decrease. Third, t-test statistics show no statistical differences between the average cost of audit and non-audit fees and that of an average CEO.

Year	Audit fees	Non audit fees	Total fees	CEO comp	CFO comp
2002	$1.23	$1.27	$2.50	$2.86	$1.00
2003	$1.49	$1.05	$2.54	$2.74	$0.98
2004	$2.50	$0.91	$3.41	$3.26	$1.16
2005	$2.79	$0.74	$3.53	$3.48	$1.16
2006	$3.04	$0.73	$3.77	$3.44	$1.24
2007	$3.13	$0.79	$3.92	$3.55	$1.19
2008	$3.25	$0.79	$4.04	$3.51	$1.18
2009	$3.11	$0.72	$3.83	$3.37	$1.17
2010	$3.05	$0.79	$3.84	$4.26	$1.14
2011	$3.14	$0.82	$3.96	–	–

Source: Audit Analytics, Compustat ExecuComp, and Authors' Calculation.

Additional costs and benefits of SOX

In 2003–2004, about 300 US companies deregistered their common stock for purposes other than mergers, acquisitions, liquidations, registration withdrawals, or going-private transactions. Some cite the rise in compliance costs as the main reason for their "going-dark" decision (Jannat, 2005; Leuz, Triantis, & Wang, 2008; Tysiac, 2013).[2,3] Ultimately those firms suffered negative stock returns after the going dark announcement (Marosi & Massoud, 2007). This evidence suggests that stock market deregistration, often cited as a way to save on compliance costs, hurts shareholders as it results in large negative stock returns.

Christopher Cox, Chairman of the SEC provided additional evidence on the benefits of SOX. Despite the opposition of the majority of public companies to the new SOX requirements, he announced that four years after SOX implementation, companies reported that they experienced improved business processes, especially in risk management, financial reporting's accuracy, and internal and external data integration.[4,5] Moreover, some researchers find

[2] Marosi and Massoud (2007), however, showed that these firms were most likely firms facing severe corporate governance problems and strong shareholder dissatisfaction.

[3] Hostak, Lys, Yang, and Carr (2013) provide evidence that compliance costs of SOX, as well as agency costs, play a role in motivating foreign firms to move away from the U.S. market.

[4] See SEC (2007). "Testimony Concerning Reporting on the Internal Controls of Small Businesses Under Section 404 of the Sarbanes–Oxley Act of 2002", by Chairman Christopher Cox, U.S. Securities & Exchange Commission, before the Committee on Small Business & Entrepreneurship, United States Senate, April 18, 2007.

[5] Protiviti, Risk & Business Consulting (2013) confirms Cox's announcement by presenting that more than two thirds of large firms have achieved significant or moderate enhancement in their internal control systems, whereas the cost of compliance was kept at manageable levels of $1 million or below. In addition, Cohen, Hayes, Krishnamoorthy, Monroe, and Wright (2013) document the effectiveness of SOX in promoting high-quality financial reporting and corporate governance.