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SOX and bondholders' reliance on monitors

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ABSTRACT

This work investigate the changes in the market participants' reliance on five types of monitors/monitoring mechanisms (auditors, corporate governance, equity analysts, credit analysts, and banks) after the implementation of the Sarbanes–Oxley Act (SOX). By focusing on changes in weights associated with the monitoring mechanisms across implementation of SOX, the results indicate that bondholders appear to rely more on the monitoring of equity analysts, the audit committee, and lenders, and less on auditors and credit rating agencies. Importantly, the results indicate that SOX reduced the bond yield interest spread. However, while SOX may have strengthened the debt market's reliance on some monitoring mechanisms, it seems to have weakened the debt market's reliance on other monitoring mechanisms some might have assumed should have been strengthened by SOX. There are three possible explanations for the finding that SOX's extensive reform in auditing has not increased bondholders' reliance on auditors. One explanation is that it may take a longer time for investors to value the effectiveness of this monitoring mechanism after the implementation of SOX, and this impact is beyond the post-SOX period analyzed. An alternative explanation is that SOX may not solve the real problems underlying the massive corporate failures. The third explanation is the potential substitution effects of the other monitoring mechanisms.

Introduction

The regulation of financial markets and the role of the accountancy profession is a complex environment. Numerous regulatory agencies are involved, as well as standard setters and professional organizations and entities. Our study provides evidence regarding the benefit of the Sarbanes–Oxley Act in reducing the cost of borrowed capital and enhancing the monitoring role of various regulatory components. The regulatory components (monitors) we study include auditors, corporate governance, equity analysts, credit rating agencies (CRAs), and banks (lenders).[1] Appropriate public policy requires regulatory changes to be tested to determine whether the new regulations meet target objectives, and we provide evidence regarding how SOX changed the market's reliance on five different corporate monitoring mechanisms. Since we show a reduction in the cost of borrowed capital and a strengthening of investors' reliance on monitoring mechanisms, our results are important since SOX has been criticized as being too costly with little or no benefit.[2]

Since 2000, policy makers, regulators, and media have noted the inefficacies of monitoring mechanisms and the

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[1] The monitoring mechanisms examined in this study are not complete or exclusive. For example, lawyers might be considered a type of corporate monitor through their litigation activities (both as plaintiff and defendant). However, we restrict our analysis to the five monitors (auditors, corporate governance, equity analysts, CRAs, and banks) because the empirical evidence supports the monitoring role of these five monitors in the bond market and we know of no data available to us that would allow access to potentially privileged information between lawyers and corporations.

[2] Our motivation to examine the regulation impact in the bond market rather than in the stock market is that any inferences from studies using current developed proxies for the cost of equity capital (Botosan & Plumlee, 2005; Easton, 2004; Easton & Monahan, 2005) are subject to concerns regarding bias in the proxies and significant measurement error. In contrast, measuring the cost of debt is relatively simple; the measurement error issue for the cost of debt is not as severe as that for the cost of equity.

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resultant scandals in accounting, the bubbles in the equity market, and the crisis in credit. As one critic has stated:

> But who was evaluating these securities? Who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors. They relied on a credit rating. Thus the agencies became the de facto watchdog over the mortgage industry. In a practical sense, it was Moody's and Standard & Poor's that set the credit standards that determined which loans Wall Street could repackage and, ultimately, which borrowers would qualify. Effectively, they did the job that was expected of banks and government regulators. And today, they are a central culprit in the mortgage bust, in which the total loss has been projected at $250 billion and possibly much more (Roger Lowenstein April 27, 2008, *The New York Times*).

In addition to "incompetent" credit rating analysts, the spotlight has implicated "overoptimistic" equity analysts, "greedy" banks, "dependent" auditors, and "weak" corporate governance in the financial crisis. Now, the role of the U.S. Security and Exchange Commission (SEC) as the monitor of monitors (auditors, corporate governance, equity analysts, CRAs, and banks) is being questioned.

The collapse of the equity market bubble in 2000 led to the implementation of the Sarbanes–Oxley Act of 2002 (SOX, passed on July 25, 2002), which mandated various changes in accounting policies and corporate governance, strengthened auditing standards, addressed equity analysts' conflicts of interest, and required the SEC to review the role and function of CRAs in the operation of securities markets. In addition, investment banks agreed to a settlement requiring that they modify their system of research analysis and address conflicts of interest. In this study, we investigate the impact of SOX on the regulatory environment and provide evidence on how SOX actually impacted the role of the different monitoring mechanisms that we study.

SOX represents a major political response to the massive high profile bankruptcies such as Enron and WorldCom.[3] Accordingly, SOX aims to strengthen corporate accountability and professional responsibility in the wake of financial scandals by assuring the integrity of U.S. capital markets and by restoring investors' confidence in financial markets. Our study investigates the changes in the market participants' reliance on various types of monitors after the implementation of SOX.[4] In our analysis, we utilize the monitoring aspects of the regulatory climate pre- and post- SOX and examine whether market participants view the changes as effective.

Assuming the SOX regulatory changes are effective, market participants should rely more on the monitoring performed by auditors and boards of directors post-SOX. Specifically, SOX was intended to increase the precision of the information provided by the CEO to investors. Evidence that the market relies less on the monitoring performed by auditors would suggest that the regulatory changes did not adequately address the auditing (auditors') deficiencies as a monitor mechanism.

Post-SOX, market participants should rely more heavily on the monitoring performed by equity analysts if SOX increased the independence of equity analysts. Alternatively, market participants may end up relying less on the monitoring performed by equity analysts if SOX interrupts the flow of credible nonpublic information into the market.

Finally, market participants may rely more on the monitoring of CRAs if SOX has improved credit ratings. Alternatively, post-SOX, market participants may rely less on the monitoring of CRAs if information from other monitors becomes more valuable, timely, and/or more accurate as a result of SOX. In other words, information from competing sources could have subsumed the information about default risks reflected in ratings and reduced the usefulness of CRAs.

Some argue that SOX imposes substantial costs and risks of doing business in the US without adequate benefit. Accordingly, it is important to examine whether investor confidence in financial reporting has been enhanced by SOX, and whether investors have relied more on monitoring systems after the implementation of SOX. The requirements of SOX include the 404 reports, mandatory rotation of auditing firms, and limitations on consulting services of auditing firms.

Prior research has found that investor confidence since SOX has been restored in terms of bid-ask spreads (Dowdell, Kim, Klamm, & Watson, 2013; Jain, Kim, & Rezaee, 2008). While other studies (Bargeron, Lehn, & Zutter, 2010; Bronson, Carcello, Hollingsworth, & Neal, 2009; Engel, Hayes, & Wang, 2007; Filbeck, Gorman, & Zhao, 2011; Gordon, Loeb, Lucyshyn, & Sohail, 2006; Jain & Rezaee, 2006; Krishnain & Visvanathan, 2008; Leuz, Triantis, & Wang, 2008; Zhang, 2007) investigate the intended or unintended consequences of SOX, we investigate the effects of SOX on market participants' reliance on the five monitoring mechanisms (auditors, corporate governance, equity analysts, CRAs, and banks) simultaneously. Accordingly, we provide insights into how the roles of the five monitoring mechanisms changed due to SOX.[5,6]

To address the degree of market participants' reliance on different monitors (auditors, corporate governance, equity analysts, CRAs, and banks) since implementation of SOX, we

[3] Asare, Cunningham, and Wright (2007) evaluate the SOX effects on auditors, corporate officers, and audit committee members, suggesting potential behavior changes in response to SOX.

[4] Congress addressed CRA issues in the Credit Rating Agency Reform Act of 2006. The Reform Act reduces the barriers to entry, prohibits the SEC from regulating the substance of credit ratings or procedures and methodologies by which a CRA determines credit ratings, and requires CRAs to adopt a written policy for managing conflicts of interest. Nonetheless, the 2006 legislation may be insufficient since investors called for increasing accountability, consistency, quality and transparency in the ratings process rather than just increasing competition. We leave further research to assess the adequacy and implications of this act.

[5] For example, Gordon et al. (2006) find that SOX has a positive impact on the corporate disclosures of information security activities, whereas Zhang (2007) analyzes returns around legislative events and concludes that SOX imposes significant costs on firms.

[6] See Coates (2007), Ribstein (2005), and Romano (2005) for an extensive literature review on the costs and benefits of SOX.