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The Impact of Sarbanes – Oxley Act on the Small Businesses

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Abstract

In 2002 Congress passed the Sarbanes-Oxley (SOX) Act after a series of fraudulent accounting and finance activities and questionable behavior by many high level corporate executives during the early part of the 21st century. The Act set new or enhanced standards for corporate officers and directors of all publicly traded US companies, as well as public accounting firms servicing those companies. In the context of Agency Theory, the main purpose was to restore investor confidence, prevent or reduce the management misconduct, and protect stockholder interest. The Act also holds both Chief Executive Officers and Chief Financial Officers of the companies criminally and civilly accountable for the financial reports of their companies. Since passage of the SOX Act, many studies have been conducted to find out the impact of the Act on businesses. The results have been mixed. In some cases the value of stocks increased, but in other cases companies experienced a significant increase in costs. The Act also has created obstacles and has made it increasingly difficult for new or small companies to go public. In such cases the compliance costs were a major issue. In this study, we are examining three such companies that were negatively impacted by the SOX Act.

Keywords: *the Sarbanes-Oxley (SOX) Act, small business*

1. Introduction

The Sarbanes-Oxley Act of 2002 also known as the "Public Company Accounting Reform and Investor Protection" Act, consists of 18 sections that serve multiple regulatory functions. The overall goal of the Act was to restore investor confidence by reinforcing corporate accountability as well as improving the accuracy and reliability of information provided to investors (Jain et al., 2006). The Act specially focuses on management responsibilities for internal control and auditing independence. The Act required the SEC to take certain actions to ensure that there are regulatory structures in place to implement it.

Kenneth Lehn (2008) summarized the key provisions of the Sarbanes-Oxley (SOX) Act as follows:

- Increased disclosure requirements of public companies
- Increased role of independent directors

- Expanded liability of officers
- Required companies to assess and disclose adequacy of internal controls
- Created the Public Company Accounting Oversight Board (PCAOB) to regulate auditors
- Prompted the Securities & Exchange Commission (SEC) and exchanges to adopt new corporate governance rules

In this landmark paper, Prof. Lehn cited very mixed results as measured by empirical financial research. Specifically, he noted the following conclusions from various studies:

- Zhang (2007) – SOX related events had negative effect on companies' stock prices.
- Li, Pincus, and Rego (2006) and Jain and Rezaee (2006) – SOX related events had a positive effect on companies' stock prices.
- Chhaochharia and Grinstein (2007) – Stock prices of large firms not in compliance with SOX increased around SOX's passage; those of small firms not in compliance with SOX declined.
- Wintoki (2007) – Stock prices of small, young, high growth companies declined around passage of SOX.
- Litvak (2007) – Stock prices of foreign firms cross-listed in the U.S. declined vis-à-vis non-cross-listed matched firms around key SOX events.
- Zingales (2007), Litvak (2007) – The premium for foreign firms cross-listing in the U.S. declined after SOX.
- Doidge, Karolyi, and Stulz (2007) – The premium for foreign firms cross-listing in the U.S. did not change significantly after SOX.

Other studies confirm that the cost of implementation of the SOX Act were proportionally higher for small businesses than large ones. According to the finding of the SEC Advisory Committee on Smaller Public Companies (88), from the earliest stages of its implementation, Sarbanes-Oxley Act Section 404 has posed special challenges for smaller public companies. To some extent, the problems smaller companies have in complying with Section 404 are:

- Lack of clear guidance;
- An unfamiliar regulatory environment;
- An unfriendly legal enforcement atmosphere that diminishes the use and acceptance of professional judgment because of fears of second-guessing by regulators and the plaintiffs' bar;
- A focus on detailed control activities by auditors; and
- The lack of sufficient resources and competencies in an area in which companies and auditors have previously placed less emphasis.

In this paper we study the impact of Section 3: Corporate Responsibility, Section 4: Enhanced Financial Disclosures and especially 4.1: Disclosures Controls, Section 4.4: Assessment of Internal Control and Section 4.5: Smaller Public Companies.

As part of this study we looked at the costs associated with implementing the SOX Act, which includes external auditor fees, director and officer insurance, board compensation, lost productivity, and legal costs. In general, each of these cost categories increased significantly between FY 2001 and FY 2006 (Foley & Larder Survey 2007).

1. Case study

Due to the aforementioned mixed results (as measured by stock price performance), and our view that perhaps the self-correcting nature of the financial markets had a greater impact than the passage of the SOX Act, we focused our research on how SOX affected risk taking. We examined real life case studies to assess how firms have incorporated SOX into their financial and strategic planning processes, and their corresponding outcomes. While these real life examples do not necessarily represent an across-the-board or universal impact, the effect on risk-taking is noticeable and has material or significant financial consequences.

The following situations are offered with the permission of the participating firms subject to the aforementioned NDAs.[1] These examples are provided to demonstrate how SOX affects risk-taking behavior, and in each case, the financial outcome associated with actions taken (or not taken) due to SOX.

We have selected three types of business models for this study: vision care solutions, oceanographic equipment and specialty consumer. For simplicity, these companies will be denoted as follows:

VCS: Vision Care Solutions
OE: Oceanographic Equipment
SC: Specialty Consumer

Basic information (for more information please see Exhibit 1):

Company	VCS	OE	SC
Revenues (E) in 3 years	$8 million	$1.5 million	$4.5 million
Debt/Equity	$50,000/$200,000	0/$500,000	0/$300,000
Number of Employees (E)	18	6	15
Owners/Operators	1	2	3

(E) Estimate

Each of these companies or business models were owner-operated with the goal of eventually becoming publicly traded entities. These case studies occurred between 2002-2010, in the aftermath of the passage of SOX. In each case, the owner-operator developed a profitable specialty niche model that had scalability (i.e., could be replicated in different regions or potential for large scale production).

[1] Please note the names were withheld due to Non-Disclosure Agreements.

In each of these situations SOX proved to be costly, burdensome, time consuming and distracting. The additional layer of costs and burdens in terms of time and implementation had the effect of diverting financial and intellectual capital away from innovation and product development and redirected toward compliance in the context of a very risk-averse internal environment. The resulting financial outcomes in relation to both the explicit and implicit costs associated with SOX compliance are self-evident. However, it should be noted that not all of these had unsatisfactory outcomes. One instance proved to be very satisfactory, but nevertheless was influenced by the preoccupation with the danger and risk of making the slightest mistake that potentially could undermine years of work.

2. VCS (Vision Care Solutions)

The Situation: In the very early 2000s, VCS was founded by an electrical engineer who was inspired to create this company in response to the onset of his own visual impairment and his empathy for others who like him, were "legally" blind. The VCS founder developed and patented three different vision care solutions that would provide glare protection without obstructing one's line of sight. Specifically, VCS's strategy was to provide solutions for potential clients seeking improved safety, increased productivity and greater comfort by enhancing various eye-care products [e.g., prescription, plain or dark glasses, goggles, helmets and related] with enhanced glare protection. As such, VCS identified three mass markets, each aligned with its specific vision care solution: (1) individual consumers of prescription and non-prescription eye glasses; (2) professional and amateur athletes; and (3) commercial drivers, truckers, pilots, railway drivers and ship captains. The total value (US$) of these three mass markets was conservatively estimated to be in the range of $25 to $30 billion.

What Happened Next: VCS developed a prototype product for each of the aforementioned mass markets, lined up future engineering, technical, sales and support staff and a proposed manufacturing site. Given the very large target markets, VCS sought equity financing via the public markets. [Bank financing proved unsatisfactory given the inherently conservative nature of commercial lenders who deemed the business model extremely risky due to perceived over dependence upon the founder and being an emerging/early stage situation.] The model VCS adopted was similar to the same one used by microbrewers that went public in the mid-to-late 1990s to capitalize on the growing public demand for craft beer. In this instance microbrewers essentially used the Internet as well as financial literature attached to its product shipments to solicit equity capital. However, by the time VCS was ready to embark on its capital raising efforts, the passage of Sarbanes-Oxley (SOX) created a whole new set of compliance protocols and filing of additional paperwork.

VCS diverted a portion of its limited capital to hiring attorneys and accountants to aid in compliance, but the financial cost associated with this process (even with self-help services) proved to be above plan. Moreover, the additional 3 to 6 month period required to comply with new SOX standards proved very costly with a negative collateral development: loss of the manufacturing site and specialized personnel that had been previously lined up. These individuals could no longer afford to wait for a capital infusion, and thus sought employment elsewhere. In a last ditch effort to sustain momentum, VCS sought grant funding from public and private sources, but the enormous paperwork and review process associated with this process proved to be an obstacle that the VCS founder was unable to overcome.

The Outcome: Following a promising start, VCS essentially went "dark" and suspended filing any further paperwork seeking equity financing. Financial capital that had been earmarked for product and business development, and then later diverted to compliance with the new SOX regulations, evaporated. As a result, VCS sought a more risk-averse strategy to pursue product licensing and/or a long-term special services employment contract to develop its products for a large company serving the vision care markets. This has proven unsatisfactory as the perceived failure to raise equity from the public markets in its earlier efforts created a "stigma" for VCS thus deterring potential corporate suitors from investment.

The Verdict: VCS believes that SOX and the resulting environment of inordinate preoccupation with compliance issues proved burdensome and ultimately a major obstacle to securing equity capital. The negative effect of missing its window of opportunity with available skilled personnel and prime manufacturing space was due to the delay associated with compliance. In addition, the financial capital was not available to retain those resources because it was being paid to attorneys and accountants. VCS has never been able to recover from this as the founder personally financed development and patent filings for his work, and no further personal capital (debt or equity) was available to him. As such, VCS is left to wonder what might have been! It should be noted that the VCS founder has no illusions but would have preferred that the negative verdict be dictated by market forces (competition, supply & demand, and so forth) rather than the vagaries and delays associated with regulations that ultimately deter risk-taking.

3. OE (Oceanographic Equipment)

The Situation: In early 2007, OE was financially exhausted after having spent more than 5 years developing a technology product for personal and commercial uses in oceanography. In the aftermath of SOX the company did not wish to pursue going public due to compliance costs, nor did it wish to disclose its technology with "angel" and venture investors because of the potential of giving up too much control and financial benefits of its intellectual properties. OE considered forming a Limited Liability Corporation (LLC) and selling units to hobbyists, scientists and others who would have interest in the company's technology, but ultimately vetoed this option due to potentially being overly cumbersome and time consuming. Despite a potentially very large end-user market for its technology, the idea of investing additional financial and intellectual capital in order to navigate through the SOX protocols or satisfy the insatiable desire for control by venture investors and financial angels was viewed as unacceptable. This forced OE to solely concentrate on how to monetize its intellectual properties in a timely manner, especially given its diminishing financial resources.

What Happened Next: OE hired a consultant to establish a valuation for its technology and develop a combined licensing strategy and special services contract to help the founders recover its cumulative investment, provide a future stream of recurring income from its technology and stable employment. While this was being done, a suitable candidate firm was found that was willing to pay for the technology, manufacture and distribute the product. This was done with the OE founders working in a consulting role to help implement this process. Armed with a valuation study, OE proposed formation of a strategic alliance that called for an upfront payment to the founders (allowing the buyer access to the technology), and then a recurring income stream arising from a percentage licensing fee applied to future revenues. Additionally, there would be a long-term special services contract whereby the founders would receive compensation for helping bring the product to market and sustain its expected commercial success. In principle, this agreement was accepted by the candidate firm with what proved to be minor adjustments or concessions by OE: the upfront payment would be paid in three equal installments over a 3-month period instead of a lump sum. Further, the majority of those payments would be classified as engineering fees rather than licensing fees so that it would not have to be treated as a capitalized expense item.

The Verdict: OE believed this financial solution was optimal from the standpoint of reflecting its mission and values. The technology was developed out of a love for oceanography, and this commitment was reflected by the founders putting their personal financial position at risk. OE was created as a vehicle for the founders to create and develop the technology for commercial application. Once completed—and after considering the further additional commitment of time and financial capital—OE determined that monetizing its intellectual properties and recovering its investment was not available only through the Initial Public Offering (IPO) venue, it could be fulfilled in a more efficient and less risky manner through a licensing agreement. Hence, the aforementioned strategic alliance with the upfront installment payments, recurring licensing fee income plus the special services contract. In this case, the new hurdles posed by SOX caused OE to reconsider carefully and ultimately pursue a strategic alternative that provided a much better fit in terms of reward and risk. Since then, OE founders concede that had it been "easy" to go the IPO route, the sustainable financial returns might have been much lower (or non-existent) because OE was better suited as a product group for a large firm rather than a stand-alone entity. SOX protocols ultimately proved to be a blessing for OE in securing an optimal financial strategy for its technology that enabled it to thrive in a more suitable venue than the publicly traded securities markets.

4. SC: (Specialty Consumer)

The Situation: From 2001–2003 SC was formed with the objective of further leveraging the "third space" concept that had taken hold during the 1990s. The "third space" concept was based on the view that with flextime and the boundaries between home and work becoming ambiguous, more people were spending leisure time outside the work place and home. The "third space" concept includes, but is not limited to, a gourmet coffee store model (e.g., Starbucks), health club, recreation centers, etc. SC created a combined wine bar and retail store that would provide a channel of distribution for small west coast wineries that were thus far unable to compete for retail shelf space in traditional wine & liquor stores or in grocery stores.

What Happened Next: SC worked closely with a financial consultant to create a business model that would be located in urban areas characterized by high foot traffic (e.g., tourists, hotel guests, cruise ship patrons, restaurant customers and so forth). The SC model would allow such patrons to enjoy sampling premium quality wines from small wineries, purchase wine and complementary food offerings along with souvenirs, all the while enjoying quiet time with friends and/or business associates. Essentially SC positioned itself as a wine version of Starbucks, and thus a scalable model that could be strategically placed to capitalize on the strong demand growth for wine while providing a distribution channel for small wineries located nationwide.

Due to the scalability factor, SC wanted to raise private equity to finance two (2) wine bars as a way of demonstrating its financial viability. Once those two operations were up and running, SC sought to tap the public equity markets to finance a large-scale expansion that would occur concurrently in various regions nationwide. SC formed a series of contractual relationships with multiple wineries eager to participate, engaged other wine and food enthusiasts to run the operations. Due to the aggressive (albeit achievable) growth plans, the imposition of SOX necessitated the use of significant financial capital to comply with the requirements of going public. While necessary and appropriate given the desire to be a vital, active and growing public entity, this ultimately diverted funds away from retaining the specialized personnel for wine & food needed to run the operation; it also provided credibility with the investing public. Without these people on hand, SC essentially became a "still born" idea as it became extremely difficult to move forward without their presence. With the funds diverted to SOX compliance, it was a company that existed only on paper.

<u>The Verdict</u>: SC initially believed that had it been able to spend its capital on retaining the specialty personnel needed to launch its flagship operation and building a "brick-and-mortar" business (i.e., deploy physical capital assets), which would have created a going-concern that would attract investor interest. Ideally, SC thought of how the McDonalds brothers attracted the interest of Roy Kroc, who had the vision to transform the brothers' burgers-and- fries outlet into a global enterprise. But upon further reflection and additional research it became evident that, had the growth idea been confined to a small scale (i.e., build a single successful wine bar business first) and refine the concept so that it developed a track record that would later attract investment funding for scaling upward, this might have been more feasible. SC sought to move forward way too fast.

While the idea of a wine bar was most feasible in terms of demand growth, profitability and return on capital, *the near instantaneous formation of a large scale public enterprise might have proven to be very difficult to manage*. The cost estimate for SOX compliance associated with a near instantaneous formation of a publicly traded enterprise was approximately $1.5 million. SOX compliance certainly absorbed a disproportionate amount of capital that otherwise would have been used for developing the business, but to cast blame for SC's failure to become a reality solely upon SOX would be inaccurate.

Ultimately, the SC founders maintained their hobbyist interest in wine, but refrained from spending additional capital as their personal resources were exhausted and they had no interest in selling or licensing the model they created. Preliminary feelers to prospective buyers or investors indicated that SC lacked sufficient product differentiation and a track record to warrant financial participation. *In a sense, the all or nothing approach taken by SC may have been its undoing*.

The very rapid financial success each of the founders experienced in their individual corporate careers prior to pooling their resources for the SC wine bar venture resulted in overconfidence because they expected similar growth progression in the entrepreneurial venue. Whether that would have occurred pre-SOX is unknown, but certainly the presence of SOX proved to be a formidable influence upon their business decisions and risk-taking behavior.

5. Finding

As all three cases show, the cost of compliance with SOX requirements have been the main reasons for the three cited companies not to pursue equity financing via the public market, and as a result they were not able to materialize their dreams.

In short our finding indicates that SOX:

- Reduces incentives for innovation and risk taking among entrepreneurs while increasing attention toward compliance because of inordinate fear of financial and legal penalties.
- Has influenced diversion of personal capital by entrepreneurs from product development and related activities toward the hiring of attorneys and accountants in order to tap the public equity markets for capital funding.
- Has reduced the flexibility of entrepreneurs in creating business models that otherwise would attract equity capital pre-SOX from prospective investors.

Exhibit 1. SUMMARY FINANCIAL INFORMATION FOR 3 COMPANIES

Explanatory Notes:

- Employees for each firm are “independent contractors” and therefore not “permanent.” Each firm sought or considered equity via the public offering route as a means to secure permanence in their “human resource” assets.
- Only SC would have “internet” based sales as part of its expected revenue stream ($1 million or 22% of sales). VCS and OE models did not have revenue-generating/transaction
- VCS would be a lab/manufacturer, OE would be contractor/vendor and SC would be retail (brick-and-mortar + internet portal).
- Total owner capital $250,000 for VCS (with $50,000/$200,000 debt/equity mix), $500,000 for OE (all equity) and $300,000 for SC (all equity). VCS owner committed 100% of personal financial resources as did OE owners, with the difference being that OE eschewed the use of debt. SC owners set a limit or threshold on equity capital at risk, and would not commit any further.

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