Sarbanes-Oxley: Some Unintended Consequences

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ABSTRACT

The Sarbanes-Oxley Act of 2002 was enacted to improve the quality of the legally required corporate disclosures of publicly-traded companies. Opponents of Sarbanes-Oxley have maintained that the costs of these increased requirements far outweigh the benefits of increased transparency of financial reporting. In this paper we examine companies' decisions to de-list in response to the costs of implementing Sarbanes-Oxley. In the two periods which precede and follow the Act, we identify press releases from publicly-traded firms that have left either an exchange or an over the counter Bulletin Board (OTCBB) to trade on Pink Sheets. We find that the proportion of firms that voluntarily de-listed in the time period following Sarbanes-Oxley was significantly higher than the proportion that de-listed in the preceding time period. We also find that the de-listing firms were predominantly small firms, suggesting that Sarbanes-Oxley places a disproportionate cost burden on small firms.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 was enacted to improve the quality of the legally required corporate disclosures of publicly-traded companies. Articles of the Sarbanes-Oxley Act include mandates to increase the number of disclosures, to hold corporate officers legally responsible for not only the accuracy of firms' financial statements but also for the efficacy of firms' internal control systems, and to publicly audit firms' internal control systems. Opponents of Sarbanes-Oxley have maintained that the costs of these increased requirements far outweigh the benefits of increased transparency of financial reporting. In this paper we examine companies' decisions to de-list in response to the costs of implementing Sarbanes-Oxley.

In the two periods which precede and follow the Act, we use press releases to identify former exchange-traded firms or firms that traded over the counter on Bulletin Board (OTCBB) and changed to trading on Pink Sheets.[1] We use this restricted set of firms, generally considered to be "going dark," because we focus on firms that intend to remain at least quasi-public, and that are not de-listing to pursue some other financial strategy. We then consider (1) whether the firm's de-listing was voluntary or involuntary and (2) the reasons given in the press release for voluntarily de-listing. We find that the proportion of firms that voluntarily de-listed in the time period following Sarbanes-Oxley was significantly higher than the proportion that voluntarily de-listed in the preceding time period. We also find that the de-listing firms were predominantly small firms, in terms of total assets. We identify one of the primary reasons reported in the press releases for de-listing is the increased costs associated with meeting the requirements of the Sarbanes-Oxley Act of 2002. These findings suggest that, for these firms, the increased costs of SEC compliance exceed the benefit of trading publicly on an exchange.

There are two issues that motivate our interest in this topic. First, Sarbanes-Oxley does not make any allowances regarding reduced reporting requirements for very small firms, although small firms have a delayed compliance deadline. Second, moving from trading on an exchange to trading on Pink Sheets is associated with lower stock prices and lower liquidity (Macey et al. 2003). While shareholders are not included in the decision to de-list and deregister, they are potentially harmed by de-listing.

Recently, SEC Chairman William Donaldson acknowledged the extensive costs of Sarbanes-Oxley,[2] and noted that the SEC plans to examine the impact of the Act on smaller companies.[3] The impact on small-cap firms has also been noted in the press. Neal Wolkoff (2005), chairman and CEO of the American Stock Exchange called the costs of Section 404 compliance costs "severe." Unlike most SEC requirements, Sarbanes-Oxley makes no allowances for smaller firms – the reporting requirements for these firms are the same as they are for very large firms such as IBM, General Electric, or Ford.[4] Since the costs of meeting Sarbanes-Oxley are not strictly variable with firm size, small firms are more likely to suffer proportionately larger costs. Small firms are also more readily able to meet the requirements of de-registration of securities. Most of the firms in our sample are relatively small in terms of both total assets and other resources available to the firm, such as human capital.

The most often cited requirements of Sarbanes-Oxley are included in Section 404, which requires that each firm's CEO and CFO examine and comment on whether the firm's internal control structure is adequate for purposes of producing fairly reported financial statements. Additionally, this requires attestations by the firm's external auditor regarding the firm's internal controls. The costs associated with meeting these requirements are extensive, and for small firms, may be prohibitive. These costs include: (1) the attestation itself, (2) the personnel costs associated with documenting the existing system, (3) the opportunity cost of the CEO's and CFO's time and attention, and (4) the cost to design and implement a formal internal control system, if such a system does not exist. Smaller, and typically younger, firms are not only less likely to have developed formal internal controls, but are also less likely to have employees other than the chief officers who understand the company well enough to develop the appropriate controls. This in turn creates an enormous hurdle for a small firm: arguably, the most constrained resource of a small company is the time of its executives.

At the margin, de-listing and de-registration may be a reasonable alternative for smaller firms. Fuller (2004) states that the benefits of being a publicly-traded firm are not consistent across firms, and that many smaller firms do not fully reap those benefits. He also suggests that, for smaller firms, the costs of meeting the requirements of SEC registration outweigh the benefits of access to the capital markets. The increase in the costs, without a corresponding shift in benefits, may have encouraged some firms to reduce their level of disclosure by de-listing, de-registering, and moving to trade on Pink Sheets. One of the firms in our sample, Gunther International, de-listed from OTCBB, and provided the following in a press release:

After careful consideration, our Board of Directors determined to take this action because of the significant and increasing administrative burdens and expenses associated with being a public company, particularly in light of the rules and regulations promulgated under the Sarbanes-Oxley Act of 2002. This action has nothing to do with the past or expected future financial performance of the Company. It is being undertaken solely because of the tremendous expense of being a public company. For a small company like ours, the benefits of being public do not begin to justify the costs, which are not measured just in financial terms. Since the adoption of the Sarbanes-Oxley Act of 2002, compliance matters are requiring an ever-increasing amount of senior management's time.

Firms that trade on any of the major exchanges or OTCBB are required to register their securities and file reports with the SEC. Additionally, firms with total assets in excess of $10 million and more than 500 shareholders of record are required to file regardless of whether they trade on an exchange. Firms that de-list from exchanges are eligible to de-register if they have fewer than 300 shareholders of record, or less than $10 million in total assets and fewer than 500 shareholders of record. To de-register, firms file Form 15 with the SEC and at that point are absolved from filing future reports with the SEC. Formal de-registration takes several months and requires board of director, *but not shareholder*, approval.

Recent research has identified an increase in firms that de-list from exchanges (Block 2004, Marosi and Massoud 2004, Leuz et al. 2004) arising for various reasons. A substantial increase followed the 1999 requirement of SEC filings by all firms listed on the OTCBB. This was followed by the accounting scandals of 2001 and 2002 and the subsequent enacting of Sarbanes-Oxley. Block (2004) reports an increase in firms going private beginning in 2001. Leuz et al. (2004) identify 380 firms that de-registered and de-listed to trade on pink sheets between 1996 and 2003. Of particular interest is the distribution of these delisting occurrences, as over half (198) occurred in 2003. However, evidence regarding whether this increase in de-listings is related to the passage of Sarbanes-Oxley is inconclusive.

PRIOR RESEARCH

Prior research has documented an association between changes in SEC reporting requirements and firms' decisions on whether or not to remain publicly traded on large exchanges. Bushee and Leuz (2005) examine firms' decisions in response to the 1999 legislation requiring all OTCBB-listed firms to file reports with the SEC. They document that a substantial proportion of firms that were not required to file before the 1999 changes to listing requirements opted to de-list from OTCBB rather than incur additional costs of SEC registration and reporting. They also find that these firms experience decreases in liquidity following a move from OTCBB to trading on Pink Sheets.

The costs that firms incur as a result of de-listing and moving to Pink Sheets have also been studied. Macey et al. (2004) examined firms that de-listed and subsequently began trading on Pink Sheets. They find substantial increases in both percentage spreads and volatility occurred when firms move to pink sheets, particularly for small firms, as well as decreases in both price and liquidity. As they note, both the decline in share value and the subsequent reduction in liquidity harm investors in these firms. Their findings are consistent with the results in Panchapagesan et al. (2004), who also focus on involuntary de-listings.

Leuz et al. (2004) focus on the characteristics of de-registering firms and the market's reactions to firms' voluntary de-registrations. They distinguish between firms that de-register but continue to trade over-the-counter (i.e., "go dark") and firms that de-register and go private through a self tender offer. Like Bushee and Leuz (2005) and Macey et al. (2004), they find negative market reactions at announcements of de-registration. They also provide evidence that firms with lower growth opportunities are more likely to de-register.

Block (2004) surveys companies that went private between January 2001 and July 2003 using a much broader definition of going private than we do, or than Leuz et al. (2004) used in their study.[5] The majority of the firms in his sample are relatively small, as fewer than 10% of those firms had market capitalizations exceeding $100 million. He reports that, post Sarbanes-Oxley, 60% of the firms in his sample cited the cost of being public as a primary reason for going private, and that the average cost of being a publicly-traded firm more than doubled after the passage of Sarbanes-Oxley. However, he does not present results of tests for differences in responses for firms that went private before versus after Sarbanes-Oxley.

Marosi and Massoud (2004) examined firms that voluntarily de-registered between January 2001 and May 2004, focusing primarily on firms that were listed on major exchanges.[6] Controlling for size and industry, they use a matched-sample design to compare firms that de-registered with firms that did not, and find no support for increased regulatory costs as an explanation for de-registration. However, they use measures based on audit fees to proxy for regulatory incentives to de-register that, for two reasons, may not capture those incentives. First, as discussed above, increased costs for audit fees are only one part of the increased reporting costs arising from Sarbanes-Oxley. Second, the largest change to audit fees is likely to arise from the Section 404 compliance audits, which Marosi and Massoud do not include in their data, as compliance with section 404 is first required for 2004 fiscal year.

We extend this literature by providing evidence about changes in firms' frequency of de-listing and de-registration after Sarbanes-Oxley as compared to before passage of the legislation. We also provide evidence that is based on the self-reported reasons of management, rather than relying on proxies that may not capture the impact of changes faced by delisting firms.

DATA AND ANALYSIS

Our sample of press releases is drawn from the period of July 1, 2000 through June 30, 2004. We selected July 1, 2000 as the beginning of our sample period, since all firms trading on OTC Bulletin Board were required to be in compliance with SEC filing requirements by that date.[7] We divide this time into two sub-periods, the period before the adoption of Sarbanes-Oxley on July 31, 2002, and the period following adoption. We collected press releases that announce delisting of a stock from an exchange to trade in pink sheets, and classified the delisting as either voluntary or involuntary. Changes in entity name or form, mergers and acquisitions, and instances where no reason are given are eliminated from our analysis. For voluntary de-listings, we identified the reasons given for de-listing. From EDGAR, we obtained total assets as reported in the last 10-K of firms that de-listed voluntarily, as well as confirmation that the firm had filed form 15 to de-register with the SEC.[8]

Figure 1 provides information about the classification of firms within our sample. The numbers of both voluntary and involuntary de-listings increased post-Sarbanes-Oxley. The increase in involuntary de-listings is not surprising considering the economic climate of the period. However, the increase in voluntary de-listings is far more dramatic, and does not have an explanation based on changes in the economy. In both periods, firms that voluntarily de-listed frequently provided reporting costs as a reason for de-listing, implying that they planned to de-register with the SEC. Finally, 34% of the firms that voluntarily de-listed post Sarbanes-Oxley were firms that qualified to file using SB forms.[9]

Figure 1
Distribution of Firms Across Periods and By Reason Given for Delisting

	July 2000 to July 2002		August 2002 to July 2004	
Sample	N	%	N	%
Involuntary Delisting	29	41	42	59
Voluntary Delisting	8	12	56	88
- mention cost savings	6		49	
- mention reporting/SEC costs	5		40	
- mention Sarbanes-Oxley	0		17	
- foreign firms	1		6	
- filed as SB			19	

Figure 2 presents information about the size of voluntarily de-listing firms in the two time periods. On average, the firms that voluntarily de-listed in the period following Sarbanes-Oxley are larger than those in the earlier period. As the distribution of total assets is skewed, we focus on medians. The medians are significantly different at $p < 0.05$ when calculated excluding foreign firms, but not when based on all firms ($p = 0.093$). These differing results likely are due to the substantial difference in number of observations between the two periods. Interestingly, the foreign firms that de-listed are larger than domestic firms in both periods, which may also contribute to the difference in results.

Figure 2
Descriptive Statistics
Firms that Voluntarily Delisted before and after passage of Sarbanes-Oxley

Total Assets (in thousands)	July 2000 to July 2002	August 2002 to July 2004	p-value	X^2
All Firms:				
Median	8,326	17,997	0.093	2.83
Mean	61,957	72,997		
Standard Deviation	134,210	156,267		
Excluding Foreign Firms:				
Median	4,732	17,172	0.018	5.56
Mean	7,209	58,047		
Standard Deviation	5,915	117,964		

Figure 3 provides evidence about whether the frequency of de-listing is different across the two periods. While there are more involuntary de-listings in total than there are voluntary de-listings, the proportion of involuntary-to-voluntary de-listings appears to differ between the two periods. Based on the chi-square test statistic of 1.024 ($p < 0.312$) for the time-period difference in the number of involuntary de-listings, we cannot reject the null hypothesis of no difference in involuntary de-listings between the two periods. In contrast, the chi-square test statistic of 20.95 ($p < 0.001$) for the time-period difference in the number of voluntary de-listings is highly significant. This result provides evidence that more firms are voluntarily de-listing since the passage of Sarbanes-Oxley.

Figure 3
Classification Method of Measuring Changes in Occurrence of Delisting Behavior from Expected Value of Equal Likelihood before and after passage of Sarbanes-Oxley

	July 2000 to July 2002		August 2002 to July 2004		Total	
Sample	N	%	N	%	N	X^2
Involuntary Delisting	29	41	42	59	71	1.024 $p < .312$
Voluntary Delisting	8	12	56	88	64	20.95 $p < .001$

CONCLUSION

In this paper we examine press releases of firms that de-listed, either voluntarily or involuntarily, and moved to trading on pink sheets. We provide evidence that more firms are de-listing voluntarily since the passage of Sarbanes-Oxley. Additionally, we find that relatively "larger" small firms have voluntarily de-listed post-Sarbanes-Oxley, as compared to those that de-listed in the two years preceding passage of the act. This finding is important, as de-listing leads to reduced access to capital and reduced liquidity, negatively affecting both firms and investors. Further, over one-third of voluntarily de-listed firms in the post-Sarbanes-Oxley period had previously qualified for the simpler reporting requirements available to small firms. These results suggest that Sarbanes-Oxley has imposed additional costs, particularly on small firms, and that the SEC might consider reduced reporting requirements under Sarbanes-Oxley for small firms.

This is an important public policy issue in that conventional wisdom holds that small firms become large firms. In addition, small firms are often touted as leading the economy in job creation (and concomitantly in wealth creation). Regulations that disproportionately burden the smallest firms should be avoided unless evidence is provided that these are the firms most likely to harm investors through poor disclosures.

[1] Pink sheets are an over-the-counter market that began to provide electronic quotations in 2000, so named because the price quotations were originally maintained on pink paper. Firms trading on pink sheets are not required to register and file with the SEC, unless otherwise required due to total assets or number of shareholders of record.

[2] See Calmes and Solomon (2004).
[3] In December 2004, Donaldson announced the formation of a committee to examine the impact of securities laws on small companies. See the SEC website for details of the press release.
[4] The average market capitalization for firms included in the December 2004 CRSP dataset is 2.5 billion, and ranges from very small firms such as Plymouth Rubber, with a market capitalization of $661 thousand to General Electric with a market capitalization of $385.9 billion.
[5] Block includes mergers, self tender offers, voluntary deregistration, and reverse stock splits in his usage of the term "going private."
[6] This excludes firms that traded on OTCBB, which are included in our sample.
[7] In 1999, the requirement that firms trading on OTCBB file with the SEC was instituted. This requirement was implemented in stages, with the final date of June 30, 2000.
[8] There were two firms in our initial sample that did not deregister with the SEC, and those firms are omitted from our analysis.
[9] Firms meeting the limitations of less than $25 million in revenues and outstanding publicly-held stock worth no more than $25 million qualify for reporting using simpler forms. These forms have the designation SB.

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