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The Impact of Sarbanes Oxley Act 2002
on Small Firms

By: Elina Grinberg

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Professor R. Jacob

In reaction to major corporate scandals that rocked the corporate world in 2001 and 2002, Congress passed the Sarbanes Oxley Act of 2002 (SOX), also called the Public Company Accounting Reform and Investor Protection Act of 2002, on July 30, 2002. The fall of Enron, a huge energy company that misrepresented its heavily indebted situation by fraudulent accounting, motivated Congress to enact financial reporting reforms encompassed in the Sarbanes Oxley Act. In addition, the subsequent accounting fraud perpetrated by Worldcom, which overstated its earnings by more than \$3.2 billion over the course of five quarters by not properly accounting for its operating costs,¹ and the fraudulent accounting and reporting policies of Tyco that followed the announcement of SOX, demonstrated the great need for financial reporting reform. Shareholder/investor interests needed to be protected, and investor confidence in the public markets needed to be restored. Although the passage of Sarbanes Oxley has restored investor confidence in financial reporting, the high costs associated with SOX compliance has financially strained most small public companies and caused many of them to go into the private sector.

The Sarbanes Oxley Act is considered to be the biggest change in US legislation since the New Deal of the 1930's.² When President Bush signed the act into legislation he referred to it as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."³ The Sarbanes Oxley Act consists of a rigid

¹ http://en.wikipedia.org/wiki/Sarbanes-Oxley_Act

² Bumiller: ""Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations" *The New York Times*, July 31, 2002, page A1

³ Bumiller: ""Corporate Conduct: The President; Bush Signs Bill Aimed at Fraud in Corporations" *The New York Times*, July 31, 2002, page A1

system of regulations. Firstly, the act created the Public Company Accounting Oversight Board, whose job is to monitor, discipline and create regulations for public accounting firms in order to aid them in their preparation of public audit reports. Secondly, the act promotes auditor independence by disallowing audit firms from providing non-audit services and audit services at the same time to a client. Furthermore, the act requires firms to switch coordinating and reviewing auditing partners every five years. Thirdly, the act improves overall corporate governance of a company by requiring public company executives to certify that their financial reports are accurate, and requiring firms to set up audit committees. Fourthly, the act improves corporate financial disclosure and internal control by prohibiting companies from granting loans to their executives, requiring management to give an assessment of their internal controls (Section 404) and include that assessment in their financial report, and requiring companies to establish a Code of Ethics for their financial officers. In addition to Sarbanes Oxley, the SEC also passed additional regulations proposed by the New York Stock Exchange that requires firms have a majority of independent board members, and the audit committees and compensation committees be composed of independent members.

Although SOX has restored investor confidence, it has been more disadvantageous for small firms in comparison to large and medium-size firms. The SEC acknowledges that implementing SOX for small firms is a much harder task; therefore, the SEC gave a one-year extension to small businesses.⁴ Furthermore, after receiving many complaints about the Act, the SEC created an advisory committee to investigate

⁴ Solomon Wall Street Journal. New York, N.Y.: Sep 13, 2005. pg. A.2

SOX's effect on small public firms. The committee suggested that the SEC grant a one-year extension to small firms because the firms were having trouble finding funds to establish necessary controls required by SOX.⁵ Therefore, the SEC was considering giving small firms that have up to \$75 million in market capitalization an additional one-year extension that would extend the compliance deadline to July 2007.⁶ The committee's consideration is in line with the findings of many studies which conclude that SOX benefits large public firms, but inhibits and stifles small public firms.

The high cost of SOX implementation is financially draining many small firms. The Sarbanes Oxley Act doesn't make a distinction between large-cap billion-dollar companies and small-cap, \$75-million companies.⁷ Therefore, the Act requires all public companies to comply with the same regulations. The act doesn't take into consideration that small companies aren't as complex in organizational structure as large companies. Since large corporations have more complex business models, they have more complicated accounting practices; therefore, in order to ensure the efficiency of their operations, large firms already have a lot of controls in place that are required by SOX. On the other hand, smaller companies have simpler organization structures and, thus, have simpler accounting practices, which generate simpler financial statements. These small firms require less internal controls. Therefore, since small companies have simpler business models and less complicated accounting practices, they shouldn't be subject to the same internal controls and external auditing requirements of large companies.

⁵ Solomon Wall Street Journal. New York, N.Y.: Sep 13, 2005. pg. A.2

⁶ Solomon Wall Street Journal. New York, N.Y.: Sep 13, 2005. pg. A.2

⁷ Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

In addition, Mr. Wolkoff, chairman & CEO of the American Stock Exchange, a public exchange that caters mostly to small and mid-size firms with market capitalization between \$50 million and \$500 million, points out that majority of corporate scandals have occurred in large corporations with “thousands of unsuspecting shareholders, and their securities were the bulk of many retirement/pension accounts.”⁸ However, small companies don’t have such investor interests and are usually owned by the entrepreneurs who started the companies, their families, and public shareholders that are not out to cheat themselves.⁹ Therefore, although shareholder interests should be protected, SOX regulations aren’t needed for smaller firms that have simple business structures and a small number of shareholders that are unlikely to defraud themselves. On the other hand, SOX requirements should be tailored to company size and be designed to improve the profitability and efficiency of smaller companies instead of placing them at a competitive disadvantage and stumping their growth by requiring them to spend excessive amounts of money and time on implementing regulations.

Moreover, SOX’s board independence requirements are designed to reduce fraud and insider trading in large firms. Chhaochharia and Grinstein tested the impact of Sarbanes Oxley’s board independence requirements on small and large firms. Their study found that lack of director independence was more positively correlated with fraudulent insider trading and related party transaction in larger firms than in smaller firms. In addition, the study detected more occurrences of potentially fraudulent insider trading and financial restatements in large corporations than in small corporations. Therefore, the

⁸ Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

⁹ Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

Sarbanes Oxley rules are designed to “align the interests of the directors, CEO, and auditors” in order to decrease the occurrence of fraud in large firms rather than in small firms; in smaller firms “incentives are more likely to be aligned” without Sarbanes Oxley already. Their research shows that the rules are specifically designed for preventing fraud in large corporations, (not in small firms).¹⁰ Therefore, Sarbanes Oxley rules should be tailored to company size

In order for small firms to comply with SOX, small firms are spending a disproportionately larger amount of money in comparison with larger firms. An advisory committee set up by the SEC to investigate the effects of SOX wrote in a memo to the SEC Chairman, Chris Cox, admitting that the costs of SOX compliance "have been far more expensive than originally forecasted and these costs are disproportionately larger for smaller companies."¹¹ An example of how these costs are disproportionately larger for small companies is displayed in a 2005 survey conducted by Financial Executives International, a membership and advocacy group for financial executives. The survey shows that small firms with annual revenues under \$100 million spend around \$824,000 in SOX compliance costs, while mid-size companies with \$100 million to \$500 million in annual revenues spend \$1.5 million to comply with SOX.¹² Considering that the median revenues for companies listed on the American Stock Exchange, which caters to small and mid-size firms, are \$57 million, the cost of compliance for an AMEX firm would be about 1.5% of revenues (.824/57 million).¹³ This compliance cost seriously diminishes small

¹⁰ Grinstein, Yaniv & Vidhi Chhaochharia pg. 28

¹¹ Solomon, Wall Street Journal New York, N.Y.: Sep 13, 2005. pg. A.2

¹² Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

¹³ Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

companies' profits and takes away funds available for reinvesting and building up the firm. Mr. Wolkoff, chairman & CEO of the American Stock Exchange, believes that the high cost of implementation of Sarbanes Oxley Act "discourages small companies from participating in the public markets."¹⁴

Furthermore, the United States Government Accountability Office, the GAO, found that audit fees associated with the implementation of SOX are much greater for smaller public companies with market capitalization of \$75 million or less than large companies. The GAO used SEC filings in order to collect and analyze audit fees paid to external auditors before and after accelerated filers implemented section 404 in 2004. The findings are shown below in Figure 1. The GAO found that audit fees "already were disproportionately greater as a percentage of revenues for smaller public companies in 2003, and that the disparity in smaller and larger public companies' audit fees as a percentage of revenues increased for those companies that implemented section 404 in 2004."¹⁵ For instance, smaller companies worth \$75 million or less spent a median of \$1.14 in audit fees for every \$100 of revenues, while public companies with market capitalization of \$1 billion or more spent a median of \$0.13 (per \$100 of revenues) in audit fees. Furthermore, the GAO also found that the 66 small public companies that implemented section 404 in 2004 paid a median of \$0.35 more per \$100 in revenues for the implementation, compared with companies that didn't implement section 404.¹⁶

¹⁴ Wolkoff , Wall Street Journal New York, N.Y.: Aug 15, 2005. pg. A.13

¹⁵ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 15

¹⁶ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 15

These findings show that just the additional audit fees associated with the implementation of SOX are far more expensive for small firms than larger firms.

Figure 1: Median Audit Fees as a Percentage of 2003 and 2004 Revenues Reported by Public Companies as of Aug. 11, 2005

Number and percentage of companies that filed internal control reports for first year of section 404 implementation	Company size (market capitalization in millions)	Median audit fee as a percentage of revenues	Difference between 404 filers and nonfilers (2004)
 66 of 2,263 3%	>\$0-\$75	 .64% .79 1.14	.35%
 520 of 1,188 44%	>75-250	 .29 .35 .56	.21
 376 of 641 59%	>250-500	 .18 .26 .40	.14
 184 of 309 60%	>500-700	 .15 .20 .30	.10
 183 of 283 65%	>700-1,000	 .13 .12 .25	.12
 927 of 1,342 69%	>1,000	 .07 .07 .13	.06

 2003 (all companies)
 Companies that did not file internal control reports (2004)^a
 Companies that filed internal control reports (2004)^b

Source: GAO analysis of Audit Analytics data.

Note: Our analysis is based on companies' end of the fiscal year market capitalization. SEC's criteria for categories of filers (accelerated versus non-accelerated filers) are based on companies' public float as of the end of their second quarter. Due to the timing difference, some of the companies identified in this analysis as having market capitalization of less than \$75 million may have been accelerated filers under SEC's criteria.

^aIn addition to non-accelerated filers that were granted extensions, this includes accelerated filers that had not filed their internal control reports to SEC for reasons such as (1) the company's fiscal year ended before November 15, 2004, which pushed their reporting date to late 2005 or early 2006, or (2) the company was delinquent in implementing section 404.

^bSome of these companies were non-accelerated filers that decided to file internal control reports voluntarily.

¹⁷ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 16

At the initial passage of SOX in 2002, many expected that the high costs of SOX would just be associated with the initial implementation of the act, and within a few years the costs would tremendously reduce for small firms. However, still in 2006 there is evidence that small firms are still paying disproportionately higher costs for SOX. A study conducted by the *Greater Boston Chamber of Commerce* in 2006 found that SOX compliance is still very costly for biotech and life science small firms in Massachusetts.¹⁸ According to the study, in 2006 small companies are still spending up to 2.5 percent or more of their annual revenues on compliance costs.

The SEC expected auditing fees to drop an average of 26% for SOX complying small and large firms in their second year of compliance; however, a survey of 238 SOX complying small and large firms found that auditing fees have gone down an average of only 13% in their second year of compliance.¹⁹ Just like Mr. Wolkoff, chairman & CEO of the American Stock Exchange believed that SOX needs to have different regulations for small and large firms, Paul Guzzi, chief executive of the Boston Chamber, also believes that SOX's "one-size-fits-all approach that treats both big and small companies equally penalizes small firms."²⁰ These compliance costs are taking away resources that companies could be spending on expanding their operations, believes Mr. Guzzi. Geoff Knapp's, chief executive of CAM Commerce Solutions, a software company in Fountain Valley, California, statement exemplifies this case: "The penalty is high for our company

¹⁸ Reidy, Chris "Study: Sarbanes-Oxley costs burden small firms" March 1, 2006

¹⁹ "Scannell, Kara and David Reilly, "Small Firms' Sarbanes Suffering?; SEC Seems Unwilling to Exempt Little Guys from Internal Controls; 'There may be a Saner Approach'"

²⁰ Reidy, Chris "Study: Sarbanes-Oxley costs burden small firms" March 1, 2006

and our shareholders as we waste hundreds of thousands of shareholder dollars that could be used in building the business or returned to shareholders.”²¹

On the other hand, tailoring SOX regulations to firm size can compromise investor protection. According to Glass Lewis & Co., a proxy-advisory and research firm, the small companies that SEC wants to exempt from SOX 404 accounted for 59% of financial restatements by public firms in 2005.²² Therefore, the SEC should not exempt firms from the regulations, but it should tailor the rules to better accommodate small firms while still keeping an eye on them.

The high cost of SOX compliance is composed of several factors. The results of a PriceWaterhouseCoopers survey of a number of senior executives of multinational corporations in 2003 found that 74% of Sarbanes Oxley compliance costs were associated with the need for additional internal resources, such as more documentation, legal requirements, policy development, self assessment, staff training, attesting requirements and certifications, and the need to buy new tools and technology.²³ The remaining 24% of the compliance costs were related to external help from consultants in preparing financial statements.²⁴

²¹ Reidy, Chris “Study: Sarbanes-Oxley costs burden small firms” March 1, 2006

²² “Scannell, Kara and David Reilly, “Small Firms’ Sarbanes Suffering?; SEC Seems Unwilling to Exempt Little Guys from Internal Controls; ‘There may be a Saner Approach’”

²³ PWC Barometer Surveys : “Senior Executives At Large Multinational Companies Divided on Cost of Complying with Sarbanes- Oxley Act” July 1, 2003

²⁴ PWC Barometer Surveys: “Senior Executives At Large Multinational Companies Divided on Cost of Complying with Sarbanes-Oxley Act” July 1, 2003

The high compliance cost is also mainly attributed to the implementation of Section 404 of the Sarbanes Oxley Act. Section 404 requires companies to assess their internal controls, and it also requires companies' external auditors to assess the controls as well.²⁵ Many small firms worry about whether they will remain profitable after compliance with Sarbanes Oxley. Since small companies don't have many controls in place, they are being forced to spend a lot of money on creating and implementing internal controls. These firms are installing and designing new software in order to document their internal controls,²⁶ and they are paying more fees to their external auditors in order to assess those controls. In addition, since more internal controls are necessary such as segregation of duties, companies have hired more employees in order to ensure that individuals aren't fulfilling tasks that should be segregated.

Furthermore, statistical research conducted by Chhaochharia and Grinstein (2005), who studied the impact of Sarbanes Oxley on the firm value of small and large companies, found that SOX compliance only benefits large firms. The study findings show that large firms, which made more changes to comply with Sarbanes Oxley outperformed large firms that made fewer changes.²⁷ However, small firms that made more changes in order to comply with Sarbanes Oxley underperformed small firms that made fewer changes.²⁸ These results show that Sarbanes Oxley implementation increases

²⁵ Solomon Wall Street Journal. New York, N.Y.: Sep 13, 2005. pg. A.2

²⁶ Solomon & Bryan-Low Wall Street Journal New York, N.Y.: Feb 10, 2004. pg. A.1

²⁷ Grinstein, Yaniv & Vidhi Chhaochharia pg.3

²⁸ Grinstein, Yaniv & Vidhi Chhaochharia pg 3

firm value for large companies, but decreases firm value for small firms. This leads to the conclusion that the cost of compliance for small firms outweighs the benefits.²⁹

Other than Section 404, board independence requirements of Sarbanes Oxley have also placed small firms at a disadvantage. The new legislation passed by Congress requires firms to have a majority of independent board directors. Lehn, Patro and Zhao have found in their study that that in comparison to large firms, smaller companies tend to have more insiders on their boards.³⁰ This implies that smaller companies operate more efficiently with less independent board members. In addition, it may be harder for small firms to attract good independent directors because directors are more interested in working for larger companies. Therefore, small firms operate with more insiders on their boards.³¹ By changing the composition of their board directors, Sarbanes Oxley is causing small companies to operate less efficiently.

Furthermore, Chhaochharia and Grinstein (2005) tested the impact of Sarbanes Oxley's board independence requirements on firm value of small and large firms. Their research found that during the announcement period of SOX, small companies that had less independent board members underperformed small companies that had more independent board members by 12%-18%.³² However, large firms with less board independence didn't under perform large firms with more board independence. On the contrary, large companies with less independent board members outperformed large

²⁹ Grinstein, Yaniv & Vidhi Chhaochharia pg 3

³⁰ Lehn, Patro and Zhao, pg. 2, 10, 20

³¹ Grinstein, Yaniv & Vidhi Chhaochharia pg. 3

³² Grinstein, Yaniv & Vidhi Chhaochharia pg. 3

companies with more independent board members by around 18% after SOX's announcement.³³ This further proves that the board independence requirements of SOX place small firms at a disadvantage in comparison with large firms.

Furthermore, found that in their sample, 59% of large firms had already had three of the four independence requirements in place, while only 48% of small firms had at least three of the four independence requirements.³⁴ This shows that when SOX was passed small firms didn't have the required independence controls in place, while large companies did. Therefore, small companies are spending far more resources on hiring and training new board directors; this is driving up compliance costs significantly. Therefore, small firms are experiencing a negative affect on their earnings.

Chhaochharia and Grinstein (2005) also found that when small firms had less director independence and were at high risk of being taken over by other firms, they earned 25% less in revenues than small firms with more director independence. Therefore, the study suggests that SOX's director independence rules are not just disadvantageous to small firms, but they actually reduce firm value for small firms.³⁵

Another negative effect of SOX is that it has made it more difficult for smaller public companies to keep their large auditing firms. The US Government Accountability Office (GAO) found that the implementation of Section 404 and other SOX regulations

³³ Grinstein, Yaniv & Vidhi Chhaochharia pg. 3

³⁴ Grinstein, Yaniv & Vidhi Chhaochharia pg. 20-21

³⁵ Grinstein, Yaniv & Vidhi Chhaochharia pg. 24

have increased the demand in auditing services for larger public firms.³⁶ For example, from 2003 to 2004, from the 2,819 companies that changed their auditors, using Audit Analytics data, GAO determined that 79 percent of the companies had a market capitalization of \$75 million or less.³⁷ (Refer to Table 5 below for the detailed analysis of companies that changed their auditors.) In addition, large auditing firms dropped their smaller clients because of the increased audit risk associated with smaller firms. A lot of the smaller companies were riskier to keep than larger companies. For instance, GAO found that around 92% of companies that changed from large to small public accounting firms had going concern issues, and 81% of the companies that changed to small public accounting firms had at least one accounting issue such as a restatement, scope limitation or management issue.³⁸ In addition to the increased load of work that came with implementing SOX, large auditing firms didn't want the added risk of being liable for clients' accounting issues. Therefore, SOX caused many large auditing firms to drop their small public clients and thus forced small firms to change auditors.

³⁶ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 46-47

³⁷ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 43

³⁸ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 47

Table 5: Companies Changing Accounting Firms, 2003-2004

	Went to large accounting firm	Went to mid-sized accounting firm	Went to small accounting firm	No auditor reported as of December 2004	Total departures
Exiting large accounting firm	311	298	353	44	1,006
Average market capitalization	\$1,829,869,346	\$172,173,323	\$52,108,359	-	
Average revenue	\$1,291,589,676	\$138,816,527	\$50,765,823	-	
Exiting mid-sized accounting firm	18	30	147	21	216
Average market capitalization	\$1,285,735,282	\$59,822,406	\$38,111,445	-	
Average revenue	\$1,044,690,777	\$53,694,660	\$22,789,900	-	
Exiting small accounting firm	41	49	1,446	61	1,597
Average market capitalization	\$213,223,882	\$78,923,135	\$18,441,598	-	
Average revenue	\$92,138,114	\$28,518,987	\$5,039,327	-	
Total gains ^a	59	347	500	126	
Total losses ^b	(695)	(186)	(151)		
Net gain (loss)	(636)	161	349	126	

Source: GAO analysis of Audit Analytics data.

Note: Average market capitalization and revenue figures are based only on those companies with available relevant financial data.

^aTotal gains represent the sum of companies that went to that particular category of accounting firm (large, mid-sized, or small) from another category (cells highlighted in grey for the particular column). For example, large accounting firms gained 59 companies from 2003 to 2004 (18 from mid-sized firms and 41 from small accounting firms).

^bTotal losses represent the sum of companies that left that particular category of accounting firm (large, mid-sized, or small) for another category of firm plus those for which there was no auditor reported as of December 2004 (cells highlighted in grey for that particular row). For example, large accounting firms lost 695 companies from 2003 to 2004 (298 went to mid-sized firms, 353 went to small-sized firms, and 44 that had no auditor reported as of December 2004).

³⁹ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 44

The change in external auditors has only benefited large public firms. Chhaochharia and Grinstein tested the impact of replacing auditors on firm value. They found that when large firms replaced their auditors, they had a positive abnormal return in the value-weighted portfolio at the announcement of SOX. However, small firms that switched their auditors didn't display any significant change in returns at the announcement of SOX. This further supports the claim that SOX only benefits large companies.⁴⁰ In conclusion, with respect to board member independence and change in auditors, Chhaochharia and Grinstein's study found that the announcement of SOX yields a higher portfolio return for large and medium size firms, but yields a lower portfolio return for small firms.⁴¹

Another direct effect of Sarbanes Oxley is the exodus of many small firms from the public market into the private sector. Mr. Wolkoff, chairman & CEO of the American Stock Exchange (AMEX) for small and mid-size companies, reports that the high costs of compliance with SOX drove over a dozen small firms to delist from the AMEX because of the exorbitant costs.⁴² Furthermore, Kamar, Karaca-Mandic & Talley from the *Kauffman-RAND Center for the Study of Small Business and Regulation* conducted a study which concludes that SOX has driven small public companies to go private. Kamar, Karaca-Mandic & Talley studied 8,266 acquisitions of public firms between January 2000 and December 2004. 2,383 of those acquisitions took place in the U.S., while the

⁴⁰ Grinstein, Yaniv & Vidhi Chhaochharia pg. 19-20

⁴¹ Grinstein, Yaniv & Vidhi Chhaochharia pg. 21-22

⁴² Wolkoff *Wall Street Journal*. : Aug 15, 2005. pg. A.

remaining 5,883 acquisitions took place outside the U.S.⁴³ They used a “difference-in-differences empirical strategy” to determine the effect of SOX by comparing the changes in the probability of public American firms being purchased by private firms rather than by public firms, to the probability of foreign public firms being purchased by private firms after the announcement of SOX.⁴⁴ The difference in these probabilities is the direct effect of SOX. Their study found that the probability of full acquisition of small companies by private firms increased from 44% (before SOX) to 55% (after SOX), however, the probability of large firms going private actually decreased from 21% (before SOX) to 19% (after SOX).⁴⁵ In addition, the probability of a small American firm going private within the first year of SOX’s announcement increased to 66%.⁴⁶ These results show that after SOX’s announcement, there was a significant increase in small American firms going private. Furthermore, this increase was mostly concentrated amongst small American companies within the first year of SOX’s announcement.⁴⁷ These findings support the theory that SOX caused small public firms to go private.

In addition, the GAO study also found that the number of companies going private increased since the passage of SOX, but more importantly, most of those companies that went private were small companies with small market capitalization, revenue and assets. In order to conduct its study, the GAO used SEC filings and press releases to create a database of public companies that went private between 1998 and

⁴³ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Talley Pg. 3

⁴⁴ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Talley Pg. 2

⁴⁵ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Pg. 48

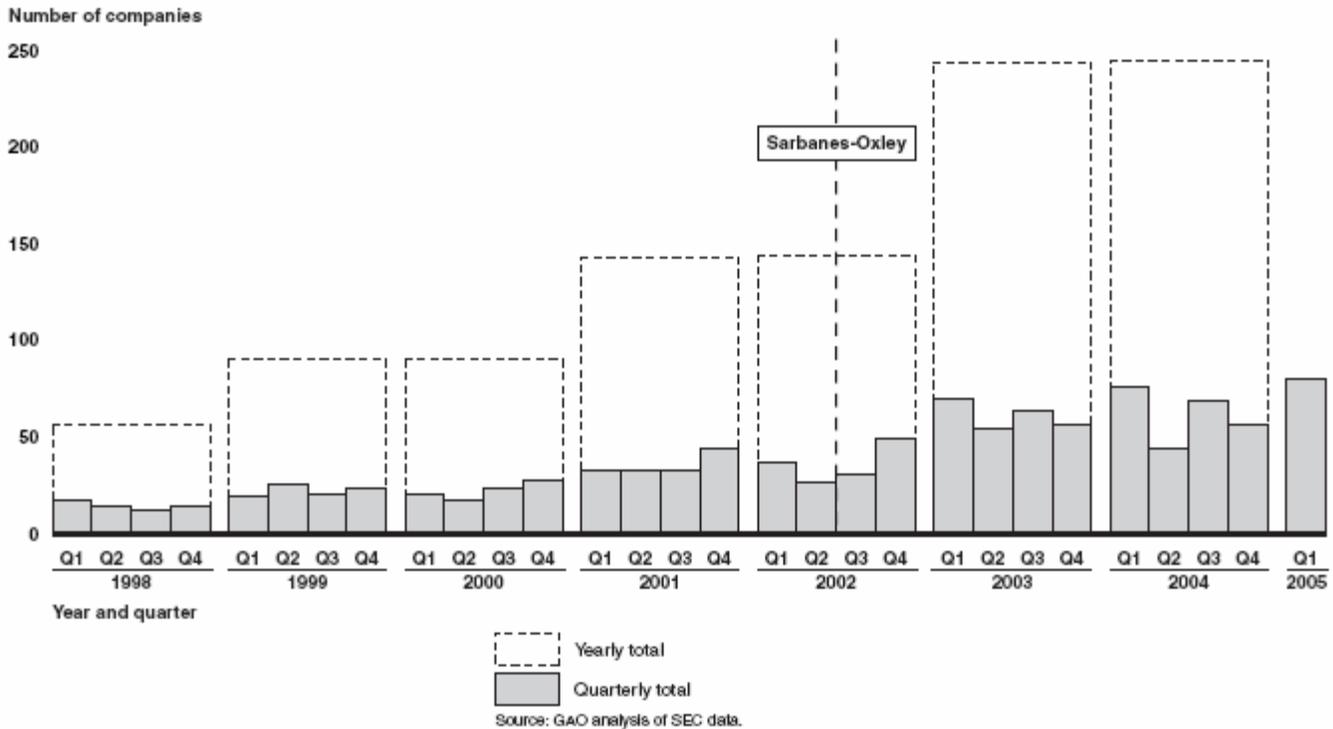
⁴⁶ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Talley Pg. 50

⁴⁷ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Talley Pg. 4

2005. As shown in Figure 2 below, the study found that from 2001 (before SOX) to 2004 (after SOX) the number of public companies that went private increased from 143 to 245.

In addition, 80 companies went private in the first quarter of 2005.⁴⁸

Figure 2: Total Number of Companies Identified as Going Private, 1998-2005



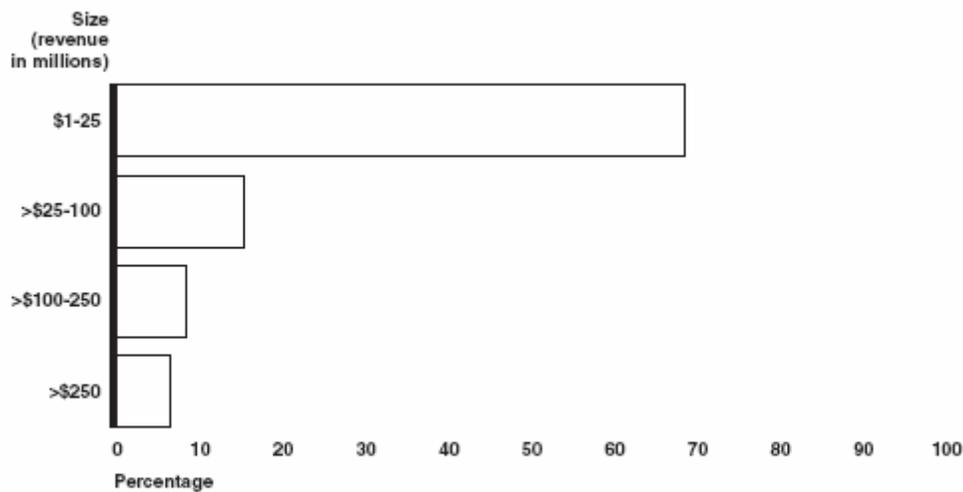
Note: Includes companies that deregistered, but continued to trade over the less-regulated Pink Sheets ("went dark") and shell companies and blank check companies. Does not include companies that filed for, or are emerging from, bankruptcy, have liquidated or are in the process of liquidating, were headquartered in a foreign country, or were acquired by or merged into another company unless the transaction was initiated by an affiliate of the company and the company became a private entity. See appendix II for a fuller discussion of our analysis.

⁴⁸ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 21

⁴⁹ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 22

Of the companies that went private, GAO found that most of the companies were small public firms. For instance, Figure 12 below shows that 84 percent of companies that deregistered in 2004 and 2005 had revenues of \$100 million or less. And about 69 percent of the companies that deregistered in 2004 and 2005 had revenues of \$25 million or less.⁵⁰

Figure 12: Revenue Categories for Companies Going Private, 2004-2005



Source: GAO analysis based on SEC and Audit Analytics data.

Note: Only includes companies with financial data available.

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There are several reasons why small firms went private after SOX's announcement. Block who surveyed 110 of the 236 firms that delisted from the NASDAQ and went private between January 2001 and July 2003⁵² lists several reasons

⁵⁰ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 83

⁵¹ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 83

⁵² Block pg 36

as to why firms went private. He reports that 60% of the firms said that the number one reason for going private was because of the high costs associated with SOX. The survey reported that the average cost of being public increased from \$900,000 (pre-SOX) to \$1,954,000 (post-SOX). These costs included the increased price of audits, higher premiums for directors and officers' insurance. In addition, since SOX required at least three outside members and one financial expert in an audit committee, companies also paid higher salaries to outside directors. With the announcement of SOX, the cost of being public dramatically increased, while the administrative costs of going private were much lower, between \$50,000 and \$100,000.⁵³ Therefore, many firms went private.

In addition, the reason why companies went private within the first year could also be attributed to the fact that public firms knew they couldn't spend large amounts of money in order to adapt to SOX's regulations and therefore, they pulled out of the public market immediately. However, large firms, which had sufficient controls and regulations in place didn't need to spend too much money on implementation and therefore, remained in the market.⁵⁴ In addition, a study conducted by Foley and Lardner law firm found that SOX increased the cost of staying public by 130 percent for small firms.⁵⁵ These findings further support the fact that SOX doesn't benefit small public firms. In actuality, SOX increases the costs involved in remaining a public entity. Since small firms compared with larger firms can't handle the high cost of compliance, they go private through deregistering from the public market or being sold to private owners.

⁵³ Block pg 37.

⁵⁴ Kamar, Ehud and Pinar Karaca-Mandic, and Eric Talley Pg. 4

⁵⁵ Paul "Repeal Sarbanes-Oxley!"

The GAO also concluded that companies went private mainly because of the increased costs associated with staying in the public market. Results from the GAO study, displayed in Table 2 below, show that from 1998 to the first quarter of 2005 the percentage of companies which deregistered because of the direct costs of maintaining public standing increased from 12 percent to 62 percent.⁵⁶

Table 2: Primary Reasons Cited by Companies for Going Private, 1998-2005, by Percent

	Direct costs	Indirect costs	Market/liquidity issues	Private company benefits	Critical business issues	Other	No reason
1998	12.3	5.3	14.0	26.3	15.8	3.5	54.4
1999	33.3	12.2	33.3	42.2	8.9	3.3	37.8
2000	20.0	11.1	32.2	37.8	20.0	5.6	38.9
2001	32.2	13.3	31.5	23.8	20.3	3.5	49.0
2002	44.4	13.9	35.4	22.9	16.0	1.4	45.1
2003	57.8	27.5	38.5	21.3	19.7	0.8	31.6
2004	52.7	25.7	28.6	15.9	15.5	1.2	38.4
2005 Q1	62.2	28.9	28.9	8.9	12.2		27.8

Source: GAO analysis of SEC filings and relevant press releases.

Note: See appendix II for a more detailed description of the categories and limitation for this analysis. Because companies were able to cite more than one reason for going private, the percentages may add up to more than 100 for each year.

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Furthermore, GAO determined that the percentage of companies that went private increased greatly since the passage of SOX due to the increased costs. Figure 10 below shows that from 2003 (before SOX) to 2004 (after SOX), the number of companies that went private solely because of high costs doubled from 21 to 43.⁵⁸ In addition, in the first

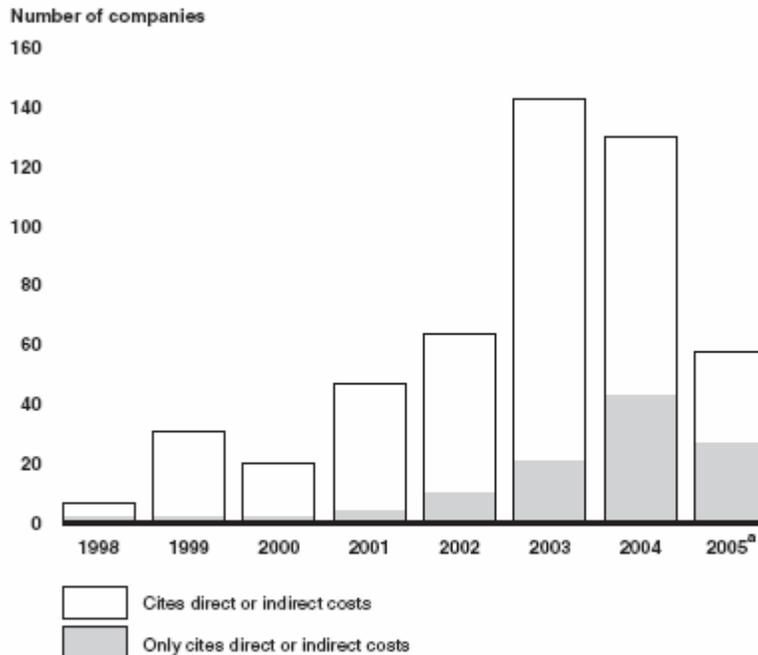
⁵⁶ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 22

⁵⁷ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 23

⁵⁸ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 80

quarter of 2005, 50 percent of the companies that went private said that cost was their reason for deregistering.⁵⁹

Figure 10: Companies Citing Costs as One of the Reasons for Going Private



Source: GAO analysis of SEC data.

^aPartial year, only includes the first 2 quarters of 2005.

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The highest second reason for going private was because SOX’s many requirements created more time constraints for top management. After SOX’s implementation, CEOs and CFOs were required to attest to the validity of the financial statements; however, most CEOs didn’t have the financial expertise to verify that the statements were correct. CEOs had to spend time learning how to interpret financial

⁵⁹ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 80

⁶⁰ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 81

statements. In addition, executives spent more time on monitoring audits, going to committee meetings in order to make sure that they were in compliance with the SEC, creating whistleblower procedures, accelerating the deadlines of reports filed in compliance with SOX, and getting the approval of each independent director before releasing any quarterly financial reports.⁶¹ SOX's requirements were too time-consuming for the top management of small firms. For example, Mr. Ash R. Huzenlaub, CEO of Emergisoft, a firm that markets software for emergency rooms, reported that since the passage of SOX, the company controllers and executives spent around 80 percent of their time on SOX compliance issues. And the chief financial officer spent about 40% of her time on SOX compliance issues instead of fulfilling her regular responsibilities of running the company.⁶² Emergisoft decided to go private after the passage of SOX so that its executives could go back to their original duties of managing the firm. Small firm CEOs don't have the time necessary in order to comply with SOX, they need to fulfill their regular duties such as looking for prospective clients and monitoring their revenues. Therefore, rather than staying public, small firms entered the private sector in order to avoid the added time pressures and tasks associated with SOX.

The third reason why companies went private was because the increased cost of staying public didn't improve the securities analysts' coverage or publicity of small companies.⁶³ After SOX's implementation, small firms were still not getting the amount of coverage by securities analysts that they wanted. Therefore, the low level of market

⁶¹ Block pg 37.

⁶² Ligos, The New York Times, June 3, 2004 Section C; Column 1 pg.7

⁶³ Block pg 37.

publicity afforded to small firms wasn't worth the increased cost of staying public. Thus, small firms went private.

A fourth reason why firms went private was because these they lacked liquidity. Originally, small firms entered the public market to improve their liquidity; however, small firms that weren't liquid at the time of SOX's announcement saw it more beneficial to go private. These firms felt that by going private they would have a better opportunity to restructure their operations and build up their companies through obtaining capital from willing private equity firms. This type of opportunity wasn't available to public companies, so firms went private in order to obtain the additional funds. ⁶⁴

The final reason why these firms went private was because they faced the threat of being delisted from the NASDAQ. The NASDAQ is capable of delisting firms whose stock prices drop below \$1 for 180 consecutive days.⁶⁵ The threat of being delisted was real to these firms at the time because from 2001 to 2003, the NASDAQ delisted 973 companies because their stocks fell below \$1 for 180 days.⁶⁶ Therefore, in order to avoid sullyng their reputation by being delisted, many small companies voluntarily deregistered themselves from public markets.

In addition, small companies preferred their private status because it freed them "from the short-term pressures of Wall Street and the belief that the markets had consistently undervalued their company."⁶⁷ Being private also allowed the firms to keep

⁶⁴ Block pg 37-40.

⁶⁵ Block pg 40

⁶⁶ Block pg 40.

⁶⁷ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 23

their company information private. Otherwise, these companies would be required to disclose their information in financial statements, which could benefit competing firms.⁶⁸

Engel, Hayes and Wang who studied 353 companies that went private between January 1998 and January 2004 also found an increase in the rate of firms going private after the announcement of SOX. In addition, they found that abnormal returns after the announcement of SOX were positively correlated with share turnover and firm size.⁶⁹ This implies that SOX compliance results in higher returns for larger companies with more liquidity than smaller companies with less liquidity. Therefore, SOX compliance doesn't yield greater returns for small and non-liquid firms, but does increase returns for large, liquid firms. Since SOX compliance wasn't beneficial for small firms, they went private.

In addition, Engel, Hayes and Wang discovered that small firms and firms with a higher percentage of inside ownership displayed higher returns when they announced to go private after SOX's implementation rather than before SOX. Engel, Hayes and Wang found that a 10% increase in inside ownership in firms reduced abnormal returns by 0.02% before SOX. But after SOX, the increase in inside ownership in firms increased returns by 3.6%.⁷⁰ However, for large firms, inside ownership didn't effect going private announcement returns.⁷¹ In conclusion, after the passage of SOX, firms that had a higher inside ownership, which were mostly small firms according to Lehn, Patro, and Zhao's

⁶⁸ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 23

⁶⁹ Engle, Hayes and Wang, Pg. 18

⁷⁰ Engle, Hayes and Wang, Pg. 21

⁷¹ Engle, Hayes and Wang, Pg. 22

findings,⁷² earned greater returns when they went private as opposed to when they remained public. Therefore, going private was a more lucrative option for small companies..

Another indirect consequence of SOX is the creation of private firms that are owned mainly by public shareholders. One way in which small firms went private during the first year of SOX's announcement was through a reverse stock split. Engel, Hayes and Wang's research found that in the pre-SOX period 13% of firms went private through a reverse stock split.⁷³ However, after SOX's announcement, the percentage of firms going private through reverse stock splits almost tripled to 37%.⁷⁴ A company performs a reverse stock split by converting every one thousand shares into one share. Those shareholders who are left with a fraction of a share are forced to sell it back to the company. This enables small firms who can't afford to buy back all their shares to buy back some shares in order to reduce the amount of their shareholders to below 300. When a company has below 300 shareholders it is exempt from filing with the SEC and from complying with SOX. Therefore, many small firms were unable to meet the cost of being public, and also weren't able to afford buying in all their shares; therefore, companies resorted to going private through reverse stock splits. After a company acquired enough shares to get under 300 shareholders, it left the rest of the shares in the public

⁷² Lehn, Patro and Zhao, pg. 2, 10, 20

⁷³ Engle, Hayes and Wang, Pg. 14

⁷⁴ Engle, Hayes and Wang, Pg. 14

shareholders' custody. Thus, a new form of private companies owned by the public shareholders formed after the first year of SOX's announcement.⁷⁵

The passage of Sarbanes Oxley has also deterred many small, start-up companies from going public. The process of going public and raising capital through selling initial public offerings (IPO) of shares through an underwriter has always been costly and time consuming for firms.⁷⁶ The GAO noted that with the passage of the Sarbanes Oxley Act in 2002, private company executives and venture capitalists observed companies, who wanted to go public, spending far more time and money showing potential investors their firms' capabilities of complying with SOX. Many companies hired auditors and extra staff members to improve their financial reporting capabilities, to reevaluate their accounting procedures, and to establish and record internal controls and processes.⁷⁷ Even underwriters of the IPO's expected companies to be ready to comply with SOX before they went public. If, however, a firm wasn't ready to comply with SOX, venture capitalists would not invest in it unless the firm presented a plan for implementing SOX regulations as soon as it went public.⁷⁸

The increase in the cost of the IPO process has put, specifically, small private firms at a disadvantage. The GAO found, between 1998 and the second quarter of 2005,

⁷⁵ Block pg 41-43.

⁷⁶ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 36

⁷⁷ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 37

⁷⁸ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 37

that direct costs of the IPO process were a larger percentage of small companies' revenues than larger companies. Furthermore, since the passage of Sarbanes Oxley Act in 2002, IPO costs have been disproportionately increasing for small firms (with revenues of \$25 million or less) that went public.⁷⁹ For instance, as shown in Table 4 on the next page, in 2003, 2004, and first two quarters of 2005, small firms with \$25 million or less in revenues paid direct IPO expenses equaling 17.5%, 25.9% and 28.1%, respectively, of their revenues. However, larger firms didn't incur IPO expenses of more than 5.3% of their revenues. Actually, most companies with \$100 million or more in revenues didn't incur costs more than 2.2% of their total revenues. Therefore, the cost and time necessary to go public especially for small private firms has greatly increased since the passage of the Sarbanes Oxley Act. As a result, the number of initial public offerings since 2002 has decreased.⁸⁰ The GAO reports that small firms are now a much smaller portion of the IPO market. For instance, the number of small company (\$25 mil or less) IPO's fell in 1999 from 70 percent of all IPO's to around 48 percent in 2004, and then to 31 percent in the first two quarters of 2005.⁸¹ In conclusion, the Sarbanes Oxley Act is slowing down the IPO market.

In addition, *Greater Boston Chamber of Commerce's* study also concluded that high SOX compliance costs are stalling start-up companies from issuing initial public stock offering in Massachusetts. Paul Guzzi, *Greater Boston Chamber of Commerce's*

⁷⁹ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 37

⁸⁰ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 37

⁸¹ "Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies", Pg. 39

chief executive said that "For many companies, the costs of Sarbanes-Oxley outweigh the benefits of going public. Without taking action to improve the legislation, we are putting the companies that fuel our regional and national economy at an unfair disadvantage in this competitive global marketplace."⁸²

Furthermore, Robert Grady, chairman of the National Venture Capital Association, said that the Sarbanes Oxley Act "threatens to make the U.S. less hospitable to company creation."⁸³ The rigid regulations of the act stop companies from expanding through going public, and are taking away from the creation of new jobs for Americans. According to National Venture Capital, "IPO's for venture backed companies" decreased from 93 in 2004, to 56 in 2005, which is a 40% drop.⁸⁴ And only 10 venture backed companies became public in the first quarter of 2006. These companies raised \$540.8 million through issuing IPO's, which is 25% less than the amount raised in the first quarter of 2005.⁸⁵

Moreover, Mr. Grady, who is also the managing director of the Carlyle Group Investment firm says that companies are listing their companies on foreign exchanges like the London Stock Exchange PLC's Alternative Investment Market (AIM) in order to avoid the high costs of going public in the U.S. Furthermore, as president and chief executive of Westminster Securities, a brokerage firm that deals with small firms, John O' Shea said that the AIM is attracting a lot of developing small companies. The number of foreign companies listed on the AIM has significantly increased since the passage of

⁸² Reidy, Chris "Study: Sarbanes-Oxley costs burden small firms" March 1, 2006

⁸³ Buckman and Scannell

⁸⁴ Buckman and Scannell

⁸⁵ Pethokoukis

Sarbanes Oxley. From 2003 through May 2006, the number of foreign companies listed on the AIM skyrocketed from 60 to more than 260.⁸⁶

Neal Wolkoff, chairman and CEO of Amex, also observed that SOX has driven many small firms out of the U.S. public market. Mr. Wolkoff believes that “The flight of smaller companies seeking to avoid the expense of Sarbanes Oxley could ultimately be a ‘Marshall Plan’ for overseas exchanges.”⁸⁷ He’s referring to the plan that put Europe back on its feet after World War II. “The result of such a movement would certainly work to the detriment of U.S. capital markets, the US economy and the oversight ability of US regulators.”⁸⁸

In addition, Sarbanes Oxley has also influenced the increase of mergers and acquisitions of small firms. Instead of going public, the GAO noted that venture capitalists observed a lot of small and mid-sized private companies merging with public companies or being acquired by public companies. This enabled the small firms to expand their operations, while avoiding the costlier IPO process.⁸⁹ Furthermore, the National Venture Capital Association has also found that the number of company acquisitions is growing. In 2005, ninety-five companies were acquired valuing over \$4.8 billion, which was the largest acquisition total in the past five years. As president of the National Venture Capital Association, Mark Heesen said that he and his firm are “becoming increasingly concerned about the economic implications of the lackluster IPO market for venture-backed companies. Although we are bolstered by the continued

⁸⁶ Guerrero

⁸⁷ Guerrero

⁸⁸ Guerrero

⁸⁹ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 39

strength of the acquisitions market, we cannot rely on it as the only avenue to produce above-average returns for the venture industry.”⁹⁰ In conclusion, small companies are opting out of the expensive IPO process, and are, instead, being acquired by public companies. The increased trend of mergers and acquisitions is taking capital away from the IPO market and is slowing it down.

Table 4: IPO Direct Expenses as a Percentage of Company’s Revenues, by Size

	\$25 million or less	\$25 -100 million	\$100-250 million	\$250-500 million	\$500 million-1 billion	Greater than \$1 billion	All companies
1998	12.5	3.0	1.2	0.6	0.3	0.2	0.9
1999	17.6	3.7	1.8	0.7	1.2	0.1	0.9
2000	21.3	3.3	1.9	0.8	0.3	0.1	0.6
2001	14.3	3.0	1.1	0.8	0.5	0.1	0.2
2002	10.6	3.1	1.1	0.6	0.3	0.1	0.1
2003	17.5	5.0	1.5	0.7	0.4	0.5	0.9
2004	25.9	4.9	2.2	1.5	0.4	0.3	1.3
2005 (Q1-Q2)	28.1	5.3	1.5	1.2	0.6	0.3	1.0
1998 – 2005 Q2	18.2	3.8	1.7	0.9	0.5	0.1	0.4

Source: GAO analysis of data from SEC filings.

Note: Includes only companies with financial data available. In some cases, pro forma or un-audited revenue data were used. There can be significant lag between the dates when a company initially files for an IPO and when the stock of the company is finally priced (begins trading). The number of priced IPOs only includes those companies that initially filed for an IPO after November 1, 1997. See appendix I for more details.

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In conclusion, the Sarbanes Oxley Act of 2002 has restored investor confidence, but not without imposing consequences on small firms. The Act has implemented regulations that have improved corporate governance, internal controls and the overall reliability of financial reporting. However, because the Act is mostly geared toward

⁹⁰ Pethokoukis

⁹¹ “Sarbanes Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Small Public Companies”, Pg. 38

preventing bad accounting policies and fraud within large companies, its many costly regulations have put most small firms at a disadvantage. In comparison to large firms, small firms didn't have most of the internal controls and policies in place that were required by SOX like large companies had in place. Therefore, the cost of implementing SOX was disproportionately larger for small firms.

Furthermore, unlike large firms that experienced an increase in firm value after Sarbanes Oxley's implementation, small companies experienced a decrease in firm value and earnings. In addition, the high costs of staying public and the independence requirements associated with the Sarbanes Oxley Act have caused many small public firms to go private. As a result, a new type of private entity has formed which is partly owned by public shareholders.

In addition, the high cost of going public has discouraged many private start-up companies from entering the public market. Instead of spending money on going public, companies prefer to spend their resources on expanding their operations. Moreover, many small private firms avoided the high costs of going public by merging with public corporations, being acquired by public firms, or listing themselves on foreign exchanges such as the AIM. Thus, as a direct result, the number of initial public offerings (IPO's) severely decreased since the passage of Sarbanes Oxley. Although the IPO market has been negatively affected by SOX, investors are optimistic that the market will turn around and companies will start issuing IPO's despite the SOX costs associated with it.

I believe that small companies with market capitalization of \$25 million or less should be exempt from complying with Sarbanes Oxley. This will allow start-up firms in

America to grow and mature into large corporations. As of today, the high costs associated with Sarbanes Oxley compliance discourages small, start-up firms from electing to go public. This prevents them from raising new capital through the issue of IPO's. And, even if small firms elect to go public, the large amount of money and time allotted to SOX compliance drains small firms of their resources, which could otherwise be spent on investing in new technology, capital assets, and research and development. Therefore, since small firms with less than \$25 million in market capitalization don't have complex business models, they shouldn't be required to set up the same costly internal controls and procedures as large, complex businesses have.

Furthermore, the regulations of Sarbanes Oxley are meant to protect corporate shareholder interest. However, small firms worth \$25 million or less are usually run and owned by the people who originally created the firm. Therefore, the owners of a small firm would not likely commit corporate fraud, because they would be defrauding themselves.

However, when a company's market capitalization exceeds \$25 million, then it should begin to start complying with a simpler version of Sarbanes Oxley, which is tailored to company size. A company that exceeds \$25 million in market capitalization, will start transforming into a more complex organization that will need to have a system of internal controls in place to ensure that it operates efficiently and effectively. In addition, in order to raise capital, the firm may issue more IPO's thus increasing its number of shareholders. These public shareholders' interests need to be protected through the implementation of the Sarbanes Oxley Act. And as the company continues to grow in

revenues and market capitalization it should be required to adapt more internal controls and SOX regulations based on its size.

In conclusion, exempting small firms with market capitalization of \$25 million or less from SOX compliance will spur the growth of entrepreneurships in America. By tailoring SOX regulations to company size, companies will be given the opportunity to grow into large corporations. This will expand the American economy. In addition, it will also rejuvenate the IPO market by making it cheaper and easier for smaller firms to issue IPO's, and stopping firms from exiting the American Stock Market.

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