Original analysis on the latest happenings in the CFO industry

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Study: Pandemic impact on small companies worsened by Sarbanes-Oxley

A provision in the 2002 federal law to improve corporate accounting leaves companies reliant on debt at a time when credit markets are wobbling.

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Author: Robert Freedman

A provision in Sarbanes-Oxley, the accounting-reform law enacted in 2002, pushed smaller companies to use debt rather than equity to grow. Now these companies are left exposed as the pandemic-driven economic downturn leaves them struggling to repay.

Congress passed Sarbanes-Oxley, colloquially known as "SOX," in response to billions of dollars in losses by Enron and WorldCom, where the companies' accounting tricks hid significant financial problems.

Among the law's provisions is Sec. 404, which requires corporate leadership and external auditors to attest to the effectiveness of internal controls over financial reporting if the company's public equity float is $75 million or more.

The requirement is expensive to meet, and it acted as an incentive for corporate leaders to use debt instead of equity to grow as a way to keep their public float — the value of company shares held by the public — below the $75 million threshold (since increased to $250 million).

As a result, companies had an incentive to hold more debt than they otherwise would have; today that decision bears consequences, say David Weber and Yanhua Sunny Yang of the University of Connecticut, who have studied the impact of the provision on corporate strategy.

"The traditional trade-off theory of capital structure views financing choices as a balancing of various costs and benefits of debt versus equity," the researchers say in a paper in **The Accounting Review, published by the American Accounting Association**. "The SOX 404 exemption can affect that balance and the resulting financing choices of firms near the threshold by making additional common equity relatively more costly and additional debt relatively less costly."

Ten years of low interest rates have made debt a cost-effective way to grow. But with credit markets seizing up, companies are increasingly at risk of default.

As of earlier this year, corporate debt totaled almost $13.5 trillion, and much of that is at the lower-end of investment-grade levels. Some analysts worry the pandemic could be the trigger for a widespread collapse of vulnerable businesses.

"We have been always saying that we are sitting on top of an unexploded bomb, but we don’t know what is going to trigger it," Emre Tiftik, director of research for global policy initiatives at the Institute of International Finance, has said. "Can the coronavirus be a trigger? We don’t know. Maybe."

"Certainly one potential cost of taking on more debt than would otherwise be optimal is the increased risk of financial stress in the event of a negative economic shock, such as the current coronavirus situation," says Weber.

Debt preference

The researchers based their findings on an analysis of 1,095 public firms whose public float was either slightly below or slightly above the $75 million threshold during the study period. Before SOX, both groups were equally likely to issue common stock to finance growth. After SOX, the below-threshold firms were almost 20% less likely to do so.

What's more, almost 80% of companies that went on to grow above the $75 million threshold continued to rely exclusively on debt, and the preference for debt was

strongest among those with the highest market-to-book ratios – that is, those with the most valuable growth options.

The findings should be considered an alert to lawmakers that using equity values as a basis for regulating companies comes with risks, the researchers said.