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Investors favor SOX 404(b) audit rule, says study

BY MICHAEL COHN

Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires public companies to undergo annual audits of the adequacy of their internal controls over financial reporting, appears to be supported by investors who want newly acquired companies to be audited as well, according to a new study.

The study, by Robert R. Carnes of the University of Florida, Dane M. Christensen of the University of Oregon and Phillip T. Lamoreaux of Arizona State University, appears in the January issue of **The Accounting Review**, published by the **American Accounting Association**. The study aims to gauge investor demand for internal control audits, which were mandated by the Sarbanes-Oxley Act in the wake of a series of accounting scandals involving companies like Enron and WorldCom. Companies are allowed to opt out of audits of newly acquired businesses for one year, but the paper found a significant drop in the acquirer's stock on the day the exclusion becomes public when the company issues its annual report.

"Companies that exclude acquired operations from the internal control audit experience negative and statistically significant abnormal returns on the day the opt-out decision is revealed," said the study. Depending on how the decline is calculated, the study found there can be up to a 44 basis-point difference in one-day abnormal returns between opt-out and opt-in companies.



Former Sen. Paul Sarbanes (D-Md), co-author of the Sarbanes-Oxley Act. Bloomberg

Some lawmakers in Congress and SEC chairman Jay Clayton have proposed to relax the Sarbanes-Oxley requirements for smaller public companies. The requirement currently applies to companies with public floats of \$75 million or more, but could be restricted to those with floats of over \$250 million or even \$500 million.

Whether investors would “demand, or value, internal control audits for large companies if they were voluntary is a particularly important question given that politicians and regulators have begun to question the merits of these audits,” said the researchers. “Overall, our results are consistent with investors' valuing (i.e. demanding) internal control audits for large U.S. companies in a setting where internal control audits are voluntary.”

They found that companies that choose to opt out of internal control audits of newly acquired businesses are more likely than those that opt in to misstate their finances in the year after the acquisition, suggesting that “investors' reactions to opt-out disclosures are not misguided.”

The researchers pointed to another study that, like their own, examined the post-acquisition exemption from SOX 404(b) and concluded that opt-out companies not only have an increased likelihood of misstating their financials but also do worse than opt-in companies on future returns on assets and short- and long-term stock performance. “Taken together, both studies suggest that investors perceive value in the internal control audit and [that] the decision to opt-out can convey information to investors.”

The professors also examined the impact of an auditing standard (AS 5) that was adopted by the Public Company Accounting Oversight Board in 2007 to lower the cost of audits of internal control. “As expected, we find that companies are less likely to opt-out of internal control audits...and abnormal [stock-price] returns are more negative for those companies that do opt-out,” they wrote. “Thus, investors appear to have higher demand for assurance on internal control quality as the cost of the assurance declines.”

For the study, the researchers analyzed 1,803 acquisitions by 925 companies over a nine-year period. They included an acquisition in the sample if the purchaser was a U.S. company subject to SOX 404(b), was audited by a Big Four firm, and bought 100 percent ownership of the target. Targets had market capitalizations at least 1 percent of their acquirers' and had to be large enough on their own to be subject to the SOX 404(b) requirements. Purchasers had, on average, market capitalizations of \$10.1 billion, and the average size of their acquisitions was \$1 billion.



Michael Cohn, editor-in-chief of AccountingToday.com, has been covering business and technology for a variety of publications since 1985.