Research Proposal

The Quality of financial Reporting after the passage of Sarbanes-Oxley Act

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Abstract

The complexity of business environment necessitates a set of required disclosures in a timely fashion. The full disclosure principle under U.S. GAAP is based on a vague definition that cannot be clearly implemented. The cost of disclosures can be significantly large and can have a negative impact on companies’ future earnings (small businesses). The purpose of this article is to examine the disclosure establishment of pre and post Enron, the effect of those disclosures on both corporations and on potential investors and to examine whether financial reporting quality improved with the passage of SOX. A total of 360 audited annual financial statements of the 500 fortune companies were selected. The paper will specifically concentrate disclosures on financial statements, Notes, supplementary (required or voluntary), and other expanded disclosures required by the SEC. The findings will shed light on our understanding about the intended and unintended consequence of SOX.
1.0 Introduction/Literature Review

The purpose of SOX Act is to increase corporate transparency and accountability (Friedman, The Business Forum). Though SOX did not address the full disclosure required by the FASB, it simply expanded disclosures by establishing responsibilities. The company’s Chief Executive Officer (CEO) and Chief Financial Officer (CFO) have to certify the accuracy of financial transactions and the reliability of internal control system. SOX further outlined the criminal penalties and sentencing guidelines in the event of financial fraud. In this study I am using an archived data to scrutinize the disclosures presented on the audited financial statement of 500 fortune companies between “2001-2010”. The study is selected for the purpose of finding whether the quality of financial reporting has improved after the passage of Sarbanes-Oxley Act (SOX). There are many studies that examined the effect of SOX on different approaches and levels. For instance, the extent of aggressive Vs conservative reporting behavior of public companies were examined and was found that firms that are subject to SOX were more aggressive in implementing the SOX requirements than the firms that are not (Lobo and Zhou, 2010). There are other researchers who looked at the ethical side of SOX for restoring integrity and public confidence and examined the auditor rotation on regular basis (Orin, 2008). Richard Orin’s article “Ethical Guidance and Constraint Under the Sarbanes-Oxley Act of 2002” concluded that SOX fall short on implementing the provision of auditing independence. Orin argues that the auditor rotation on regular basis is a positive step, but should have been rotation of audit firms not a rotation of a lead auditor within the firm. As the nature of competition, firms have substantial financial incentives to report and detect material misstatement of another firm’s audit (Orin, 2008).
FASB’s Conceptual Framework for financial reporting has three levels; objectives, qualitative characteristics and recognition and measurement concepts. Companies however, have the liberty to decide what information to recognize and what to disclose (Clor-Proell, 2009). The disclosures related to income statements and balance sheets should be scrutinized very carefully. Recognition of sales prematurely, unrealistic estimation of liability and deferring expenses are among the many tactics to boost earnings. Wall Street expectation puts on publicly traded firms into an ethical dilemma for they either have to meet or fail the expectation. If for some reason a company falls short on Wall Street expectation, the price of company’s stock and management’s stock option will decrease. Managers are very much interested to sacrifice long-term value benefit for short-term earnings to establish trustworthiness and reliability in order to keep high stock price and future growth (J.R. Graham, 2005). Former SEC chairman Mr. Arthur Levitt’s top priority throughout his tenure with SEC was, to protect potential investors. Mr. Levitt’s policy was to increase the quality of financial reporting and strengthen the role of the corporate audit committees. Contingent liabilities are often referred as off-balance sheet activities and they are neither recognized as assets or liabilities nor they are reported on the balance sheet simply because GAAP does not recognize them as such. Enron and many other large companies were successful to keep billions of dollars of debt off-balance sheet (Chandra, et al, 2006). Title 4 section 401, j of SOX’s enhanced financial disclosures required the disclosure of all material off balance sheet transactions, obligations, arrangements and any material current or future that will have an effect on the financial condition (SOX, 2002). Economics and Accounting literature devoted considerable amount of time to analyze the cost-benefit of SOX and found that US firms incur 6.1 billion was spent of manpower, IT and consulting services (CFO, Bergen 2004 and 2005). The debate of whether the cost of complying SOX is cost effective, is an impetus toward
a policy change, however, one can ask, ever since the SOX implementation, how the quality of financial reporting has effected?

**Research Question and Hypothesis Development**

Many studies have addressed disclosure mismanagement of financial statements before and after Enron scandal, however, the few studies that have tackled the issue have not comprehensively addressed the quality of the financial statement after the passage of SOX and after the creation of PCAOB. A study on the impact of financial statement disclosures based on legal and ethical considerations concluded that “immaterial illegal acts have significant effect on investors’ perceptions of the quality of corporate management and the potential users’ investment decisions” (Shafer, 2004). I have developed four research questions.

*Research Question 1: Does the potential investors perception of quality of financial reporting changed after the passage of SOX?*

*Research Question 2: Do the corporate managers believe the quality of the financial reporting has improved?*
1.1. Methodology

I have obtained 360 audited financial statements from public company’s web sites. The financial statements were pre and post 2002. The data of pre and post 2002 will be analyzed with SPSS. Results will be interpreted and discussed. To test the quality improvement of the financial statements after the passage of SOX, I have developed survey questions for 85 corporate managers to rank the quality of financial statements from 1 being low quality to 5= high quality. Survey data will also be analyzed with SPSS and the result will be interpreted. Measuring the improvement of the quality of financial statement is one of the most difficult to determine, however, accruals can be used to measure the quality of financial reporting (Dechow and Dichev, 2002; McNichols, 2002), because the accruals are approximation of future earnings and future cash flows (Verdi, 2006). Accounts receivables, inventories, accounts payables and cash of the selected firms will be compared. Reduction of the accruals indicates high cash flows, but the high accruals are nothing but promises of future earnings. Quality improvement of financial reporting means the company will be able to pay off its current liabilities from its operation in any given year, weighted average of cost capital will be lower (high risk firms will pay higher interest rate), and higher firm growth (Leuz and Verrecchia, 2000; Francis et al., 2004, 2005; Martin, Khurana, and Pereira, 2005).
1.2. Results and Conclusions

Sarbanes-Oxley Act also known as Public Company Accounting Reform and Investor Protection Act was passed July 30, 2002 in respond to a number of corporate and accounting scandals. However, SOX triggered a debate of whether the regulation will restore the investor’s confidence in the nation’s securities market or just impose unnecessary cost to American firms. Unlike prior researches that examined the implication or the cost of SOX, This study examined whether the quality of financial reporting has improved after the passage of SOX. Since I was interested to examine the quality of financial reporting after the passage of SOX, I tested research question 1 by collecting data from 360 firms from 500 fortune companies. SPSS was used to analyze the data. The output given in table 1 is paired sample statistics pre and post disclosure variables are compared and identified, the mean, N, standard deviation, standard error of the mean of each variable and 95% of confidence interval is given. Paired samples correlations on table 2 is a comparison between pre and post test variables. Since we are measuring the variable more than once, a higher degree of correlation is expected. There is possibility that a firm can have higher degree of transparency post and pre-Enron era. The result is significant t(360) = -49.074, p = 0.0001. I reject null hypothesis in favor of the alternative. Therefore, I conclude that it is more likely to have been due to post Enron increase of disclosures. 

\[ \eta^2 = \frac{(-49.074)^2}{(-49.074)^2 + 360} = 0.86995. \] So, 87.0%, so 87% of the variability in increase disclosures can be explained by the impact of SOX. I also found an increase of off-balance sheet entity disclosures as opposed to pre-Enron era. My finding is consistent with the previous researches (Chandra, et al, 2006). I also tested research question 2 by sending a survey to 85 corporate managers to rank the quality of their financial reporting pre and post-Enron. I used
SPSS to analyze the survey. I found that post-Enron, the ratings of the quality of financial reporting by the corporate managers was statistically significant.

1.3. Acknowledgements

I would like to thank all PDBP faculty and staff for their continuous support in the Post Doctoral Bridge Program. They were always there to listen and to give advice. They are responsible for my completion success of the PDBP. A special thanks goes to Dr. Stephen K. Asare and Dr. Sandy Berg for their encouraging words and their inputs. Both Dr. Assare and Dr. Berg were friends and mentors for me, as well as the rest of PDBP participants. I am also greatly indebted to Berna Mutlu, the Postdoctoral Program coordinator, for assisting me with administrative tasks necessary to complete my postdoctoral program.
References

Changes in Discretionary Financial Reporting Behavior Following the Sarbanes-OxleyAct


Subjects: AUDITORS; ACCOUNTANTS; AUDITORS' reports; FINANCIAL statements; UNITED States; UNITED States. Sarbanes-Oxley Act of 2002; Offices of Certified Public Accountants.

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Table 1

Descriptive Statistics for Dependent and Independent Variables

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<tr>
<th>Statistic</th>
<th>N</th>
<th>Range</th>
<th>Minimum</th>
<th>Maximum</th>
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