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### The Sarbanes-Oxley Act: Legal Implications and Research Opportunities

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# THE SARBANES-OXLEY ACT: LEGAL IMPLICATIONS AND RESEARCH OPPORTUNITIES

Stephen Kwaku Asare, Lawrence A. Cunningham and  
Arnold Wright

## ABSTRACT

*Congress passed the Sarbanes-Oxley Act to restore investor confidence, which had been deflated by massive business and audit failures, epitomized by the demise of the Enron Corporation and Arthur Andersen LLP. The Act altered the roles and responsibilities of auditors, corporate officers, audit committee members, as well as other participants in the financial reporting process. We evaluate the potential legal implications of some of the Act's major provisions and anticipate participants' likely responses. Our evaluation suggests that these provisions will significantly change behavior, increase compliance costs and alter the legal landscape. We also identify promising avenues for future research in light of the new landscape.*

## INTRODUCTION

This paper has four purposes. First, we discuss how the Sarbanes-Oxley Act of 2002 (hereafter referred to as the Act) altered the roles and responsibilities

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of auditors, corporate officers and audit committee members in financial reporting (Sarbanes-Oxley Act, 2002). Second, we analyze the potential legal implications of these changes. Third, we anticipate how participants are likely to react in light of the evolving legal landscape. Finally, we suggest research opportunities that shed light on the effects of the Act.

Congress passed the Act to rehabilitate investor confidence following a series of financial frauds (e.g., Enron, Global Crossing, Qwest and WorldCom) that dissipated investment holdings and shook investors' trust in the capital markets.<sup>1</sup> These corporate failures exposed weaknesses in the capacity of the corporate governance system for systematically relaying reliable financial information to market participants. Each debacle revealed corporate officers allegedly engaged in deliberate falsification while their audit committee members and auditors either apparently could not identify the deception vehicles or looked the other way. For instance, at WorldCom, corporate officers fraudulently capitalized an expense aggregating to billions of dollars over several years that went undetected by the audit committee and external auditors.

Our primary thesis is that roles and responsibilities inform a court's view of the appropriate standard of legal obligation to be applied in cases against a defendant. As such, the expanded roles and responsibilities brought on by the Act will likely impact the way each participant evaluates potential legal liability risks. Anticipating changes in culpability levels, we expect participants to discharge these new roles in the ways designed to control their liability risk to an acceptable low level. Importantly, such strategies, while rational for each participant, may impair the Act's objectives of improving the quality of financial reporting. As will be discussed more fully, depending on the applicable legal standard (e.g., scienter; willfulness; recklessness; and negligence), the Act may actually lead to lower levels of reporting quality. As such, the effects must be monitored through empirical research and, where appropriate, remedial measures, such as amendments or the creation of safe harbor provisions, must be taken (see also Moehrle & Reynolds-Moehrle, 2005, for an annotated bibliography of regulation related research reported in 2003–2004).<sup>2</sup>

The rest of the paper proceeds as follows. In the next section, we discuss the Act's changes to the auditing function, consider the likely effect on legal liability, anticipate auditors' responses and identify the implications of these dynamics for future research. This section is followed by a similar analysis for corporate officers and audit committee members, respectively. The final section summarizes the major issues identified and their implications for practice and research.

## THE ACT'S EFFECT ON AUDITORS

### *Auditors' Roles and Responsibilities*

The primary change in the auditors' scope of responsibilities is Section 404(b) of the Act, which requires auditors to attest to, and report on, managements' assessments of the internal controls over financial reporting (ICOFR), with the attestation made in accordance with standards issued or adopted by the PCAOB.<sup>3</sup> The client's ICOFR assertion and its related audit are intended, in part, to create an early warning system to alert financial statement users to material weaknesses in ICOFR that may impair an issuer's ability to prepare reliable financial statements in current- and future-accounting periods (PCAOB, 2004; Cunningham, 2004). These mechanisms are also intended to enhance a company's control environment to promote reliability of financial reporting. Although auditors have always considered a client's control edifice as part of the financial statement audit (e.g., see SAS 78), this consideration was only "a means to an end." That is, auditors looked to controls to help them determine the nature, extent and timing of substantive procedures but were not, per se, interested in forming an independent view of the controls. In this regard, AS 2 alters the audit terrain significantly.

PCAOB AS 2, the implementing standard, prescribes an "integrated audit" of the financial statements and ICOFR. Under AS 2, auditors provide three opinions: one on the financial statements, one on managerial ICOFR assertions, and one concerning their own ICOFR assessment. The ICOFR opinions are based upon an independent *audit* of ICOFR, requiring the auditor's *opinion specifically on ICOFR* effectiveness, with any material weakness *compelling* the auditor to issue an *adverse* opinion with accompanying disclosure. The PCAOB defines material weakness as control deficiencies resulting in more-than-a-remote likelihood of material misstatements in financial reports (PCAOB AS 2, par. 10). A material weakness is presumably a particularly severe form of "significant deficiency," which the PCAOB defines, in turn, as posing more than inconsequential risks for financial statement reliability (see Table 1).

**Table 1.** Classifying Control Exceptions per AS 2.

|                  | Inconsequential    | More than Inconsequential | Material           |
|------------------|--------------------|---------------------------|--------------------|
| Remote           | Control deficiency | Control deficiency        | Control deficiency |
| More than remote | Control deficiency | Significant deficiency    | Material weakness  |

Significantly, an adverse ICOFR opinion is also necessary when material weaknesses exist that nevertheless do not prevent giving an unqualified opinion on the financial statements (AS 2, par. 177). In this case, control reports must explain that the auditor considered the material weakness in planning substantive audit tests of financial statement assertions and that the adverse control report did not affect the financial statement audit report. It is also possible for the auditor to issue an unqualified control report coupled with a qualified audit report. This requires three things to happen: (1) the auditor detects a material misstatement in the financial statements; (2) the client refuses to revise the statements; and (3) presumably the auditor reconsiders the control decision but concludes that this decision is still appropriate. Finally, because the ICOFR opinion attests to control effectiveness as at the financial statement date, management has an opportunity to remediate control deficiencies (whether material or otherwise) identified at interim periods. The PCAOB does not currently require the report to disclose this remediation.

### *Potential Legal Implications*

*Section 11 Liability and Attesting to Management's Assessment of ICOFR*  
Securities Act Section 11 provides a civil remedy in the case of a registration statement accompanying an initial public offering that contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Joint and several liabilities may fall on an auditor when he takes responsibility for some portion of the registration statement (Soderquist & Gabaldon, 2004).<sup>4</sup>

The scope of the auditor's liability under Section 11 is seemingly narrow because of the requirement that a Section 11 plaintiff trace the purchase of securities directly to the complained-of securities offering (see *Barnes v. Osofsky*, 373 F. 2d 269 (1967), *Barnes v. Osofsky*, 1967). That is, remote secondary and market transactions are not subject to Section 11 claims. Meeting this burden is difficult (see e.g., Sale, 2000) and could potentially limit the number of Section 11 claims against auditors (see e.g., Freund, Fuerman, & Shaw (2002) who present empirical evidence supporting the paucity of Section 11 claims against auditors). Nevertheless, the tracing burden imposed on potential plaintiffs is not insurmountable and case law reveals numerous instances in which plaintiffs have successfully maintained a Section 11 action against auditors (Hazen, 2006).<sup>5</sup> Moreover, even if the

probability of a successful Section 11 claim against an auditing firm is low, the magnitude of resulting damages can be large (see Talley, 2006).<sup>6</sup>

Traditionally, because auditors had no duty to disclose control weaknesses or their effects on substantive audit testing in the audit report (see SAS 78), courts deemed control irregularities immaterial for adjudicating auditors' culpability under Section 11. The case of *Monroe v. Hughes* (1994) illustrates the current law. In that case, the auditor found internal control irregularities, conferred with management and expanded the scope of its financial audit by performing more elaborate substantive testing. The auditor issued an unqualified audit report, but did not disclose the control irregularities in the audit report. In the following year, the auditor found significant deterioration in internal controls and was unable to issue an unqualified financial statement opinion for that year. The client collapsed and investors sued the auditor under Section 11, claiming that the auditor should have disclosed in its audit opinion the internal control irregularities it discovered. The *Monroe* court (and others facing similar questions) rejected the investors' argument, citing Section 11's due diligence defense, negligence standard, and observing that good faith compliance with GAAS discharges an auditor's professional obligation to act with reasonable care. No legal or accounting authority required auditors to disclose control irregularities.

AS 2 likely will reverse this rule, since it imposes duties on auditors to disclose and explain in their reports material control weaknesses and their effect on the overall audit process (Cunningham, 2004). Although no case has ensued after AS 2, it seems reasonable to assume that a court answering the *Monroe* question, under the new standard, will find an auditor culpable for failing to disclose a material weakness. That is, auditors must plan their audit to detect all material weaknesses in the client's control architecture. Failing to disclose detected material weaknesses exposes them to Section 11 liability.

#### *Auditors' Likely Response to Section 11 Liability*

If we are correct that auditors can no longer avail themselves of the *Monroe* protection, they would have incentives when providing ICOFR opinions to disclose discovered weaknesses and to err on the side of characterizing control deficiencies as material when they could alternately be described instead as significant deficiencies, not requiring disclosure. Although that incentive seemingly comports with AS 2's early warning system objectives, it is likely to be fraught with false positive signals, which ultimately may

render the adverse opinion less meaningful or result in lower pricing by the market of public offerings (assuming the market considers the report to be relevant). Adding to this incentive is a definition of material weakness that sets such a low threshold that even some well-managed companies are likely to be ensnared by the negative ICOFR net (see Table 1). The February 8, 2006 edition of Compliance Week reports that adverse control recipients for Form 10-Ks (annual reports) filed in January 2005 include Visteon, Eastman Kodak and SunTrust Bank. Ge and McVay (2005) identified 261 companies that disclosed at least one internal control material weakness in their SEC filings from August 2002 to November 2004 (SEC, 2003).<sup>7</sup> They report that reported cause for material weaknesses vary from deficient revenue-recognition policy to inappropriate account reconciliations. Further, they report that disclosures vary widely in terms of details.

#### *Section 10(b) Liability and ICOFR Opinions*

Section 10(b) of the Securities Exchange Act of 1934 addresses all purchases or sales of securities and is relevant for all regular filings with the SEC such as the Form 10-K or 10-Q (quarterly report) (Securities Exchange Act, 1934). Anyone making material misstatements (or omissions), on which traders rely, faces liability as a primary violator under Section 10(b) when they have a duty to disclose. Liability is imposed when defendants exhibit “scienter,” generally meaning intent to deceive and commonly understood as fraud.

An important distinction in this context concerns an auditor’s status as either a “primary” or “secondary” actor. The Supreme Court holds that Section 10(b) imposes liability on primary actors (i.e., those directly culpable in committing fraud), but does not impose liability on secondary actors (i.e., those merely aiding or abetting fraud (see *Central Bank of Denver v. First Interstate Bank of Denver*, 1994). However, the Court also states that this does not prevent holding auditors liable as primary actors in certain circumstances. Most courts apply a bright-line rule providing that a secondary defendant, such as an auditor, must make a false or misleading statement to the public to be liable under Section 10(b). Absent such a statement, the actor is an aider and abettor, outside Section 10(b)’s liability reach. A few courts use a substantial-participation approach, exposing auditors to Section 10(b) liability by attributing another person’s misstatement to a silent auditor when the auditor’s participation in the activity where the misstatement occurred was so significant that it became directly culpable in the fraud. In none of the cases, however, has an auditor been held liable as a primary actor on the basis of omissions.

PCAOB AS 2 is likely to change the legal landscape. Under that standard, auditors are required to speak directly in furnishing their opinions on ICOFR. If they conclude that controls are effective when they are not, the situation is akin to that occurring when they inappropriately conclude that financial statements are fair and conform to GAAP. In this case, they may be seen as secondary actors, insulated from Section 10(b) liability (see Cunningham, 2003).

Under AS 2, auditors must describe material weaknesses, their actual or potential effects on financial statements and on related control objectives, and their effects on the auditor's financial statement audit. The direct and involved declarations of a material weakness(es) may trigger a primary-actor status under any of the various formulations of the Supreme Court's interpretation of Section 10(b) (see Cunningham, 2004). They are certainly within Section 10(b)'s reach under the substantial participation approach, and likely render auditors primary actors under the bright-line rule favored by most courts. Thus, it appears that AS 2 increases auditor legal risk when they "speak" about material weaknesses.<sup>8</sup> However, in a paradoxical situation, when they are silent by not identifying material weakness, auditors arguably maintain their secondary-actor status, therefore leaving legal risk unchanged.

#### *Auditors' Likely Response to Section 10(b) Liability*

If an auditor issuing an unqualified control opinion is a secondary actor insulated from Section 10(b) liability, while an auditor issuing an adverse opinion explaining material weaknesses is a primary actor subject to Section 10(b) liability, then auditors have clear legal incentives to prefer the former. For control deficiencies at the border (likely to be numerous because of vague guidance under AS 2), this situation induces auditors to characterize control weaknesses as significant deficiencies rather than material weaknesses. This bias undermines AS 2's goal of providing an early warning of potential problems in the reliability of future financial statements. It also conflicts with the opposite effect arising for public offerings under Section 11, which induces auditors to err on the side of designating close cases as material weaknesses.

#### *Combined Effects of Sections 11 and 10(b)*

The two effects of Sections 11 and 10(b) cannot be counted on to offset each other. The statutory Sections address different circumstances and provide



different legal standards and procedures. Section 11 covers only registration statements, whereas Section 10(b) covers all matters in connection with the purchase and sale of securities. For disclosures outside registered offerings, where Section 11 does not apply, Section 10(b) effects are not offset by the opposite Section 11 incentives. To the extent auditor behavior is influenced by applicable legal liability risks, Section 10(b)'s incentives could bias auditors' decisions to resolve uncertain cases as significant deficiencies rather than material weaknesses.

#### *Penalties for Violation of the Act*

Under Section 3 of the Act, a violation of the Act or any rule of the PCAOB shall be treated for all purposes in the same manner as a violation of Securities Exchange Act of 1934 (Securities Exchange Act, 1934). Any person who willfully violates any provision of the 1934 Act (therefore the Sarbanes-Oxley Act) shall upon conviction be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding \$25,000,000 may be imposed. However, no person shall be subject to imprisonment for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

#### *Research Implications of the Act*

The prime driver of the Act was the need to restore investor confidence. Thus, a key research question is whether ICOFR reports do, in fact, increase investor confidence, serve as an effective early warning signal and/or provide important incremental information beyond the financial statement audit. Although these potential benefits provide the impetus for the Act, the limited empirical evidence that is present suggests that these benefits may not be realized. Specifically, Wallace (1982) surveyed various user groups to assess the effect of audit reports on internal controls. A majority of the respondents were opposed to auditor reporting on internal controls and believed that such reports would lead to increased costs due to additional audit services and associated liability risk as well as incorrect beliefs about potential fraud. Nearly two decades after her survey, Hermanson (2000) found that respondents believed that mandatory audit reports on controls would lead to improved controls and oversight of controls but felt less strongly about the information value of these reports. On the other hand, the FDIC Improvement Act of 1991 requires management and auditors to attest to the

quality of internal controls of banks (see Hermanson, 2000), and Congress appeared confident that the ICOFR report is value relevant.

In a recent empirical study, Ogneva, Subramanyam, and Raghunandan (2006) investigated the effect of receiving an adverse ICOFR report on implied costs of equity by comparing a sample of firms that received an adverse ICOFR report to a control sample of firms that received clean reports. They found that firms that received the adverse ICOFR report had a modestly higher implied cost of equity – ranging from 26 to 126 basis points – than firms that received the clean report. However, after controlling for analyst forecast bias and firm characteristics identified by prior research to be associated with internal control weaknesses, they report no differences in the implied cost of capital suggesting that there is unlikely any direct relation between IC weaknesses and cost of equity.

In contrast, Ashbaugh-Skaife, Collins, Kinney, and Lafond (2006) found that firms with internal control deficiencies have significantly higher idiosyncratic risk, systematic risk and cost of equity capital. They also report that remediation of an internal control deficiency is followed by a significant reduction in the cost of equity capital ranging from 50 to 150 basis points. Similar results have been reported by Beneish, Billings, and Hodder (2006) who found that firms disclosing an adverse ICOFR report have negative abnormal earnings in the 3 days surrounding disclosure and a higher cost of capital. Ashbaugh-Skaife et al. (2006) suggest that their results differ from those of Ogneva et al. (2006) because of the use of different cost of capital measures and the effect of those measures on the samples.

In a related event study, Haidan, Pincus, and Rego (2006) found a negligible effect of the Act on stock prices. On the other hand, Pankaj, Kim, and Zabihollah (2003) report that the Act improved market liquidity in the short-and long-term. Cohen, Dey, and Lys (2004) also report that the passage of the Act was associated with a reversal in a trend of earnings management. However, both of these studies did not focus directly on ICOFR. Going forward, more controlled experimental studies could help reconcile the conflicting findings.

Further, what are the effects of seemingly incongruous reports (e.g., an unqualified ICOFR audit report accompanied by a qualified financial statement audit report) on stakeholders, including investors, analysts and the judiciary? For instance, will investors discount an adverse control report when it is accompanied by an unqualified financial statement report on grounds that any errors have likely been detected and corrected? Conversely, how will investors interpret an adverse control report that is accompanied by an unqualified financial statement report?

Given the low thresholds set by the standard and the liability implications under Section 11, clients are highly likely to receive an adverse ICOFR report accompanied by an unqualified financial statement audit report. For instance, of the 316 accelerated filers that received an adverse report, almost all received an unqualified financial statement report.<sup>9</sup> Will the proliferation of these adverse reports dilute their significance or relevance? Will detailed auditor disclosures avoid diluting the value of these opinions?

Prior research shows that decision-makers are cognitive misers and suffer from functional fixation (e.g., Hopkins, Houston, & Peters, 2000; Luft & Shields, 2001). For instance, professional financial analysts are unable to unscramble the effects of alternative accounting methods when predicting stock prices (Hopkins, 1996; Hopkins et al., 2000). Moreover, the fixation effects persist even when there are learning opportunities (Luft & Shields, 2001). This phenomenon is attributed to the development of category structures in memory, which allows efficient decision making (see Libby, Bloomfield, & Nelson, 2002). In these structures, attributes are associated with categories rather than individual instances of the category, leading to an individual event being interpreted based on its category membership. While efficient, this strategy can produce errors when the particular instance does not match the typical category attributes as well.

Because there are a variety of material weaknesses that can trigger an adverse report, the use of such categorizations to interpret adverse ICOFR opinions could pose consequences disproportionate to their significance. While some material weaknesses (e.g., management that is overly aggressive in the choice of accounting methods to achieve earnings targets) may justify extraordinary responses from investors, such as their withholding of investment capital, other material weaknesses (e.g., untimely reconciliation of intercompany accounts) will arguably not warrant such a severe response. Although AS 2 requires detailed auditor disclosure tailored to the particular circumstances, this effort will not yield much fruit if investors functionally fixate on the presence of an adverse report rather than the content of that report. The 316 firms receiving adverse reports show that material weaknesses could exist for a variety of reasons ranging from staffing problems (see e.g., the 2004 control report for Eastman Kodak), application of GAAP (see e.g., the 2004 control report for General Electric) to weaknesses in specific applications, such as property, equipment and leases (see e.g., 2004 control report for American Eagle Outfitters). Thus, an important research question is whether, and the extent to which, investors distinguish particular instances of material weakness (i.e., will they encode the specific content of an adverse report (unscrambling)) or whether adverse reports are treated as the same

category (functional fixation)? Will stakeholders consider all material weaknesses as equally serious or relevant? If not, are we likely to see a new industry that focuses on granularizing these material weaknesses? Will investors understand the nature and implications of various detailed control problems?

We noted that AS 2 sets a vague and low threshold for defining a deficiency. As shown in Table 1, auditors are required to classify all control exceptions into one of the six categories based on their likelihood (remote vs. more than remote) and magnitude (inconsequential, more than inconsequential and material).

There are a wide variety of control types, population characteristics and types of exceptions. Distinguishing among these control exceptions requires substantial judgment. Whether a significant deficiency amounts to a material weakness depends on the possibility that a material financial misstatement could result. But, how is an auditor to tell whether a control exception has the potential to lead to misstatements of varying magnitudes? Unlike the audit of financial statements, which typically requires the auditor to evaluate a known or projected misstatement,<sup>10</sup> the ICOFR auditor must contemplate the potential of what could happen, in light of an aberrant control. Thus, descriptive research on how such decisions are made is warranted, as is normative research on how such decisions should be made.

Compounding this classification difficulty is the requirement that deficiencies be aggregated and their overall effect evaluated. Specifically, AS 2 requires auditors to accumulate and track deficiencies across locations, accounts, processes and assertions and make an overall evaluation of these disparate deficiencies. But exactly how is this to be done? For instance, how does one aggregate a deficiency in accounts payable in Division B concerning a complete assertion and those governing acquisitions in Division Y dealing with authorization issues? Future research could investigate the aggregation processes that auditors use and also develop a model of the processes necessary to ensure consistent application of this standard. Also, research that develops quantitative models of the aggregation process may provide normative breakthroughs.

With what level of consistency will auditors apply these thresholds? For instance, it is possible that an audit firm will evaluate and describe as a material weakness what other firms consider a significant deficiency. Will such initial disclosures set the tone for future periods (for instance, if one firm issues an adverse ICOFR because of the failure to emplace a process to implement management's performance review will this disclosure make such exceptions a bright-line rule)? If not, how will the profession develop uniformity? What role will the PCAOB need to play in the process?

Under AS 2, auditors have an option to issue either a combined report (encompassing ICOFR and the financial statement audit) or separate reports. The PCAOB does not explain why there is this choice nor provide any guidance on when either is appropriate. In effect, the PCAOB assumes that the reporting options are formally equivalent and should exact the same effects. Nevertheless, prior behavioral studies consistently show that decisions are not invariant across alternative presentation formats (see Tversky & Kahneman, 1981; Hirst & Hopkins, 1998; Maines & McDaniel, 2000). For instance, studies show that the placement of elements of comprehensive income on a statement of comprehensive income versus the statement of stockholders' equity affected nonprofessional investors' judgment of corporate and management performance (Maines and McDaniel, 2000). Similarly, analysts acquire unrealized gain and loss information when this information is presented in a statement of comprehensive income, but fail to consider that information when it is presented in the statement of stockholders' equity. While Hirst and Hopkins (1998) and Maines and McDaniel (2000) show a format effect, the effect was driven by weighting for the nonprofessional investors and acquisition by the analysts.

Maines and McDaniel (2000) identified five factors that account for the "format effect": placement; labeling; linkage to net income; isolation; and aggregation (p. 186). Of direct relevance to the AS 2 options is the effect of aggregation since auditors can issue a combined report (aggregated) or separate reports (disaggregated). In general, decision makers tend to place less weight on aggregated data than they place on the same information when it is disaggregated (Fischhoff, Slovic, & Lichtenstein, 1978). For instance, a combined audit report containing an unqualified financial statement report may mask an adverse control report in a way that separate reports would not. This is so because investors and other users may not be willing or able to expend the cognitive cost to decode the integrated report. This raises the possibility that the same control report will be weighted more when it is included in a separate report than when it is included in a combined report. Thus, future research can focus on how investors respond to these reporting options, whether the responses vary by investor class (e.g., professional versus non-professional), and whether any differences occur as a result of acquisition, weighting or evaluation.

Given the asymmetric liability risks under Sections 10(b) and 11, an empirical issue arises as to whether more adverse opinions are likely to appear in connection with registered offerings under the 1933 Act compared to those accompanying periodic reports filed under the 1934 Act. If so, a prescriptive response appears to be creating safe harbors for auditor disclosure

to negate the skewed effects of the 10(b) risk and to neutralize any intrinsic bias (Cunningham, 2004). Given that most information the early warning system seeks bears a forward-looking character, existing safe harbors protecting issuers from liability for forward-looking statements could be adapted to apply to auditor statements required by AS 2.

## THE ACT'S EFFECT ON CORPORATE OFFICERS

### *Officers' Roles and Responsibilities*

The primary role shift for corporate officers is the certification requirements under Sections 302 and 906. Section 302 requires CEO/CFO certifications of the financial statements and the effectiveness of controls (including ICOFR and an SEC-created cognate concept called disclosure controls and procedures), to the best of the officer's knowledge. Section 906 certifications cover financial statement compliance with the 1934 Act and fair presentation; the certification itself is absolute (not according to the officer's knowledge), but related criminal liability exists only if the officer knew about a material misstatement or fraud (and heightened penalties apply for willful as opposed to merely knowing false certifications).

The officer certifications differ incrementally from longstanding federal law. Previous law required officers to sign periodic reports and at least a majority of directors to sign annual reports, but not with specific certification of the financial statements or controls. What is new, therefore, is the singling out of these officers, the attestation to particular compliance matters, including specific certification of the financial statements and the additional attestation concerning controls. While legal scholars debate the significance of these refinements, there seems little doubt that they alter the stakes for officers and therefore the overall corporate compliance landscape (Cunningham, 2003).

The chief practical goal and effect of Section 906 is to diminish the *ignorance* defense. In the past, noncompliance with the 1934 Act or materially misstated financials exposed officers and directors to criminal liability, but only if prosecutors could prove beyond a *reasonable doubt* that such persons acted with the requisite mental state of *scienter*, generally meaning an intention to deceive. Requiring these specific certifications is intended to substantially strengthen a prosecutor's case that such officers acted with an intention to deceive (i.e., certification makes the ignorance defense less availing). Similarly, Section 302 affirmations limit officers' ability to hide behind the defense of ignorance.

Raising the stakes for CEOs and CFOs are penalty rules that impose forfeiture of bonuses if their company must restate its financials due to misconduct producing material noncompliance with financial reporting requirements (Section 304 of the Act). In such cases, officers will have to pay back bonuses and stock options received for the year after the related report was made, along with any profits generated on the award during that year. This is a novel and proportionate penal scheme, intended to destroy what many saw as part of the incentives for manipulation, and also to discourage poor accounting treatments that are the product of mere haste, bad judgment or other carelessness.

### *Officers' Likely Response to Litigation Effects*

As a practical matter, the chief effect of Sections 302 and 906 is that officers now insist that subordinates certify what they provide to them ("sub-certifications") (Lipton & McIntosh, 2002). Certifying officers must demonstrate a basis for the knowledge they reflect in certifications. This entails elaborate due diligence, involving counsel, auditors, internal auditors, audit committee and junior officers. This raises the issue of how the new reporting requirements affect interactions between top management, internal auditors, and other managers responsible for designing and evaluating controls.

### *Research Opportunities*

Given the Act's emphasis on CEO/CFO certification, and the corresponding potential liability, a critical research question is whether there will be a reduction in the pre-audit probability of management misstatement and fraud. Certification, investment in controls, and audit committee involvement should reduce the pre-audit probability of fraud; otherwise, these investments are inefficient. Secondly, because management is required to assess and report on the controls, they face the same classification and aggregation problems described above for auditors. Thus, research that evaluates management control decisions is important. Further, because management is asked to self-report on its controls, we anticipate a self-reporting bias, which management can easily justify because of the inherent imprecision of the ICOFR terrain. It seems unlikely that an investor, who believes solid controls are essential, will find any solace in a managerial assessment and report on its own controls. An important research question

remains whether and how management will signal the quality of their controls mandate. For instance, will/should management create an independent in-house control evaluation function? If so, will stakeholders reward this effort? Where management disagrees with an auditor's conclusion about a material weakness, is it likely that management will issue an unqualified control report while the auditor issues an adverse control report? Even though this is theoretically possible, it seems unlikely as such a disagreement will only accentuate the adverse control report. Management of accelerated 2004 filers was in concurrence with the 316 adverse control reports issued by auditors. While this shows *ex post* unanimous agreement, it leaves open the question of the extent of *ex ante* disagreements and auditor-client negotiations.

Presentation issues are also relevant. For instance, AS 2.43 allows management to document their ICOFR in a variety of forms, including paper, electronic files, or other media. Further, the documentation can include a variety of information, including policy manuals, process models, flowcharts, etc. As discussed, seemingly alternative methods of presentation may exact different responses by an evaluator. Thus, what is the best format for management to document their controls to elicit the most favorable assessments from auditors?

The resolution of contentious accounting issues has been recognized as a negotiation process between management and auditors (e.g., Gibbins, Salterio, & Webb, 2005, 2001). SOX now adds another layer of potential disputes in the resolution of whether or not discovered control weaknesses are sufficiently serious to be considered a material weakness and, therefore, require an adverse ICOFR report. Further, SOX expands the responsibilities of the audit committee in ensuring sound financial reporting and communicating with auditors. Prior research has suggested that audit committees generally have not been effective in helping to resolve auditor-management disputes (Cohen, Krishnamoorthy, & Wright, 2002). However, SOX's specific empowerment of the audit committee (as discussed below) may change this situation. There is little consideration in the negotiation literature of the influence of third parties on the negotiation process or outcomes (Bazerman, Curhan, Moore, & Valley, 2000), suggesting a unique setting for future research.

There is considerable concern about excessive compliance costs. For instance, the PCAOB chairman has noted that "it is clear that the first round of internal control costs too much" (see PCAOB, 2005). Engel, Hayes, and Wang (2004) show that the expected cost of compliance with Sarbanes-Oxley may have driven some companies to remain private rather than go



public. There is therefore considerable scope for descriptive, normative and prescriptive research on the management control assessment process. For instance, descriptive research could document how companies are complying with Section 404 with a view to identifying best practices. Normatively, is there an optimal approach to determine which locations the internal audit team should visit to assess controls? Finally, what is the proper balance of work between the external auditor and management to avoid duplications and redundancies?

## THE ACT'S EFFECT ON AUDIT COMMITTEE MEMBERS

### *Audit Committee Members' Roles and Responsibilities*

Section 301 requires that each member of the audit committee be independent.<sup>11</sup> The committee's responsibilities are expanded to embrace the appointment, compensation and oversight of external auditors. At the same time, the PCAOB directs auditors to evaluate audit committee effectiveness, as part of their evaluation of ICOFR. When auditors conclude an audit committee is ineffective, AS 2 directs that this be treated as at least a significant deficiency and a strong indicator of material weakness in ICOFR. Further, the committee must establish procedures for the "receipt, retention, and treatment of complaints" about the company's accounting, internal controls and auditing.

Pursuant to Section 407, the SEC issued final rules requiring issuers to disclose whether they have an audit committee financial expert (and a company code of ethics) (Release No. 33-8177). Under these rules, issuers must disclose in the Form 10K whether they have at least one audit committee financial expert and, if so, the individual's name. A company may, but does not need to, disclose that it has more than one such expert. A company disclosing that it does not have a financial expert must explain why.<sup>12</sup> The objective of this latter provision is to enhance the caliber of audit committees, given their critical function in promoting the integrity of financial reporting. However, the goal is not reinforced by any legal rules. On the contrary, the SEC, in response to concerns raised in comments to the proposed rules, included an express provision stating that designation of a person as an audit committee financial expert does not impose any such duties, obligations or liability greater than those imposed on other non-designated directors. The provision also states that a person so designated is

not deemed an expert for any legal purpose, including, without limitation, for purposes of Section 11 of the 1933 Act (Securities Act, 1933).

Taken at face value, these stances mean financial experts, as well as other audit committee members, will be treated the same as all corporate directors. This means they owe the corporation duties of care and loyalty. The duty of loyalty prohibits self-dealing and exposes a director's performance to meaningful judicial scrutiny; the duty of care requires performing up to the par of an abstract reasonable person in similar circumstances, and judges defer under the business judgment rule to a director's decisions taken in good faith in the absence of self-dealing. These basic principles of corporate law are unchanged by the financial-expert designation. At most, however, some courts may find a slightly higher standard of obligation for what a reasonable financial expert would do as compared to a reasonable non-financial expert.

Even if this risk were theoretically higher, moreover, the practical risk is not. In the modern era, virtually no outside director (and all audit committee members must be outside directors) has ever been held personally liable for money damages for violating basic vigilance duties, such as the duties of loyalty and care (Black, Bernard, Cheffins, & Klausner, 2003).<sup>13</sup> A combination of judicial deference, exculpatory charter provisions, insurance and indemnification prevents this liability. Thus, the odds of this new designation actually changing behavior as a result of legal risks are very low indeed.

On the other hand, lawyers advising the audit committee members (and others) tend to exaggerate legal risks (Langevoort & Rasmussen, 1997). In the Act's aftermath, such highly cautionary advice became commonplace when law firms advised clients on corporate governance matters. Lawyers overestimate legal risks partly motivated by self-interest, including overstating the consequences of new legal developments and overselling the contributions they can make to manage the fallout. These effects may enhance corporate governance integrity and performance, but also may impair optimal risk-taking and produce sub-par results. This is because the Act itself did not create a safe harbor provision, which would make it clear that designated experts are not exposed to potentially increased liability. It is also possible that a designated expert may believe that the due diligence defense is less availing.

Section 301(5) also mandates that each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. This is an unusual provision with unclear legal ramifications. On one hand, board committees always have these

powers under state corporation law and since corporations must act through agents (like audit committees) such agents are always separate legal entities from the corporation. On the other, specific federal directives also authorizing the audit committee may be treated, in a particular case, as establishing normative behavior, the departure from which (for example, failing to retain such advisors in recognized circumstances) may be treated as a factor tending to support claims against those committees and members.

#### *Audit Committee Members' Likely Response to Litigation Effects*

Two issues arise concerning the liability effects on directors of auditor evaluation of audit committees. First, auditors evaluating audit committee effectiveness may expose audit committee members to liability for violation of fiduciary obligations. Suppose an auditor evaluates a corporation's audit committee as ineffective. Whether or not fraud exists within the corporation, shareholders are now armed with a theory of liability against those directors. While, traditionally outside directors have little to fear from such liability risks, this could nevertheless lead auditors to unduly lower the requirements they insist that audit committees meet before drawing a favorable assessment. This bias cannot be counted on to offset the bias created by auditor liability risk. Rather, taken together they may exacerbate conflicts.

Second, auditors evaluating audit committee effectiveness may expose themselves to liability for violation of professional standards. Suppose an auditor evaluates a corporation's audit committee as effective. Subsequently, a major financial fraud is uncovered within the company. Auditors are likely defendants in lawsuits by shareholders now armed with an additional liability theory. This auditor liability risk may unduly raise the requirements auditors insist that audit committees meet before drawing a favorable assessment. Taken together, this could accentuate conflicts of interest between the audit committee and auditors.

#### *Implications for Research*

Numerous potential research issues arise. First, a potential research question is the extent to which Section 407 of the Act, and related legal advice, will lead audit committee financial experts to see themselves as bearing additional legal duties in performing their audit committee functions. While

the Act and accompanying SEC rules deny this result, risk-averse lawyers and risk-averse financial experts on audit committees may view their tasks differently. In addition, market participants, including D&O insurers, may rank this obligation higher than the legal regime intended it to be set. As a result, two approaches to studying this issue appear promising. First, a study of insurance premiums may be an *indicia* of potential liability (Core, 2000). Second, experimental studies using judges or surrogates such as practicing lawyers or law students is an approach to gauging the direction of a court. Third, audit committee members could be surveyed or placed in an experimental setting to determine their views or actions in the face of potential liability in serving as a financial expert and how this affects their approach to their functions.

The SEC rule allows registrants to indicate that they have no financial expert. Further, research shows that the market reacts positively to an announcement that a financial expert has been appointed to the audit committee (e.g., Davidson, Xie, & Xu, 2004). It will be important to study the profile of firms that choose this option and whether that choice is value-relevant (i.e., how does the capital market respond to registrants who announce that they have no such experts?).

Third, auditors are hired by the audit committee and yet must evaluate the audit committee as part of ICOFR. This basically shifts the prior auditor/management relationship to auditor/audit committee. How does the conflict affect the ICOFR audit? For instance, how well do audit committee members respond when auditors opine that they are ineffective? How does this potential conflict impact the effectiveness of interactions between the auditor and the audit committee in exchanging information and promoting quality financial reporting?

## CONCLUSION

The Sarbanes-Oxley Act established a regulatory framework that redefined the roles and responsibilities of external auditors, corporate officers, and audit committee members. This paper outlines the new roles and responsibilities and their potential impact on the legal terrain. In so doing, we also anticipate strategies participants may pursue and their likely effect on the Act's stated goals. Four themes emerge.

First, an important change for auditors is the PCAOB AS 2 implementation of Section 404(b), which calls for an integrated audit of ICOFR and the financial statements. It is generally assumed that this requirement will

provide an early warning system for investors of the quality of financial reporting. Yet the guidance given to auditors is imprecise and the reporting choices yield seemingly incongruous outcomes. What is clear is the additional compliance cost (see below) for registrants.

With respect to cost, a survey by the Financial Executive Institute (FEI, 2005) reports that in the first year companies spent an average of \$4.4 million to comply with Section 404.<sup>14</sup> Costs include an incremental fee for the annual Section 404 auditor attestation of 38% over current audit fees. In comparison, a subsequent survey conducted by the FEI (2006) a year later indicates that total average costs fell about 16% (\$3.8 million) when compared to the first year. Nonetheless, respondents, representing corporate management, believe the costs are still excessively high, especially for smaller companies. What pressures will be exerted to further reduce these costs over time?

Second, corporate officers face a maze of criminal liabilities and potentially new liability risks as they navigate certification, disclosure and document retention responsibilities. Whether this threat is enough to elicit the desired corporate conduct sought by the Act remains to be seen and likely hinges, in part, on a cost-benefit calculus that is difficult to model. Further, management's role in designing, testing and documenting the control architecture is intended to be a durable feature of corporate reporting; but absent a rational process to implement this elaborate scheme this could lead to unwarranted enforcement actions and financial disclosures.

Third, audit committees have oversight responsibilities for financial reporting and auditing, and members must ensure that they meet the independence and expertise requirements. Audit committees are empowered to engage independent advisors, the effects of which are uncertain. The designated financial expert is expected to be able to apply GAAP to estimates, accruals and reserves and must have experience in financial statements similar in complexity to those of the subject company. Despite these requirements, the SEC carefully emphasized that the designation does not impose additional liabilities beyond those faced by other directors. Judges, however, may not find this interpretation satisfactory and would not necessarily feel bound to follow the SEC's position.

In all, the Sarbanes-Oxley Act is a landmark piece of legislation that is intended to alter the roles and responsibilities of management, auditors and directors. With such changes it is important for policy setters, researchers and Congress to evaluate how the Act changes the behaviors of these parties in response to altered legal responsibilities and risks and, in so doing, whether the Act fulfills its objectives. This paper provides an evaluation

and dialogue on this important issue and suggests promising avenues for study.

## NOTES

1. Whether the loss of confidence is justified is subject to debate. For instance, Thompson and Larson (2004) suggest that the widespread loss of investors' confidence in financial reporting does not seem justified based on evidence from 2001 restatements.

2. Safe harbor provisions are imperfect inoculations, even when provided by statute. Safe harbors articulated by administrative agencies, such as the Securities and Exchange Commission (SEC), are even more vulnerable to plaintiff attack and judicial interpretation. Further, federal safe harbor provisions do not necessarily apply to actions brought under state law (though the Private Securities Litigation Reform Act of 1995 and the Securities Law Uniform Standards Act of 1998 effectively made federal courts the exclusive forum for litigating public-company securities fraud actions).

3. Other significant changes entail: Title I, which created the PCAOB as a new oversight regime for auditors of public companies, ending the prior self-regulation by the AICPA (see Carmichael, 2004); and Title II curtailing the scope of non-audit services and emplacing a mandatory partner rotation scheme. Mandatory audit firm rotation was also considered as a reform to enhance independence, but was not included in the act. Rather, the GAO was tasked to conduct a study on the potential effects of such a reform. The study by the GAO concluded that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality (GAO, 2003).

4. The Private Securities Litigation Reform Act (PSLRA, 1995) did not extend proportionate liability to auditors under the 1933 Act.

5. Hazen provides several illustrations. For instance, *In re American Bank Note Holographics Securities Litigation*, 93 F.Supp.2d 424 (S.D.N.Y.2000) (tracing requirements satisfied even for plaintiffs who purchased in the after market (we note that Deloitte was among the defendants and it did not even join in the motion to dismiss under consideration by the court)); *American Bank Note Holographics Securities Litigation* (2000); In *Neuberger v. Shapiro*, 1998 WL 408877, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) 90,261 (E.D. Pa. 1998) (tracing sufficiently alleged (we note that an accounting firm was among the defendants in this case)); *In re Crazy Eddie Securities Litigation*, 747 F.Supp. 850 (E.D.N.Y.1990) (some investors sufficiently pleaded that securities were traceable to an allegedly defective registration statement although it would have been preferable to have pleaded the dates on which the shares were purchased (Crazy Eddie Securities Litigation, 1990); the claim of the investor who failed to allege that securities were traceable was dismissed (we note that the defendants included Peat Marwick)); In *Lee v. Ernst & Young, LLP*, 294 F.3d 969 (8th Cir.2002) (plaintiffs who were aftermarket purchasers could trace securities to the registration statement (we note that Ernst & Young was among the defendants)) (*Lee v. Ernst & Young*, 2002).

6. Hazen (section 7.3(10)) also explores specific liability risks for accountants, citing among other cases *McFarland v. Memorex Corp.*, 493 F.Supp. 631, 644-47 (N.D.Cal.1980) *reconsideration granted* 581 F.Supp. 878 (N.D.Cal.1984); *McFarland v. Memorex Corp.* (1980); *Steiner v. Southmark Corp.*, 734 F.Supp. 269 (N.D.Tex.1990) (sufficiently alleging liability of accountants); *Steiner v. Southmark Corp.* (1990); *Grimm v. Whitney-Fidalgo Seafoods, Inc.*, 1973 WL 495, [1977-1978 Transfer Binder], Fed.Sec.L.Rep. (CCH) 96,029 (S.D.N.Y.1973) (*Grimm v. Whitney-Fidalgo Seafoods & Inc.*, 1973); *Jiffy Lube Securities Litigation*, 772 F.Supp. 258 (D.Md.1991) (stating a section 11 claim against alleged misstatements attributable to the auditor) *Jiffy Lube Securities Litigation* (1991).

7. Ge and McVay (2005) focused on management disclosures in conformance with section 302 of the Act. They did not report the auditors' report.

8. Legal exposure comes from current shareholders who can link the report to a decline in value.

9. Even the four exceptions (Broad Vision Inc.; Foster Wheeler Ltd.; Intelidata Technologies Corp.; Applied Analytical Industries) received a modified going concern report not directly attributable to the material weakness.

10. Audit detected misstatements may be based on sampling and, thus, projected to the population. Further, misstatements identified involving estimates such as bad debts do not represent a "known" or absolute amount but rather must be projected based on knowledge of the company and industry.

11. The SEC promulgated Rule 10A-3 to implement Section 301 in April 2003. For directors, "independence" is a legal concept defined in the Act as characterized by not receiving, other than for board service, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof. The SEC may make exemptions for certain individuals on a case-by-case basis; the stock exchanges impose additional requirements in their listing agreements.

12. An expert is defined as a person possessing the following attributes: an understanding of GAAP and financial statements; the ability to assess the general application of such principles in connection with accounting estimates, accruals and reserves; experience preparing, auditing or analyzing financial statements that present a breadth and level of complexity comparable to the registrants; an understanding of internal controls and procedures for financial reporting; and an understanding of audit committee functions.

13. Recent events may, however, be changing this. For instance, in the litigation surrounding the Worldcom fraud, the former directors made personal contributions of approximately US\$24.75 million toward the settlement, rather than the settlement money coming entirely from the company and/or the proceeds of directors' and officers' (D&O) insurance (see <http://www.allbusiness.com/periodicals/article/849140-1.html>). Similarly, the directors of Enron made personal contributions in the settlement of litigation against them (see <http://www.californiaaggie.com/media/storage/paper981/news/2005/01/19/FrontPage/Former.Enron.Directors.Offer.A.Settlement-1319224.shtml?norewrite200607280019&sourcedomain=www.californiaaggie.com>).

14. On average costs were almost directly proportional to the size of the company and in 2006 represented an average of 0.06% of revenues. The highest relative costs were for companies with revenues under \$25 million where compliance costs averaged 2.46% of revenues.

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