



# Analyzing the Managers' Trusteeship Economically in Sarbanes-Oxley Act

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## Abstract

Sarbanes-Oxley Act, which aims at reforming and bettering the managers' trusteeship, gives a great influence on the corporate governance and internal controls of more than thirty listed companies in America. This text applies the client-agent theory to analyze the significance of economics of the Act and shows that the essence of the Act is to reduce the cost of the incentive contract between the investors and the personnel owners and the measurement cost in implementation by strengthening internal control and emphasizing the managers' trusteeship. The purpose of it is to achieve the accuracy and reliability of the corporate information disclosure so as to protect the investors and others objectives. It is of great significance for reference for Chinese businesses to better the corporate governance and deep reform.

**Keywords:** Sarbanes-Oxley Act, Principal-Agent Theory, Corporate Governance

## 1. Questions are put forward

In the early new century, people are sorry to see some world-class companies such as Tyco, Global Crossing, WorldCom and Enron in bankruptcy. The event of the world's communication in June 2002 discouraged the investors in American capital markets (Congress report, 2002). In December 20 2002, The People's Daily carried the article of the world's top ten corporate scandals in 2002. Eight of them are about the financial fraud. The rampant fraud of financial reporting and the imprudent management have become a cancer of capital accumulation. They should be cured with all the means of therapy of the modern commercial society (Steven • J • Root, 2004).

In July 2002, the United States Congress and the government quickly passed the Sarbanes-Oakley Act (SOA). President George W. Bush delivered a speech at the news conference for signing the Act. He said, "It will produce a most far-reaching impact on the business sectors since President Roosevelt signed the Securities Act in 1933 and Securities Exchange Act in 1934." One of the main content of the Act prescribes the clear responsibilities of a company's management (such as the task of assessment of internal control and information disclosure), especially the fiduciary duties entitled by the shareholders. Accordingly, the United States Securities and Exchange Commission (SEC) and New York Stock Exchange (NYSE) then shaped the detailed rules and control measures, which would give a great impact on the corporate governance of listed companies and the internal control, changing the traditional client-agent relationship between the corporate investors and managers to some extent. The Act applies to those companies registered in the United States Securities and Exchange Commission. More than thirty China's listed companies in the United States, such as China National Petroleum Corporation, China Petroleum & Chemical Corporation, China Eastern Airlines, China Life Insurance Company, China Mobile and China Netcom etc would inevitably meet the challenge by Sarbanes-Oakley Act. Then what is the significance of economics in the Sarbanes-Oakley Act? What influence would it give to corporate governance and risk control? What lessons would it give to China's companies? Therefore it was worth further exploring.

## 2. The articles in Sarbanes-Oakley Act concerning the operators' fiduciary duties

Sarbanes-Oxley Act is also named Public Company Accounting Reform and Investor Protection Act. It starts with "abiding by the securities law to improve the accuracy and reliability of the information disclosure by companies and therefore protect investors and other purposes." The 301st article of chapter III, named corporation responsibilities, provides that all the members of the Audit Committee of the companies issuing securities must be made up of members of the independent board of directors. They should, in terms of subordinate committee of the Board, assume the direct responsibility of supervising the employment, remuneration of the registered accounting firm, which aims at establishing the account report. They are also in charge of urging the coordination between the company managers and

the audit departments on the disputable points of the report of financial affairs. The registered accounting firm is asked to report to the Committee. The Board should set up corresponding procedures to deal with the complaints of its accounting, internal controls or auditing methods. If the Board considers it necessary to perform their duties, it has the right to hire independent consultants.

Those companies issuing securities should offer considerable funds (the amount is determined by the Audit Committee subordinate to the company's board) to pay the cost of hiring a registered accounting firm to write audit reports and the cost of hiring consultants. Article 302 of the company's responsibilities of financial reporting, defines the duties of the listed companies in the management of financial reporting and internal controls. Article 404, the management's assessment of internal controls, provides that a quoted company has the responsibility of reporting the effectiveness of its internal control system and it must maintain the effective operation of internal control system. It requires that the management of a quoted entity must give a record, test and evaluation of the basic framework of the company's internal control. The provisions of article 304 and 305 are that if a member of the management commits a crime, all his bonuses, dividends or other remuneration of rights should be confiscated, and he will receive other punishment. Chapter VIII of the Act of corporate fraud and criminal liability, and the relevant provisions of Chapter IX further emphasize the responsibilities of the white-collar workers and the management will be punished more severely if getting out of line.

### 3. Analyzing the significance of economics of relevant provisions of the trusteeship in SOA of the managers

The followings are the Mirrlees-Holmstrom model in the client-agent theory and the solution (Mirrlees, 1974, 1976. Holmstrom, 1979) to analyze the economic meaning of SOA. Supposed a capital owner entrusts a manager or operator to engage in operation and management of decision-making, they form the relationship of client and agent. The former is client and the latter is the agent. The utility functions of the manager and the capital owner are different. A capital owner aims at maximizing the enterprise value while a manager aims at maximizing the integrated utility of income and rights of controlling.  $A$ , standing for the set, includes all the optional action of the manager.  $a \in A$ , means a specific act of the manager, and stands for a one-dimensional variable denoting the degree to which the manager exerts his ability.  $c(\cdot)$ , stands for the manager's cost of action.  $s(x)$  stands for incentive contract.  $x(\cdot)$  and  $u(\cdot)-c(\cdot)$  stand for the utility functions of capital owner and the manager.  $F(x, a)$  and  $f(x, a)$  show the distribution function and distribution density of the enterprise value after the manager chooses act  $a$ . IR means the manager's expected utility from the contract should not be less if he does not accept the contract ( $u_0$ ). IC, the incentive and compatible constraint, means that the capital owner can only depend on the manager to maximize the effectiveness. How capital owners maximize the effectiveness can be expressed as follows:

$$\max \int v(x - s(x))f(x, a)d_x$$

$$\text{s.t. (personal rational constraint)} \quad \int u[s(x)]f(x, a)d_x - c(a) \geq u_0$$

$$\text{(Incentive and compatible constraints)} \quad \int u[s(x)]f(x, a)d_x - c(a) \geq \int u[s(x)]f(x, a')d_x - c(a'), \quad \forall a' \in A$$

Provided  $f$  a  $(x, a)$  is against  $f(x, a)$ , what is the derivative of  $a$ . To get the extremum of the formula above, if the acts of the manager,  $a \in A$ , are observable, that is,  $f$  a  $(x, a)=0$ , the optimization can be reduced into  $\frac{v'[x - s(x)]}{u'[s(x)]} = \lambda$ , i.e.

$$v'[x - s(x)] = \lambda * u'[s(x)], \text{ The solution to the formula is } s(x) = \frac{x}{1 + \lambda}$$

Because the specific act of every manager can be observed, the optimal incentive contractual arrangement is only related with the output  $x$ , and proportional to  $x$ . However, with the fierce competition among enterprises, there appears more uncertainty. The managers will have larger stage. This assumption that "the actions of the managers,  $a \in A$ , can be fully observed", means more stringent. Or it can be explained that the transaction cost from the assumption will exceed the realized profit. Barone in 1908 applied the general equilibrium theory of neo-classical economics to prove the centralized planned economy can realize the optimal allocation of resources in the absence of friction (i.e. the conditions of zero transaction cost). Although the premise of the theory is rigorous, the optimal solution and the theoretical basis of the incentive contract under the planned economy give me important inspiration. That is, if the actions of the managers,  $a \in A$ , can be fully observed, the simple incentive contract of the managers can realize the optimality. The observable degree of the incentive program determines the performance of the contract. In studying the incentive contract, an important purpose is to make the practice of the managers more observable. Sarbanes-Oxley Act is one of the acts that give most influences on American businesses. One of its content requires that the manager should assess their economic performance and ask intermediary agencies or authentication department to give an appraisal then

publicize it, aiming at protecting the investors and other related purposes. The improvement of the management and control in defining the value of the businesses can effectively reduce the contracting cost between the owner of capital and the labor force and the measurement cost in the implementation.

The relevant provisions in Sarbanes-Oakley Act have stressed the managers' fiduciary responsibilities. The implementation of the Act has brought some effectiveness as follows: most of the listed companies abandon the single leadership model that CEO and chairman are served as one person; the number of directorate conference increases; members of directors risk more potential litigation, so liability insurance of them and the managers increased to 94.2%; members of the board in the listed company change frequently (Huang Jingjing, 2005). The incentive programs guided by the traditional incentive theory win the managers "fresh flowers and applause". They earned a surprisingly high salary without corresponding responsibilities. Series of financial scandals and failures of management change people's modus operandi that such incentive programs as stock and shares were depended on to spur the managers or operators. People turn to internal controls. Sarbanes-Oakley Act, in a way, strengthens the property rights of the capital owners. In other hand, as for the regulatory bodies and shareholders supervisors concerned, it gives a clear requirement and standard for the managers to protect the corporate value to the minimum extent. In practice, COSO internal control framework has become a criterion of the golden rule and relevant law for the Federal government of United States to appraise whether the managers are duteous.

#### **4. Conclusions and revelation**

In terms of significance of economics, the essence of Sarbanes-Oakley Act is to improve the internal controls and emphasize the fiduciary duties to effectively reduce the contracting costs between the owner of financial capital and human capital and the measurement cost in practice. The incentive contract of the business owners and managers does not stress the concept of incentive ownership and corporate governance structure. Incentive problems about managers in client-agent contract should be considered in the round. It is of important guiding significance for China to deepen the reform of state-owned enterprises and improve the incentive and restrictive mechanism concerning managers.

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