Why Sarbanes Oxley isn't the answer for the investor confidence… **Jeffrey Ishmael**
Sarbox will not likely be the cure for what ails investor confidence. **April 25, 2008**

With only the best intentions, the Sarbanes Oxley Act was enacted in 2002 as federal law in response to a number of high-profile accounting scandals that rocked the financial markets and individual investor trust. The Act also established the formation of the PCAOB, or Public Company Accounting Oversight Board, which is entrusted to oversee, regulate, inspect, and discipline the work of accounting firms regarding public companies. The Act also provides guidance on major other issues such as auditor independence, corporate governance, internal controls, as well as enhanced financial disclosures.

With almost six years since the passing of SOX, the vast majority of public firms have moved well beyond the implementation, testing, and validation phase to now begin working on new major projects. Further, I have been seeing a shift in the demand for new candidates softening in this area since most implementations are complete and internal audit departments are established.

So all of this must be fantastic for the individual investor and trust must certainly be building exponentially in the public markets? Right? Not necessarily……

Let's take a look at one company, who's management seems to have undermined the effectiveness of SOX through ineffective forecasting, poor communication, and inattention to key corporate performance indicators. My company of choice for this analogy is Crocs, Inc. (CROX).

I first started following Crocs after the bludgeoning the stock took in November-07 following their inventory announcements. At a high of almost $80, the stock was beat down to the $40 level almost immediately where it languished for the better part of Q407. The stock then drifted down to the mid-$30 range for the better part of Q1-08. Where things started to get interesting was at the announcement of the FY07 results and guidance moving forward.

Just prior to the announcement, the stock was at $32/share. The company announced fantastic results for the prior year but there were two primary elements to the release that did not sit well with the markets.

1. Inventory levels had grown disproportionately to revenues.
2. The company provided guidance of $2.70/share rather than the $2.71 analysts were expecting.

The company's stock was immediately punished again and began a slow downward ascent to it's current level. Over the course of 6-weeks, the stock lost an additional 70% in share value when it reached the mid-$9 range, which was down 85% from the November high of just under $80. **How was this possible for a company that had grown revenues at almost 100% over the prior year?**

1. *Preliminary inventory concerns*. These started becoming public issues in November during the first correction.

2. *Continued inventory concerns*. These continued to be an issue during the release of FY07 results where inventory growth was in excess of revenue growth.

3. *EPS guidance*. Although only one cent, this was less than analyst guidance, which was relatively immaterial on a $2.71 expectation. Underlying issues?

4. *Conference call tone*. The management team did not come across as confident or that they had a strong handle on the business and a plan of action to address deficiencies.

5. *Growth estimates*. Although the company had estimated strong growth in the domestic markets and rapid growth in international markets, management came back only five-weeks later to say that estimates were overly optimistic. That growth in

domestic markets would be in the single digit range and that international growth would be less than expected. How could they have been so wrong in communicating a forecast only 5-weeks earlier?

6. *EPS forecast*. Management also came back at the same time to say that EPS forecasts were now overly optimistic and would need to be cut back by approximately 35%.

7. *Restructuring*. While not communicated as a full restructuring effort, the company communicated that the Canada manufacturing facility would be closed and production would be moved to more cost-effective 3rd party manufacturers.

8. *Continued inventory issues*. Revised estimates conveyed that it could be well into Q3 before the inventory issues would be addressed, & possibly corrected.

9. *Analyst meetings*. The company held a number of Analyst meetings with notable firms that included the likes of Piper Jaffray and others. These meetings happened in the weeks following the release of FY07 results and further decreased the window for management to see a change in their guidance. To the contrary, they affirmed their guidance of FY08 numbers to analysts.

For a company that is publicly held on the Nasdaq exchange, one has to assume that the company is in compliance with all public company regulations, has successfully implemented all Sarbanes Oxley initiatives, and is not fraudulent in its approach to communicating with analysts or investors.

With the intent of Sarbanes Oxley to increase individual investor confidence and trust, along with increasing the transparency of public financial reporting, what is an individual investor to do?

In my conversations with private investors, most take a diligent approach in their research on companies. They review all public filings on record, review any non-financial press releases, look to the guidance provided by management, *consider* the guidance provided by analysts, run their own form of financial forecasts, along with any other information they can collect on the company. Only then do they make what is perceived to be an **informed / educated** decision on their investment. *Keep in mind that the group I tend to discuss these topics with could be considered well-versed in financial knowledge and modeling.*

So what should one think when a decision is made prior to earnings, and then the stock held, based on further guidance from management and analysts, only to see it drop by another 70%?

How will Sarbanes Oxley counter the inability of management to properly forecast?

How will Sarbanes Oxley counter poor communication by management?

How will Sarbanes Oxley counter a management team that exhibits a lack of knowledge about their own business and the ability to plan properly?

How will Sarbanes Oxley counter a lack of trust for management by investors and the market?

Simply, Sarbanes Oxley won't be able to counter any of these. All SOX will ultimately provide is a foundation for "accurate" reporting, auditing, and corporate governance. **The underlying red flag is the likelihood for human error and the inability to predict the behaviors of management, which can have a much more disastrous effect on share price than any perceived deterioration in financial performance.**

Thanks for reading…..

Jeffrey