SEC Office of Economic Analysis Releases Results of Study About Sarbanes-Oxley Section 404

In early October 2009, the Securities and Exchange Commission's ("SEC") Office of Economic Analysis issued a report entitled, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements* (the "Study").[1] The report presents an analysis of Study findings as to the costs and benefits of implementation of Section 404 of the Sarbanes-Oxley Act of 2002.

I. Background

The Sarbanes-Oxley Act of 2002 (the "Act") was signed into law on July 30, 2002.[2] The Act was adopted in the wake of a series of high-profile corporate scandals involving companies such as Enron and Worldcom. The Act imposed new substantive corporate governance and disclosure requirements on all SEC reporting companies in an effort to improve transparency and make such companies more accountable to investors. Section 404(a) of the Act requires that management provide an assessment of the effectiveness of internal control over financial reporting ("ICFR") in their annual 10-K report. Section 404(b) requires that an independent auditor attest to, and report on, management's assessment regarding the effectiveness of those internal controls.

The high costs incurred by many companies in implementation and complying with these reforms were unexpected. As a result, the SEC took a number of steps to reduce costs and improve the effectiveness and efficiency of Section 404 implementation.[3]

II. The Study and Its Key Findings

The Study was conducted via an internet survey on the SEC's website. All companies with Section 404 compliance experience were invited to respond, and participation was voluntary. Data was collected in December 2008 and January 2009. In all, the SEC received over 2,000 responses to the survey.[4]

The report notes several key findings from the Study:

- Compliance costs vary with company size (increasing with size), compliance history (decreasing as compliance experience increases), and compliance regime (decreasing after SEC actions aimed at reducing costs and improving efficiency in 2007).[5]

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[1] Available at http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

[2] See P.L.107-204, the Public Company Accounting Reform and Investor Protection Act.

[3] See Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers (June 26, 2008), available at http://www.sec.gov/rules/final/2009/33-9072.pdf. See also our firm memorandum, SEC Guidance Regarding Management's Report on Internal Control over Financial Reporting (July 5, 2007), available at http://cgrnyvs1/Firm%20Memos/SEC%20Guidance%20Regarding%20Management%27s%20Report%20on%20Internal%20Control%20over%20Financial%20Reporting.pdf.

[4] See SEC News Digest, SEC Staff Extends Sarbanes-Oxley Survey to January 31 (January 16, 2009), available at http://www.sec.gov/news/digest/2009/dig011609.htm.

[5] The SEC efforts that were the focus of the Study were the SEC's approval of the PCAOB's issuance of Auditing Standard No. 5 and the SEC's issuance of interpretive guidance to assist management in complying

- Larger companies (measured by public float) tend to incur higher absolute costs, while smaller companies tend to incur higher scaled costs (*i.e.,* costs as a fraction of asset value).

- Compliance costs tend to be higher for companies complying with both Section 404(a) and Section 404(b).[6]

- Internal labor costs exceeded audit costs in the case of Section 404(b) compliance and were found to comprise more than 50% of total compliance costs in some cases.

With respect to the beneficial effects of Section 404 compliance, respondents were more likely to report direct benefits of compliance (*i.e.,* improvements directly related to a company's financial reporting process, such as the quality of the ICFR) rather than indirect benefits of compliance (*i.e.,* improvements indirectly related to a company's financial reporting process, such as the ability to raise capital). Further, respondents from larger companies were more likely to ascribe positive direct and indirect effects to Section 404 compliance than respondents from smaller companies. Notably, when asked to assess the benefits of Section 404 compliance relative to the costs, most respondents viewed the costs as outweighing the resulting benefits. This was especially true among smaller companies.

In order to obtain a more complete picture of the effects of Section 404 implementation, SEC staff members from the Office of the Chief Accountant conducted separate in-depth phone interviews with a sample of 30 users of financial statements, including lenders, security analysts, credit rating agencies, and other investors. The results of these interviews showed that:

- Financial statement users generally regarded ICFR disclosures to be beneficial, and they indicated that Section 404(a) and Section 404(b) compliance has had a positive impact on their confidence in the companies' financial reports.

- Users believed that Section 404(b) provides an incremental benefit beyond what is required by Section 404(a), because the audit requirement was perceived as providing necessary discipline to the reporting process.

- Users tended to perceive the benefits of Section 404 compliance to vary with a company's complexity and industry affiliation but not with its size.

- Users indicated that the benefits they perceived from Section 404 compliance have not changed substantially over time, despite the actions taken by the SEC.

- Users believed that the process of compliance with Section 404 has become more efficient since the initial implementation in 2004.

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with the ICFR evaluation and disclosure requirements in 2007.

[6] Only "large accelerated filers" and "accelerated filers" are currently required to comply with both Section 404(a) and Section 404(b). Although currently required to comply with Section 404(a), "non-accelerated filers" (generally, companies with public float of less than $75 million) will not be required to comply with Section 404(b) until they file annual reports for fiscal years ending on or after June 15, 2010.

The report concludes by noting that the evidence from the survey response data and the findings from the in-depth phone interviews show that the costs of Section 404 compliance decreased following actions taken by the SEC to reduce costs and improve the effectiveness and efficiency of Section 404 implementation. Further, respondents indicated that they expected the costs of compliance with Section 404 to continue decreasing over time. The report notes that this evidence may prove useful in guiding any future regulatory efforts to improve the efficiency and effectiveness of Section 404 implementation.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.