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**Study and Recommendations on Section 404(b)  
of the Sarbanes-Oxley Act of 2002  
For Issuers With Public Float Between \$75 and \$250 Million**

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**As Required by Section 989G(b)  
of the Dodd-Frank Wall Street Reform  
and Consumer Protection Act of 2010**



**This is a study by the Staff of the Office of the Chief Accountant  
of the U.S. Securities and Exchange Commission.**

**The Commission has expressed no view regarding the analysis, findings,  
or conclusions contained herein.**

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**April 2011**



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## Executive Summary

Under Section 989G(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),<sup>1</sup> the Securities and Exchange Commission (“SEC” or “Commission”) is required to conduct a study to determine how the Commission could reduce the burden of complying with Section 404(b) of the Sarbanes-Oxley Act of 2002<sup>2</sup> (“Section 404(b)”) for companies whose market capitalization is between \$75 and \$250 million, while maintaining investor protections for such companies. Section 989G(b) also provides that the study must consider whether any methods of reducing the compliance burden or a complete exemption for such companies from Section 404(b) compliance would encourage companies to list on exchanges in the United States in their initial public offerings (“IPOs”).

This study addresses the auditor attestation requirement with respect to an issuer’s internal control over financial reporting (“ICFR”) pursuant to Section 404(b) as required by Section 989G(b) of the Dodd-Frank Act. It does not address management’s responsibility for reporting on the effectiveness of ICFR pursuant to Section 404(a) of the Sarbanes-Oxley Act. Although many of the academic and other studies surveyed relate to Section 404 in general and to Section 404(b) for all issuers, the research discussed in this study primarily focuses on findings related to accelerated filers. However, in conducting this study, the SEC Staff’s research and analysis considered certain existing information about Section 404 compliance beyond the specific areas of the study requirements as provided in the Dodd-Frank Act. This approach was used to develop findings and recommendations regarding Section 404(b) through the analysis of existing research, even though the purpose of the existing research may have been broader than the requirements of the current study.

Broadly, the Staff gathered information for this study through: (1) a review of publicly-available information (including the 2009 SEC Staff study on Section 404, discussed in Section III of this study), focusing our data analysis on issuers that would be within the range called for by the study; (2) a review of prior academic and other research, including hundreds of studies and research papers with respect to Section 404; and (3) a request for public comment which included 23 specific areas of inquiry on how the Commission could reduce the burden of

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<sup>1</sup> Pub. L. No. 111-203 (Jul. 21, 2010).

<sup>2</sup> 15 U.S.C. 7201 *et seq.*

complying with Section 404(b) for issuers with \$75-\$250 million in public float, while maintaining investor protections for such issuers, and whether any methods of reducing the compliance burden or a complete exemption for such issuers from Section 404(b) would encourage issuers to list on U.S. exchanges in their IPOs.

The purpose of using these sources was to: (1) learn about the specific characteristics of the issuers in the range of the study, how they compare to other issuers reporting as accelerated filers and non-accelerated filers, and the benefits and current and historical costs of compliance with Section 404(b) and current investor protections relating to such issuers; and (2) facilitate the development of potential new ideas for reducing the compliance burden among such issuers, including the effects of such compliance burden reduction or complete exemption from Section 404(b) to encourage companies to list IPOs in the United States.

### **Consideration of Prior Action by the Commission and Others**

In performing this study, the Staff first considered actions taken by the Commission and others since the enactment of Section 404(b). The Staff performed this analysis to consider the effects of the significant steps that have already been taken to reduce the overall compliance burden on the population that is the subject of this study. Broadly, the timeline is as follows:

- The Commission's initial implementing rule provided a phased-in approach to compliance;
- In response to concerns from issuers (particularly non-accelerated filers) about compliance costs and management's preparedness, the Commission provided several extensions to the compliance dates;
- The Commission provided that Section 404 compliance is not required in an IPO and in the first annual report after an IPO;
- In 2007, the Commission issued an interpretive release to provide guidance for management regarding its evaluation of internal controls and disclosure requirements;
- At approximately the same time that the Commission's interpretive release was issued, the Public Company Accounting Oversight Board (the "PCAOB" or "Board") adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial*

*Reporting that is Integrated with an Audit of Financial Statements* (“AS 5”)<sup>3</sup> to address feedback from constituents about the costs of conducting an effective audit of internal controls, including feedback received from roundtables and other activities with the Commission; and

- Additionally, in 2008 the Commission directed the Staff to conduct a study on Section 404, which was released in 2009 and forms part of the basis for the current study.

### **Analysis of the Issuers Subject to this Study**

After considering prior actions taken to reduce the compliance burden on all issuers subject to Section 404, the Staff analyzed the characteristics of issuers that are the subject of this study. The Staff performed this analysis to assist with the development of potential recommendations specific to any unique circumstances rather than to identify the exact listing of issuers as of any point in time that could be affected by any future actions resulting from the implementation of particular recommendations of the study. The characteristics analyzed included the following information about the issuers: (1) size in terms of assets and revenues; (2) industries; (3) locations; (4) audit fees and scalability; (5) restatement rates; and (6) reported material weaknesses in ICFR. The Staff also analyzed changes to the population of the issuers over time, noting that issuers frequently enter and exit this band of public float, such that the composition changes greatly from year to year.

The Staff identified an illustrative population of issuers as of December 31, 2009 as a proxy for those in the studied range. The Staff observes that auditor attestation on ICFR has been required for accelerated filers since 2004 for domestic issuers and 2007 for foreign private issuers. The Staff’s analysis reveals that the illustrative population is, in many important respects, significantly different from the population of all non-accelerated filers (the group of issuers permanently exempted from the requirements of Section 404(b) by the Dodd-Frank Act), particularly in relation to size (by revenue and assets), audit fees relative to size, restatement rates, and internal control issues discovered by management and auditors. Many of the characteristics point to similar financial reporting risks between the studied group of issuers and

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<sup>3</sup> PCAOB Release No. 2007-005A (Jun. 12, 2007), *available at* [http://pcaobus.org/Rules/Rulemaking/Docket%20021/2007-06-12\\_Release\\_No\\_2007-005A.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%20021/2007-06-12_Release_No_2007-005A.pdf). On July 27, 2007, the Commission approved the issuance of this auditing standard. *See* Release No. 34-56152 (Jul. 27, 2007).



issuers with larger public float that also must comply with Section 404(b). The Staff recognizes, as would be the case with establishing any numeric thresholds, that issuers at the lower end of the studied range within the illustrative population could be more likely to have characteristics more similar to non-accelerated filers (*i.e.*, issuers that are just under or just over the \$75 million threshold are likely to have similar characteristics to one another). This analysis suggests that there generally are not unique characteristics in the illustrative population that would suggest sufficient reasons for differentiating these filers from accelerated filers taken as a whole, including the requirement for an auditor attestation on “ICFR” pursuant to Section 404(b).

To understand whether any possible recommendations may encourage companies to list IPOs in the United States, the Staff analyzed the characteristics of global IPOs with respect to those likely to be in the range of issuers subject to this study. Although the U.S. IPO market over time has recovered from the 2007 levels, it has not reached the 1999 levels (*i.e.*, we reviewed IPO activity over a range of years and noted that it was at a relatively low point during the financial crisis and has since recovered, but not to the peak for the range of years studied). The Staff’s analysis shows that the United States has not lost U.S.-based companies filing IPOs to foreign markets for the range of issuers that would likely be in the \$75-\$250 million public float range after the IPO and that issuers filing IPOs in this range are not likely to remain in this range for an extended period of time. While U.S. markets’ share of world-wide IPOs raising \$75-\$250 million has declined over the past five years, there is no conclusive evidence from the study linking the requirements of Section 404(b) to IPO activity. In addition, as noted above, the Commission has previously taken action to reduce the compliance burden for new issuers by not requiring the auditor attestation on ICFR for the IPO and the first annual report thereafter.

#### **Analysis of the 2009 SEC Staff Study on Section 404**

Once the Staff understood the characteristics of the studied group of issuers, it used the data from its 2009 Section 404 study to analyze the effects of prior efforts to reduce the Section 404(b) compliance burden on such issuers. The Staff found that the 2007 reforms (broadly, the Commission’s June 2007 interpretive release and the PCAOB’s adoption of AS 5) had the intended effect of reducing the compliance burden and improving the implementation of Section 404, including the requirements of Section 404(b) for the studied group of issuers. This information, in conjunction with the analysis of prior reforms and general information about the characteristics of the studied group of issuers, provided the Staff with a starting point to consider

new public input, existing academic research, and other information to determine whether there are additional ways to further reduce the compliance burden of Section 404(b) while maintaining investor protections for such issuers.

### **Discussion of Public Comments**

To assist the Staff in considering possible recommendations, the Commission requested public input on 23 specific areas about how the Commission could reduce the burden of complying with Section 404(b) for the studied group of issuers, while maintaining investor protections for such issuers, and whether any methods of reducing the compliance burden or a complete exemption for such issuers from Section 404(b) would encourage issuers to list on U.S. exchanges in their IPOs.

There were few suggestions provided from the public input that addressed techniques for further reducing the compliance burden while maintaining investor protections without providing a complete exemption. For example, the three industry groups that advocated an exemption from Section 404(b) for issuers in the studied market capitalization range did not provide other recommendations for reducing the compliance burden. The Staff considered this input as well as public input previously received on the compliance burden of Section 404(b) from past Commission and PCAOB actions, but generally did not believe that those suggestions, beyond those previously implemented, were appropriate recommendations for the issuer group the Staff was required to study (*e.g.*, forms of rotational or reduced testing and raising the threshold of what constitutes a material weakness). The Staff is also aware that there are continuing negative perceptions attributed to the Sarbanes-Oxley Act, including Section 404.

However, the Staff does believe that certain other suggestions from the public that involve Commission coordination and support for other groups will likely take into account both the compliance costs and effectiveness for all issuers, including those in the studied range. First, certain commenters recommended that the PCAOB publish additional observations about the implementation of the PCAOB's auditing standards related to Section 404(b), including comparing such implementation to the PCAOB's original intent. These commenters believed that additional observations could assist auditors in performing more efficient and effective audits. The Staff supports recommending to the PCAOB that it continuously review inspection results and consider whether publishing observations is warranted to improve the effective and efficient application of its auditing standard. If such observations were published, they may

contribute to a reduction in the compliance burden for issuers in the studied range and also provide auditors, issuers, investors, and others with important information about audit performance and quality.

Second, certain commenters recommended that the Commission actively participate and monitor the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) update to its internal control framework. COSO announced plans to update its framework, which was originally released in 1992, in November of 2010. The stated aims of the update to the 1992 framework do not explicitly address the compliance burden on issuers that use the COSO framework to evaluate ICFR, and it is not aimed at any particular size of issuer. However, the update is designed to describe how to evaluate internal controls in an environment that is more complex than it was when the original framework was developed. The Staff supports this recommendation, as the update may have implications on the compliance burden on issuers, including those in the studied range.

#### **Summary of Prior Academic and Other Research on Section 404**

Finally, the Staff considered existing research on Section 404 to understand the trends in compliance costs and the existing investor protections provided by compliance with Section 404(b), as well as to discern any additional ideas for reducing the compliance burden for issuers in the studied range. The research was useful to inform the Staff’s broader consideration of how and if the compliance burden could be reduced for such issuers by examining, for example, compliance cost trends, listing trends, and individuals’ decision making in lending and investing activities.

The academic and other research on Section 404:

- Indicates that the cost of compliance with Section 404(b), including both total costs and audit fees, has declined since the 2007 reforms;
- Does not provide conclusive evidence linking the enactment of Section 404(b) to decisions by issuers to exit the reporting requirements of the SEC, including ICFR reporting;
- Indicates that auditor involvement in ICFR is positively correlated with more accurate and reliable disclosure of all ICFR deficiencies, and restatement rates for issuers with the auditor attestation is lower than that for issuers without this attestation; and

- Indicates that disclosure of internal control weaknesses conveys relevant information to investors.

The Staff also considered and does not recommend an approach detailed in certain studies suggesting that the Commission allow an issuer to “opt out” of Section 404(b) compliance. “Opt out” approaches can provide a mechanism to allow an issuer options regarding compliance rather than a strict requirement. Under such an approach, so long as an investor was informed as to an issuer’s decision to opt out or comply, an investor could consider this decision in allocating capital and otherwise making investment decisions. Although some suggest that allowing flexibility of this type could be beneficial, in the context of Section 404(b) the Staff considered the suggestion of an “opt out” to be too similar to providing a full exemption given the Staff’s view of the benefits of auditor involvement to reliable ICFR disclosures and reliable financial reporting. Academic literature also suggests it could incentivize insiders to exploit the information asymmetry between themselves and other investors about the incidence and severity of material weaknesses in ICFR.

### **Conclusion and Recommendations**

The information compiled for the study provided the Staff with an understanding that:

- The costs of Section 404(b) have declined since the Commission first implemented the requirements of Section 404, particularly in response to the 2007 reforms;
- Investors generally view the auditor’s attestation on ICFR as beneficial;
- Financial reporting is more reliable when the auditor is involved with ICFR assessments; and
- There is not conclusive evidence linking the requirements of Section 404(b) to listing decisions of the studied range of issuers.

The Staff also received public input suggesting certain means to reduce the compliance burden that were previously considered by the Commission or the PCAOB and they determined not to adopt. The Staff considered this input but believes these suggestions would possibly be detrimental to effectiveness of audits of ICFR and, therefore, not maintain investor protections provided by Section 404(b).

After considering the information gathered from internal and external sources, the Staff concludes the study with the following two recommendations:

- 1. Maintain existing investor protections of Section 404(b) for accelerated filers, which have been in place since 2004 for domestic issuers and 2007 for foreign private issuers**

The Staff believes that the existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should be maintained (*i.e.*, no new exemptions). There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers subject to the study, given the auditor's obligations to perform procedures to evaluate internal controls even when the auditor is not performing an integrated audit. Also, while the research regarding the reasons for listing decisions is inconclusive, the evidence does not suggest that granting an exemption to issuers that would expect to have \$75-\$250 million in public float following an IPO would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States. The Staff acknowledges that the reasons a company may choose to undertake an IPO are varied and complex. The reasons are often specific to the company, with each company making the decision as to whether and where to go public based on its own situation and the market factors present at the time. The costs associated with conducting an IPO and becoming a public company no doubt factor into the decisions and may be particularly challenging for smaller companies. The Staff appreciates that the costs and benefits of the regulatory actions that the Commission takes – and does not take – certainly can impact these decisions. At Chairman Schapiro's request, the Staff is taking a fresh look at several of the Commission's rules, beyond those related to Section 404(b), to develop ideas for the Commission about ways to reduce regulatory burdens on small business capital formation in a manner consistent with investor

protection.<sup>4</sup> However, the Dodd-Frank Act already exempted approximately 60% of reporting issuers from Section 404(b), and the Staff does not recommend further extending this exemption.

**2. Encourage activities that have potential to further improve both effectiveness and efficiency of Section 404(b) implementation**

The Staff recommends that the PCAOB monitor its inspection results and consider publishing observations, beyond the observations previously published in September 2009, on the performance of audits conducted in accordance with AS 5. These observations could assist auditors in performing top-down, risk based audits of ICFR. These communications could include the lessons that can be learned from internal control deficiencies identified through PCAOB inspections.

The Staff is observing COSO's project to review and update its internal control framework, which is the most common framework used by management and the auditor alike in performing assessments of ICFR. The Staff believes that this project can contribute to effective and efficient audits by providing management and auditors with improved internal control guidance that reflects today's operating and regulatory environment and by allowing constituent groups to share information on improvements that can be made that enhance the ability to design, implement, and assess internal controls.

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<sup>4</sup> See Letter from Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, to Congressman Darrell E. Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives (Apr. 6, 2011), available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>.

## **I. Introduction**

### **A. Statutory Mandate, Approach, and Structure**

#### **1. Statutory Mandate**

Section 989G(b) of the Dodd-Frank Act directed the SEC to conduct a study with respect to the auditor attestation requirement under Section 404(b) for issuers whose market capitalization is between \$75 and \$250 million. Specifically, the Dodd-Frank Act provides:<sup>5</sup>

The Securities and Exchange Commission shall conduct a study to determine how the Commission could reduce the burden of complying with section 404(b) of the Sarbanes-Oxley Act of 2002 for companies whose market capitalization is between \$75,000,000 and \$250,000,000 for the relevant reporting period while maintaining investor protections for such companies. The study shall also consider whether any such methods of reducing the compliance burden or a complete exemption for such companies from compliance with such section would encourage companies to list on exchanges in the United States in their initial public offerings. Not later than 9 months after the date of the enactment of this subtitle, the Commission shall transmit a report of such study to Congress.

In addition, Section 989G(a) of the Dodd-Frank Act amended the Sarbanes-Oxley Act so that Section 404(b) does not apply with respect to “any audit report prepared for an issuer that is neither a ‘large accelerated filer’ nor an ‘accelerated filer’ as those terms are defined in Rule 12b-2 of the Commission.”<sup>6</sup>

Pursuant to Section 989I of the Dodd-Frank Act, the Government Accountability Office (“GAO”) is required to conduct a study on the impact of the Section 404(b) amendments under the Dodd-Frank Act and to submit a report “not later than 3 years after the date of enactment” of that Act (July 2013). The GAO study is to include an analysis of:<sup>7</sup>

- (1) whether issuers that are exempt from such section 404(b) have fewer or more restatements of published accounting statements than issuers that are required to comply with such section 404(b);
- (2) the cost of capital for issuers that are exempt from such section 404(b) compared to the cost of capital for issuers that are required to comply with such section 404(b);

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<sup>5</sup> *Supra* note 1.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

(3) whether there is any difference in the confidence of investors in the integrity of financial statements of issuers that comply with such section 404(b) and issuers that are exempt from compliance with such section 404(b);

(4) whether issuers that do not receive the attestation for internal controls required under such section 404(b) should be required to disclose the lack of such attestation to investors; and

(5) the costs and benefits to issuers that are exempt from such section 404(b) that voluntarily have obtained the attestation of an independent auditor.

## **2. Approach to this Study**

This study addresses the auditor attestation requirement with respect to an issuer's ICFR pursuant to Section 404(b) as required by Section 989G(b) of the Dodd-Frank Act. It does not address management's responsibilities pursuant to Section 404(a) of the Sarbanes-Oxley Act. Under the Commission's rules prescribed pursuant to Section 404(a) of the Sarbanes-Oxley Act, issuers, other than registered investment companies, are required to include in their annual reports a report of management on the issuer's ICFR that: (1) states management's responsibility for establishing and maintaining the internal control structure; and (2) includes management's assessment of the effectiveness of the ICFR. Section 404(b) requires the auditor to attest to, and report on, management's assessment.<sup>8</sup> In light of the interrelationship between the requirements in Section 404(a) and Section 404(b), and to be complete in our efforts to identify potential methods of reducing the Section 404(b) compliance burden, the Staff's research and analysis included consideration of certain existing information about Section 404 compliance more broadly, particularly where such information did not distinguish among the various requirements in Section 404.

In order to fulfill the statutory mandate and produce this study, the Staff has assigned meaning to certain terms as described below:

- For purposes of this study, the Staff generally uses public float as the measure of market capitalization.<sup>9</sup> As the Commission described in its request for comment in connection with this study:<sup>10</sup>

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<sup>8</sup> See Exchange Act Rules 13a-15 and 15d-15 [17 CFR 13a-15 and 17 CFR 15d-15].

<sup>9</sup> While the Staff believes that public float is the appropriate measure of market capitalization for the purposes of the study, an exact measure of public float as reported annually by issuers was not readily available for the dates the Staff analyzed. In Sections II and III, the Staff generally used free float capitalization, as determined by Thomson



The Dodd-Frank Act does not define “market capitalization” and it is not defined in Commission rules. For purposes of the study, we believe that public float is an appropriate measure of market capitalization. Public float, which is the aggregate worldwide market value of an issuer’s voting and non-voting common equity held by its non-affiliates, is the measure used in Commission rules for determining “accelerated filer” and “large accelerated filer” status. The Commission has used public float historically in its actions to phase issuers into Section 404 compliance, and Section 404(c) of the Sarbanes-Oxley Act of 2002, as amended by Section 989G(a) of the Dodd-Frank Act, provides that Section 404(b) shall not apply with respect to issuers that are neither an “accelerated filer” nor a “large accelerated filer” pursuant to Commission rules, which are generally issuers with a public float below \$75 million. We therefore believe it would be consistent to use public float between \$75 million and \$250 million to describe the group of issuers that are the subject of the study.

- “Accelerated filer” means an issuer after it first meets the following conditions as of the end of its fiscal year:<sup>11</sup>
  - (i) The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$75-\$700 million as of the last business day of the issuer’s most recently completed fiscal quarter;
  - (ii) The issuer has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for at least twelve calendar months;
  - (iii) The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and
  - (iv) The issuer is not eligible to use the requirements for smaller reporting companies in its annual and quarterly reports.
- “Large accelerated filer” means an issuer that had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$700 million or more as of the last business day of the issuer’s most recently completed

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Datastream and defined as the market value of shares available to ordinary investors, as a proxy for public float, even though free float capitalization excludes some shares that may be considered in calculating public float. *See infra* note 52 regarding the use of free float capitalization as a proxy for public float.

<sup>10</sup> See Release No. 34-63108 (Oct. 14, 2010) (footnotes omitted).

<sup>11</sup> See Exchange Act Rule 12b-2 [17 CFR 240.12b-2].

fiscal quarter and also meets the requirements of (ii) – (iv) listed above in the definition of accelerated filer.<sup>12</sup>

- The study uses the term “non-accelerated filer” to refer to an issuer that does not meet the definition of either an “accelerated filer” or a “large accelerated filer,” which principally are issuers with a public float of less than \$75 million.
- The study uses the term “illustrative population” to refer to the group of issuers identified for the analyses in Section II of this study.

The methodologies used by the Staff to gather and analyze data for Sections II –V of this study are described in each of those sections. Broadly, the Staff gathered information for this study through: (1) a review of publicly-available information (including the prior Staff study on Section 404), focusing our data analysis on issuers that would be within the range called for by the study; (2) a review of prior academic and other research, including hundreds of studies and research papers with respect to Section 404; and (3) a request for public comment which included 23 specific areas of inquiry on how the Commission could reduce the burden of complying with Section 404(b) for issuers with \$75-\$250 million in public float, while maintaining investor protections for such issuers, and whether any methods of reducing the compliance burden or a complete exemption for such issuers from Section 404(b) would encourage issuers to list on U.S. exchanges in their IPOs.

### **3. Structure of this Study**

This study is organized into the following sections:

Executive Summary – The Executive Summary provides an overview of the Staff’s study and also recaps the Staff’s recommendations.

Section I: Introduction – This section discusses the statutory mandate, approach, and structure of the study, and provides a history of Commission action and other developments related to Section 404.

Section II: Analysis of the Issuers Subject to this Study – This section analyzes demographic data for an illustrative population of issuers as a proxy for those in the studied range, including: size; industry; geographic location; audit fees; restatement data;

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<sup>12</sup> See *id.*

and past results of auditor and management assessments of internal controls over financial reporting. This section also includes data on new listings.

Section III: Analysis of the 2009 SEC Staff Study on Section 404 – This section analyzes the SEC Staff’s 2009 study on Section 404, including further analysis of the data gathered in that study, focusing on findings related to issuers with \$75-\$250 million in public float.

Section IV: Discussion of Public Comments – This section discusses the public comments received from the Commission’s October 2010 request for public comment in connection with this study, as well as comments received from earlier Commission and PCAOB actions with respect to Section 404.

Section V: Summary of Prior Academic and Other Research on Section 404 – This section summarizes the Staff’s review of external studies and research reports on Section 404, including research related to benefits and costs of compliance, internal control deficiencies, financial reporting quality, cost of debt and equity capital, individual users’ decision making, and alternatives to existing auditor attestation.

Section VI: Conclusion and Recommendations – This section summarizes the Staff’s findings and also provides the Staff’s recommendations.

## **B. History of Commission Action and Other Developments**

Since the enactment of the Sarbanes-Oxley Act, the Commission has taken several steps to reduce the burden for issuers to comply with the reporting and attestation requirements under Section 404. First, the Commission’s initial implementing rule provided a phased-in approach to compliance. Then, in response to concerns from issuers (particularly non-accelerated filers) about compliance costs and management’s preparedness, the Commission provided several extensions to the compliance dates discussed further below. In 2007, the Commission issued an interpretive release to provide guidance for management regarding its evaluation of ICFR and the related disclosure requirements. Additionally, in 2008, the Commission directed the Staff to conduct a study on Section 404. Each of these initiatives is described below, listed in chronological order along with related actions taken by the PCAOB and others.

## **1. Initial Commission Rule**

Section 404 of the Sarbanes-Oxley Act provided that the Commission prescribe rules requiring each Exchange Act annual report to include a report of management's assessment of the effectiveness of ICFR pursuant to Section 404(a) and an independent auditor's attestation to the effectiveness of those controls pursuant to Section 404(b). Consistent with Sections 404(a) and 404(b) of the Sarbanes-Oxley Act, on June 5, 2003, the Commission adopted initial amendments to its rules and forms requiring issuers, other than registered investment companies, to include in their annual reports filed with the Commission a report of management and an accompanying auditor's attestation report on the effectiveness of the issuer's ICFR.<sup>13</sup> The Commission's release provided for a phase in of the compliance dates as follows:<sup>14</sup>

- Accelerated filers were to comply with the Section 404 requirements for their first fiscal year ending on or after June 15, 2004; and
- Issuers that were not accelerated filers as of June 15, 2004, including foreign private issuers that file annual reports on Form 20-F or Form 40-F, were to comply with the Section 404 requirements for their first fiscal year ending on or after April 15, 2005.

## **2. First Extension of the Compliance Dates**

On February 24, 2004, the Commission extended the compliance dates as follows:<sup>15</sup>

- Accelerated filers were to comply with the Section 404 requirements for their first fiscal year ending on or after November 15, 2004; and
- Non-accelerated filers and foreign private issuers that file annual reports on Form 20-F or Form 40-F were to comply with the Section 404 requirements for their first fiscal year ending on or after July 15, 2005.

The Commission extended the compliance dates in light of the time and resources needed to properly implement the rules and to provide additional time for issuers and their auditors to implement a new auditing standard<sup>16</sup> of the PCAOB, which set forth new standards for

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<sup>13</sup> See Release No. 33-8238 (Jun. 5, 2003).

<sup>14</sup> Note that at the time of this release, there was no "large accelerated filer" category in the Commission's rules.

<sup>15</sup> See Release No. 33-8392 (Feb. 24, 2004).

<sup>16</sup> See PCAOB Rulemaking Docket Matter No. 008: Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("AS 2"), *available at*

conducting an audit of ICFR performed in conjunction with an audit of the financial statements.<sup>17</sup>

### 3. Subsequent Extensions of the Compliance Dates

In December 2004, the Commission announced that it was establishing the SEC Advisory Committee on Smaller Public Companies (“ACSPC”) to assist the Commission in evaluating the current securities regulatory system relating to smaller public companies, including the rules relating to internal control reporting.<sup>18</sup> In addition, the SEC Staff held roundtable discussions on April 13, 2005 and, jointly with the PCAOB, on May 10, 2006, to obtain input from the public about their experiences in implementing the Section 404 requirements in order to help develop policies to effectively and efficiently improve the reliability of financial statements.<sup>19</sup> The roundtable participants included issuers, auditors, investors, representatives of the PCAOB, and other interested parties. In addition to these roundtables, SEC Staff also issued staff guidance on Section 404 compliance in January and May of 2005.<sup>20</sup> As discussed below, the Commission provided further extensions to the compliance dates:

- On March 2, 2005, the Commission extended the compliance date for non-accelerated filers and foreign private issuers that file annual reports on Form 20-F or Form 40-F to their first fiscal year ending on or after July 15, 2006.<sup>21</sup> The Commission approved this extension in response to, among other things, the challenges that non-U.S. issuers

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<http://pcaobus.org/Rules/Rulemaking/Pages/Docket008.aspx>. Note that AS 2 is not discussed in detail because it was superseded by a new auditing standard of the PCAOB. See the discussion of AS 5 in Subsection B.8. of Section I of this study.

<sup>17</sup> See Release No. 33-8392 (Feb. 24, 2004).

<sup>18</sup> See Release No. 33-8514 (Dec. 16, 2004).

<sup>19</sup> See SEC Press Release 2005-13, Commission Announces Roundtable on Internal Control Reporting Requirements (Feb. 7, 2005), available at <http://www.sec.gov/news/press/2005-13.htm>; SEC Press Release 2005-20, Commission Seeks Feedback and Announces Date of Roundtable on Implementation of Sarbanes-Oxley Internal Control Provisions (Feb. 22, 2005), available at <http://www.sec.gov/news/press/2005-20.htm>; SEC Press Release 2006-22, Commission and PCAOB Announce Roundtable on Internal Control Reporting Requirements (Feb. 16, 2006), available at <http://www.sec.gov/news/press/2006-22.htm>.

<sup>20</sup> See Office of the Chief Accountant, Division of Corporation Finance: Staff Statement on Management’s Report on Internal Control Over Financial Reporting (May 16, 2005), and Division of Corporation Finance: Exemptive Order on Management’s Report on Internal Control over Financial Reporting and Related Auditor Report; Frequently Asked Questions (Jan. 21, 2005), available at <http://www.sec.gov/spotlight/soxcomp.htm>.

<sup>21</sup> See Release No. 33-8545 (Mar. 2, 2005).

faced in complying with the ICFR requirements, including language, culture, and organization structures that are different than what is found typically in the United States.<sup>22</sup> The Commission also noted that it was important to allow time for the ACSPC to consider the framework for ICFR applicable to smaller issuers, methods for management's assessment of the controls, and standards for auditing the controls.<sup>23</sup>

- On September 22, 2005, the Commission extended the compliance date for non-accelerated filers to their first fiscal year ending on or after July 15, 2007.<sup>24</sup> This extension was consistent with an ACSPC interim recommendation to extend the compliance date while the ACSPC continued its evaluation of the impact of the ICFR requirements on smaller public companies. Also, COSO was continuing its efforts to develop guidance for smaller public companies.<sup>25</sup> This extension also provided time for the Commission to review responses to its request for public comment on several questions about the application of the internal control reporting requirements, including questions regarding the amount of time and expense that non-accelerated filers had incurred to prepare for compliance with the internal control reporting requirements.<sup>26</sup>
- On August 9, 2006, the Commission extended the Section 404(b) compliance date for foreign private issuers that are accelerated filers and file annual reports on Form 20-F

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<sup>22</sup> *See id.*

<sup>23</sup> *See id.*

<sup>24</sup> *See* Release No. 33-8618 (Sept. 22, 2005).

<sup>25</sup> COSO is a private-sector organization that provides frameworks and guidance on organizational governance, business ethics, internal control, enterprise risk management, fraud, and financial reporting. It was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative which studied the causal factors that can lead to fraudulent financial reporting. In the adopting release for the initial rules implementing Section 404, the Commission noted that the rules require management to base its evaluation of the effectiveness of the company's internal controls on a suitable framework and, while the rules do not mandate use of a particular framework, the COSO framework satisfies the Commission's criteria and may be used for management's evaluation and disclosure requirements. *See* Release No. 33-8238 (Jun. 5, 2003).

<sup>26</sup> *See* Release No. 33-8731 (Aug. 9, 2006).

or Form 40-F to their first fiscal year ending on or after July 15, 2007.<sup>27</sup> The Commission extended the compliance date in order to provide foreign private issuers and their auditors an additional year to consider and adapt to actions by the Commission and the PCAOB to improve the implementation of the Section 404 requirements.<sup>28</sup> Also, the extension enabled management of this group of foreign private issuers to begin the process of reviewing and evaluating the effectiveness of ICFR prior to the initial ICFR audit.

#### **4. ACSPC Report**

On April 23, 2006, the SEC's ACSPC issued its final report to the Commission including, among other things, the following recommendations:<sup>29</sup>

- Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from Section 404 requirements to microcap companies with less than \$125 million in annual revenue, and to smallcap companies with less than \$10 million in annual product revenue, that have or add corporate governance controls that include:
  - adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Exchange Act; and
  - adoption of a code of ethics within the meaning of Item 406 of Regulation S-K applicable to all directors, officers and employees and disclosure of the code in connection with the company's obligations under Item 406(c) relating to the disclosure of the code of ethics.

In addition, as part of this recommendation, we recommend that the Commission confirm, and if necessary clarify, the application to all microcap companies, and indeed to all smallcap companies also, of the existing general legal requirements regarding internal controls, including the requirement that companies maintain a system of effective internal control over financial reporting, disclose modifications to

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<sup>27</sup> See Release No. 33-8730A (Aug. 9, 2006). Also on August 9, 2006, the Commission issued proposed rules to further extend the compliance date for non-accelerated filers to their first fiscal year ending on or after December 15, 2007. See Release No. 33-8731 (Aug. 9, 2006).

<sup>28</sup> See SEC Press Release 2006-75 (May 17, 2006), SEC Announces Next Steps for Sarbanes-Oxley Implementation, available at <http://www.sec.gov/news/press/2006/2006-75.htm>, and PCAOB News Release (May 17, 2006), Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements, available at [http://www.pcaobus.org/News\\_and\\_Events/News/2006/05-17.aspx](http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx).

<sup>29</sup> See Final Report of the Advisory Committee on Smaller Public Companies (Apr. 23, 2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. The Co-Chairs of the ASCPC included a separate statement in the report, noting that their intent was to “fix 404, not repeal it, so that it is both effective and efficient.” *Id.* at 124.

internal control over financial reporting and their material consequences, apply CEO and CFO certifications to such disclosures and have their management report on any known material weaknesses.

- Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from external auditor involvement in the Section 404 process to the following companies, subject to their compliance with the same corporate governance standards as detailed in the recommendation above:
  - Smallcap companies with less than \$250 million in annual revenues but more than \$10 million in annual product revenue; and
  - Microcap companies with between \$125 and \$250 million in annual revenue.
- While we believe that the current costs of the requirement for an external audit of the effectiveness of internal control over financial reporting are disproportionate to the benefits, and have therefore adopted [the recommendation] above, we also believe that if the Commission reaches a public policy conclusion that an audit is required, we recommend that changes be made to the requirements for implementing Section 404's external auditor requirement to a cost-effective standard, which we call "ASX," providing for an external audit of the design and implementation of internal controls.
- Provide, and request that COSO and the PCAOB provide, additional guidance to help facilitate the assessment and design of internal controls and make processes related to internal controls more cost-effective; also, assess if and when it would be advisable to reevaluate and consider amending AS2.

## **5. COSO Guidance**

Shortly after the release of the ACSPC report, COSO released a document entitled "Internal Control Over Financial Reporting – Guidance for Smaller Public Companies," which provides guidance on how to apply the COSO internal control framework to smaller issuers and describes considerations related to designing and implementing cost-effective ICFR.<sup>30</sup> The guidance also was intended to be useful to management in more efficiently evaluating ICFR in the context of guidance provided by regulators.

## **6. Additional Extension of the Compliance Dates**

Based on extensive analysis from investors, issuers, auditors, and others, the Commission on May 16, 2006 announced a series of actions to improve the implementation of the Section 404 requirements, including: (1) issuing guidance for issuers; (2) working with the PCAOB on

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<sup>30</sup> See Internal Control over Financial Reporting - Guidance for Smaller Public Companies, June 2006, *available at* [www.coso.org/ICFR-GuidanceforSPCs.htm](http://www.coso.org/ICFR-GuidanceforSPCs.htm).



revisions to its internal control auditing standard; and (3) conducting inspections of the PCAOB's efforts to improve Section 404 oversight.<sup>31</sup> On July 11, 2006, the Commission issued a Concept Release to solicit public comment on providing additional guidance for management on its assessment of the effectiveness of ICFR.<sup>32</sup> The release requested comment on a number of areas, including the level of public interest in any additional guidance and the appropriate scope for the guidance.<sup>33</sup> On December 15, 2006, the Commission provided further relief to non-accelerated filers by:<sup>34</sup>

- Extending the Section 404(a) compliance date for non-accelerated filers to their first fiscal year ending on or after December 15, 2007; and
- Extending the Section 404(b) compliance date for non-accelerated filers to their first fiscal year ending on or after December 15, 2008.

The Commission provided this extension in part because it would shortly be proposing interpretive guidance for management regarding its evaluation of ICFR and requesting public comment on the proposed guidance.<sup>35</sup> This guidance was designed to increase the efficiency and cost-effectiveness of management's evaluation and to provide scalability and flexibility to issuers, particularly smaller issuers.

Additionally, the Commission held an open meeting on April 4, 2007 to discuss the PCAOB's proposed revised auditing standard on ICFR audits, described below, and to facilitate the alignment of the proposed revised standard with the Commission's related guidance.<sup>36</sup> The open meeting was a continuation of the process announced by the Commission and the PCAOB

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<sup>31</sup> See SEC Press Release 2006-75, *supra* note 28.

<sup>32</sup> Release No. 34-54122 (Jul. 11, 2006).

<sup>33</sup> See *id.*

<sup>34</sup> See Release No. 33-8760 (Dec. 15, 2006).

<sup>35</sup> See Release No. 33-8762 (Dec. 20, 2006).

<sup>36</sup> See SEC Press Release 2007-56 (Mar. 28, 2007), SEC Schedules Open Meeting to Discuss PCAOB's Proposed Auditing Standard and SEC's Proposed Management Guidance for Section 404 of Sarbanes-Oxley Act, *available at* <http://www.sec.gov/news/press/2007/2007-56.htm>.

in May 2006 to improve the reliability of issuers' financial statements while providing guidance to make the Section 404 process more efficient and cost-effective.<sup>37</sup>

## **7. Transition Period for Newly Public Companies**

On December 15, 2006, the Commission also amended its rules to reduce the burden on newly public companies by providing that such issuers do not need to comply with the Section 404 requirements until the second annual report filed with the Commission.<sup>38</sup> The Commission recognized that preparation of an issuer's first annual report is a comprehensive process involving compilation of information in response to many public disclosure requirements and that requiring a newly public company to comply with the Section 404 requirements during this same timeframe would impose an additional burden on these issuers.<sup>39</sup>

## **8. PCAOB Auditing Standard No. 5**

On June 12, 2007, the PCAOB issued AS 5 to address the costs in conducting an effective audit of internal controls, feedback from constituents, and participation in roundtables and other activities with the Commission. The Board further explained in the adopting release to AS 5 its rationale for issuing the new standard:

The Board issued [the AS 5 proposal] with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand.<sup>40</sup>

The Board also stated that AS 5 aligned closely with guidance that the Commission had proposed in December 2006 (and adopted in June 2007, as described below) to help management

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<sup>37</sup> *See id.*

<sup>38</sup> *See* Release No. 33-8760 (Dec. 15, 2006).

<sup>39</sup> *See id.*

<sup>40</sup> PCAOB Release No. 2007-005A (Jun. 12, 2007), *available at* [http://pcaobus.org/Rules/Rulemaking/Docket%2021/2007-06-12\\_Release\\_No\\_2007-005A.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%2021/2007-06-12_Release_No_2007-005A.pdf).

(not the auditor) evaluate internal controls for the purposes of its annual assessment.<sup>41</sup> The PCAOB, while acknowledging fundamental differences in the evaluations performed by management and auditors, described its auditing standard as using a “top down” approach, similar to that performed in financial statement audits and closely aligned to the concept described by the Commission in its guidance for management assessments of ICFR. AS 5 contained provisions on scaling ICFR audits for smaller and less complex issuers, including consideration of how smaller issuers achieve control objectives and address risk of management override differently than larger issuers.

## **9. Commission Interpretive Release**

On June 20, 2007, the Commission issued an Interpretive Release entitled “Commission Guidance Regarding Management’s Report on Internal Control over Financial Reporting Under Section 13(a) and 15(d) of the Securities Exchange Act of 1934” (“Management Guidance”), which described a “top-down, risk based evaluation” as one way that registrants could satisfy the requirements of Rules 13a-15(c) and 15d-15(c).<sup>42</sup>

Although the Management Guidance applies to all issuers, it specifically encourages smaller issuers “to take advantage of the flexibility and scalability to conduct an evaluation of ICFR that is both efficient and effective at identifying material weaknesses.”<sup>43</sup> The Commission further indicated that it believed “principles-based guidance permits flexible and scalable evaluation approaches that will enable management of smaller public companies to evaluate and assess the effectiveness of ICFR without undue cost burdens.”<sup>44</sup>

## **10. Guide for Small Businesses on Section 404**

In January 2008, the SEC Staff published a guide for small businesses to assist these issuers in understanding the steps necessary in connection with their initial evaluations of

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<sup>41</sup> *See id.*

<sup>42</sup> *See* Release No. 33-8810 (Jun. 20, 2007). The Management Guidance had been proposed by the Commission in December 2006. *See* Release No. 33-8762 (Dec. 20, 2006).

<sup>43</sup> Release No. 33-8810 (Jun. 20, 2007).

<sup>44</sup> *Id.* at 50. SEC Staff issued further guidance in the form of a “Frequently Asked Questions” document in September 2007. *See* <http://www.sec.gov/info/accountants/controlfaq.htm>.

internal controls.<sup>45</sup> This publication also provided information on other sources of guidance to assist management in performing its assessment of internal controls.

### **11. Further Extension of the Compliance Dates**

On June 26, 2008, the Commission approved a further extension of the Section 404(b) compliance date for non-accelerated filers to fiscal years ending on or after December 15, 2009.<sup>46</sup> The extension was to allow time for the PCAOB to issue final staff guidance on auditing ICFR of smaller issuers and for the SEC Staff to undertake a study to help determine whether AS 5, and the Commission’s Management Guidance on evaluating ICFR, were facilitating more cost-effective ICFR evaluations and audits.

### **12. PCAOB Staff Views on Integrated Audits**

On January 23, 2009, the PCAOB issued its staff’s views on integrated audits under AS 5. The guidance was provided to assist auditors in designing and executing audit strategies that would achieve the objectives of AS 5. Specifically, the expressed purpose of this guidance was to “help auditors apply the provisions of [AS 5] to audits of smaller, less complex public companies” and to provide “direction to auditors on scaling the audit based on a company’s size and complexity.”<sup>47</sup> The guidance discussed the selection of controls to test, testing the operating effectiveness of controls, evaluating entity-level controls, and determining the effect of entity-level controls on other controls. The guidance also addressed, among other things, assessing the risk of management override, evaluating mitigating controls (including audit committee oversight and whistleblower programs), and evaluating segregation of duties.

### **13. SEC Staff Study on Section 404; Final Extension of the Compliance Date**

On October 2, 2009, the SEC Staff released its study on Section 404 (discussed in Section III of this study). Due to the proximity of the date of the Staff’s study to the proposed

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<sup>45</sup> See Sarbanes-Oxley Section 404 – A Guide for Small Business, *available at* [www.sec.gov/info/smallbus/404guide.pdf](http://www.sec.gov/info/smallbus/404guide.pdf).

<sup>46</sup> Release No. 33-8934 (Jun. 26, 2008).

<sup>47</sup> Staff Views - An Audit of Internal Control that is Integrated with an Audit of the Financial Statements: Guidance for Auditors of Smaller Public Companies (Jan. 23, 2009), *available at* <http://pcaobus.org/Standards/Auditing/Documents/AS5/Guidance.pdf>.

date that Section 404(b) compliance would have been required absent the further delay, on October 13, 2009, the Commission provided a final extension of the Section 404(b) compliance date for non-accelerated filers to fiscal years ending after June 15, 2010.<sup>48</sup> In the release, the Commission noted that “all steps necessary to implement the requirements of Section 404 of the Sarbanes-Oxley Act have been completed, and non-accelerated filers should work with their auditors to comply with Section 404(b) for annual reports for fiscal years ending on or after June 15, 2010” and that the Commission “does not expect to further defer the obligation of non-accelerated filers to comply with Section 404(b).”<sup>49</sup>

#### **14. Section 404(c) of the Sarbanes-Oxley Act, as added by the Dodd-Frank Act**

On July 21, 2010, the Dodd-Frank Act was enacted and it added Section 404(c) to the Sarbanes-Oxley Act. Section 404(c) provides that Section 404(b) shall not apply with respect to any audit report prepared for an issuer that is neither a large accelerated filer nor an accelerated filer.

On September 15, 2010, the Commission amended its rules to conform them to the new Section 404(c).<sup>50</sup> Prior to enactment of the Dodd-Frank Act, non-accelerated filers would have been required, under existing Commission rules, to include an auditor attestation report on ICFR in the annual report filed with the Commission for fiscal years ending on or after June 15, 2010.

#### **15. PCAOB Small Business Forums**

Since 2004, the PCAOB has been holding forums throughout the year to share information about PCAOB activities with auditors operating in the small business community. Auditors working with small businesses have an opportunity to share their concerns with Board members and staff. At the forums, SEC staff provides updates on recent SEC activities and observations about common financial reporting issues facing smaller public companies. Feedback received from these forums is used to assist the PCAOB in understanding and considering the unique needs and challenges of the small business community.

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<sup>48</sup> See Release No. 33-9072 (Oct. 13, 2009).

<sup>49</sup> *Id.*

<sup>50</sup> See Release No. 33-9142 (Sept. 15, 2010).

## 16. Tabular Summary of the Final Compliance Dates

The following table summarizes the final compliance dates for issuers considering the actions described above and enactment of the Dodd-Frank Act. Note that accelerated filers with a public float between \$75 and \$250 million, which are the subject of this study, have been required to comply with Section 404(b) since 2004 (or for foreign private issuers, since 2007), and they have now benefited from the 2007 reforms (the Commission’s Management Guidance and the PCAOB’s AS 5) for several years. In contrast, non-accelerated filers have never been required to comply with Section 404(b).

	<b>Filer Status</b>	<b>Management’s Report</b>	<b>Auditor’s Attestation</b>
<b>U.S. Issuer</b>	Large Accelerated Filer OR Accelerated Filer	Annual reports for fiscal years ending on or after November 15, 2004	Annual reports for fiscal years ending on or after November 15, 2004
	Non-accelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Exempt as a result of the Dodd-Frank Act
<b>Foreign Private Issuer</b>	Large Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Non-accelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Exempt as a result of the Dodd-Frank Act
<b>U.S. Issuer or Foreign Private Issuer</b>	IPO	Second Annual Report	Second Annual Report <sup>51</sup>

<sup>51</sup> The auditor attestation is not required in any period where the issuer does not meet the definition of an accelerated filer or large accelerated filer.

## II. Analysis of the Issuers Subject to this Study

The Staff analyzed certain characteristics of issuers in the studied range, including past costs of compliance with Section 404(b). Specifically, we identified an illustrative population of issuers as of December 31, 2009 as a proxy for those in the studied range. We then obtained and analyzed data about the issuers in the illustrative population, including: (1) size in terms of assets and revenues; (2) industries; (3) locations; (4) audit fees and scalability; (5) restatement rates; and (6) reported material weaknesses in ICFR. In addition to conducting an analysis of the characteristics of the issuers in the 2009 illustrative population, we also separately conducted an analysis of how the composition of issuers within a \$75-\$250 million range changed from 2005-2009.

The purpose of these analyses were to assist with the development of potential recommendations specific to any unique circumstances of the issuers subject to this study, rather than to identify the exact listing of issuers as of any point in time that could be affected by any future actions resulting from the implementation of particular recommendations. The Staff also sought to understand the existing investor protections relating to these issuers, particularly those protections provided by Section 404(b).

The findings of the analysis of the illustrative population demonstrates that the issuers in the studied range differ substantially from non-accelerated filers taken as a whole, which are already exempt from Section 404(b), in terms of the characteristics noted above. The Staff recognizes, as would be the case with establishing any numeric thresholds, that issuers at the lower end of the \$75-\$250 million range within the illustrative population could be more likely to have characteristics more similar to non-accelerated filers (*i.e.*, issuers that are just under or just over the \$75 million threshold are likely to have similar characteristics to one another). Importantly, however, the Staff's analysis of the population over time demonstrated that issuers frequently enter and exit this band of public float, such that the composition changes greatly from year to year. As discussed further in Section VI, based on the Staff's analysis, there generally do not appear to be unique characteristics in the illustrative population that would suggest sufficient reasons for differentiating them from accelerated filers taken as a whole, including with respect to compliance with Section 404(b).

To understand whether any possible recommendations may encourage companies to list IPOs in the United States, the Staff analyzed the characteristics of global IPOs with respect to

those likely to be in the range of issuers subject to this study. The Staff's analysis shows that the United States has not lost U.S.-based companies filing IPOs to foreign markets for the range of issuers that would likely be in the range of issuers that are the subject of this study. In addition, U.S. markets have experienced a decline in overall share of the world-wide IPO market beginning in 2001. While this decline in market share could be attributed to, among other things, additional regulations imposed in U.S. markets after 2001, as discussed below, the study produced no conclusive evidence linking the requirements of Section 404(b) to IPO activity.

#### **A. Population Size Over Time**

The number of issuers with public float between \$75 and \$250 million changes over time due to fluctuations in public float, new issuers entering the reporting system, and issuers exiting the reporting system. The table below shows the number of issuers at December 31 for 2005-2009, with \$75-\$250 million of "free float" capitalization as determined by Thomson Datastream.<sup>52</sup> Within each year, the Staff then determined the number of those issuers that reported as accelerated filers and large accelerated filers during that period by ascertaining each issuer's self-reported filing status in its annual report.<sup>53</sup>

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<sup>52</sup> Free float capitalization is defined by Thomson Datastream as the market value of shares available to ordinary (*i.e.*, not strategic) investors. The Staff used free float capitalization as a proxy for public float because an exact measure of public float as reported annually by issuers was not available for the dates the Staff analyzed. Data on free float capitalization was available for all periods studied and was the measure used to define public float in the Staff's 2009 study described in Section III of this study. Free float capitalization excludes certain categories of shares that, if applicable, would be considered in calculating public float. However, in light of the use of free float capitalization as a proxy for public float, the Staff also analyzed the 2009 data using a proxy for public float that added back certain strategic holdings excluded from free float capitalization that were likely not held by the issuers' affiliates (the "modified free float population"). Such analysis of issuers in the modified free float population did not result in any materially different conclusions compared to the characteristics of the 2009 illustrative population as defined by free float capitalization.

<sup>53</sup> Sources: EDGAR and Audit Analytics. A proxy for the number of accelerated filers in the population is the number of issuers that filed an auditor attestation on ICFR, even though they may not have checked a filing status box on the Form 10-K. The population of issuers with an auditor attestation on ICFR includes a small number of non-accelerated filers that voluntarily obtained the attestation.

The larger number of issuers in the table that self-reported as large accelerated filers in 2008 may result from the fact that filing status is measured as of the issuer's most recently completed fiscal second quarter, and the measurement of public float for purposes of this analysis was as of December 31. In 2008, there was a broad and significant decline in equity markets, with the S&P 500 dropping 38.5% in that year, and dropping 29.4% from June 30 (when a significant number of issuers measure their public float for determining filing status) to December 31. Source: Standard & Poor's. Large accelerated filers may also be in the illustrative population if free float capitalization is substantially different from actual public float as calculated for the issuer's most recently completed second quarter.



Year	2005	2006	2007	2008	2009
Issuers with free float capitalization of \$75-\$250 million at December 31	1,016	1,010	1,096	911	967
Those reporting as accelerated filers **	*	634	827	708	766
Those reporting as large accelerated filers **	*	16	24	83	2
Those with auditor attestation on ICFR	756	735	867	826	818

\* Data not available

\*\* Filing status as self-reported by issuers in their annual reports. Issuers with public float of \$75-\$250 million as of December 31 of a given year may not have been accelerated filers for that year if their public float as of the most recently completed second quarter was less than \$75 million or more than \$700 million. Further, newly public issuers are not considered accelerated filers until their second annual report.

Using this data, approximately 2,300 unique issuers had a free float capitalization between \$75 and \$250 million at December 31 for at least one of the years from 2005-2009.<sup>54</sup> However, only approximately 5% met the \$75-\$250 million float criterion for all five years.<sup>55</sup> Issuers entered and exited the list due to growth and contraction in public float, mergers, and securities registration termination (including for bankruptcy). Additionally, of the approximately 2,300 issuers, approximately 40% appeared only once in the five-year period.<sup>56</sup>

## **B. 2009 Illustrative Population**

For purposes of analyzing the demographics of issuers that are the subject of this study, the Staff identified a population of issuers with a free float capitalization of \$75-\$250 million at December 31, 2009 as reported by Thomson Datastream.<sup>57</sup> A reference point of December 31, 2009 was chosen because this is the most recent year where full information about audit fees, management and auditor ICFR assessments, and other matters was available as of the writing of this study. The Staff analyzed these matters to ascertain the characteristics of the illustrative population and to compare such characteristics to those of all accelerated filers taken as a whole and to those of all non-accelerated filers taken as a whole that filed an annual report with the

<sup>54</sup> Source: Thomson Datastream.

<sup>55</sup> Source: Thomson Datastream.

<sup>56</sup> Source: Thomson Datastream.

<sup>57</sup> This includes any issuer with a fiscal year that ended in 2009, not just issuers with a fiscal year end of December 31, 2009. In addition, because the Staff used free float capitalization from Thomson Datastream, the float amount could differ from the amount in the issuer's Form 10-K or 20-F filed with the Commission, which is calculated as of the last day of the issuer's most recently completed second quarter. See note 52 regarding why the Staff used free float capitalization as a proxy for those in the standard range for this portion of the study.

Commission on Form 10-K or 20-F for fiscal years ending anytime in 2009. The Staff used such information to facilitate the development of potential recommendations for reducing the compliance burden among these issuers while maintaining investor protections.

There were about 1,000 issuers in the 2009 illustrative population. Approximately 80% of the issuers reported in EDGAR as accelerated filers in 2009 (and would have had to comply with Section 404(b) for that year), and approximately 20% reported in EDGAR as non-accelerated filers in 2009 because the public float reported for the most recently completed second fiscal quarter may have been less than \$75 million or the issuer may not have otherwise met the definition of an accelerated filer.<sup>58</sup> Two issuers in the illustrative population reported as large accelerated filers in 2009.<sup>59</sup>

The Staff also evaluated the distribution of issuers overall by filing status. According to EDGAR, there were 9,092 unique issuers<sup>60</sup> that filed annual reports with the Commission on Forms 10-K or 20-F for fiscal years ending anytime in 2009.<sup>61</sup> Issuers that reported as non-accelerated filers for 2009, which generally would be exempt from Section 404(b) if their filings

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<sup>58</sup> For example, the issuer may have been reporting for less than one year. Pursuant to the Commission's rules implemented as a result of the Dodd-Frank Act, non-accelerated filers are now exempt from Section 404(b).

<sup>59</sup> Such issuers would be part of the illustrative population if public float fell below \$250 million from the most recently completed second quarter to December 31, 2009. Large accelerated filers may also be in the illustrative population if free float capitalization is substantially different from actual public float as calculated for the issuer's most recently completed second quarter.

<sup>60</sup> The number of unique issuers excludes investment companies, asset backed securities issuers that file annual reports on Form 10-K but are not required to file audited financial statements or management's assessment of internal control over financial reporting, issuers that file annual reports on Form 10-K but are not required to file audited financial statements or management's assessment of internal control over financial reporting because they are considered inactive under Rule 3-11 of Regulation S-X [17 CFR 210.3-11], certain Canadian issuers that file annual reports on Form 40-F, guarantors that are issuers for purposes of the federal securities laws but for which there is not separate reporting under Rule 3-10 of Regulation S-X [17 CFR 210.3-10], and certain financial institutions that report to other regulators pursuant to Section 12(i) of the Exchange Act. The number of unique filers also excludes filers that were delinquent with their 2009 annual report as of January 4, 2011.

<sup>61</sup> About 3% of issuers with public float between \$75-\$250 million at December 31, 2009 did not file an annual report for a year ended in 2009, either because their year-end fell in the first week of 2010 (and the previous year end was in 2008), they were late in filing the report but were still required to file, or they registered securities in a time frame where an annual report was not required in 2009. For these issuers, the filing status from the annual report closest to 2009 was used, or the filing status was assumed to be that as indicated by the public float at December 31, 2009 for those with recent registration statements.

statuses did not change for 2010,<sup>62</sup> made up 60.7% of all filers. The unique issuers reported the following statuses in the annual reports filed for 2009:

Large Accelerated Filer	1,670	18.4%
Accelerated Filer	1,875	20.6%
Non-Accelerated Filer	5,518	60.7%
Status Unknown or Not Indicated	29	0.3%
Total	9,092	

Comparing to the table above, the issuers in the illustrative population constitute approximately 10% of all issuers that filed an annual report with the Commission on Forms 10-K or 20-F for fiscal years ending any time in 2009. The issuers in the illustrative population constituted approximately 40% of all accelerated filers and approximately 4% of all non-accelerated filers.

The remainder of this Section II analyzes the illustrative population against all accelerated filers and non-accelerated filers. The primary purpose of this analysis is to compare the illustrative population to non-accelerated filers, and also to highlight the difference between all non-accelerated filers and all accelerated filers. However, because the illustrative population accounts for 40% of the all accelerated filers group, we do not base our findings on the analysis of differences between the illustrative population and all accelerated filers.

### **1. Size Information**

Figure 1 shows the percentage of issuers in the illustrative population, and all accelerated filers and all non-accelerated filers from the EDGAR population, within certain ranges of revenues.<sup>63</sup> The illustrative population has a much lower percentage of issuers with less than \$10 million in revenue than the non-accelerated filer population in EDGAR taken as a whole.

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<sup>62</sup> As discussed in more detail below, although non-accelerated filers generally are exempt from Section 404(b), some of these issuers comply voluntarily with Section 404(b) and include an auditor attestation on ICFR with their annual report filings to the Commission.

<sup>63</sup> Source: Audit Analytics. Issuers with no information reported to Audit Analytics for revenues are excluded, including foreign private issuers that do not report such information under Generally Accepted Accounting Principles in the United States (“U.S. GAAP”). Issuers reporting no revenues are included; most of these are development stage companies. Ten million and \$250 million were chosen for analysis, as these amounts of revenue were discussed as scaling thresholds for Section 404(b) in the final report of the ACSPC. We also used these amounts to present the assets of the illustrative population with those of accelerated filers and non-accelerated filers.

**Figure 1- Size of Selected Issuers by Revenue, 2009**

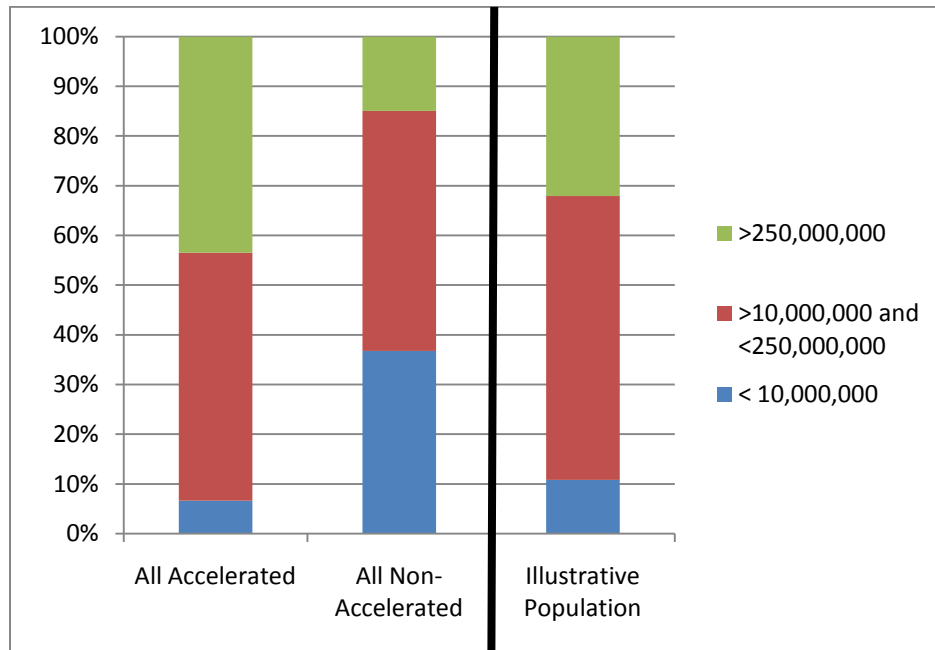
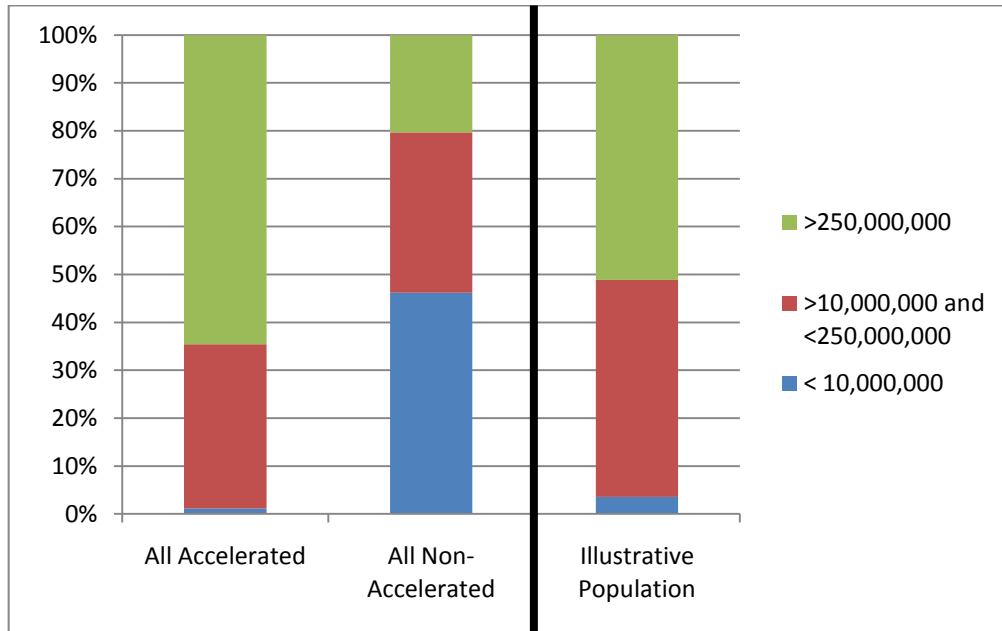


Figure 2 shows the percentage of issuers in the illustrative population, and all accelerated filers and all non-accelerated filers from the EDGAR population, within certain ranges of total assets.<sup>64</sup> The illustrative population has a much lower percentage of issuers with less than \$10 million in assets and a much higher proportion of issuers with more than \$250 million in assets than the non-accelerated filer population taken as a whole. The revenue and asset information suggests the illustrative population is composed of a higher percentage of issuers with substantial assets than those in the population of all non-accelerated filers.

<sup>64</sup> Source: Audit Analytics. Issuers with no information reported to Audit Analytics for assets are excluded, including foreign private issuers that do not report such information under U.S. GAAP.

**Figure 2- Size of Select Issuers by Assets, 2009**



## 2. Industry Information

Table 1 shows the industry classifications of the illustrative population and all accelerated filers and all non-accelerated filers from the EDGAR population. The industry classifications are derived from the reported SIC codes of registrants in EDGAR and mapped to the 49 industry categories devised by Fama and French.<sup>65</sup>

Issuers in the illustrative population represent almost all industries represented by other filer groups. Compared to all accelerated filers taken as a whole, issuers in the illustrative population were represented:

- more frequently in the medical equipment, pharmaceutical product, business services, and communication industries; and

<sup>65</sup> E.F. Fama & K.R. French, Industry Costs of Equity, 43 J. FIN. ECON. 153 (1997). Using the Fama-French categorization results in a manageable number of industry descriptions for purposes of this study, compared to over 440 unique SIC classifications used by issuers. The Fama-French classification system is used in many academic papers researching industry cost of equity and other industry topics in finance.

- less frequently in the banking and trading industries, although the banking industry was the largest individual industry group for both the illustrative population and the group of all accelerated filers from the EDGAR population.<sup>66</sup>

Because the group of accelerated filers is 40% comprised of the illustrative population, these differences, reported above, would be even more pronounced if the illustrative population were compared only to those accelerated filers not in the illustrative population.

Compared to all non-accelerated filers taken as a whole, issuers in the illustrative population were represented:

- more frequently in the medical equipment, pharmaceutical product, banking and insurance industries; and
- less frequently in the entertainment, mining, real estate and trading (*e.g.*, security and commodity brokering) industries.

While issuers in the illustrative population represent almost all industries represented by other filer groups, the Staff considered the effect of certain recommendations for reducing the compliance burden of Section 404(b) on financial institutions subject to the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”),<sup>67</sup> and on pharmaceutical and medical product issuers that have \$75-\$250 million in free float capitalization but little or no reported revenue.

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<sup>66</sup> As discussed above, financial institutions that do not report to the Commission under Section 12(i) of the Exchange Act are not considered in the illustrative population nor in the entire population of accelerated filers or non-accelerated filers.

<sup>67</sup> P.L. 102-242, 105 Stat. 2236.

**Table 1- Fama-French Industry Classification, 2009**

	Illustrative Population		All Accelerated Filers		All Non-Accelerated		All Filers		
	N	%	N	%			N	%	
1 Agriculture	4	0.4%	11	0.6%		23	0.4%	35	0.4%
2 Food Products	12	1.2%	19	1.0%		69	1.3%	119	1.3%
3 Candy & Soda	1	0.1%	1	0.1%		7	0.1%	15	0.2%
4 Beer & Liquor	-	0.0%	2	0.1%		20	0.4%	32	0.4%
5 Tobacco Products	-	0.0%	1	0.1%		3	0.1%	9	0.1%
6 Recreation	4	0.4%	7	0.4%		36	0.7%	47	0.5%
7 Entertainment	8	0.8%	25	1.3%		121	2.2%	161	1.8%
8 Printing and Publishing	10	1.0%	13	0.7%		42	0.8%	66	0.7%
9 Consumer Goods	9	0.9%	20	1.1%		56	1.0%	94	1.0%
10 Apparel	6	0.6%	14	0.7%		40	0.7%	73	0.8%
11 Healthcare	16	1.7%	38	2.0%		61	1.1%	116	1.3%
12 Medical Equipment	43	4.4%	66	3.5%		156	2.8%	258	2.8%
13 Pharmaceutical Products	86	8.9%	135	7.2%		266	4.8%	466	5.1%
14 Chemicals	17	1.8%	23	1.2%		128	2.3%	186	2.0%
15 Rubber and Plastic Products	4	0.4%	12	0.6%		43	0.8%	60	0.7%
16 Textiles	1	0.1%	3	0.2%		11	0.2%	16	0.2%
17 Construction Materials	12	1.2%	21	1.1%		62	1.1%	108	1.2%
18 Construction	11	1.1%	22	1.2%		46	0.8%	90	1.0%
19 Steel Works Etc.	10	1.0%	20	1.1%		26	0.5%	74	0.8%
20 Fabricated Products	1	0.1%	5	0.3%		10	0.2%	18	0.2%
21 Machinery	25	2.6%	43	2.3%		86	1.6%	182	2.0%
22 Electrical Equipment	9	0.9%	27	1.4%		58	1.1%	103	1.1%
23 Automobiles and Trucks	15	1.6%	26	1.4%		45	0.8%	91	1.0%
24 Aircraft	3	0.3%	10	0.5%		17	0.3%	37	0.4%
25 Shipbuilding, Railroad Equipment	5	0.5%	4	0.2%		2	0.0%	9	0.1%
26 Defense	2	0.2%	4	0.2%		5	0.1%	12	0.1%
27 Precious Metals	11	1.1%	11	0.6%		102	1.8%	121	1.3%
28 Non-Metallic and Industrial Metal Mining	6	0.6%	18	1.0%		291	5.3%	329	3.6%
29 Coal	5	0.5%	7	0.4%		11	0.2%	29	0.3%
30 Petroleum and Natural Gas	46	4.8%	79	4.2%		295	5.3%	468	5.1%
31 Utilities	16	1.7%	35	1.9%		96	1.7%	234	2.6%
32 Communication	30	3.1%	42	2.2%		168	3.0%	289	3.2%
33 Personal Services	12	1.2%	33	1.8%		66	1.2%	115	1.3%
34 Business Services	73	7.5%	126	6.7%		480	8.7%	689	7.6%
35 Computers	13	1.3%	27	1.4%		60	1.1%	116	1.3%
36 Computer Software	51	5.3%	99	5.3%		262	4.7%	441	4.9%
37 Electronic Equipment	68	7.0%	120	6.4%		219	4.0%	437	4.8%
38 Measuring and Control Equipment	15	1.6%	32	1.7%		74	1.3%	130	1.4%
39 Business Supplies	5	0.5%	15	0.8%		22	0.4%	52	0.6%
40 Shipping Containers	-	0.0%	2	0.1%		6	0.1%	17	0.2%
41 Transportation	32	3.3%	57	3.0%		74	1.3%	195	2.1%
42 Wholesale	27	2.8%	37	2.0%		160	2.9%	242	2.7%
43 Retail	34	3.5%	79	4.2%		165	3.0%	329	3.6%
44 Restaurants, Hotels, Motels	9	0.9%	27	1.4%		57	1.0%	106	1.2%
45 Banking	111	11.5%	236	12.6%		479	8.7%	822	9.0%
46 Insurance	26	2.7%	56	3.0%		67	1.2%	203	2.2%
47 Real Estate	9	0.9%	17	0.9%		235	4.3%	260	2.9%
48 Trading	50	5.2%	116	6.2%		548	9.9%	799	8.8%
49 Other	4	0.4%	16	0.9%		123	2.2%	154	1.7%
50 None Specified	-	0.0%	16	0.9%		19	0.3%	38	0.4%
	967		1,875			5,518		9,092	

### 3. Geographic Information

The Staff analyzed the geographic location of the illustrative population to ascertain if there were any particular characteristics that may be relevant to identifying potential methods for reducing the compliance burden. Approximately 90% of issuers in the illustrative population are based and incorporated in the United States and filed annual reports with the Commission on Form 10-K in 2009. This compares to approximately 80% of non-accelerated filers based and incorporated in the United States and approximately 90% of accelerated filers based and incorporated in the United States from the EDGAR population.<sup>68</sup>

Only approximately 4% of the illustrative population filed their annual reports on Form 20-F and therefore were considered foreign private issuers under the Exchange Act.<sup>69</sup> In contrast, approximately 8% of accelerated filers and approximately 5.5% of non-accelerated filers were foreign private issuers in the EDGAR population.

Foreign private issuers filing on Form 20-F have the option to prepare their financial statements in accordance with U.S. GAAP, International Financial Reporting Standards as issued by the International Accounting Standards Board (“IFRS”), or another basis of accounting (if accompanied by a reconciliation to U.S. GAAP).<sup>70</sup> Nearly three-quarters of foreign private issuers in the illustrative population used U.S. GAAP in preparing their financial statements, compared to approximately 65% of foreign private issuers that were accelerated filers and approximately 50% of foreign private issuers that were non-accelerated filers in the EDGAR population.<sup>71</sup>

The data demonstrate that issuers in the range contemplated by Section 989G(b) of the Dodd-Frank Act are predominantly U.S. issuers or issuers that otherwise file using U.S. GAAP. This indicates that any recommendation that would reduce the compliance burden on issuers that

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<sup>68</sup> Source: EDGAR. The percentages exclude issuers based in the U.S. that are foreign private issuers.

<sup>69</sup> Foreign private issuers are foreign issuers that do not have more than 50% of their outstanding voting securities directly or indirectly held by residents of the U.S. and either (1) the majority of their executives officers or directors are not U.S. citizens or residents, (2) more than 50% of their assets are located outside the U.S., or (3) their business is not administered principally in the U.S. *See* Exchange Act Rule 3b-4 [17 CFR 240.3b-4].

<sup>70</sup> *See* Rule 4-01(a)(2) of Regulation S-X [17 CFR 210.4-01(a)(2)].

<sup>71</sup> Source: EDGAR.



file using U.S. GAAP (which includes U.S. issuers) would have an effect on the vast majority of the illustrative population.

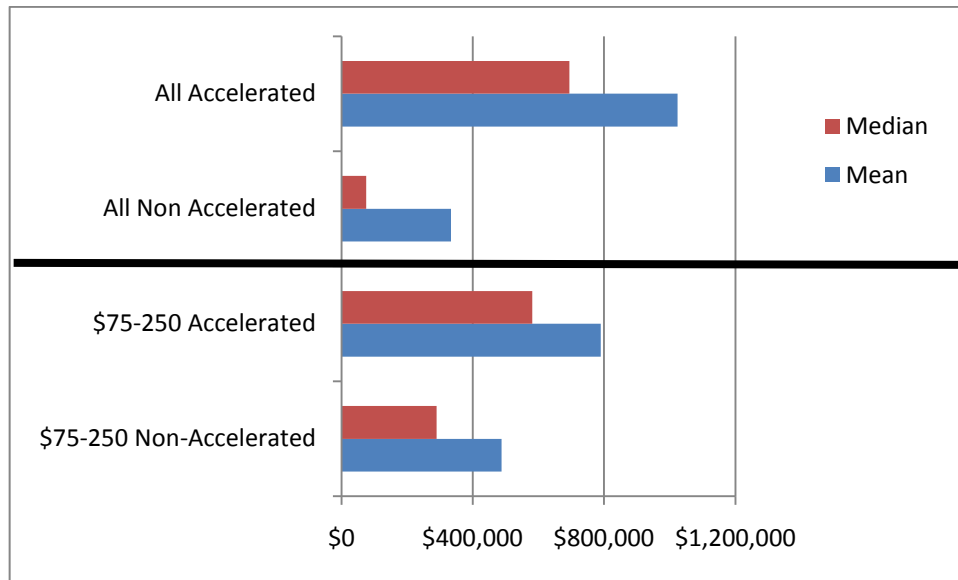
#### **4. Audit Fees**

Audit fees are one component of the total cost of compliance with Section 404(b). Audit fees comprise costs relating to the financial statement audit and to the auditor's attestation on ICFR. The Staff analyzed audit fees to assess the current compliance burden on issuers for the audit component of total Section 404(b) cost and to evaluate the trend in such fees over time, including since the 2007 reforms that were intended to reduce compliance burden. To analyze total audit fees, we separated the illustrative population into those reporting as non-accelerated filers and those reporting as accelerated filers, because the issuers that were accelerated filers were already subject to Section 404(b), while the non-accelerated filers were not. The audit fees of accelerated filers include fees relating to the auditor attestation under Section 404(b), while audit fees for non-accelerated filers do not include such fees unless the issuer voluntarily elected to have the auditor attestation.

The mean and median audit fees for issuers in the illustrative population that reported as non-accelerated filers were significantly higher than mean and median fees for all non-accelerated filers from the EDGAR population. The mean and median audit fees for those in the illustrative population that reported as accelerated filers were lower than the mean and median fees for all accelerated filers from the EDGAR population. Because the group of accelerated filers is 40% comprised of the illustrative population, these differences, reported above, would be even more pronounced if the illustrative population were compared only to those accelerated filers not in the illustrative population.

These findings demonstrate that audit fees were positively correlated with float, as the population of all accelerated filers includes those issuers with public float greater than \$250 million. Figure 3 shows the mean and median audit fees for issuers in the illustrative population compared to other issuers with the same filing status from the EDGAR population.

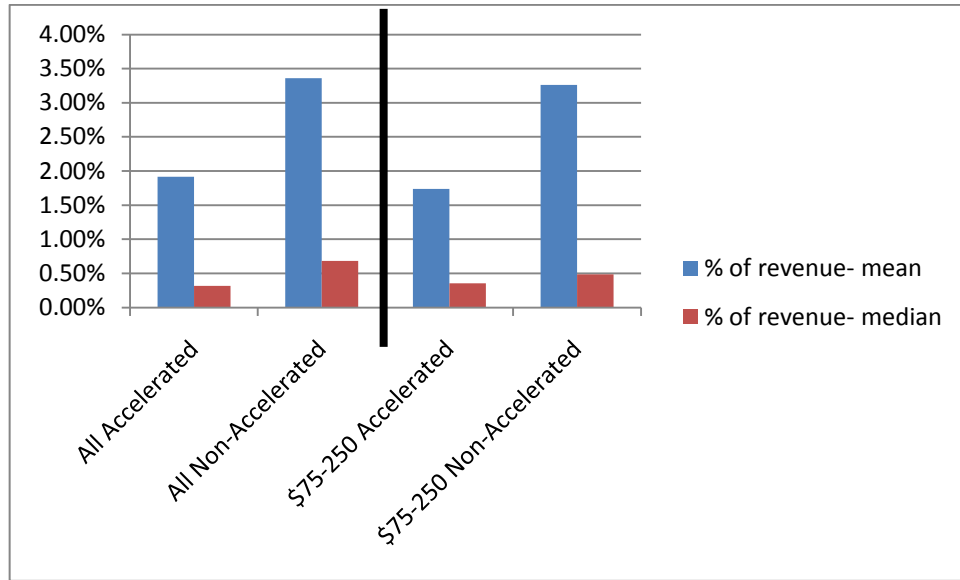
Figure 3- Audit Fees of Select Issuers, 2009



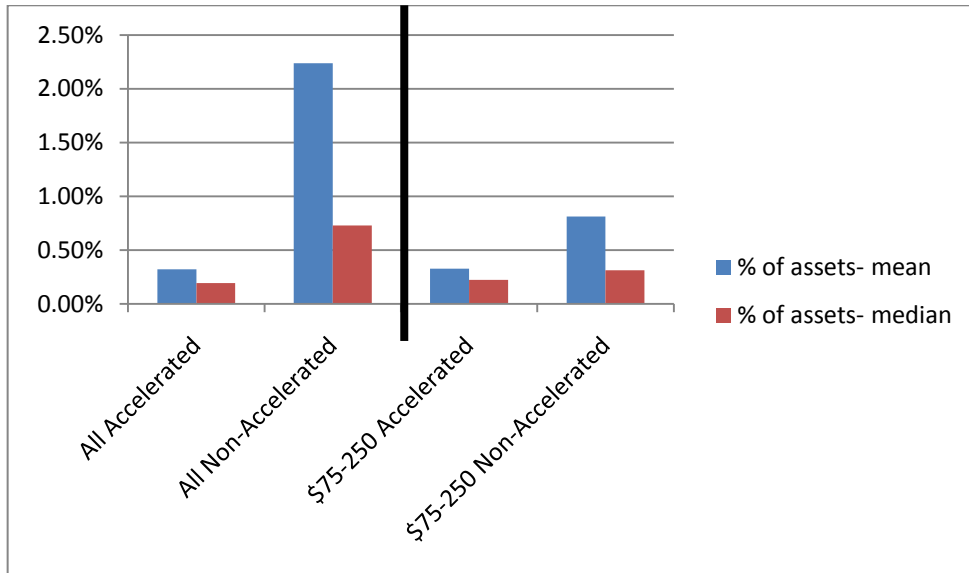
Figures 4 and 5 show the mean and median audit fees as a percentage of revenues and assets, respectively, for issuers in the illustrative population and for all accelerated filers and all non-accelerated filers in the EDGAR population.<sup>72</sup> As shown in Figures 4 and 5, the mean and median of audit fees as a percentage of revenue and of assets for accelerated filers in the illustrative population were similar to those of all accelerated filers (which, as noted above, includes a substantial portion of the illustrative population) and less than those of all non-accelerated filers in the EDGAR population. This demonstrates that the scalability of audits for accelerated filers in the illustrative population is similar to that of all accelerated filers; that is, those in the illustrative population incurred audit fees as a percentage of revenue and assets that were similar to the percentages incurred for all accelerated filers taken as a whole. The non-accelerated filers in the illustrative population incurred similar fees as a percentage of revenues compared to all non-accelerated filers taken as a whole in the EDGAR population, but the issuers in the illustrative population and in the overall non-accelerated filer population are not required to comply with Section 404(b).

<sup>72</sup> Source: Audit Analytics. In calculating the mean audit fees as a percentage of both revenue and assets, issuers in all categories with less than \$100,000 in either revenue and assets are excluded. As a result, some of these issuers have audit fees as a percentage of revenue and assets that are over 100,000%. Such issuers are not excluded from the calculation of the medians.

**Figure 4- Audit Fees of Select Issuers as Percentage of Revenue, 2009**



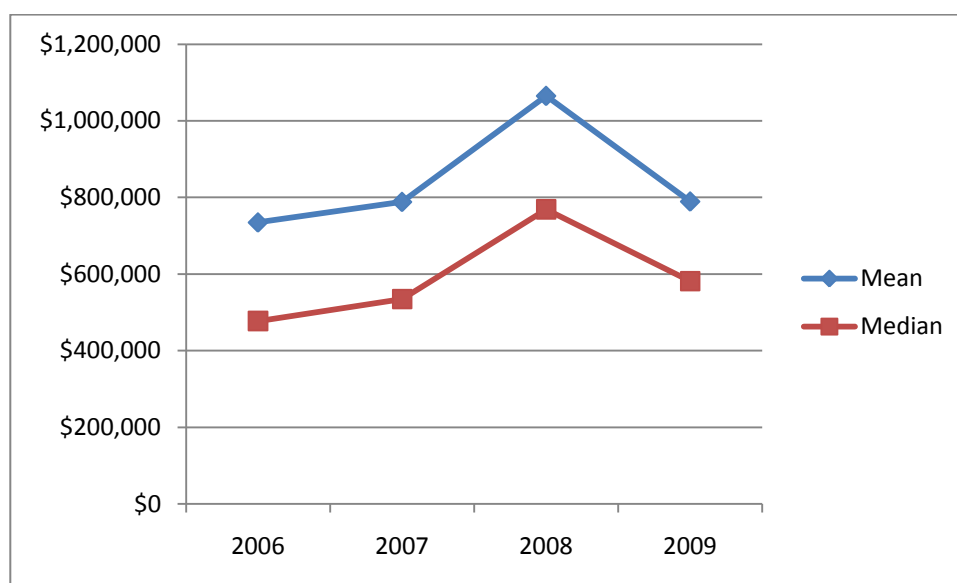
**Figure 5- Audit Fees of Select Issuers as Percentage of Assets, 2009**



The Staff separately analyzed the mean and median audit fees for 2006-2009 of issuers identified in Section II.A. that reported as an accelerated filer or large accelerated filer. As shown in Figure 6, the overall trend from 2006-2009 is a modest increase in the mean and median audit fees. The increase could be caused by a number of factors, including general fee inflation, different characteristics of the issuers reporting in each of the periods, and changes in audit risk. As discussed above, the reduction in equity values across public markets in 2008

resulted in many issuers dropping below \$250 million in free float capitalization, although some of these issuers were large by other measures, such as assets or revenues. Many of these issuers possess characteristics such as financial reporting complexity and geographical diversity that may have resulted in mean and median audit fees that were higher in 2008 compared to other years, as some of these issuers likely did not have \$75-\$250 million in free float capitalization before or after 2008.

**Figure 6- Mean and Median Audit Fees for Accelerated Filers and Large Accelerated Filers, 2006-2009**



## 5. Restatements

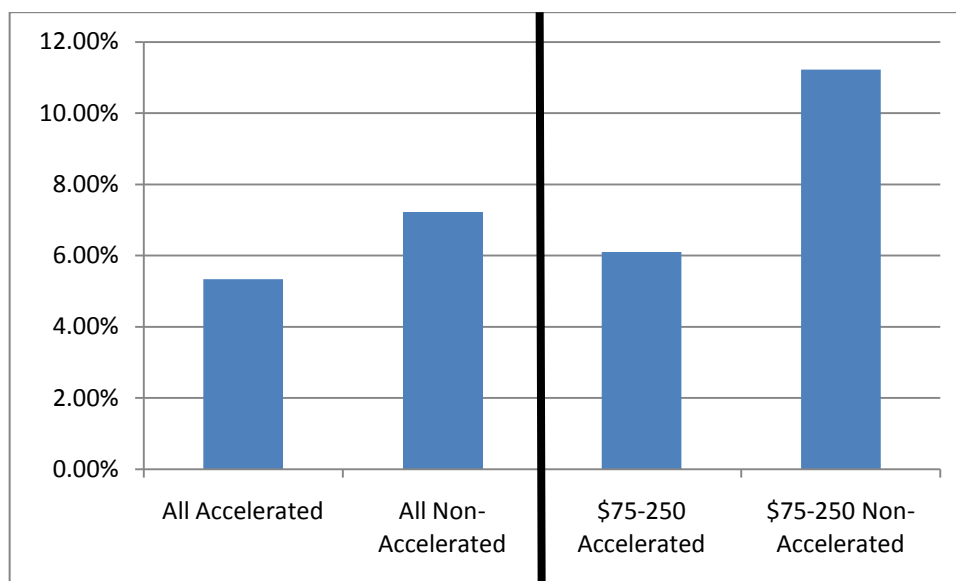
The Staff analyzed restatement data to determine if the illustrative population has unique characteristics that indicate a particular need for the investor protections provided by Section 404(b). To analyze restatement rates in the illustrative population, we separated it into those reporting as non-accelerated filers and those reporting as accelerated or large accelerated filers because the issuers that are accelerated filers are already subject to Section 404(b), while the non-accelerated filers are not. Figure 7 shows the restatement rates for restatement periods ending anytime in 2009 for issuers in the illustrative population and for all accelerated filers and all non-accelerated filers in the EDGAR population.<sup>73</sup> The data show higher restatement rates in

<sup>73</sup> Source: Audit Analytics. The table counts incidents of restatement of 2009 periods by issuers, not by number of restatements. Issuers with multiple restatements of 2009 periods are only counted once. In addition, the

the illustrative population. As noted previously, because both comparison groups contain the illustrative population, these differences would be even more pronounced if the illustrative population was removed from the comparison groups. This suggests that issuers in the illustrative population may benefit from the auditor focusing on ICFR to reduce such restatements.

Issuers with a requirement to have an auditor attestation on ICFR in 2009 (*e.g.*, all accelerated filers in the EDGAR population and accelerated filers in the illustrative population) generally had a lower rate of restatement than issuers that did not have such a requirement. These findings suggest that Section 404(b) may contribute to valuable investor protections. Approximately 84% of the restatements in the illustrative population were caused by misapplication of GAAP, compared to approximately 81% for all accelerated filers and approximately 94% for all non-accelerated filers in the EDGAR population.<sup>74</sup>

**Figure 7- Restatement Rates for Select Issuers, 2009**



restatements reported may have occurred after 2009. The data for this table is the number of restatements relating to 2009 periods reported as of January 10, 2011. As discussed in note 52 above, the Staff also analyzed results using a modified free float population. For restatement rates, the Staff notes that the modified free float population did not result in a significantly different restatement rate for those reporting as accelerated filers, but would result in a reduction in the restatement rate for non-accelerated filers from approximately 11% as reported in Figure 7 to approximately 8%.

<sup>74</sup> Source: Audit Analytics.

## 6. Management ICFR Assessment

The Staff analyzed the management ICFR reports of issuers in the illustrative population to assess whether the nature of the material weaknesses in this population may be relevant to identifying potential methods for reducing the compliance burden. Of those in the illustrative population with a management report on ICFR, approximately 7% reported ineffective ICFR.<sup>75</sup> For all accelerated filers in the EDGAR population with a management report on ICFR, approximately 4.5% reported ineffective ICFR. For all non-accelerated filers in the EDGAR population with a management report on ICFR, approximately 28% reported ineffective ICFR.<sup>76</sup>

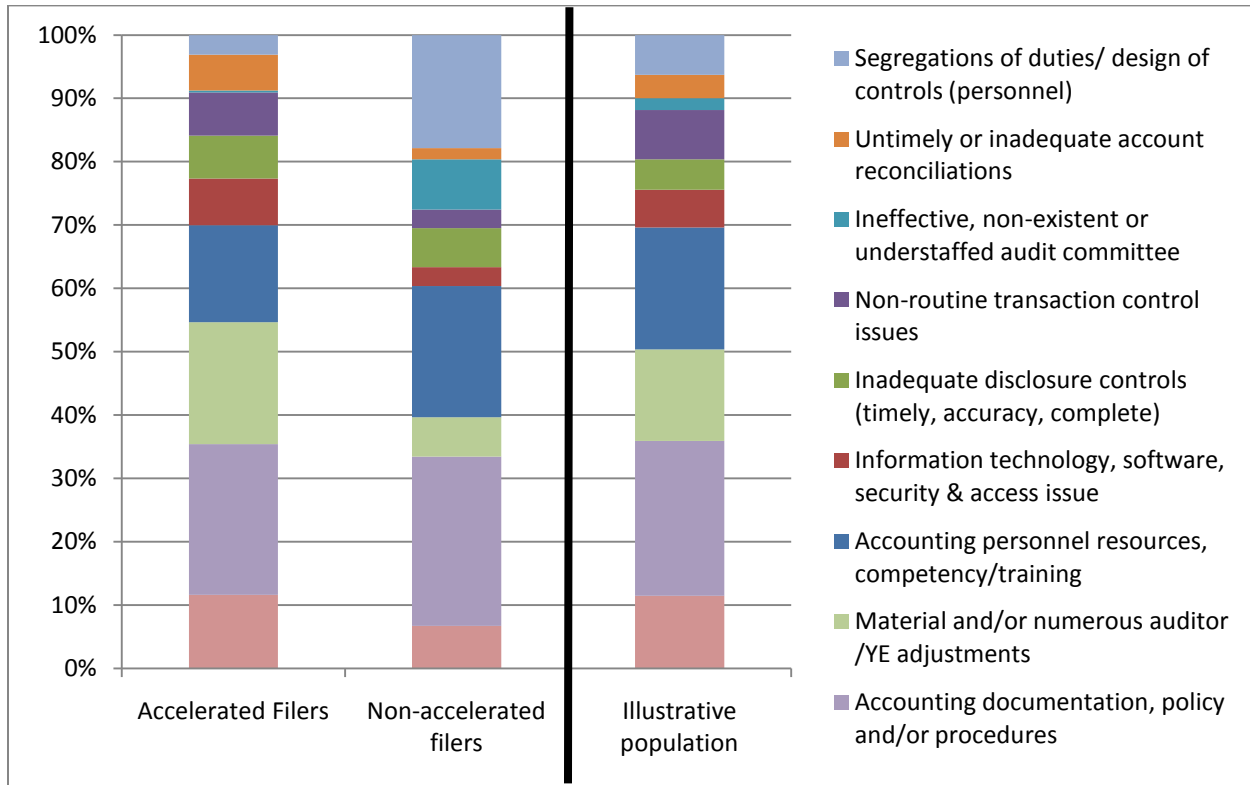
Of those with ineffective ICFR as determined by management, Figure 8 below shows the percentages of material weaknesses by category. For 2009, all non-accelerated filers had disproportionately more material weaknesses relating to segregation of duties and to ineffective audit committees than accelerated filers. For 2009, non-accelerated filers also had disproportionately fewer material weaknesses relating to material year-end adjustments, account reconciliations, and non-routine transactions than accelerated filers. The relationship of the illustrative population to all non-accelerated filers in the EDGAR population yields similar differences. This suggests that the control environment for issuers in the illustrative population, which the auditor tests for operating effectiveness, was similar to that of accelerated filers taken as a whole in 2009. As to the larger proportion of non-accelerated filers with material weaknesses related to segregation of duties, non-accelerated filers as a group tend to be more centralized and less complex than accelerated filers, but sometimes have less sophisticated governance and fewer personnel to which to assign duties.

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<sup>75</sup> Source: Audit Analytics. The sample does not include restated management ICFR disclosures and excludes issuers that were required to file the management report but had not yet done so for 2009 as well as newly public issuers that were not yet required to provide a management report on ICFR.

<sup>76</sup> The ineffective ICFR rate in management reports for the modified free float population was approximately 11%, compared to approximately 7% for the illustrative population.

**Figure 8- Categories of Material Weaknesses Identified by Management, 2009**



## 7. Auditor Attestation on ICFR

Of the issuers in the illustrative population, approximately 85% included an auditor attestation on ICFR for 2009.<sup>77</sup> This includes 60 non-accelerated filers that voluntarily included such an attestation. Of those in the illustrative population with an ICFR report from their auditor, approximately 4% had ineffective ICFR as reported by the auditor before considering any restatement of the ICFR opinion.<sup>78</sup> The rate is lower than the ineffective rate for management reports in the illustrative population given the illustrative population includes issuers that were not required to have an auditor’s attestation and that more frequently have segregation of duties deficiencies that prevent management from asserting that the issuer has

<sup>77</sup> Source: Audit Analytics. The sample does not include restated ICFR opinions and excludes accelerated filers that were required to file the auditor’s attestation but had not yet done so for 2009, as well as issuers with recent registration statements that do not need to file such reports.

<sup>78</sup> The ineffective ICFR rate in auditor reports for the modified free float population was approximately 6%, compared to approximately 4% for the illustrative population.

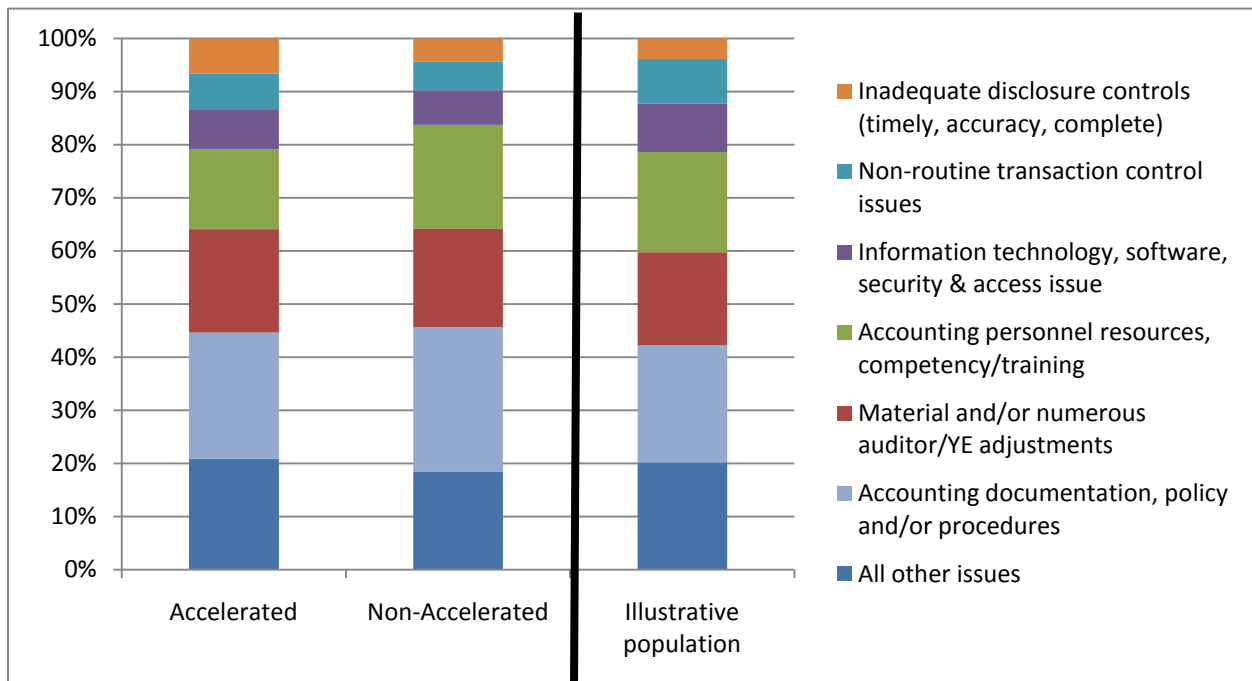
effective ICFR. These issuers do not have an auditor’s attestation on ICFR but are required to have a management assessment on ICFR.

For all accelerated filers in the EDGAR population, nearly 99% included an auditor attestation on ICFR, of which approximately 4.5% had ineffective ICFR. For non-accelerated filers in the EDGAR group, approximately 8.2% included an auditor report on ICFR, of which approximately 6% had ineffective ICFR according to their auditors.

The relatively low rate of ineffective ICFR in all three groups may suggest that an auditor attestation on ICFR contributes positively to the maintenance of effective controls and therefore provides a valuable investor protection. As noted previously, the non-accelerated filers were not required to comply with Section 404(b), but may have done so voluntarily.

Figure 9 below shows that the percentages of material weaknesses by category for issuers in the illustrative population, all accelerated filers, and all non-accelerated filers complying voluntarily with Section 404(b). The percentage by category did not differ substantially among these groups.

**Figure 9- Categories of Material Weaknesses Identified by Auditor, 2009**





### C. New Public Listings

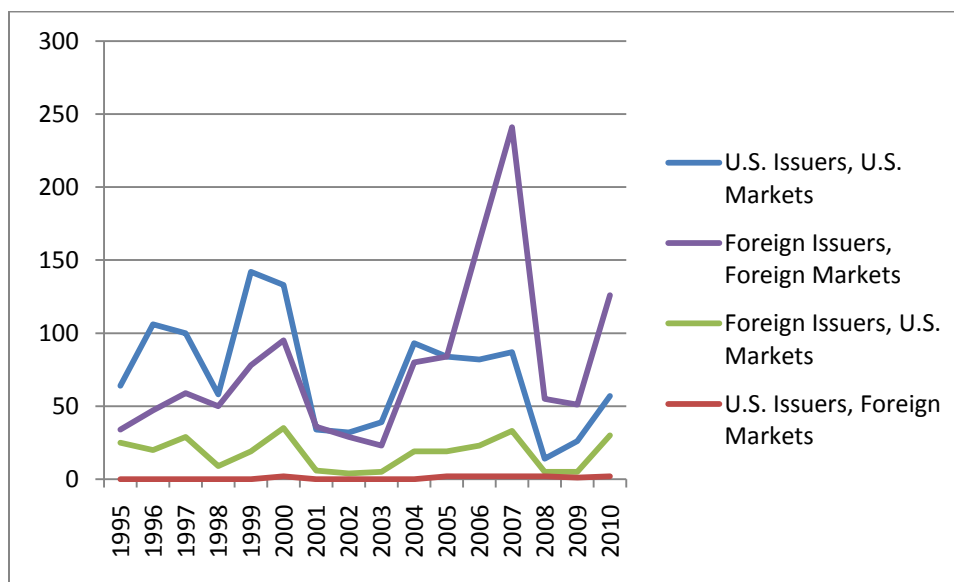
To understand whether any possible recommendations may encourage companies to list IPOs in the United States, the Staff analyzed the characteristics of global IPOs with respect to those likely to be in the range of issuers subject to this study. Although the U.S. IPO market over time has recovered from the 2007 levels, it has not reached the 1999 levels (*i.e.*, we reviewed IPO activity over a range of years and noted that it was at a relatively low point during the financial crisis and has since recovered, but not to the peak for the range of years studied). The Staff's analysis shows that the United States has not lost U.S.-based companies filing IPOs to foreign markets for the range of issuers that would likely be in the \$75-\$250 million public float range after the IPO. However, the analysis does show that the U.S. markets' share of world-wide IPOs raising less than \$250 million has declined over the past five years and further shows a dramatic decline in the number of smaller IPOs since 1999. There is no conclusive evidence from the study linking the requirements of Section 404(b) to IPO activity. The Staff notes that the Commission has previously taken action to reduce the compliance burden for new issuers by not requiring the auditor attestation on ICFR for the IPO and the first annual report thereafter and that the population of smaller issuers has been the subject of many of the reforms related to Section 404.

Figure 10 shows the number of IPOs in the United States and abroad that raised between \$75 and \$250 million from 1995-2010.<sup>79</sup>

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<sup>79</sup> Source: Thomson Reuters SDC Platinum. Figure 10 excludes the IPOs of investment funds, as these funds are not required, under existing SEC rules, to have an auditor attestation on ICFR, regardless of the fund's size. Figure 10 also excludes IPOs for which the market location is not reported by Thomson.

**Figure 10- Number of new listings with proceeds of \$75-\$250 million, 1995-2010**



Although an issuer that raises between \$75 and \$250 million in an IPO will not necessarily be an accelerated filer when the issuer assesses its Section 404(b) compliance requirements,<sup>80</sup> this data provides useful information in determining the relative mix of markets<sup>81</sup> where companies that have an IPO will potentially have a public float between \$75 and \$250 million. Less than five U.S.-based companies that raised \$75-\$250 million listed in a foreign market in an IPO in each year from 2005-2010. This suggests that the United States has not lost a significant amount of offerings in the United States that raise \$75-\$250 million to foreign jurisdictions due to Section 404(b), which was in effect for this entire period, or for any other reason.

Both U.S. and foreign markets saw a significant plunge in new listings in the \$75-\$250 million range from 2007 to 2008, which coincided with the decline in equity markets worldwide in 2008 discussed above.<sup>82</sup> In this size range, 130 foreign IPOs occurred in foreign markets in

<sup>80</sup> Measures of amounts raised in Figure 10 are not necessarily the same as what will be measured as public float when an issuer is required to determine filing status. Assuming no other market movements, IPO proceeds would be presumed to equal public float on the day of the offering if the remaining common equity held before the offering was retained by affiliates. Newly public issuers do not need to comply with Section 404(b) until they file their second annual report with the Commission (assuming they meet the definition of an accelerated filer at that time).

<sup>81</sup> Markets include exchanges and over-the-counter bulletin board markets.

<sup>82</sup> Without regard to the \$75-\$250 million range, the percentage of U.S. issuers choosing to list only on foreign exchanges increased from 8.6% in 2007 to 20% in 2008. See Letter from Congressman Darrell E. Issa, Chairman, Committee on Oversight and Government Reform, U.S. House of Representatives, to Mary L. Schapiro, Chairman,

2010, compared to 57 U.S. issuers that listed IPOs in U.S. markets in that year. Also in this size range, 30 foreign issuers listed IPOs in the United States in 2010. All jurisdictions saw increased listings since 2008 in this size range. Foreign listings in the United States have rebounded to levels of 2007, while foreign listings in foreign markets have increased since 2008 but are still significantly below 2007 levels.<sup>83</sup> The table does, however, show that U.S. markets have experienced a decline in overall share of the world-wide IPO market beginning in 2001.

Figures 11 and 12 show that the number of IPOs in U.S. markets with proceeds less than \$75 and \$50 million, respectively, has declined dramatically since 1999. While this data does not necessarily indicate that the issuer would be a non-accelerated filer when it first determines its filer status, it does indicate a decline in smaller IPOs for a population of issuers that has been the subject of many of the prior actions related to Section 404. This analysis is consistent with the view that there is no conclusive evidence linking Section 404(b) to the reduction in IPOs among smaller companies, because such companies were never the subject of such requirements.<sup>84</sup>

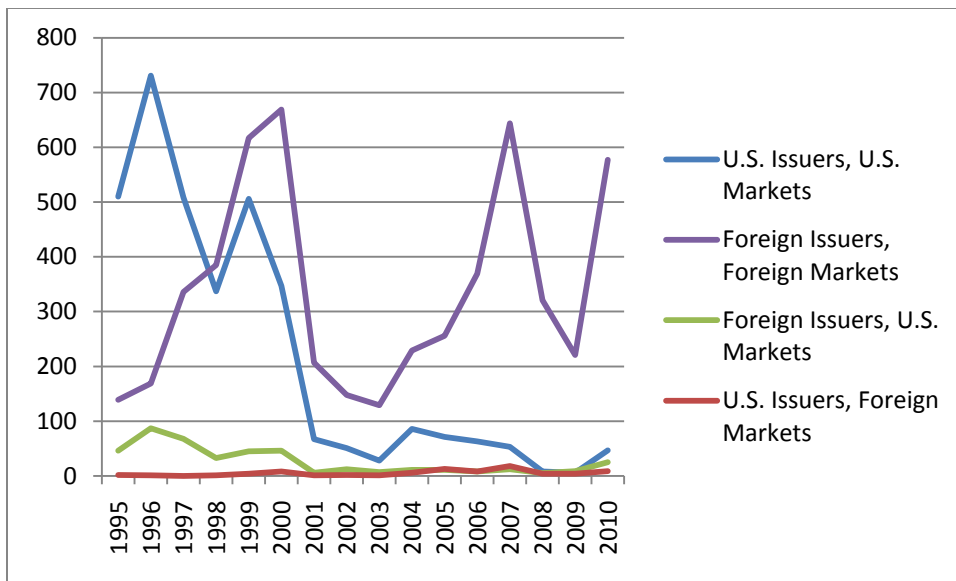
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U.S. Securities and Exchange Commission (Mar. 22, 2011). This may not be due to compliance costs alone, however, as the evidence shows a decline in the relative liquidity of the U.S. market attributable primarily to an increase in the liquidity of equity markets in other countries. See M. Halling, M. Pagano, O. Randl & J. Zechner, *Where is the Market? Evidence from Crosslistings in the U.S.*, REV. FIN. STUDIES 21, 725-61 (2008).

<sup>83</sup> According to Thomson Reuters SDC Platinum, the total number of new listings on AIM (domestic and international) for companies with proceeds of \$75-\$250 million were 4, 24, 38, 11, 3, and 6 for 2005, 2006, 2007, 2008, 2009, and 2010, respectively.

<sup>84</sup> The Staff recognizes that while the issuers in this range were never subject to Section 404(b), for most of the period between 2003 and 2010, the fact that compliance was simply deferred may have had an impact on eventual compliance costs. However, as noted in Figures 11 and 12, the trend in U.S. IPOs in this range began to significantly decrease well before 2003, when the Commission adopted rules that would have subjected such issuers to Section 404(b) but for the repeated compliance deferrals.

**Figure 11- Number of new listings with proceeds of less than \$75 million, 1995-2010**



**Figure 12- Number of new listings with proceeds of less than \$50 million, 1995-2010**

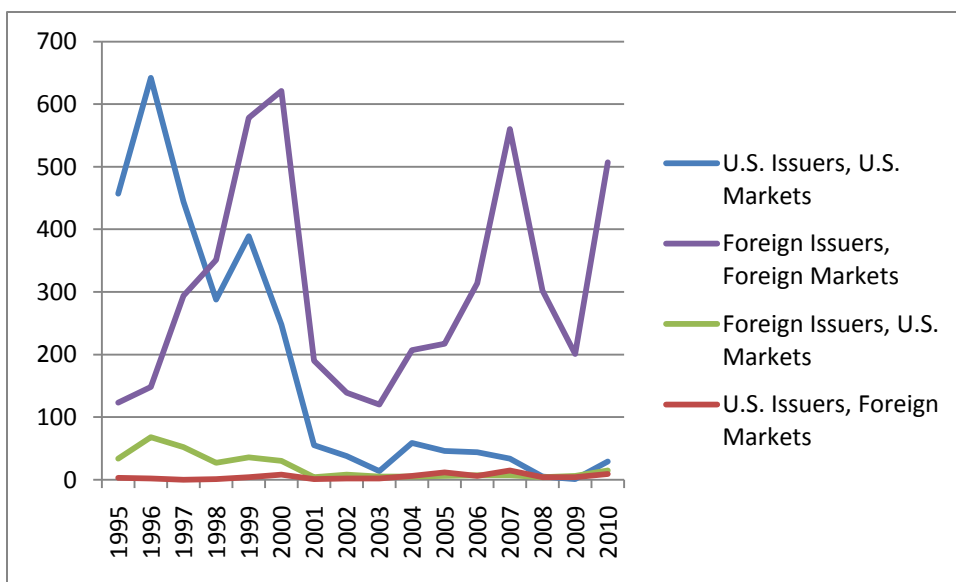
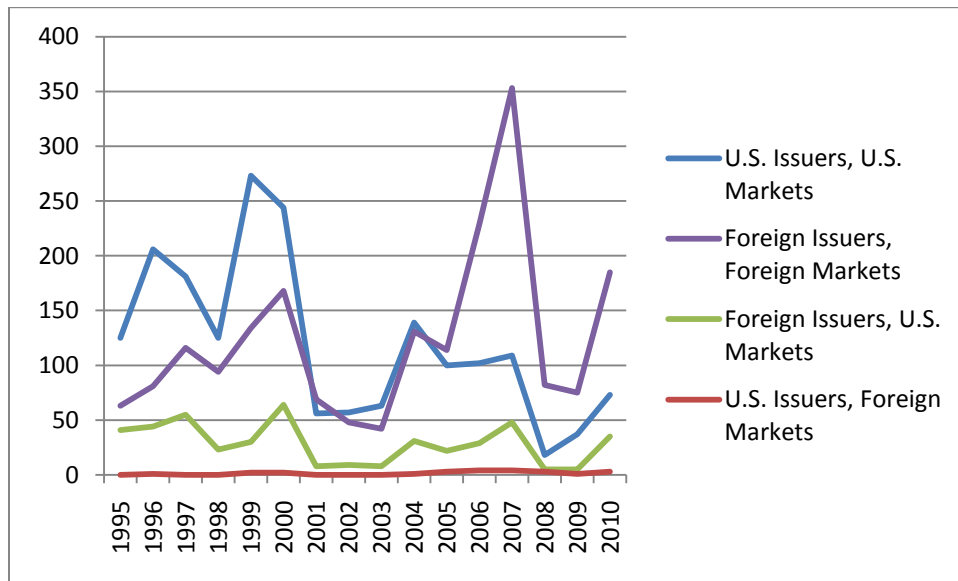


Figure 13 shows the number of IPOs in the United States and abroad that raised between \$50 and \$500 million from 1995-2010.<sup>85</sup> There is a similar trend in listings for this group compared to those raising between \$75 and \$250 million discussed above. This illustrates that our findings concerning listings in foreign jurisdictions would not have been materially different by contemplating this wider range of proceeds.

<sup>85</sup> Source: Thomson Reuters SDC Platinum.

**Figure 13- Number of new listings with proceeds of \$50-\$500 million, 1995-2010**



### III. Analysis of the 2009 SEC Staff Study on Section 404

This section of the study analyzes the data gathered from the SEC Staff's 2009 study on Section 404.<sup>86</sup> The Staff believes that an assessment of the self-reported views about the costs of compliance under Section 404(b) and the impact of the 2007 reforms is useful in our broader evaluation of ways to reduce the burden costs of Section 404(b). Specifically, the Staff endeavored to understand the extent to which the 2007 reforms had the intended effect of improving the implementation of Section 404, including the requirements of Section 404(b). This information, in conjunction with the general information about the characteristics of issuers in Section II, provided us with a starting point to consider new public input, existing academic research, and other information to determine whether there are additional ways to further reduce the compliance burden of Section 404(b) for the range of issuers identified in Section 989G(b) while maintaining investor protections.

In connection with this current study, data from the 2009 study the Staff determined to be most relevant for this study were partitioned into four groups based on public float<sup>87</sup> (< \$75 million, \$75-\$250 million, \$250-\$700 million, and > \$700 million) and then primarily examined to analyze the reported cost under Section 404(b) to determine the impact of the 2007 reforms (the Commission's Management Guidance and the PCAOB's AS 5) on Section 404(b) compliance costs. We reanalyzed the data in this manner because the 2009 study did not analyze the population of accelerated filers that had a public float between \$75 and \$250 million

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<sup>86</sup> See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, Office of Economic Analysis, September 2009, *available at* [http://www.sec.gov/news/studies/2009/sox-404\\_study.pdf](http://www.sec.gov/news/studies/2009/sox-404_study.pdf). The 2009 study was based on web-based survey responses from 3,138 corporate executives. The study also involved separate, in-depth interviews of a sample of 30 users of financial statements, including lenders, securities analysts, auditors, rating agencies, and other investors. The response rate to the web-based survey was 49% among all 404(b)-compliant companies and 55% among domestic 404(b)-compliant companies. Based on the survey data, the Staff determined that "the costs of Section 404 compliance decreased following the Commission's reforms introduced in 2007 and is expected to decrease further based on respondent's estimates for the fiscal year in progress at the time of the survey" and "the survey participants perceive the reforms to have been a significant catalyst for these changes." *Id.* at 96-7. In addition, from the perspective of the financial statement users involved, they generally regarded ICFR disclosures to be beneficial and indicated that Section 404(a) and Section 404(b) compliance has had a positive impact on their confidence in issuers' financial statements.

<sup>87</sup> Based on the 2009 study, size categories are determined by the issuer's market value of public float, which is "free float" capitalization as discussed in Section II (henceforth, "public float"), measured two quarters prior to the relevant fiscal year end date. SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 3. The market value of the issuer's public float was reported by Thomson Financial Datastream six months prior to the fiscal year-end – the day used to assess accelerated filer status. *Id.* at 28.

separately from other accelerated filers. We separated the \$75-\$700 million group from the 2009 study into two public float groups (\$75-\$250 million and \$250-\$700 million) to gain more insight about the population that is the subject of this study. We then reviewed issuers' views on:

- the cost of Section 404(b) compliance and its components by size and year relative to the 2007 reforms;
- the cost of Section 404 compliance by total assets, size and years of Section 404(b) compliance experience;
- the impact of the 2007 reforms on the costs of compliance; and
- the impact of AS 5 on the amount of time required to complete Section 404(b) audits.

As discussed in Section VI, the overall results based on the four public float groups reveal that compliance costs typically increased as issuer size increases, decreased as issuers gained compliance experience, and decreased after the 2007 reforms. Across all size categories, including the \$75-\$250 million range, compliance costs decreased steadily following the 2007 reforms. Issuers also reported important benefits associated with Section 404 compliance, including improvements in their internal control structure, financial reporting quality and ability to prevent and detect fraud. The results suggest that issuers have already significantly reduced the compliance costs burden of Section 404(b) and, as of the time of the 2009 survey, anticipate further reductions.

In addition, smaller (< \$75 million) issuers in the survey, which generally provided less favorable responses about the costs of compliance and 2007 reforms, have subsequently been exempted from Section 404(b). The results further show that issuers with a public float of \$75-\$250 million tended to be comparable with issuers with a public float of \$250-\$700 million, demonstrating that the \$75-\$250 million issuers more proportionately benefited from the reforms than the smaller (< \$75 million) issuers that are now exempted. Therefore, in light of the extensive nature of the 2007 reforms, including new auditing standards that were aligned with the new Management Guidance for issuers, the Staff believes that to meaningfully further reduce the compliance burden of Section 404(b), any additional reforms beyond those implemented in 2007 would have to be significant rather than marginal.<sup>88</sup> However, any change of such

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<sup>88</sup> See Section IV.B. of this study.

magnitude also would most likely adversely affect the investor protections provided by Section 404(b).

**A. Costs of Section 404(b) Compliance and its Components by Size and Year Relative to the 2007 Reforms**

Table 1 reveals mostly a downward trend in total Section 404 compliance costs that is independent of firm size.<sup>89</sup> The declines in costs for Section 404(b)-related audit fees and outside vendor costs between pre- and post-2007 reform years were statistically significant for the medium (\$75-\$250 million and \$250-\$700 million) and large (>\$700 million) issuers:

- For issuers with public float between \$75 and \$250 million, the average decline in audit fees (-13%) and outside vendor costs (-21.2%) was significant at the 10% level and 5% level, respectively.<sup>90</sup>
- For issuers with public float between \$250 and \$700 million, the average decline in audit fees (-24.2%) and outside vendor costs (-24.1%) was highly significant at the 1% level.
- For issuers with public float >\$700 million, the average decline in audit fees (-19.5%) was significant at the 5% level while the decline in outside vendor costs (-31%) was highly significant at 1% level.
- The drop in audit fees and outside vendor costs across time was not statistically significant for smaller (< \$75 million) issuers, which are now exempt from Section 404(b), and was mostly projected by these issuers themselves rather than realized.<sup>91</sup>

Further details about the total costs of compliance and its component costs across the four public float groups are discussed below. Specifically,

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<sup>89</sup> Table 1 reflects Table 9 in the 2009 study, partitioned into four groups based on public float (< \$75 million, \$75-\$250 million, \$250-\$700 million, and > \$700 million). *See* SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 46.

<sup>90</sup> A significance level “.01” or 1% means that there is a 99% (1-.01=.99) chance of the findings being true. A significance level of “.05” or 5% means that there is a 95% (1-.05=.95) chance of the findings being true. A significance level of “.10” or 10% means that there is a 90% (1-.10=.90) chance of the findings being true.

<sup>91</sup> As noted by the SEC Staff in the 2009 study, “compared to the medium and larger filers, smaller companies tend to have less experience with Section 404(b) compliance at the time of the survey. This might explain why the difference in costs across time is not significant for smaller companies and underscores the importance of controlling for companies’ compliance experience when drawing inferences about changes in the costs of compliance.” SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 45.



- The average total Section 404 compliance costs declined as follows:
  - 10.3% for smaller (< \$75 million) issuers;
  - 7% and 7.4% for medium (\$75-\$250 million and \$250-\$700 million, respectively) issuers; and
  - 20.9% for large (> \$700 million) issuers.
- Average Section 404(b) audit fees declined as follows:
  - 16.6% for smaller (< \$75 million) issuers;
  - 13% and 24.2% for medium (\$75-\$250 million and \$250-\$700 million, respectively) issuers; and
  - 19.5% for large (> \$700 million) issuers.
- Average outside vendor costs declined as follows:
  - 25.9% for smaller (< \$75 million) issuers;
  - 21.2% and 24.1% for medium (\$75-\$250 million and \$250-\$700 million, respectively) issuers; and
  - 31% for large (> \$700 million) issuers.
- Following the 2007 reforms, there also was a decrease in average internal labor costs and average non labor costs across all size categories, but these results were mostly insignificant, except for non labor costs for large (> \$700 million) issuers.

Further analysis of the data in Table 1 also generally reveals a decline in the post-2007 reform period in average Section 404(b) audit fees as a percentage of average total Section 404 compliance costs:<sup>92</sup>

- Pre-2007 reforms:
  - 40.4% for smaller (< \$75 million) issuers; and
  - 29.2%-34.5% for medium (\$75-\$250 million and \$250-\$700 million) and large (> \$700 million) issuers.
- Post-2007 reforms:
  - 37.5% for smaller (< \$75 million) issuers; and
  - 27.3%-28.2% for medium (\$75-\$250 million and \$250-\$700 million) and large (> \$700 million) issuers.

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<sup>92</sup> The percentages are calculated by dividing the mean value of “404(b) audit” costs by the mean value of “Total Section 404” costs reported in Table 1.

**Table 1 – Cost of Section 404 compliance by size and year relative to 2007 reforms for Section 404(b) companies**

This table reports summary statistics for the total cost of Section 404 compliance and its components for Section 404(b) compliant issuers reported by Audit Analytics in the relevant fiscal year (*Pre*, *Post*, and *Next*). *Pre* includes firm-fiscal year observations pre-dating November 15, 2007; *Post* includes all completed firm-fiscal year observations post-dating November 15, 2007; and *Next* includes all firm observations referring to the fiscal years in progress at the time of the survey. The earliest completed fiscal year end is January 8, 2007 and the latest reported fee is for the fiscal year ending December 31, 2009. In cases where issuers have two complete fiscal years in *Pre* (*Post*), we retain the fiscal year closest to the passage of the reform, *i.e.*, the last (first) fiscal year prior to (following) the November 15, 2007 date. This approach resulted in a reduction of the overall sample (firm-fiscal year observations) of less than 2% and it ensures that issuers are not double counted in any column. Panel A (B, C, D) is restricted to issuers with public float < \$75 million (\$75-\$250 million, \$250-\$700 million, > \$700 million) in the relevant fiscal year. The public float is from DataStream and measured as of six months prior to the fiscal year end. The earliest public float data is from July 8, 2006 and the latest data is from June 30, 2009. When survey participants responded “not applicable” for outside vendor costs or non-labor costs, the responses were coded as zero. Responses of “cannot estimate” were replaced with the mean of non-missing values conditional on the company assets. The last two columns report differences in means and medians. \*\*\*, \*\*, and \* indicate significance at a 1%, 5%, and 10% levels, respectively.

		Pre	Post	Next		%	%
					<i>Post-Pre</i>	<i>Post-Pre</i>	<i>Next-Post</i>
<b>Panel A: Public float &lt; \$75M</b>							
A. 404(b) audit	Mean	310,613	259,004	171,784	-51,609	-16.6%	-87,220**
	Med	200,000	157,500	116,750	-42,500	-21.3%	-40,750***
	N	63	99	162			
B. Outside vendor	Mean	194,429	144,093	98,555	-50,336	-25.9%	-45,538**
	Med	98,000	57,500	50,000	-40,500**	-41.3%**	-7,500
	N	76	120	205			
C. Internal labor	Mean	327,145	317,846	283,698	-9,300	-2.8%	-34,147
	Med	121,000	145,200	121,000	24,200	20%	-24,200
	N	61	98	167			
D. Non labor	Mean	55,873	40,882	41,745	-14,991	-26.8%	863
	Med	12,500	10,000	5,000	-2,500	-20%	-5,000
	N	76	117	200			
Total Section 404 (A+B+C+D)	Mean	769,266	690,219	581,176	-79,047	-10.3%	-109,043
	Med	579,277	439,460	365,900	-139,817	-24.1%	-73,560
	N	50	83	134			

**Table 1 – Cost of Section 404 compliance by size and year relative to 2007 reforms for Section 404(b) companies (cont'd)**

		Pre	Post	Next		%		%
					Post-Pre	Post-Pre	Next-Post	Next-Post
<b>Panel B: Public float \$75-\$250M</b>								
A. 404(b) audit	Mean	263,492	229,127	206,576	-34,365*	-13%*	-22,551	-9.8%
	Med	180,000	147,834	147,000	-32,166**	-17.9%**	-834	-0.6%
	N	364	398	365				
B. Outside vendor	Mean	189,701	149,432	97,174	-40,269**	-21.2%**	-52,258***	-35%***
	Med	75,000	60,000	40,000	-15,000**	-20%**	-20,000***	-33.3%***
	N	490	502	472				
C. Internal labor	Mean	429,642	397,460	388,806	-32,182	-7.5%	-8,654	-2.2%
	Med	242,000	217,800	211,750	-24,200	-10%	-6,050	-2.8%
	N	419	437	411				
D. Non labor	Mean	73,295	62,398	66,642	-10,897	-14.9%	4,244	6.8%
	Med	20,000	13,750	12,500	-6,250*	-31.3%*	-1,250	-9.1%
	N	485	492	461				
Total Section 404 (A+B+C+D)	Mean	903,725	840,276	728,701	-63,449	-7%	-111,575	-13.3%
	Med	664,000	574,527	510,392	-89,473**	-13.5%**	-64,135	-11.2%
	N	315	344	314				
<b>Panel C: Public float \$250-\$700M</b>								
A. 404(b) audit	Mean	452,680	343,305	348,993	-109,375***	-24.2%***	5,688	1.7%
	Med	303,775	257,070	250,000	-46,705***	-15.4%***	-7,070	-2.8%
	N	304	331	291				
B. Outside vendor	Mean	244,904	185,870	175,872	-59,034***	-24.1%***	-9,998	-5.4%
	Med	100,000	80,000	75,000	-20,000*	-20%*	-5,000	-6.3%
	N	448	469	430				
C. Internal labor	Mean	593,381	590,184	601,237	-3,197	-0.5%	11,053	1.9%
	Med	360,000	342,733	326,700	-17,267	-4.8%	-16,033	-4.7%
	N	382	398	369				
D. Non labor	Mean	107,621	97,880	93,162	-9,741	-9.1%	-4,718	-4.8%
	Med	35,000	28,500	25,000	-6,500	-18.6%	-3,500	-12.3%
	N	447	464	424				
Total Section 404 (A+B+C+D)	Mean	1,312,682	1,215,808	1,185,910	-96,874	-7.4%	-28,898	-2.4%
	Med	930,500	839,643	812,128	-90,857	-9.8%	-27,515	-3.4%
	N	272	288	258				

**Table 1 – Cost of Section 404 compliance by size and year relative to 2007 reforms for Section 404(b) companies (cont'd)**

		Pre	Post	Next		%		%
					Post-Pre	Post-Pre	Next-Post	Next-Post
<b>Panel D: Public float &gt;\$700M</b>								
A. 404(b) audit	Mean	1,400,443	1,127,325	1,045,150	-273,118**	-19.5%**	-82,175	-7.3%
	Med	675,500	600,000	547,080	-75,500**	-11.2%**	-52,920	-8.8%
	N	595	659	598				
B. Outside vendor	Mean	695,522	479,832	343,888	-215,689***	-31%***	-135,944***	-28.3%***
	Med	195,740	123,000	90,000	-72,740***	-37.2%***	-33,000***	-28.8%***
	N	871	959	869				
C. Internal labor	Mean	2,765,204	2,350,656	2,193,364	-414,548	-15%	-157,292	-6.7%
	Med	968,000	847,000	847,000	-121,000**	-12.5%**	0	0%
	N	728	820	746				
D. Non labor	Mean	248,771	208,307	194,585	-40,464**	-16.3%**	-13,722	-6.6%
	Med	100,000	62,500	60,000	-37,500*	-37.5%*	-2,500	-4%
	N	869	954	863				
Total Section 404 (A+B+C+D)	Mean	5,041,707	3,986,121	3,585,743	-1,055,586**	-20.9%**	-400,378	-10%
	Med	2,446,750	1,993,800	1,790,000	-452,950***	-18.5%***	-203,800*	-10.2%*
	N	524	591	533				

Table 2 reports the summary statistics for survey participants' estimates of the percent of audit fees, outside vendor costs, and internal labor costs attributed to Section 404(b) compliance.<sup>93</sup> Overall, the mean share of audit fees allocated to Section 404(b) was significantly lower post-2007 reforms, except for smaller (< \$75 million) issuers that are now exempt from Section 404(b) compliance. However, all issuers projected a statistically significant decline in the percent of audit fees allocated to Section 404(b) beyond the first post-reform year. Regarding outside vendor costs, the mean share was only significantly lower post-2007 reforms for smaller (< \$75 million) issuers and a subset of medium (\$250-\$700 million) issuers. Finally, the mean share for internal labor costs was not significantly different following the 2007 reforms, regardless of size. Specifically,

- The mean share of the total audit fees allocated to Section 404(b) compliance ranged from approximately 35.8% to 42.9% of the total compliance costs pre-2007 reforms and was inversely related to the issuer's size. During the first post-2007 reforms year, this share was significantly lower (at the 5% level) for issuers with public float

<sup>93</sup> Table 2 reflects Table 10 in the 2009 study, partitioned into four groups based on public float (< \$75 million, \$75-\$250 million, \$250-\$700 million, and > \$700 million). See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 49. Based on the 2009 study, the values in Table 2 are management estimates – given that it is an integrated audit, the percentage of audit fees relating to ICFR is not separately determined.

between \$75 and \$250 million, and highly significantly lower (at the 1% level) for issuers with public float between \$250 and \$700 million and issuers with public float greater than \$700 million, while insignificantly lower for smaller (< \$75 million) issuers. However, this share was projected to continue to decrease at a highly significant rate (at the 1% level) beyond the first post-reforms year, regardless of size, with both categories of medium issuers projecting roughly equal decreases.

- 42.9% to 32.5% [< \$75 million]
  - 40.4% to 34.1% [\$75-\$250 million]
  - 40.0% to 34.4% [\$250-\$700 million]
  - 35.8% to 30.5% [> \$700 million]
- The mean share of outside vendor costs that was attributed to Section 404(b) compliance ranged from approximately 16.6% and 36.3% pre-2007 reforms. Although smaller (< \$75 million) issuers allocated higher shares of outside vendor costs to Section 404(b) compliance, both the mean and median realized of these costs are significantly lower the first post-reforms year for both the smaller (< \$75 million) issuers and a subset of medium (\$250-\$700 million) issuers. The mean share of outside vendor costs was mostly projected to continue to decrease beyond the first post-reforms year, regardless of size, with again both categories of medium issuers projecting roughly equal decreases.
    - 36.3% to 23.8% [< \$75 million]
    - 28.5% to 26.7% [\$75-\$250 million]
    - 30.7% to 27.0% [\$250-\$700 million]
    - 16.6% to 16% [> \$700 million]
  - The mean share of internal labor costs attributed to Section 404(b) compliance ranged from approximately 24% to 40% pre-2007 reforms and, once again, this share was inversely related to size. However, it did not appear that this share for internal labor costs was significantly different following the 2007 reforms, regardless of size.
    - 40.0% to 31.4% [< \$75 million]
    - 31.9% to 32.6% [\$75-\$250 million]
    - 32.4% to 33.6% [\$250-\$700 million]
    - 24.0% to 24.6% [> \$700 million]

**Table 2 – Percent allocation of cost components to Section 404(b) compliance by year relative to 2007 reforms and size**

Survey participants provided an estimate of the percent of total audit fees, outside vendor costs, and internal labor hours attributed to compliance with Section 404(b) requirements. This table reports the summary statistics for these allocations (in percentage terms) by issuer size and year relative to the 2007 reforms. Panel A (B, C, D) is restricted to issuers with public float < \$75 million (\$75-\$250 million, \$250-\$700 million, > \$700 million) in the relevant fiscal year (*Pre*, *Post*, and *Next*). The public float is from DataStream and measured as of six months prior to the fiscal year end. The earliest public float data is from July 8, 2006 and the latest data is from June 30, 2009. Panel E includes all issuers. *Pre* includes firm-fiscal year observations pre-dating November 15, 2007; *Post* includes all completed firm-fiscal year observations post-dating November 15, 2007; and *Next* includes all firm observations referring to the fiscal years in progress at the time of the survey. The earliest completed fiscal year end is January 8, 2007 and the latest reported fee is for the fiscal year ending December 31, 2009. In cases where issuers have two complete fiscal years in *Pre* (*Post*), we retain the fiscal year closest to the passage of the reform, *i.e.*, the last (first) fiscal year prior to (following) the November 15, 2007 date. This approach resulted in a reduction of the overall sample (firm-fiscal year observations) of less than 2% and it ensures that issuers are not double counted in any column. When survey participants responded “not applicable” for outside vendor costs or non-labor costs, the responses were coded as zero. Responses of “cannot estimate” were replaced with the mean of non-missing values conditional on the company assets. The rows labeled *Post-Pre* (*Next-Post*, *Next-Pre*) report differences in means and medians. \*\*\*, \*\*, and \* indicate significance at a 1%, 5%, and 10% levels, respectively.

	Percent of audit fees allocated to Section 404(b)			Percent of outside vendor costs allocated to Section 404(b)			Percent of internal labor costs allocated to Section 404(b)		
	Mean	Median	N	Mean	Median	N	Mean	Median	N
<b>Panel A: &lt; \$75M</b>									
Pre	42.9	42.0	63	36.3	40.0	58	40.0	40.0	55
Post	40.5	40.0	99	27.2	20.0	89	36.8	35.0	95
Next	32.5	34.5	162	23.8	0.0	145	31.4	30.0	158
<i>Post-Pre</i>	-2.4	-2.0		-9.1*	-20.0**		-3.2	-5.0	
<i>Next-Post</i>	-8.0***	-5.5***		-3.4	-20.0		-5.4	-5.0	
<i>Next-Pre</i>	-10.4***	-7.5***		-12.5***	-40.0***		-8.6**	-10.0**	
<b>Panel B: \$75-\$250M</b>									
Pre	40.4	40.0	364	28.5	20.0	303	31.9	25.0	345
Post	37.9	35.0	398	29.6	25.0	319	32.8	30.0	361
Next	34.1	31.3	365	26.7	20.0	316	32.6	25.0	346
<i>Post-Pre</i>	-2.5**	-5.0**		1.1	5.0		0.9	5.0	
<i>Next-Post</i>	-3.9***	-3.7***		-2.9	-5.0**		-0.1	-5.0	
<i>Next-Pre</i>	-6.4***	-8.7***		-1.8	0.0*		0.7	0.0	
<b>Panel C: \$250-\$700M</b>									
Pre	40.0	40.0	304	30.7	20.0	268	32.4	25.0	303
Post	36.3	35.0	331	25.9	10.0	303	31.8	25.0	328
Next	34.4	34.0	291	27.0	10.0	288	33.6	30.0	302
<i>Post-Pre</i>	-3.7***	-5.0***		-4.8*	-10.0**		-0.6	0.0	
<i>Next-Post</i>	-1.9*	-1.0*		1.1	0.0		1.8	5.0	
<i>Next-Pre</i>	-5.6***	-6.0***		-3.7	-10.0**		1.2	5.0	

**Table 2 – Percent allocation of cost components to Section 404(b) compliance by year relative to 2007 reforms and size (cont'd)**

	Percent of audit fees allocated to Section 404(b)			Percent of outside vendor costs allocated to Section 404(b)			Percent of internal labor costs allocated to Section 404(b)		
	Mean	Median	N	Mean	Median	N	Mean	Median	N
<b>Panel D: &gt; \$700M</b>									
Pre	35.8	35.0	595	16.6	0.0	510	24.0	20.0	603
Post	32.2	30.0	659	17.4	0.0	573	25.2	20.0	678
Next	30.5	30.0	598	16.0	0.0	530	24.6	20.0	614
Post-Pre	-3.6***	-5.0***		0.9	0.0		1.2	0.0	
Next-Post	-1.6**	0.0**		-1.5	0.0**		-0.6	0.0	
Next-Pre	-5.2***	-5.0***		-0.6	0.0**		0.6	0.0	
<b>Panel E: All issuers</b>									
Pre	38.3	38.8	1,326	24.1	10.0	1,139	28.7	25.0	1,306
Post	35.2	34.7	1,487	23.1	10.0	1,284	29.3	25.0	1,462
Next	32.5	31.0	1,416	22.0	0.0	1,279	29.2	25.0	1,420
Post-Pre	-3.2***	-4.1***		-0.9	0.0		0.6	0.0	
Next-Post	-2.7***	-3.7***		-1.1	-10.0***		-0.1	0.0	
Next-Pre	-5.9***	-7.8***		-2.1*	-10.0***		0.5	0.0	

To determine if experience in Section 404 compliance can explain the reduction in costs documented in the previous tables, Table 3 reports total Section 404 compliance costs for issuers sorted by public float and the number for years of compliance experience with Section 404(b).<sup>94</sup> The results show that when focusing on issuers with more than one year of compliance experience, the total costs are significantly lower (at the 5% level) following the 2007 reforms among medium (\$75-\$250 million and \$250-\$700 million) issuers complying for the second time with Section 404(b). In addition, the total costs are significantly lower (at the 10% level) following the 2007 reforms for a subset of medium (\$250-\$700 million) issuers complying for the third time with Section 404(b) and highly significantly lower (at the 1%) level for large (> \$700 million) issuers complying for the fourth time.

The data in Table 3 reveals no significant difference in the mean total cost of compliance as a fraction of assets between issuers with a public float of < \$75 million and issuers with a public float of \$75-\$250 million. However, there was a statistically significant difference in the mean total cost of compliance as a fraction of assets between issuers with a public float of \$75-\$250 million and issuers with a public float of \$250-\$700 million.

<sup>94</sup> Table 3 reflects Table 12 in the 2009 study, partitioned into four groups based on public float (< \$75 million, \$75-\$250 million, \$250-\$700 million, and > \$700 million). See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 53.

Table 3 shows that for Section 404(b) issuers, the total cost of compliance as a fraction of assets appears to decrease as the size of the issuer increases. In addition, for all size categories, scaled compliance costs typically decreased with the number of years of Section 404(b) compliance experience. In particular, a comparison of compliance costs over time (*i.e.*, 4+ yrs – 1 yr) reveals a statistically significant reduction in compliance costs for medium (\$75-\$250 million and \$250-\$700 million) issuers and large (> \$700 million) issuers relative to small (< \$75 million) issuers. These reductions may be attributable to the absorption of start-up costs and other non-recurring fixed costs, as well as the 2007 reforms. Moreover, these results are consistent with the notion that experience with Section 404 compliance may explain some of the differences in compliance costs.

**Table 3 – Total Section 404 compliance cost scaled by total assets, by size and years of Section 404(b) compliance experience**

This table reports mean total cost of compliance with Section 404 as a fraction of the issuer’s total assets, measured at the end of the relevant fiscal year. In this table, issuers are segmented by their public float and by the number of years of experience complying with Section 404(b) in the relevant fiscal year. The unit of observation is a firm-fiscal year, the corresponding public float is downloaded from DataStream and measured as of six months prior to the fiscal year end, and Section 404(b) compliance status for the relevant year is from Audit Analytics. The earliest completed fiscal year end is January 8, 2007 and the latest reported fee is for the fiscal year ending December 31, 2009. The earliest public float data is from July 8, 2006 and the latest data is from June 30, 2009. When survey participants responded “not applicable” for outside vendor costs or non-labor costs, the responses were coded as zero. Responses of “cannot estimate” were replaced with the mean of non-missing values conditional on the company assets. The row labeled *2yrs - 1yr* [*3yrs - 2yrs*, *4yrs - 3yrs*, *4yrs - 1yr*] report differences in means between the corresponding subsamples. \*\*\*, \*\*, and \* indicate significance at a 1%, 5%, and 10% levels, respectively.

		Public Float						
		(1)	(2)	(3)	(4)			
	stats	<\$75M	\$75M- \$250M	\$250M- \$700M	>\$700M	(2)-(1)	(3)-(2)	(4)-(3)
1 year	mean	0.70	0.77	0.58	0.14	0.07	-0.20*	-0.44***
	N	25	109	68	92			
2 years	mean	0.53	0.52	0.37	0.11	-0.00	-0.15*	-0.27***
	N	20	87	53	82			
3 years	mean	0.48	0.49	0.28	0.11	0.01	-0.21***	-0.17***
	N	40	231	232	453			
4+ years	mean	0.64	0.41	0.25	0.08	-0.23	-0.16***	-0.17***
	N	28	141	177	416			
<i>2yrs - 1yr</i>		-0.17	-0.25**	-0.20**	-0.03			
<i>3yrs - 2yrs</i>		-0.05	-0.04	-0.10*	-0.00			
<i>4+yrs - 3yrs</i>		0.17	-0.08	-0.02	-0.03***			
<i>4+yrs - 1yr</i>		-0.05	-0.36***	-0.32***	-0.06***			



## B. Survey Participants' Perceptions of the Impact of the 2007 Reforms on the Costs of Compliance

In an optional section of the survey, participants characterized the impact of the 2007 reforms on the costs of complying with Section 404 requirements. Table 4 reveals that on average, issuers perceive that the 2007 reforms helped reduce the cost of complying with Section 404.<sup>95</sup> Although this result holds true at a high level of statistical significance independent of the size of the issuer, large (> \$700 million) issuers ascribe a larger impact to the reforms, while a subset of medium (\$75-\$250 million) issuers ascribe a smaller impact to the reforms.

**Table 4 – Impact of 2007 reforms on cost of compliance for Section 404(b) companies – (Optional Survey Section)**

In an optional section of the survey, participants characterized the impact of the 2007 reforms on the costs of complying with Section 404 requirements. The response could vary between  $-1$  and  $+1$ , where:  $-1$  referred to “a decrease,”  $0$  referred to “little or no impact,”  $+1$  referred to “an increase.” Alternatively, the response could be “not sure” or “not applicable.” This table is restricted to Section 404(b) issuers and reports summary statistics for the participants’ responses to questions about the isolated and combined impact of the reforms on compliance costs. Issuers are segmented based on public float, measured as of 2008. The column labeled *Mean* reports the mean response in the relevant sample. The row labeled (2)-(1) [(3)-(1), (3)-(2), (4)-(1), (4)-(2), (4)-(3)] reports differences in mean responses across the relevant subsamples. \*\*\*, \*\*, and \* indicate significance at 1%, 5%, and 10% levels, respectively.

		N	decrease/none/increase			Mean
			-1	0	1	
Impact of Management Guidance on total cost of compliance	< \$75M (1)	40	47.5%	50.0%	2.5%	-0.450***
	\$75M-\$250M (2)	189	27.5%	66.1%	6.4%	-0.212***
	\$250M-\$700M (3)	187	33.2%	65.2%	1.6%	-0.316***
	>\$700M (4)	364	45.3%	53.3%	1.4%	-0.440***
(2) - (1)						0.238**
(3) - (1)						0.134
(3) - (2)						-0.104*
(4) - (1)						0.010
(4) - (2)						0.228***
(4) - (3)						-0.124***
Impact of Auditing Standard No. 5 on total cost of compliance	< \$75M (1)	41	48.8%	46.3%	4.9%	-0.439***
	\$75M-\$250M (2)	191	39.8%	52.4%	7.9%	-0.319***
	\$250M-\$700M (3)	191	56.0%	41.4%	2.6%	-0.534***
	>\$700M (4)	373	66.5%	31.4%	2.1%	-0.643***

<sup>95</sup> Table 3 reflects Table 17 in the 2009 study, partitioned into four groups based on public float (< \$75 million, \$75-\$250 million, \$250-\$700 million, and > \$700 million). See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 70.

**Table 4 – Impact of 2007 reforms on cost of compliance for Section 404(b) companies – (Optional Survey Section) (cont'd)**

		decrease/none/increase				
		N	-1	0	1	Mean
		(2) - (1)				0.120
		(3) - (1)				-0.095
		(3) - (2)				-0.215***
		(4) - (1)				-0.204**
		(4) - (2)				-0.324***
		(4) - (3)				-0.109**
Combined impact of Management Guidance and AS 5 on total compliance cost	< \$75M (1)	40	55.0%	40.0%	5.0%	-0.500***
	\$75M-\$250M (2)	192	41.2%	51.0%	7.8%	-0.333***
	\$250M-\$700M (3)	190	55.3%	42.6%	2.1%	-0.532***
	>\$700M (4)	357	69.1%	29.6%	1.3%	-0.677***
		(2) - (1)				0.167
		(3) - (1)				-0.032
		(3) - (2)				-0.198***
		(4) - (1)				-0.177*
		(4) - (2)				-0.344***
		(4) - (3)				-0.146***

Finally, survey participants tended to provide a relatively favorable assessment of the impact of AS 5 in terms of the amount of time required for auditor attestation, and of the direct and indirect effects of Section 404 compliance on a number of factors, including the quality of the internal control structure and financial reporting and going-private decisions.<sup>96</sup>

- Approximately 60% of all respondents believe AS 5 reduced the time required for auditor attestation under Section 404(b); medium (\$75-\$700 million) and large (> \$700 million) issuers perceived the time reduction to be greater than that perceived by smaller (< \$75 million) issuers.<sup>97</sup>
- Overall, some of the positive direct effects to Section 404 compliance ascribed by respondents included:

<sup>96</sup> The findings are based on the results from Table 14 and Table 15 in the 2009 study. See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 49, 64.

<sup>97</sup> The findings are based on the results from Table 18 in the 2009 study. See *id.* at 72.

- improved quality of the internal control structure;
  - improved confidence by the audit committee in the issuer's ICFR;
  - improved quality of the issuer's financial reporting; and
  - improved ability of the issuer to prevent and detect fraud.
- When assessing the indirect effects of Section 404 compliance, the majority of respondents perceived no effect on:
    - the issuer's ability to raise capital;
    - investors' confidence in the issuer;
    - the liquidity of the issuer's common stock; or
    - the issuer's overall value.
  - Nearly 40% of respondents claimed that they were more confident in the financial reports of other Section 404 compliant issuers, as opposed to only about one in four that found compliance to improve investors' confidence in their own company's reports. This discrepancy may imply that "corporate insiders' representation of the benefits enjoyed by users of financial statements as a result of Section 404 compliance may be downward biased."<sup>98</sup>
  - The perceived net benefits of Section 404 compliance significantly increased with the size of the issuer. The average perceived net benefits of Section 404 compliance in the first fiscal year post-2007 reforms was higher relative to the prior year across all sizes of issuers, significantly so for medium (\$75-\$250 million and \$250-\$700 million) issuers and large (> \$700 million) issuers.
  - Net benefits were also expected to continue to be higher beyond the first post-reform year.
  - Although approximately 44% of respondents from U.S. issuers indicated that Section 404 requirements prompted their companies to seriously or at least somewhat consider going private, this result was largely driven by smaller (< \$75 million) issuers, which are now exempt from Section 404(b).<sup>99</sup> Seventy percent of smaller (< \$75 million) issuers reported that their companies considered going private as a result

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<sup>98</sup> See *id.* at 57.

<sup>99</sup> *Id.*

of Section 404 requirements. Among foreign issuers, 26% of respondents reported their company had seriously considered delisting, while 25% report to have considered this option less seriously. Similar to the evidence for domestic issuers, this result primarily reflects the responses of smaller foreign issuers. The evidence implies that respondents from small issuers more frequently reported that their companies had considered delisting than did respondents from larger issuers.<sup>100</sup>

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<sup>100</sup> *Id.* at 66.

## IV. Discussion of Public Comments

Input from the public informed the Staff's analysis of potential ways to reduce the compliance burden for issuers with \$75-\$250 million in public float.<sup>101</sup> In particular, the Commission solicited public input about the unique characteristics of these issuers and about how to reduce the compliance burden of complying with Section 404(b) and whether it would encourage the listing of IPOs in the United States. The Staff also considered public input previously received on the compliance burden of Section 404(b) from other Commission and PCAOB actions described in Section I of this study. The Staff is also aware that there are continuing negative perceptions attributed to the Sarbanes-Oxley Act, including Section 404.<sup>102</sup>

As discussed in Section VI of this study, there were few suggestions provided from the public input that addressed techniques for further reducing the compliance burden while maintaining investor protections without providing a complete exemption. For example, the three industry groups that advocated an exemption from Section 404(b) for issuers in the studied market capitalization range did not provide other recommendations for reducing the compliance burden. Several of the other suggestions short of an exemption were considered by either the Commission or the PCAOB in adopting the 2007 reforms, but were not adopted.

However, the Staff believes that certain other suggestions from the public to reduce compliance costs are likely to take into account both the compliance costs and effectiveness for all issuers, including those subject to this study. These relate to suggestions regarding the PCAOB potentially publishing additional observations on Section 404(b) implementation and the COSO's project to update its internal control framework.

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<sup>101</sup> In addition to recommendations regarding the population of issuers with \$75-\$250 million in public float, several commenters made recommendations for disclosures for issuers that are already exempt from Section 404(b). One commenter recommended that the Commission amend certain disclosure requirements for issuers that are exempt from the reporting requirements of Section 404(b), both by changing the front cover of Form 10-K and requiring more prominent disclosure within the form. Another commenter recommended that the auditor be required to state in its report that it did not audit the ICFR of issuers that are exempt from Section 404(b).

<sup>102</sup> See, e.g., *Whatever Happened to IPOs?* WALL ST. J., Mar. 22, 2011. This editorial on initial public offerings stated that "the 2002 Sarbanes-Oxley law...triggered billions of dollars in new compliance costs for public companies" including "an external audit of... a company's financial practices, known as 'internal controls,' on top of the traditional audits of corporate financial statements...The question for companies now, as ever, is whether the benefits of going public are worth the costs. It's indisputable that America has raised those costs in recent years."

## **A. Request for Public Comment in Connection with this Study**

On October 14, 2010, the Commission requested public comment in connection with this study.<sup>103</sup> The request invited comments on the following topics:

- (1) quantitative and qualitative information about the trends of internal and external costs of having an external auditor attest to management's assessment under Section 404(b) for issuers with a public float between \$75 million and \$250 million from the first year of required compliance to the present;
- (2) current cost of auditor attestation under Section 404(b) in relation to overall cost of compliance with all of Section 404 (*i.e.*, including management's assessment required by Section 404(a)) and changes to this relative cost over time;
- (3) characteristics of internal controls, management's evaluation process and corporate governance of subject issuers that distinguish them from other issuers;
- (4) unique audit planning and performance characteristics, if any, associated with subject issuers;
- (5) incremental effort for preparers and auditors to comply with the auditor attestation requirement of Section 404(b) for an integrated audit beyond the efforts that would already be incurred to comply with the requirements for a financial statement only audit, including the requirement to evaluate internal controls in connection with such an audit, for subject issuers;
- (6) whether and how initiatives of the Commission, such as the Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, have reduced the burden of complying with Section 404(b) for subject issuers;
- (7) whether and how any aspects of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, such as its focus on risk and materiality, scalability, tailoring of testing to risk, and extent of permitted use of the work of others, have reduced costs of compliance with Section 404(b) versus PCAOB Auditing Standard No. 2 for subject issuers;
- (8) whether and how other initiatives of the PCAOB, such as its staff guidance for auditors of smaller public companies, have reduced the burden of complying with Section 404(b) for subject issuers;
- (9) whether and how initiatives of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), such as the June 2006 guidance for smaller public

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<sup>103</sup> Release No. 34-63108 (Oct. 14, 2010).

companies on internal control over financial reporting, and the January 2009 Guidance on Monitoring Internal Control Systems, have reduced the burden of complying with Section 404(b) for subject issuers;

- (10) whether and how initiatives of any other organization have reduced the burden of complying with Section 404(b) for subject issuers;
- (11) the possibility that guidance or rules issued by the Commission, PCAOB or others could further reduce the burden of complying with the auditor attestation requirement of Section 404(b), while maintaining investor protection, for subject issuers, and any specific recommendations concerning any such guidance or rules;
- (12) the impact on investor protection, investor confidence, and the cost of capital arising from the establishment and ongoing compliance with Section 404(b) by subject issuers, including in the context of initial public offerings;
- (13) the degree to which investor protection, investor confidence, and the cost of capital would increase or decrease, if any, as a function of each specific recommendation by which the Commission, the PCAOB, or others might reduce the burden of complying with Section 404(b) for subject issuers, while maintaining investor protection;
- (14) the impact of costs of complying with the auditor attestation requirement of Section 404(b) on company decisions to list on exchanges in the United States versus foreign exchanges in initial public offerings for subject issuers after the offering;
- (15) the impact of costs of complying with Section 404(b) on company and investor decisions to engage in initial public offerings versus other financing alternatives for issuers whose public float is expected to be between \$75 million and \$250 million after the offering;
- (16) potential effect on the number of companies listing initial public offerings in the United States of a complete exemption from the internal control audit requirements for subject issuers, and the potential effect on listings for each specific recommendation for reducing the compliance burden of such requirements on subject issuers;
- (17) any qualitative differences between subject issuers that might list securities on a U.S. exchange in connection with their initial public offerings if the existing internal control audit requirement of Section 404(b) remains in effect and subject issuers that might list securities on a U.S. exchange in connection with their initial public offerings if subject issuers are completely exempt from the internal control audit requirements of Section 404(b), and any such qualitative differences that may arise from each specific recommendation for reducing the compliance burden of such requirements on subject issuers;

- (18) the potential effect of a complete exemption from Section 404(b) for subject issuers on matters such as: raising capital; engaging in mergers, acquisitions and similar corporate transactions; and attracting and retaining qualified independent directors;
- (19) whether and how the use of the auditor’s attestation report on internal control over financial reporting for subject issuers differs from the use of the auditor’s attestation report on internal control over financial reporting for issuers whose public float is greater than \$250 million and the reason(s) for those differences;
- (20) quantitative and qualitative information about whether and how compliance with Section 404(b) has benefited investors and other users of financial statements of subject issuers;
- (21) whether and to what extent auditor attestation reports on internal control over financial reporting enhances confidence in management’s assessment of the effectiveness of its internal control over financial reporting, improves the reliability of financial reporting and improves the prevention and detection of fraud and other misconduct for subject issuers;
- (22) any additional information for the Commission to consider to describe the illustrative population and how the Commission could reduce the burden of complying with Section 404(b) on that population; and
- (23) any other information commenters would like the Commission to consider in regards to the study.

### 1. Summary of Comments Received

The Commission received a total of twelve comment letters.<sup>104</sup> The following table shows the number of letters received by group:

Investor Groups <sup>105</sup>	2
Public Accounting Firms and Affiliated Organizations <sup>106</sup>	4
Industry Organizations <sup>107</sup>	3
Individuals <sup>108</sup>	3

<sup>104</sup> This number reflects comments received through April 21, 2011. Full text of these comment letters is available at <http://www.sec.gov/comments/s7-29-10/s72910.shtml>. In addition to these twelve letters, an additional comment letter (Stephen A. Boyko) was received, addressing subjects not related to the scope of this study.

<sup>105</sup> See letters from Council of Institutional Investors (CII) and CFA Institute.

<sup>106</sup> See letters from Center for Audit Quality (CAQ), Deloitte & Touche LLP (Deloitte), Ernst & Young LLP (E&Y), and Grant Thornton LLP (Grant Thornton).

<sup>107</sup> See letters from Biotechnology Industry Organization (BIO), American Bankers Association, and Independent Community Bankers of America (ICBA).

<sup>108</sup> See letters from Georg Merkl (Merkl), John L. Pierschbacher, and James Brady Vorhies (Vorhies).



Following is a summary of comments received, grouped by the subject of the comment.

***Whether some portion of issuers with public float greater than \$75 million should be exempt from 404(b)***

Six commenters<sup>109</sup> (including all of the Investor Groups and Accounting Firms) stated that they did not support extending the 404(b) exemption to any issuers with public float greater than \$75 million:

- One commenter<sup>110</sup> believes that any such exemption would have a “negative effect on both investors’ ability to review and analyze potential investments in these companies, and that the exempted issuers themselves will be less rigorous in the design and application of ICFRs.” As a result, this commenter contends that investors “will pay with higher long-term capital costs than they would have otherwise had to pay.”
- Another commenter<sup>111</sup> cited a recent study by COSO that analyzed financial statement fraud cases over the past 10 years,<sup>112</sup> noted that “companies committing fraud had median revenues and total assets just under \$100 million,” and further noted that:

In addition to the negative stock market reactions to news announcements about alleged fraud or fraud investigations, many fraud firms suffered long-term consequences, including bankruptcy, delisting by national exchanges, and material asset sales. Twenty-eight percent of fraud firms were bankrupt or liquidated within two years from the year in which the SEC issued the last [Accounting and Auditing Enforcement Release] related to the fraud, and 47 percent were delisted from a national stock exchange. Material asset sales also affected about 62 percent of fraud companies. These rates of occurrence were significantly higher than the experiences of no-fraud firms during those years.

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<sup>109</sup> See letters from CFA Institute, CII, CAQ, E&Y, Deloitte, and Grant Thornton.

<sup>110</sup> See letter from CFA Institute.

<sup>111</sup> See letter from CII.

<sup>112</sup> Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting 1998-2007, An Analysis of U.S. Public Companies* 4 (May 2010), available at <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.

- Another commenter,<sup>113</sup> commenting on the risk of fraud at smaller public companies, stated:

Further, research has shown that the incidents of material internal control deficiencies, financial statement restatements, and fraud are all more prevalent in smaller companies indicating that smaller companies have the greatest need for improvement in their internal control systems. Accordingly, we strongly believe that it is neither warranted nor prudent to eliminate compliance with Section 404(b) for subject issuers. Section 404 should be viewed as the underpinning of reliable financial reporting, rather than a compliance burden.

Four commenters<sup>114</sup> suggested that extending the Section 404(b) exemption to issuers with a public float up to \$250 million would be appropriate:

- One commented<sup>115</sup> that:

The overwhelming majority of [biotech] companies do not have revenue and are years away from putting a product on the market. An exemption from Section 404(b) for companies with public floats of \$250 million or less would help these companies continue to grow during this rough economic climate.
- Another commenter<sup>116</sup> “strongly favors” extending the exemption to public companies with public float between \$75 and \$250 million, noting that “micro-cap and small-cap companies disproportionately share in the compliance burden and costs of Section 404, particularly the external audit costs of complying with Section 404(b)” and the “costs far outweigh the benefits.”
- Another commenter<sup>117</sup> also supported extending the exemption, stating that although the costs of compliance have fallen, “they are still unreasonably large, especially in relation to the size of these companies.”

Another commenter<sup>118</sup> did not advocate a complete exemption for issuers with market capitalization up to \$250 million, but rather suggested that certain accelerated filers that did not

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<sup>113</sup> See letter from Grant Thornton.

<sup>114</sup> See letters from American Bankers Association, BIO, ICBA, and John L. Pierschbacher.

<sup>115</sup> See letter from BIO.

<sup>116</sup> See letter from ICBA.

<sup>117</sup> See letter from American Bankers Association.

<sup>118</sup> See letter from Merkl.

meet certain revenue thresholds (the dollar amount of which were not specifically identified by the commenter) should be exempt, as their market capitalizations are driven by investor expectations about the value of research projects for which there is no current revenue. This commenter stated “the valuation implied by their market capitalizations and the investment decisions of investors are primarily based not on the financial statements, but on non-financial disclosures, such as the results of certain clinical trial milestones, certain FDA approvals or the granting of patent protection.”

### ***Cost of Compliance with Section 404(b)***

Four commenters<sup>119</sup> expressed the view that there is a declining cost trend:

- One commenter<sup>120</sup> stated that:

[T]he PCAOB’s internal control auditing standard, AS 5, as well as the additional guidance issued by the PCAOB, the SEC, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and other professional organizations have led to more efficient and effective Section 404 compliance processes for both issuers and auditors. Moreover, efficiencies in the effective implementation of Section 404 have been gained as a result of issuers and auditors becoming more experienced with assessing the design and operating effectiveness of ICFR. The combination of these factors has contributed to a general decline in costs associated with management’s assessment and the external audit of ICFR.

- Another commenter,<sup>121</sup> referring to the cost trend, stated:

[S]udies illustrate that the normal learning curve since the introduction of the Section 404 requirements, along with the reforms undertaken by the SEC and the PCAOB and the activities of other organization, such as COSO and the Center for Audit Quality, have had a significant impact on the effort associated with the ICFR audit, particularly at smaller public companies. While we note that there is limited data with respect to the particular subset of companies subject to the SEC’s study, as well as for periods subsequent to 2007, we believe that additional experience by both management and auditors with the SEC’s management guidance, the requirements of AS No. 5 and the other tools available continue to drive improvements in the efficiency and effectiveness of the ICFR audit.

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<sup>119</sup> See letters from CAQ, Deloitte, E&Y, and Grant Thornton.

<sup>120</sup> See letter from Deloitte.

<sup>121</sup> See letter from E&Y.

- However, another commenter<sup>122</sup> noted that despite the recent guidance from the SEC, the PCAOB, COSO and others, “studies continue to show that publicly held companies pay an extraordinary amount to comply with SOX 404.” This commenter cited a Financial Executives International study on Section 404 costs, noting that “while 404 auditor costs declined 5.4% from 2006 as the auditor scope of work narrowed, these costs were offset by a reported five percent increase in the average hourly audit rate charged by auditors.” Further, that commenter cited the 2009 SEC Staff study on costs of complying with Section 404 and stated:

[E]ven though the overall mean 404 compliance costs had dropped 19% from the pre-guidance cost, for smaller reporting companies, the drop was not as significant. In fact, the Study showed that for filers with public float lower than \$75 million, the mean SOX 404 compliance cost following the issuance of SEC guidance was very high--\$690,000 per year and the mean 404(b) audit cost was \$259,004. From its study, the SEC generally concluded that smaller publicly held companies have higher Section 404 compliance costs as a fraction of their asset value.<sup>123</sup>

***Impact of investor protection, investor confidence, and the cost of capital arising from the establishment and ongoing compliance with Section 404(b) by subject issuers***

Six commenters<sup>124</sup> expressed the view that compliance with Section 404(b) has had a positive impact on investor protection and investor confidence.

- Regarding the impact on investor protection, for example, one commenter<sup>125</sup> stated:  
An auditor’s involvement in the annual evaluation of the design and effectiveness of ICFR encourages additional accountability of individuals involved in financial reporting with respect to the design and maintenance of internal control, which enhances the quality and reliability of companies’ financial reports. For example, as noted in the SEC’s SOX study released in 2009, Section 404(b) causes management to devote more resources to a disciplined financial reporting process in order to better understand financial reporting risks, implement controls to address those risks, and address control issues more timely... We believe that the discipline and accountability that the Section 404(b) attestation requirement fosters in an issuer’s management is crucial in today’s reporting environment given the complexity and pace of

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<sup>122</sup> See letter from ICBA.

<sup>123</sup> As previously noted, issuers with a public float less than \$75 million are now exempt from Section 404(b).

<sup>124</sup> See letters from CFA Institute, CII, CAQ, Deloitte, E&Y, and Grant Thornton.

<sup>125</sup> See letter from CAQ.

change in accounting standards and the increasing reliance on management's judgment in adopting and implementing those standards.

- This commenter also stated “there is no clear and compelling reason to roll back the current requirements given the potential reduction in benefits from auditor attestation on ICFR” and having another group of issuers that are not subject to Section 404(b) “will likely confuse investors and may undermine their confidence in financial reporting.” Also regarding the impact on investor confidence, this commenter cited a 2007 Financial Executives International survey of representatives from issuers which found that as a result of compliance with Section 404, over 50% of issuers have increased confidence in the accuracy of financial reports and 56% have confidence that financial reports are more reliable.
- Regarding the impact on investor confidence, one commenter<sup>126</sup> expressed the view that:

The decision about whether public companies should be required under the federal securities law to fully comply with Section 404(b) should be based on the views of the companies' shareowners rather than the companies' lobbyists. CII believes that this view is supported by a recent CAQ survey of investors that “found that 65 percent of respondents are concerned about the exemption from 404(b) for companies with less than \$75 million in public float. More importantly, for purposes of the Study, the survey also found that 81 percent of investors are concerned about the possibility that Congress may extend the exemption to larger companies.

Five commenters<sup>127</sup> expressed the view that compliance with Section 404(b) was a factor in a decreasing number of restatements since the implementation of 404(b):

- One commenter<sup>128</sup> cited a study by Audit Analytics that finds “a review of SOX 404 disclosures and subsequent restatements found that those companies that complied with the auditor attestation requirement of Section 404(b) had significantly lower rates of restatement.”
- This commenter also cited a study performed at the request of the Ohio Public Employees Retirement System, which found that “the stock price of companies that

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<sup>126</sup> See letter from CII.

<sup>127</sup> See letters from CII, CAQ, Deloitte, E&Y, and Grant Thornton.

<sup>128</sup> See letter from CII.

had restatements prior or subsequent to disclosure of internal control weaknesses underperformed market benchmarks by more than 10 percentage points.”

- Another commenter<sup>129</sup> stated that, “Eliminating compliance with Section 404(b) will reduce the willingness of subject issuers to invest any additional effort in evaluating the effectiveness of their internal controls systems, ultimately affecting the quality of financial reporting and investor confidence.”

Another commenter<sup>130</sup> questioned the impact of Section 404(b) on investor confidence. It stated that the benefits to investors of Section 404(b) “are not clear” and that the SEC’s own 2009 study on Section 404 indicates that the benefits investors receive “appear to be nominal” because “the majority of respondents [to the survey of issuers] recognize no effect of Section 404 compliance on the company’s ability to raise capital, investor confidence in the company’s financial reports, the company’s overall firm value, and the liquidity of the company’s stock.”<sup>131</sup> This commenter also questioned the benefit of improving financial reporting quality by reducing restatements given the substantially higher costs.

### ***Impact on public company listings***

Concerning the impact of compliance on public company listings, one commenter<sup>132</sup> stated:

Due to the current economic environment, we believe that it is not feasible to determine the effect Section 404(b) has had, or may continue to have, on the number of companies listing initial public offerings. It would seem that any intention to increase initial public offerings in the U.S., by reducing the initial requirements for auditor attestation would negate the original intent and spirit of Section 404. It is our belief that an auditor’s report on the effectiveness of a subject issuer’s internal control over financial reporting provides the same value to an investor in a non-accelerated filer as it does for an investor in an accelerated filer. We would also observe the impact on certain public exchanges when a significant economic downturn or financial reporting crises occurs. Such events often result in a debilitating impact on public listings on exchanges that are not grounded in sound, transparent, and robust financial reporting and governance

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<sup>129</sup> See letter from Grant Thornton.

<sup>130</sup> See letter from American Bankers Association.

<sup>131</sup> The “respondents” referred to in this quote are public companies themselves, indicating their perceptions of investor benefit.

<sup>132</sup> See letter from Grant Thornton.

standards. We believe that considering the impact on company shares, listings, and sustainability of those exchanges in challenging times is just as important as studying listings on exchanges with less restrictive reporting requirements in periods of economic growth.

Another commenter<sup>133</sup> referred to the 2009 SEC study and stated the following concerning the impact of compliance on public company listings:

Overall, publicly held companies view the costs of Section 404 compliance as far outweighing the resulting benefits. The feeling was even more pronounced among smaller public companies. When asked if the costs of Section 404 motivated their company to consider going private, among all firms, 16.8% answered that they were very seriously considering it and 27.4% said they were somewhat considering it. However, among smaller firms, 31.5% said they were seriously considering going private and 38.2% said they were somewhat considering it. Interestingly, when smaller foreign firms were asked if the costs of Section 404 motivated their company to consider delisting from U.S. exchanges, 46.2% said they were very seriously considering it and 30.8% said they were somewhat considering it.<sup>134</sup>

This commenter also noted that many publicly held community banks are having trouble raising capital due to the economic climate. The commenter stated that the costs of Section 404 compliance are a “drain on the earnings” of these banks, making it more difficult for them to compete with private banks.<sup>135</sup>

Another commenter<sup>136</sup> stated:

While transparency is paramount to promoting robust capital markets, costly regulatory rules without proper adjustments for smaller companies can take away already scarce financial resources that would otherwise be used for research and development. Scaling certain regulatory measures that provide for adequate transparency while minimizing the financial burden on small companies must be an achievable goal in today’s economic climate. In 2010, the [biotech] industry has had 15 IPOs. However, the majority of these IPOs did not raise the amount that was originally filed.

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<sup>133</sup> See letter from ICBA.

<sup>134</sup> As previously noted, issuers with a public float less than \$75 million are now exempt from Section 404(b).

<sup>135</sup> *Id.*

<sup>136</sup> See letter from BIO.

***Recommendations for further efficiencies in the Section 404(b) process***

Five commenters<sup>137</sup> offered recommendations for further efficiencies in the Section 404(b) process (aside from recommending a full exemption from 404(b)). One commenter<sup>138</sup> suggested that “through the course of its work, the PCAOB is in a unique position where its inspection teams might identify efficient and effective audit approaches that could be vetted with its standards-setting staff with the objective of identifying “best practices” for AS 5 audits.” It also suggested that, “similar to how the PCAOB conducted forums with auditors and audit committees of smaller public companies across the country on the implementation of Section 404...we recommend that the SEC explore the merits of working with the PCAOB to conduct similar events for subject issuers, audit committee representatives and auditors...”

Consistent with that commenter’s observation that the PCAOB is in a position to promote further efficiencies, another commented:<sup>139</sup>

As a result of its inspections of 2007 audits, the PCAOB issued a report in 2009 related to its observations on the first year implementation of AS No. 5. As that report was focused only on the first year of implementation of AS No. 5, we believe that the PCAOB should consider publishing observations on how the implementation in 2008 and 2009 has progressed relative to its expectations when AS No. 5 was issued. Such information might enable auditors to continue to adjust their ICFR procedures to further improve effectiveness and efficiency of the ICFR audit.

Two commenters<sup>140</sup> suggested that the SEC “actively participate [in] and monitor” the recently announced COSO project to review and update its *Internal Control—Integrated Framework*, to better inform the SEC Staff’s Section 404(b) study. One of these commenters indicated that COSO internal control update could “lead to additional efficiencies in the effective implementation of Section 404.”

Other suggestions from commenters, short of a full exemption for issuers with \$75-\$250 million in public float included:

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<sup>137</sup> See letters from CAQ, CFA Institute, E&Y, Merkl, and Vorhies. Certain respondents recommended disclosures for issuers that are already exempt from Section 404(b) and related audit report requirements for their auditors. See letters from CFA Institute and Merkl.

<sup>138</sup> See letter from CAQ.

<sup>139</sup> See letter from E&Y.

<sup>140</sup> See letters from CAQ and E&Y.



- Allowing for the integration of management’s ongoing monitoring process (“key controls self-assessment”) and the processes used for Section 404(a) compliance, and then enable the independent auditors issuing reports under Section 404(b) to be able to place more reliance upon this integrated process.<sup>141</sup>
- Requiring an audit of the effectiveness of ICFR less frequently than every year.<sup>142</sup>
- Requiring an opinion on only the effectiveness of the design of ICFR.<sup>143</sup>
- Requiring more disclosures, such as those described in Item 304 of Regulation S-K when a CFO or other key accounting personnel leave an issuer when a reason for such departure was any disagreement over any matter of accounting principles or practices or financial statement disclosure.<sup>144</sup>

## 2. Staff Analysis of Comments Received

The feedback from investor groups responding to the Staff’s October 2010 request for comment strongly opposed any further exemption from Section 404(b). These groups cited the auditors’ role in uncovering ICFR deficiencies and increased cost of capital for issuers without the auditor attestation.

There were few suggestions provided from the public input that addressed techniques for further reducing, but not eliminating, the compliance burden while maintaining investor protections. The three industry groups that advocated an exemption from Section 404(b) for issuers in the studied market capitalization range did not provide recommendations for reducing the existing compliance burden without eliminating it altogether. In contrast, four commenters to the Commission’s request for public comment, including the three industry groups, recommended that the Commission permanently exempt registrants in the studied market capitalization range from the provisions of Section 404(b), as Congress did for non-accelerated filers pursuant to the Dodd-Frank Act.<sup>145</sup> One commenter stated that the benefits to investors of

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<sup>141</sup> See letter from Vorhies.

<sup>142</sup> See letter from Merkl.

<sup>143</sup> See *id.*

<sup>144</sup> See *id.*

<sup>145</sup> See letters from American Bankers Association, BIO, ICBA, and John L. Pierschbacher.

Section 404(b) compliance were “not clear,” and “appear to be nominal.”<sup>146</sup> These perspectives appear to conflict with the evidence from the user interviews from the Staff’s 2009 study, the comments received from investor groups for this study, and the academic research described in Section V, which suggests that investors receive valuable information from the auditor attestation on ICFR. Further, several of the commenters, in citing data from the Staff’s 2009 study, cited data relating to issuers with less than \$75 million in public float, which are now exempt from Section 404(b).

Another commenter indicated that the implementation of Section 404(b) had “gone awry.”<sup>147</sup> As discussed throughout this study, the implementation of reforms such as the Commission’s management guidance and the PCAOB’s AS 5 has reduced the compliance burden for issuers required to comply with Section 404(b). Another commenter supported a recommendation of the ACSPC, which recommended exempting issuers with up to \$787 million of public float from the external auditor requirement of Section 404(b).<sup>148</sup> The Staff notes that this suggestion was conditional on there not being a framework for assessing ICFR. The Commission released the management guidance in 2007, in part as a response to the ACSPC recommendations. The PCAOB released AS 5 in 2007 and COSO released its smaller company guidance as a response to other ACSPC recommendations.

Two industry groups representing the banking industry were among those that supported an exemption for issuers with up to \$250 million in public float. Section 112 of the FDICIA added Section 36, “Early Identification of Needed Improvements in Financial Management,” to the Federal Deposit Insurance Act (“FDI Act”).<sup>149</sup> Part 363 of the Federal Deposit Insurance Corporation’s (“FDIC”) regulations, which implements Section 36 of the FDI Act, requires insured depository institutions with \$1 billion or more in total assets to have an assessment of ICFR by both management and their independent auditors, regardless of their filing status for purposes of Section 404.<sup>150</sup> Part 363 requires independent public accountants to perform

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<sup>146</sup> See letter from American Bankers Association.

<sup>147</sup> See letter from BIO.

<sup>148</sup> See letter from ICBA.

<sup>149</sup> P.L. 81-797, 64 Stat. 873.

<sup>150</sup> Part 363 was initially adopted by the FDIC’s Board of Directors in 1993 and was most recently amended in June 2009. See <http://www.fdic.gov/news/news/financial/2009/fi109033.html>.

financial statement audits and assessments of ICFR in accordance with the AICPA's generally accepted auditing standards and generally accepted standards for attestation engagements or the PCAOB's auditing standards, if applicable. The standards of the AICPA that do apply to such audits conform very closely to AS 5,<sup>151</sup> suggesting an audit engagement of similar cost.

Approximately 18% of the 111 banks in the 2009 illustrative population identified in Section II had less than \$1 billion in total assets.<sup>152</sup> Of these 20 banks, many were within \$200 million of this threshold (*e.g.*, 14 had more than \$800 million in assets but less than \$1 billion in assets).<sup>153</sup> To the extent the Part 363 requirement is similar in scope to the Section 404(b) requirement, this suggests an exemption from Section 404(b) would not reduce a bank's compliance burden if it had more than \$1 billion in assets. However, to the extent an exemption from Section 404(b) would mean there was not public disclosure to investors of the results of the ICFR audit in an issuer's annual report, investor protections from the Section 404(b) requirement may not be maintained.

One commenter proposed having the auditor opine on the design, but not the operation, of ICFR.<sup>154</sup> When it considered the 2007 reforms, the Commission explained that “[t]o have a reasonable basis for its assessment of the effectiveness of ICFR, management must have sufficient evidence supporting the operating effectiveness of all aspects of its ICFR as of the date of its assessment.”<sup>155</sup> The Staff believes this reasoning also applies to the auditors' work because of the importance of the auditor in identifying material weaknesses.

The same commenter recommended requiring auditor attestation less than annually. The Staff notes that the PCAOB also considered but did not adopt provisions that would permit rotational testing due to the potential negative impact on audit quality given that the auditor is

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<sup>151</sup> AT Section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*, applies to examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements for entities that are not issuers. This standard, which is effective for periods ending after December 15, 2008, is similar to the standards for integrated audits for issuers described in the PCAOB's AS 5.

<sup>152</sup> Source: Audit Analytics.

<sup>153</sup> Source: Audit Analytics.

<sup>154</sup> See letter from Merkl.

<sup>155</sup> See Release No. 33-8810 (Jun. 20, 2007).

required by the Sarbanes Oxley Act to opine on ICFR every year, stating “it is not possible to assess [a] control’s operating effectiveness without performing some level of testing.”<sup>156</sup>

However, the PCAOB noted that the approach described in AS 5 allows the auditor to consider past testing and risk assessments that “might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.”<sup>157</sup>

Requiring an opinion only on control design would still impose a cost on issuers, though less than that for a full integrated audit. However, investors would likely lose a key protection if the auditor’s attestation only focused on design, as even properly designed controls that do not operate effectively will not prevent or detect a material misstatement. Auditors may also obtain information about the design of controls by testing their operating effectiveness. The Staff did not find any evidence from the work it performed that the cost savings of requiring the auditor to opine on only control design would justify the significant lost benefit. Furthermore, auditors may need to test the operating effectiveness of controls in many instances even when they are performing only a financial statement audit.

Another commenter implied that a revenue threshold, in addition to the current public float threshold, may be appropriate for determining the issuers that are required to comply with Section 404(b).<sup>158</sup> The Staff does not believe this would be an appropriate basis to distinguish Section 404(b) compliance because even issuers with little or no revenue may have other significant financial reporting risks, such as risks related to valuation, classification, and recognition. The 2007 reforms, including AS 5, were designed in part to ensure that the auditor focuses on risks to reliable financial reporting. The Staff believes public float is a better measure for determining compliance because it relates to the public’s financial exposure to the issuer.

One commenter recommended that the Commission consider requiring more disclosures, such as those described in Item 304 of Regulation S-K when a CFO or other key accounting personnel leave an issuer when a reason for such departure was any disagreement over any matter of accounting principles or practices or financial statement disclosure.<sup>159</sup> Although such

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<sup>156</sup> PCAOB Release No. 2007-005A (Jun. 12, 2007), available at [http://pcaobus.org/Rules/Rulemaking/Docket%202007-06-12 Release No 2007-005A.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%202007-06-12%20Release%20No%202007-005A.pdf).

<sup>157</sup> *Id.*

<sup>158</sup> *See* letter from Merkl.

<sup>159</sup> *See id.*

disclosure might provide investors with more information about possible financial reporting and internal control issues at an issuer, such a rule would not likely change any compliance costs and would not impact the auditor's reporting under Section 404(b).

Another commenter recommended that the Commission enable issuers to use what the commenter termed "key control activity self-assessments" to evaluate ICFR, and for the Commission to instruct the PCAOB to change its auditing standards to enable audit firms to more easily rely on these assessments.<sup>160</sup> The PCAOB stated in its adopting release to AS 5 that the standard focuses auditors "on the most important matters in the audit of internal control over financial reporting" and eliminates procedures that the PCAOB believes are "unnecessary to an effective audit of internal control."<sup>161</sup> Further, AS 5 is designed to increase the likelihood that material weaknesses in internal control will be uncovered before they lead to a material misstatement of the financial statements, "steer the auditor away" from unnecessary procedures, and make the audit of internal control "more clearly scalable" for smaller, less complex issuers.<sup>162</sup> AS 5 also allows the auditor to use the work of others (working under the direction of management or the audit committee) including, but not limited to, internal auditors, in order to obtain evidence about the design and operating effectiveness of controls. AS 5 thus permits the use of evaluation methods that meet its testing requirements.

Several commenters made suggestions to reduce compliance costs that the Staff believes would take into account both the compliance costs and effectiveness for issuers subject to this study. First, three commenters recommended that the PCAOB publish additional observations about the implementation of AS 5, including comparing such implementation to the PCAOB's original intent.<sup>163</sup> The PCAOB issued a similar document in 2009<sup>164</sup> describing the implementation of AS 5 for the first year it was effective. These commenters believed that additional observations could assist auditors in performing efficient and effective audits. The

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<sup>160</sup> See letter from Vorhies.

<sup>161</sup> PCAOB Release No. 2007-005A (Jun. 12, 2007), available at [http://pcaobus.org/Rules/Rulemaking/Docket%202007-06-12\\_Release\\_No\\_2007-005A.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%202007-06-12_Release_No_2007-005A.pdf).

<sup>162</sup> *Id.*

<sup>163</sup> See letters from CAQ, E&Y, and Grant Thornton.

<sup>164</sup> See [http://pcaobus.org/Inspections/Documents/09-24\\_AS5\\_4010\\_Report.pdf](http://pcaobus.org/Inspections/Documents/09-24_AS5_4010_Report.pdf).

Staff supports recommending to the PCAOB that it continuously review inspection results and monitor whether a Rule 4010<sup>165</sup> report or other communication is warranted to improve the application of AS 5. If a 4010 report is issued, it may contribute to a reduction in the compliance burden for issuers subject to this study and also to provide auditors, issuers, investors, and others with important information about audit performance and quality.

Second, several commenters recommended that the Commission actively participate in and monitor COSO's update to its Internal Control- Integrated Framework.<sup>166</sup> COSO announced plans to update its framework, which was originally released in 1992, in November of 2010, describing the initiative as making "the existing Framework and related evaluation tools more relevant in the increasingly complex business environment so that organizations worldwide can better design, implement, and assess internal control."<sup>167</sup> The stated aims of the update to the 1992 framework do not explicitly address the compliance burden on issuers that use the COSO framework to evaluate ICFR, and it is not aimed at any particular size issuer. The update will describe how to evaluate internal controls in an environment that is more complex than it was when the original framework was developed. The Staff supports this recommendation, as the update may have implications on the compliance burden on issuers in the illustrative population.

#### **B. Comments Received From Earlier Commission and PCAOB Actions**

The Staff also considered comments received from past Commission and PCAOB actions related to the implementation of Section 404(b), beyond those previously implemented, that may affect the compliance burden. Such ideas included:

- Increasing the extent to which evidence of operating effectiveness of controls can be obtained through the performance of walkthroughs;

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<sup>165</sup> PCAOB Rule 4010 permits the Board to publish summaries, compilations, or other general reports concerning the procedures, findings, and results of its various inspections provided that no such published report may identify the firm or firms to which criticisms of or defects in quality controls relate. In adopting Rule 4010, the PCAOB indicated that it would not customarily issue reports of positive trends and best practices but "does not believe its rule needs to be changed to permit this type of report to be issued." PCAOB Release No. 2003-019 (Oct. 7, 2003), available at <http://pcaobus.org/Rules/Rulemaking/Docket%20006/Release2003-019.pdf>.

<sup>166</sup> See letters from CAQ, E&Y, and Grant Thornton.

<sup>167</sup> <http://www.coso.org/documents/COSOReleaseNov2010.pdf>. As discussed above, the COSO framework is the internal control framework used by most registrants and auditors to evaluate ICFR under Section 404 of the Sarbanes-Oxley Act.

- Allowing the auditor to use the work of others, including management, beyond direct assistance in the conduct of walkthroughs; and
- Changing the threshold for what constitutes a material weakness.

The Staff reviewed prior recommendations for reducing the Section 404(b) compliance burden related to the extent to which evidence of operating effectiveness of controls can be obtained through the performance of walkthroughs.<sup>168</sup> The PCAOB previously considered these suggestions and implemented a risk-based approach. The PCAOB noted in its adopting release to AS 5 that it would not explicitly define situations in which walkthroughs alone could be accepted as evidence on the operating effectiveness of controls because such acceptance depends “on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.”<sup>169</sup> Accordingly, the PCAOB included provisions in AS 5 that address this area.<sup>170</sup>

The Staff also reviewed prior recommendations for reducing the Section 404(b) compliance burden related to using the work of others, such as the issuer’s internal audit personnel and management. While AS 5 allows the auditor to use the work of such personnel in performing an audit of internal control in appropriate circumstances, it allows the auditor to use the work of others to achieve the objectives of a walkthrough only as direct assistance. Allowing the auditor to expand the use of the work of others in achieving the objectives of walkthroughs beyond direct assistance might reduce the compliance burden of Section 404(b) by reducing the time the auditor spends in performing walkthroughs; however, as the PCAOB noted in its adopting release to AS 5 “allowing the use of the work of others to a greater extent . . . would not provide the auditor with an adequate understanding of the relevant risks and the related controls.”<sup>171</sup>

Finally, the Staff reviewed prior comments regarding whether the definition of material weakness should have a greater threshold of probability that a material misstatement would

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<sup>168</sup> A “walkthrough” is a combination of inquiry, observation, evaluation of documents, and re-performance of a control, as evidence of the operating effectiveness of a control.

<sup>169</sup> See PCAOB Release No. 2007-005A, *supra* note 161.

<sup>170</sup> See paragraph 49 of AS 5, including the related note, *available at* [http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_5.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx).

<sup>171</sup> *Id.*

result from the weakness. The comments were received when the Commission proposed amendments to its rules on management's report on ICFR. Certain commenters believed that raising the probability threshold would result in a reduced burden since a higher threshold would make it less likely that a deficiency would be a material weakness. The Commission declined to adopt a change to the definition of material weakness, noting that it was important for investors to be aware of any material weaknesses, and the evidence did not suggest that a higher threshold would reduce the compliance burden. The Commission stated that "revisions that have the effect of increasing the likelihood (that is, risk) of a material misstatement in a company's financial reports that can exist before being disclosed could give rise to questions about the meaning of a disclosure that ICFR is effective and whether the threshold for 'reasonable assurance' is being lowered."<sup>172</sup>

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<sup>172</sup> See SEC Release 33-8809 (Jun. 20, 2007).



## V. Summary of Prior Academic and Other Research on Section 404

The implementation of Section 404 of the Sarbanes-Oxley Act has generated debate since enactment in 2002. Some of this debate has centered on the efforts and attendant costs of complying with Section 404. This section of the study summarizes academic and other research in an effort to further assess the benefits and costs of compliance and to identify potential additional ways to reduce the cost burden of Section 404(b).<sup>173</sup>

Academic and other researchers have employed an array of methodological tools to evaluate the costs and benefits of compliance with Section 404 by primarily focusing on the following broad areas related to Section 404 compliance:

- (1) benefits to compliance;
- (2) costs of compliance;
- (3) behavior of issuers in an effort to avoid being subject to the requirements;
- (4) effects of internal control disclosures and auditor attestation; and
- (5) alternatives to reduce the burden of compliance.

Although many of the academic and other studies surveyed relate to Section 404 in general and to Section 404(b) for all issuers, the research discussed in this study primarily focuses on findings related to accelerated filers. The research informed the Staff's broader consideration of how and if the burden of compliance with Section 404(b) could be reduced for such issuers by examining, for example, compliance cost trends, listing trends, and individuals' decision making in lending and investing activities. The Staff considered Section 404 overall and not just Section 404(b) in order to put the importance of the audit in the appropriate context (*i.e.*, the ICFR disclosures required broadly by Section 404). This enabled us to consider a broader base of research from which to develop potential ideas to reduce the Section 404(b) compliance burden, particularly given the important past efforts by the Commission and the

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<sup>173</sup> The research herein extends an earlier review of academic research on internal control reporting under the Sarbanes-Oxley Act. See A. Schneider, A. A. Gramling, D. R. Hermanson & Z. Ye, *A Review of Academic Literature on Internal Control Reporting Under SOX*, J. OF ACCT. LIT., Vol. 28, 1-46 (2009). It is not intended to be an exhaustive summary of all research pertaining to Section 404, but rather the research the Staff deemed most pertinent to the present study. The Staff acknowledges that the research discussed may have limitations and biases due to the scale and scope of analysis and other factors, such as the accuracy of measures and/or proxies used, omitted variables, and simultaneous event occurrences. As such, the research was evaluated for potential policy considerations rather than for evaluating for empirical accuracy or determinativeness.

PCAOB to align management's requirements pursuant to Section 404(a) and the auditor's requirements pursuant to Section 404(b).

Similar to the Staff's analysis in prior Sections of this study, the academic and other research demonstrates that the costs of compliance with Section 404(b) have declined since the 2007 reforms. The research also suggests that Section 404(b) generally did not affect decisions by issuers to exit the reporting requirements of the SEC. Academic research also shows that auditor involvement in ICFR promotes more accurate and reliable disclosure, and lower restatement rates.

The literature includes some suggestions for potential reductions in the Section 404(b) compliance burden.<sup>174</sup> However, these suggestions were already raised and either incorporated or determined not to adopt in connection with earlier actions by the Commission and the PCAOB.

#### **A. Benefits to Section 404 Compliance**

Numerous research papers and studies address the benefits of compliance with Section 404. Considering Sections 302<sup>175</sup> and 404 of the Sarbanes-Oxley Act broadly, the research results suggest that unless the external auditor is involved in testing and reporting on the effectiveness of internal controls, as is the case under Section 404(b), the reliability of information about controls may be negatively affected.<sup>176</sup> Auditor testing of accelerated filers'

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<sup>174</sup> See, e.g., J. Grundfest & S. Bochner, *Fixing 404*, MICHIGAN L. REV., Vol. 105, 1643-76 (2007). The authors proposed substantive fixes such as amending AS 2 to focus on risk thereby eliminating large costs, providing issuers with an efficient means of delisting from the market, providing a continued exemption for smaller issuers, and writing a separate set of rules only applicable in situations where the issuer is sufficiently small that the costs of compliance would likely exceed the benefits, even under an amended and more cost-effective AS 2 regime. *Id.* at 1671-72.

<sup>175</sup> Section 302 of the Sarbanes-Oxley Act requires an issuer's principal executive officer and principal financial officer to certify in each annual or quarterly report, among other things, that they are responsible for establishing and maintaining the issuer's internal controls, that the internal controls have been designed to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to the certifying officers, that they have evaluated the effectiveness of the issuer's internal controls, and that they have disclosed their conclusions about such effectiveness in the report.

<sup>176</sup> See e.g., J. S. Hammersley, L.A. Myers & C. Shakespeare, *Market Reactions to the Disclosure of Internal Control Weaknesses and to the Characteristics of those Weaknesses under Section 302 of the Sarbanes-Oxley Act of 2002*, REVIEW OF ACCT. STUDIES, Vol. 13(1), 141-65 (2008); J. C. Bedard & L. Graham, *Detection and Severity Classifications of Sarbanes-Oxley Section 404 Internal Control Deficiencies*, ACCT. REV., Vol. 86(3), (2011, forthcoming); J. C. Bedard, R. Hoitash & U. Hoitash, *Evidence from the United States on the Effect on Auditor Involvement in Assessing Internal Control Over Financial Reporting*, INT'L J. OF AUDITING, Vol. 13 (2), 105-25 (2009); D. R. Hermanson & Z. Ye, *Why Do Some Accelerated Filers With SOX Section 404 Material Weaknesses*

controls has generally resulted in the disclosure of internal control deficiencies (“ICDs”) that were not previously disclosed by management, and the external auditor attestation appears to have a positive impact on the informativeness of internal control disclosures and financial reporting quality.<sup>177</sup>

Studies also document that Section 404(a)-only issuers, comprised of mostly smaller issuers, have more material weaknesses, restatements, and incidences of fraudulent financial reporting as compared to most issuers that comply with Section 404(b). For example:

- Section 404(a) and (b)-compliant issuers are less likely to issue materially misstated financial statements than issuers not subject to these requirements.<sup>178</sup>
- The rate of restatements surrounding a disclosure of effective ICFR was 46% higher among issuers that only filed Section 404(a) reports as compared to those that also filed auditor attestations under Section 404(b) during the cumulative four years of compliance with Section 404. Specifically, Section 404(b)-compliant issuers that reported effective ICFR experienced a financial restatement rate of 5.1%, while Section 404(a)-only issuers experienced a restatement rate of 7.4%.<sup>179</sup>
- From 2003-2009, non-accelerated filers have accounted for approximately 65% of the total financial restatements compared to accelerated filers (3,979 restatements out of a total of 6,116).<sup>180</sup>

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*Provide Early Warning Under Section 302? AUDITING: J. PRAC. & THEORY, Vol. 28(2), 247-71 (2009); T. Whitehouse, Internal Controls Audits Continue to Shine, COMPLIANCE WEEK, Nov. 16, 2010.*

<sup>177</sup> *See id.*

<sup>178</sup> *See A. L. Nagy, Section 404 Compliance and Financial Reporting Quality, ACCT. HORIZONS, 24(3), 441-54 (2010); Bedard, Hoitash & Hoitash, supra note 176 at 105.*

<sup>179</sup> *See Audit Analytics, Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers, Nov. 4, 2009, available at <http://www.complianceweek.com/s/documents/AARestatemments2.pdf>. Audit Analytics also reported that if an auditor is involved in an ICFR assessment and there is a subsequent restatement, the public is immediately notified through disclosure that past financials cannot be relied upon. *See Audit Analytics, New Research: SOX 404 ICFR Disclosures and Restatements, Dec. 4, 2009, available at <http://www.auditanalytics.com/bulletins/2009-12-04-bulletin.php>.**

<sup>180</sup> *See Audit Analytics, 2009 Financial Restatements: A Nine Year Comparison, Feb. 2010, available at <http://www.complianceweek.com/s/documents/AARestatemments2010.pdf>, at 18.*

- Section 404(a)-only issuers had a higher adverse management report percentage rate (27.8%; 853 out of 3,066 annual reports), indicating that non-accelerated filers failed to maintain ICFR that were as reliable as accelerated filers' ICFR.<sup>181</sup>
- A number of investors and stakeholder organizations opposed exempting smaller issuers from Section 404(b).<sup>182</sup>

## **B. Costs of Section 404 Compliance**

Several academic studies that address the costs of complying with Section 404 have focused on audit fees. Some of these studies, using various measures of public float and market capitalization, suggest that there is a large burden on smaller issuers and that the benefits do not outweigh the costs, including limited value added from the Section 404(b) requirement for smaller firms.<sup>183</sup>

Earlier studies reveal a steep increase in audit fees and other costs borne by accelerated filers in the initial years of Section 404 implementation and varying audit fees in subsequent years, including significant declines in fees related to the Section 404(b) auditor attestation. More recent studies provide additional evidence of a significant decline in total average compliance costs, including auditor attestation fees, after the 2007 reforms. The decline in costs suggests that issuers and auditors are adapting to Section 404 and becoming more efficient at

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<sup>181</sup> See Audit Analytics, *SOX 404 Dashboard Year 6 Update*, Oct. 2010, available at <http://www.complianceweek.com/s/documents/AASOX404.pdf>. Audit Analytics report that adding this population of 3,066 Section 404(a) reports to the 3,356 Section 404(b) reports, the adverse percentage of the total population of 6,422 disclosures becomes 14.6%. *Id.* at 3. Audit Analytics stated: "As of June in SOX 404 Year 6...the percentage of adverse Management-Only Assessments filed was the lowest, but this rate was about 10 times higher than the rate experienced by companies required to file Auditor Attestations. *Id.* at 1. See also, Council of Institutional Investors, *Glass, Lewis Finds Poor Internal Controls at Smaller Companies Hurt Investors*, Council Governance Alert, Vol. 14(48), Dec. 10, 2009, available at <http://www.cii.org/UserFiles/file/resource%20center/council%20governance%20alert/2009%20Archive/2009%20Alert%2048.pdf>; E. R. Patterson & J. R. Smith, *The Effects of Sarbanes-Oxley on Auditing and Internal Control Strength*, *ACCT. REV.*, Vol. 82(2), 427-55 (2007).

<sup>182</sup> See CAQ, *The Main Street Investor Survey, Key Findings*, Sept. 2010, at 13, available at <http://www.thecaq.org/newsroom/pdfs/2010SummaryInvestorSurvey.pdf>. See also, N.T. Hill, J.E. McEnroe & K.T. Stevens, *A Comparison of CFOs' and CPAs' Perception of the Sarbanes-Oxley Act and the PCAOB*, *CPA J.*, Aug. 2009, at 30-33; Protiviti, *2010 Sarbanes-Oxley Compliance Survey, Where U.S.-Listed Companies Stand: Reviewing Cost, Time, Effort and Processes*, available at <http://www.auditnet.org/articles/KL201010.pdf>.

<sup>183</sup> See, e.g., P. Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality and Stock Prices*, *J. FIN.*, Vol. - LXV(3), 1163-96 (2010); W. Kinney & M. Shepardson, *Do Control Effectiveness Disclosures Require SOX 404(b) Internal Control Audits? A Natural Experiment With Small U.S. Public Companies*, *J. ACCT. RES.*, Vol. 49(2), 413-48 (2011).

implementing and assessing ICFR, especially after the 2007 reforms. In addition, audit fees tend to decline as issuers gain more experience in the Section 404 compliance process. Below is more discussion of the academic research that was conducted before and after the 2007 reforms.

### 1. Pre-2007 Reforms

Academic researchers found the following with respect to the impact of Section 404 on audit fees prior to the 2007 reforms:

- There was an overall audit fee increase during the initial years of Section 404 compliance compared with those fees before the Section 404 requirements.<sup>184</sup>
- Issuers with Section 404 ICDs (material weakness, significant deficiency, or control deficiency) paid incrementally higher audit fees, especially for material weaknesses and for company-level internal control problems rather than account-specific internal control problems.<sup>185</sup>
- Issuers that did not remediate previously disclosed internal control material weaknesses had higher audit fees compared to issuers that remediated such weaknesses.<sup>186</sup>

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<sup>184</sup> See, e.g., K. Raghunandan & D. V. Rama, *SOX Section 404 Material Weakness Disclosures and Audit Fees*, *AUDITING: J. OF PRAC. & THEORY*, Vol. 25(1), 99-114 (2006); R. Hoitash, U. Hoitash & J. Bedard, *Internal Control Quality and Audit Pricing Under the Sarbanes-Oxley Act*, *AUDITING: J. OF PRAC. & THEORY*, Vol. 27(1), 105-26 (2008). See also, W. J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private'*, *EMORY L.J.*, Vol. 55, 141-60, 148 (2006); O. Rezy, *Sarbanes-Oxley: Progressive Punishment for Regressive Victimization*, *HOUS. L. REV.*, Vol. 44(1), 95-129 (2007); L. Sneller & H. P. A. J. Langendijk, *Sarbanes-Oxley Section 404 Costs of Compliance: A Case Study*, *CORP. GOVERNANCE: AN INT'L REV.*, Vol. 15(2), 101-11 (2007); D. M. Fleming & R. N. Romanus, *Auditor Industry Specialization and Audit Fees Surrounding Section 404 Implementation*, Working Paper, SAN DIEGO ST. U. & TEXAS TECH U., 2007, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1012202](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1012202); SEC Staff Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86.

<sup>185</sup> See, e.g., Hoitash, Hoitash & Bedard, *supra* note 184; C. E. Hogan & M. S. Wilkins, *Evidence on the Audit Risk Model: Do Auditors Increase Audit Fees in the Presence of Internal Control Deficiencies?* *CONTEMP. ACCT. RES.*, Vol. 25(1), 219-42 (2008); R. Elder, Y. Zhang, J. Zhou & N. Zhou, *Internal Control Weaknesses and Client Risk Management*, *J. OF ACCT., AUDITING & FIN.*, Vol. 24(4), 543-79 (2009); V. Munsif, K. Raghunandan, D. V. Rama & M. Singhvi, *Audit Fees after Remediation of Internal Control Weaknesses*, *ACCT. HORIZONS*, Vol. 25(1), (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1687134](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1687134). See also, D. Hay, W. R. Knechel & H. Ling, *Evidence on the Impact of Internal Control and Corporate Governance on Audit Fees*, *INT'L J. OF AUDITING*, Vol. 12, 9-24 (2008).

<sup>186</sup> See, e.g., Munsif, Raghunandan, Rama & Singhvi, *supra* note 185; S. M. Albring & M. J. Keane, *The Effect of Internal Control Weaknesses and Their Remediation on Audit Fees*, Working paper, SYRACUSE U. & PROVIDENCE COLL. (2009), available at <http://aaahq.org/meetings/AUD2010/EffectOfInternalControlWeaknessesAndRemediation.pdf>, finding that audit fees remained high one, two, and three years following remediation, and firms that reported consecutive material weaknesses paid significantly higher audit fees than firms that remediated. See also, J. S. Hammersley, L. A. Myers

- Issuers that did remediate continued to pay higher audit fees in subsequent periods compared to issuers with clean Section 404 reports.<sup>187</sup>
- Total compliance costs were higher with issuer size (*i.e.*, larger issuers had larger Section 404-related costs but lower costs as a percentage of the issuer's assets), the presence of material internal control weaknesses, the installation costs of new computer systems and establishment of formal internal control policies, the involvement of auditors from the four largest audit firms, and corporate governance characteristics.<sup>188</sup>
- Total compliance costs were lower for issuers in regulated industries and issuers that raised new financing through the issuance of debt or equity.<sup>189</sup>
- For micro-audit offices (audit firms with fewer than 20 clients), audit fees were higher with Section 404 experience; however, fees were not higher for clients of larger-audit offices (the largest six audit firms) that had Section 404 experience (although fees were generally higher for these firms).<sup>190</sup>

In general, the academic research on Section 404 costs demonstrates that issuers incurred significant audit fees in complying initially with the Section 404 requirements. Notwithstanding, numerous studies, surveys, and academic papers reveal a decline in total Section 404 compliance costs even before the 2007 reforms, including in audit fees.<sup>191</sup> Additionally, one researcher

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& J. Zhou, *The Failure to Remediate Previously-Disclosed Material Weaknesses in Internal Controls*, Working paper, U. OF GEORGIA (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1327470](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327470). The authors conjectured that non-remediating companies must do “additional, more costly substantive testing to support their financial statement opinions in the presence of the continuing material weaknesses.” *Id.* at 12.

<sup>187</sup> See *id.*

<sup>188</sup> See J. Krishnan, D. Rama & Y. Zhang, *Costs to Comply with SOX Section 404*, AUDITING: J. OF PRAC. & THEORY, VOL. 27(1), 169-86 (2008). See also, H. Huang, K. Raghunandan & D. Rama, *Audit Fees for Initial Audit Engagements Before and After SOX*, AUDITING: J. OF PRAC. & THEORY, Vol. 28(1), 171-90 (2009); A. Ghosh & R. Pawlewicz, *The Impact of Regulation on Auditor Fees: Evidence from the Sarbanes-Oxley Act*, AUDITING: J. OF PRAC. & THEORY, Vol. 28(2), 171-97 (2009); Albring & Keane, *supra* note 186; Hay, Knechel & Ling, *supra* note 185.

<sup>189</sup> Krishnan, Rama & Zhang, *supra* note 188 at 169, 183. See also, Hay, Knechel & Ling, *supra* note 185.

<sup>190</sup> See Bedard, Hoitash & Hoitash, *supra* note 176 at 108.

<sup>191</sup> See, *e.g.*, B. P. Foster, W. Ornstein & T. Shastri, *Audit Costs, Material Weaknesses Under SOX Section 404*, MANAGERIAL AUDITING J., Vol. 22(7), 661-73 (2007); H. M. Roybark, *Section 404 Reporting and Attestation Reports: A Descriptive Analysis of Attestation Reports Issued for ICFR During the First Two Years of Section 404 Reporting*, ICAFI U. J. OF AUDIT PRAC., Vol. V(3), 7-34 (2008); M. W. Maher & D. Weiss, *Costs of Complying with*

noted that although the compliance cost of Section 404 was high, there were “future long term benefits” because the incidence of fraud may be reduced and issuers may have a better ability to raise capital at a lower cost.<sup>192</sup>

## 2. Post-2007 Reforms

The research suggests that Section 404(b) costs declined further following the adoption of AS 5.<sup>193</sup> Similarly, the SEC Staff’s 2009 study on Section 404 revealed that the 2007 reforms achieved their intended effect as reported compliance costs declined following the reforms and survey participants stated that the reforms were a contributing factor.<sup>194</sup> Other research and surveys also revealed further declines in compliance costs after the 2007 reforms.<sup>195</sup>

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*the SOX – Measurement, Variation, and Investors’ Anticipation*, Working paper, U. OF CAL.—DAVIS & TEL AVIV U. (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1699828](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1699828); M. K. Aguilar, “Year Two” SOX Audit Fees Down, COMPLIANCE WEEK, Apr. 4, 2006, available at <http://www.complianceweek.com/article/2418/-year-two--404-audit-fees-down>; R. Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of Section 404*, CARDOZO L. REV., Vol. 29(2), 703-64 (2008); CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update*, Apr. 17, 2006, available at [http://www.complianceweek.com/s/documents/cra\\_survey.pdf](http://www.complianceweek.com/s/documents/cra_survey.pdf); Financial Executives International, *FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping: Average Compliance Costs are \$3.8 Million, Down 16% from Prior Year, Reductions About Half of What Were Anticipated*, PRNewswire, Apr. 6, 2006, available at <http://fei.mediaroom.com/index.php?s=43&item=74>; Financial Executives International, *FEI Survey: Management Drives Sarbanes-Oxley Compliance Costs Down, but Auditors Fees Virtually Unchanged*, May 16, 2007, available at [http://www.financialexecutives.org/eweb/DynamicPage.aspx?site=fei&webcode=ferf\\_404survey](http://www.financialexecutives.org/eweb/DynamicPage.aspx?site=fei&webcode=ferf_404survey); Financial Executives International, *FEI Audit Fee Survey Including Sarbanes-Oxley Section 404 Costs*, Financial Executives Research Foundation, 1-17 (Apr. 2008); J. L. Orcutt, *The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Likely to Harm Ordinary Investors*, FORDHAM J. OF CORP. & FIN. L., Vol. XIV, 325-414 (2009); C. Schelleman, R. Deumes & M. Finkeldei, *SOX 404 Related Audit Fees and their Determinants*, Working paper, U. MAASTRICHT & ERNST & YOUNG (2007); SEC – Roundtable Discussion of Second-Year Experience with Internal Control Reporting and Auditing Provisions, May 10, 2006, transcript available at <http://www.sec.gov/spotlight/soxcomp/soxcomp-transcript.txt>.

<sup>192</sup> See Krishnan, Rama & Zhang, *supra* note 188 at 184. The authors supported the adoption of Section 404 by smaller issuers. See *id.*

<sup>193</sup> See, e.g., R. M. Dey & M. W. Sullivan, *What Will Non-Accelerated Filers Have to Pay for the Section 404 Internal Control Audit?* Working paper, ROCHESTER INST. OF TECH. & GEO. WASH. U. (2009), available at [http://www.fdewb.unimaas.nl/ISAR2009/02\\_15\\_Dey\\_Sullivan.pdf](http://www.fdewb.unimaas.nl/ISAR2009/02_15_Dey_Sullivan.pdf); Kinney & Shepardson, *supra* note 183. See also, Financial Executives International, *FEI Audit Fee Survey Including Sarbanes-Oxley Section 404 Costs*, *supra* note 191; R. Doogar, P. Sivadasan & I. Solomon, *The Regulation of Public Company Auditing: Evidence from the Transition to AS 5*, J. ACCT. RES., Vol. 48(4), 795-814 (2010).

<sup>194</sup> See SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, *supra* note 86 at 95.

<sup>195</sup> See, e.g., Protiviti, *supra* note 182; T. Whitehouse, *Exclusive Report: Audit Fees Continue to Plummet*, COMPLIANCE WEEK, Aug. 24, 2010, available at <http://www.complianceweek.com/exclusive-report-audit-fees-continue-to-plummet/article/186924>.

## C. Behavior of Issuers in an Effort to Avoid Compliance

### 1. Listing Trends

With respect to the portion of the study addressing the question of an impact on Section 404(b) compliance on listing decisions, the Staff reviewed research on listing trends.

#### a. Going-Private and Going-Dark Transactions

One aspect of listing trends relates to issuers that determine to exit the reporting system. Some academic literature on going-private transactions and going-dark transactions<sup>196</sup> suggests that the enactment of the Sarbanes-Oxley Act, including Section 404(b), has generally had relatively little or no effect on decisions to engage in these types of transactions.<sup>197</sup> However, there is reported evidence suggesting Sarbanes-Oxley Act compliance costs disproportionately burdens smaller issuers, resulting in delisting activities.<sup>198</sup> The findings also show that many going-private transactions resulted in surviving companies that remained subject to SEC reporting requirements or became SEC reporting companies within twelve months of the transaction.<sup>199</sup> Specifically:

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<sup>196</sup> A going-private transaction generally involves the cash-out of all or a substantial portion of an issuer's shares so that the issuer can then deregister the shares under the Exchange Act. The transaction may involve, among other things, a merger, tender offer, or reverse split of the issuer's shares. A going-dark transaction is when an issuer voluntarily delists from a securities exchange(s) and subsequently deregisters its shares under the Exchange Act, to end its reporting obligations under the Exchange Act (assuming it is not subject to another reporting obligation).

<sup>197</sup> See, e.g., C. Leuz, *Was the Sarbanes-Oxley Act of 2002 Really this Costly? A Discussion of Evidence from Event Returns and Going-private Decisions*, J. ACCT. & ECON., Vol. 44, 146-65 (2007); R. P. Bartlett, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions*, U. CHICAGO L. REV., Vol. 76, 7-44 (2009). See also, Iliev, *supra* note 183 at 1176; G. A. Karoyli, *Discussion of A Lobbying Approach to Evaluating the Sarbanes-Oxley Act of 2002*, J. ACCT. RES., Vol. 47(2), 585-95 (2009).

<sup>198</sup> This research focuses on non-accelerated filers, which are now exempt from Section 404(b), and accelerated filers. See, e.g., S. Block, *The Latest Movement to Going Private: An Empirical Study*, J. APPLIED FIN., Vol. 14, 36-44 (2004); E. Engel, R. Hayes & X. Zhang, *The Sarbanes-Oxley Act and Firms Going Private Decisions*, J. ACCT. & ECON., Vol. 44, 116-45 (2007); E. Kamar, P. Karaca-Mandic & E. Talley, *Sarbanes-Oxley's Effects on Small Firms: What is the Evidence*, Working paper, U. S. CAL., RAND CORP. & U. CAL. BERKELEY (2007), available at <http://ssrn.com/abstract=993198>; D. Piotroski & S. Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, J. ACCT. RES., Vol. 46(2), 383-425 (2008); E. Kamar, P. Karaca-Mandic & E. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, J. L., ECON. & ORG., Vol. 25(1), 107-33 (2009); X. Li, *An Examination of the Impact of the Sarbanes-Oxley Act on Cross-Listed Foreign Private Issuers and the Legal Bonding Hypothesis*, Working Paper, BOSTON COLL. (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=952433](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952433).

<sup>199</sup> See Bartlett, *supra* note 197 at 29.



- There are instances in which the Sarbanes-Oxley Act in general,<sup>200</sup> increased compliance costs, or Section 404 implementation was cited as a reason for delisting, especially for smaller, low performing (*e.g.*, less liquid, slow growth), or high inside ownership issuers.<sup>201</sup>
- There was a sharp increase in the rate at which issuers have gone private since the enactment of the Sarbanes-Oxley Act. However, the rate at which such issuers remained Exchange Act reporting companies following a going-private transaction significantly increased between 2003 and 2006.<sup>202</sup>
- There was an increase in the quarterly frequency of going-private activities from 1998 to 2005<sup>203</sup> and an increase in going-dark transactions in 2003 and 2004,<sup>204</sup> which may be due to increased Sarbanes-Oxley costs, although several academic researchers argue that the link between the Sarbanes-Oxley Act and going-dark or going-private decisions in the United States is somewhat doubtful.<sup>205</sup>
- There was no relative increase in the rate of acquisitions by private acquirers (going private) among U.S. issuers, and while there was an increase in the rate of going private transactions by small U.S. issuers in the first year after the Sarbanes-Oxley

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<sup>200</sup> See S. Wolff & C. D. Long IV, *Post-SOX Trends in Delistings and Deregistration*, RICHMOND J. GLOBAL L. & BUS., Vol. 9(1), 53-59 (2010).

<sup>201</sup> See, *e.g.*, L. A. Austen & D. Dickens, *SOX Doomsday Predictions in Hindsight: Evidence from Delisting*, CURRENT ISSUES IN AUDITING, Vol. I, A21-27 (2007); Engel, Hayes & Zhang, *supra* note 198; B. Hansen, G. Pownall & X. Wang, *The Robustness of the Sarbanes-Oxley Effect on the U.S. Capital Market*, REV. ACCT. STUD., Vol. 14(2-3), 404-39 (2009); C. Leuz, A. Triantis & T. Y. Wang, *Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, J. ACCT. & ECON., Vol. 45, 181-208 (2008).

<sup>202</sup> See Bartlett, *supra* note 197 at 10, 31. The author conjectures that these companies have elected to remain SEC reporting companies due to the use of high-yield debt financing. *Id.* at 10.

<sup>203</sup> See, *e.g.*, Engel, Hayes & Zhang, *supra* note 198; Carney, *supra* note 184; Block, *supra* note 198.

<sup>204</sup> See Leuz, Triantis & Wang, *supra* note 201. See also, J. L. Coles, *Disclosure Policy: A Discussion of Leuz, Trantis and Wang (2008) on "Going Dark"*, J. ACCT. & ECON., Vol. 45, 209-20 (2008).

<sup>205</sup> See, *e.g.*, Leuz, Triantis & Wang, *supra* note 201. Controlling insiders may have taken their companies dark for other reasons, such as to protect private control benefits and decrease outside scrutiny, especially when corporate governance and investor protection were deemed weak. *Id.* at 181. See also, Karoyli, *supra* note 197; Hansen, Pownall & Wang, *supra* note 201. Hansen, Pownall & Wang stated that: "both general market conditions and firm fundamentals explain the delisting incidence and firms' delisting decisions; while SOX variables are positively associated with firms' delisting likelihood only when general market conditions are not included in the analyses." *Id.* at 401.

Act was enacted, there was no effect for acquisitions announced more than a year after the enactment of the Sarbanes-Oxley Act.<sup>206</sup>

- Although an increasing number of foreign issuers exited the U.S. securities markets after the enactment of the Sarbanes-Oxley Act, the research suggests that these issuers had greater control by insiders rather than outside investors.<sup>207</sup>

b. Listing on Foreign Exchanges

Another aspect of listing trends relates to issuers' decisions to list on foreign exchanges. Some research suggests that the decline in cross-listings may mostly be explained by changes in characteristics of the issuers, rather than changes in the benefits of cross-listing.<sup>208</sup> The AIM market represents a distinct exception, with few delistings relative to the high rate of new listings in the period following the enactment of the Sarbanes-Oxley Act.<sup>209</sup> More recent data on IPO activity on AIM shows that 102 companies raised £3.4 billion in the first half of 2007, 38 companies raised £829.83 million in the first half of 2008, 3 companies raised £223 million in the first half of 2009, and 16 companies raised £350.6 million in the first half of 2010.<sup>210</sup>

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<sup>206</sup> See E. Kamar, P. Karaca-Mandic & E. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, J. L., ECON. & ORG., Vol. 25(1), 107-33 (2009).

<sup>207</sup> See A. Marosi & N. Massoud, "You Can Enter But You Cannot Leave...": *U.S. Securities Markets and Foreign Firms*, J. FIN., Vol. 63LXIII(5), 2477-506 (2008). See also, H. Huang, *Sarbanes-Oxley Section 404 Compliance: Recent Changes in US-traded Foreign Firms' Internal Control Reporting*, MANAGERIAL AUDITING J., Vol. 24(6), 584-98 (2009).

<sup>208</sup> See C. Doidge, G. A. Karolyi & R. M. Stulz, *Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices Over Time*, J. FIN. ECON., Vol. 91(3), 253-77 (2009). See also, C. Doidge, G. A. Karolyi & R. M. Stulz, *Why do Foreign Firms Leave U.S. Equity Markets?*, J. FIN., Vol. 65(4), 1507-53 (2010); G. Gong, B. Ke & Y. Yu, *Home Country Investor Protection, Ownership Structure and Cross-Listed Firms' Compliance With SOX-Mandated Internal Control Deficiency Disclosures*, Working paper, PENN. ST. U., NANYANG TECH. U. & U. TEX. (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1624186](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624186); Piotroski & Srinivasan, *supra* note 198. Among large foreign companies choosing between a U.S. exchange and the LSE's Main Market, listing preferences did not change following the enactment of the Sarbanes-Oxley Act, and the attractiveness of U.S. markets may have slightly increased. *Id.* at 410-11. Among smaller foreign companies eligible to choose between the Nasdaq and LSE's AIM, the likelihood of a U.S. listing declined following the enactment of the Sarbanes-Oxley Act, consistent with small, less profitable companies being unable to absorb the incremental costs associated with Sarbanes-Oxley Act compliance. *Id.* at 412.

<sup>209</sup> The LSE's AIM experienced a nearly 775% increase in monthly listings over the forty-four month period following the enactment of the Sarbanes-Oxley Act, compared to the period before enactment of the Act. See Piotroski & Srinivasan, *supra* note 198 at 399.

<sup>210</sup> <http://www.londonstockexchange.com/statistics/new-issues-further-issues/new-issues-further-issues.htm>.

Despite a strong post-2002 market growth, the U.S. IPO market remained “cold” overall from 2001-2007, posting seven consecutive years with less than 200 IPOs being completed each year.<sup>211</sup> Prior to 2001, the last time that less than 200 IPOs were completed in a year was 1990, and only three times during that 11-year span were less than 300 IPOs completed.<sup>212</sup> If 1999 and 2000 are eliminated as bubble years, the aggregate proceeds raised by IPOs recovered in 2004 and maintained that level through 2007, despite the drop in number of the number IPOs compared to the pre-2001 era.<sup>213</sup>

A number of academics suggest that the net effect of Section 404 on smaller companies’ IPOs is difficult to measure and may be due to other factors, such as the economic environment.<sup>214</sup> One researcher found that between 2008-2009, the numbers of IPOs remained low, noting that this does not appear to be a result of the Sarbanes-Oxley Act.<sup>215</sup> In addition, several studies demonstrate that “foreign listing activity has slowed and foreign de-listing and deregistration activity has increased, but there is no consensus on how much influence the Sarbanes-Oxley Act has had” on these decisions.<sup>216</sup>

Overall, although there is some reported evidence consistent with Sarbanes-Oxley Act compliance cost disproportionately burdening small companies, the research on listing trends generally reveals that the enactment of Section 404(b) has not noticeably affected decisions by issuers to exit the reporting requirements of the SEC, including ICFR reporting, and therefore

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<sup>211</sup> Orcutt, *supra* note 191 at 385. Orcutt stated that critics of Section 404 argue that “the increase in costs imposed by SOX, and specifically by Section 404, is a significant reason for the failure of the U.S. IPO market to rebound for smaller companies.” *Id.* at 386.

<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> See Prentice, *supra* note 191; J. R. Ritter, *Some Factoids About the 2008 IPO Market*, Working paper, U. FLA. (2009), available at <http://bear.cba.ufl.edu/ritter/IPOs2008Factoids.pdf>.

<sup>215</sup> J. R. Ritter, *Some Factoids About the 2009 IPO Market*, Working paper, U. FLA. (2010), available at <http://bear.cba.ufl.edu/ritter/IPOs2009Factoids.pdf>. The author noted that there were 21 IPOs in 2008 and 41 in 2009, with aggregate proceeds of \$22.76 billion and \$13.17 billion, respectively. *Id.* at 2.

<sup>216</sup> See Karoyli, *supra* note 197 at 589. See also, C. Stoltenberg, K. A. Lacey, B. C. George & M. Cuthbert, *A Comparative Analysis of Post-Sarbanes-Oxley Corporate Governance Developments in the US and European Union: The Impact of Tensions Created by Extraterritorial Application of Section 404*, AM. J. COMP. L., Vol. 53(2), 457-91(2005).

evidence does not indicate that issuers' listing behavior would be significantly altered by reducing the cost of compliance or by granting further exemptions under Section 404(b).

## 2. Managing Public Float

The research evidences that some issuers may attempt to avoid Section 404 costs by reducing or managing their public float in order to become or remain a non-accelerated filer.<sup>217</sup> Specifically, academic researchers found that:

- Issuers with market capitalization between \$60 and \$90 million reduced their market values during the relevant time periods that determined Section 404 compliance by increasing insider purchases to impact the number of shares outstanding and using discretionary accruals<sup>218</sup> to achieve stock price reduction.<sup>219</sup>
- Some smaller issuers strived to remain below the \$75 million non-accelerated filer threshold by reducing investments in property, plant, and equipment, intangibles, and acquisitions, increasing cash payouts to shareholders via ordinary and special dividends and share repurchases, reducing the number of shares held by non-affiliates, making more “bad news” disclosures, and reporting lower earnings.<sup>220</sup>
- Cost savings from the avoidance of Section 404 compliance requirements motivated some non-accelerated filers to underreport public float while the cost efficiency and flexibility of Form S-3 eligibility motivated other issuers to overreport public float.<sup>221</sup>

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<sup>217</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 29.

<sup>218</sup> The research proxies for discretionary accruals typically reflect management's choices; for example, in estimating allowance for doubtful accounts, warranty provisions, provisions for reorganization, layoffs, and restructuring, and contract completion costs.

<sup>219</sup> See M. E. Nondorf, Z. Singer & H. You, *A Study of Firms Surrounding the Threshold of Sarbanes-Oxley Section 404 Compliance*, Working paper, U. CAL.-BERKELEY, MCGILL U. & HONG KONG U. (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1004965](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1004965).

<sup>220</sup> See F. Gao, J. S. Wu & J. Zimmerman, *Unintended Consequences of Granting Small Firms Exemptions From Securities Regulation: Evidence From the Sarbanes-Oxley Act*, J. ACCT. RES., Vol. 47(2), 459-506 (2009). See also, R. M. Hayes, *Discussion of 'Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act'*, J. ACCT. RES., Vol. 47(2), 507-18 (2009).

<sup>221</sup> See F. Gao, *The Use of Discretion in Reporting Public Float*, Working paper, U. ILLINOIS CHICAGO (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1549165](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1549165). When non-accelerated filers became accelerated filers in a subsequent year, they were less likely to continue underreporting public float. *Id.* at 2. See also, Iliev, *supra* note 183 at 1177-80.

Overall, the research suggests that issuers may attempt to manage public float to remain or fall below a threshold for additional reporting; therefore, any further exemptions under Section 404(b) could lead to such incentives by issuers that are larger (in terms of revenues and assets) than issuers with public float less than \$75 million.

#### **D. Internal Control Deficiencies and Auditor Attestation**

A number of research papers study the association between ICDs and auditor attestation. The primary focus has been: the existence, discovery, and disclosure of ICDs; financial reporting quality; cost of debt and equity capital; and individual users' decision making.<sup>222</sup> This research provides further insight into the investor protection function of existing Section 404(b) requirements that should be considered in evaluating any potential reductions in the burden, including a complete exemption.

##### **1. Existence of Internal Control Deficiencies**

The academic research shows that the existence of ICDs, especially material weaknesses, is associated with smaller, complex (*e.g.*, rapidly growing, undergoing restructuring and/or mergers), riskier, and more financially-distressed issuers.<sup>223</sup> In addition, the expertise provided by stronger corporate governance and more qualified management teams, including the expertise of the audit committee, is associated with stronger internal controls.<sup>224</sup> ICDs under Section 404 most often relate to areas commonly found in accounting fraud cases or areas believed to be

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<sup>222</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173.

<sup>223</sup> See *id.* at 8. See also, W. Ge & S. McVay, *The Disclosure of Material Weaknesses in Internal Control After the Sarbanes-Oxley Act*, ACCT. HORIZONS, Vol. 19(3), 137-58 (2005); H. Ashbaugh-Skaife, D. W. Collins & W. R. Kinney, *The Discovery and Reporting of Internal Control Deficiencies Prior to SOX-Mandated Audits*, J. ACCT. & ECON., Vol. 44(1/2), 166-92 (2007); J. Doyle, W. Ge & S. McVay, *Determinants of Weaknesses in Internal Control Over Financial Reporting*, J. ACCT. & ECON., Vol. 44(1/2), 193-223 (2007); M. Ogneva, K. R. Raghunandan & K. Subramanyam, *Internal Control Weakness and Cost of Equity: Evidence From SOX 404 Disclosures*, ACCT. REV., Vol. 82(5), 1255-97 (2007).

<sup>224</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 4. See also, Y. Zhang, J. Zhou & N. Zhou, *Audit Committee Quality, Auditor Independence, and Internal Control Weaknesses*, J. ACCT. & PUB. POL'Y, Vol. 26(3), 300-27 (2007); G. V. Krishnan & G. Visvanathan, *Reporting Internal Control Deficiencies in the Post-Sarbanes-Oxley Era: The Role of Auditors and Corporate Governance*, INT'L J. AUDITING, Vol. 11(2), 73-90 (2007); U. Hoitash, R. Hoitash & J. C. Bedard, *Corporate Governance and Internal Control over Financial Reporting: A Comparison of Regulatory Regimes*, ACCT. REV., Vol. 84(3), 839-67 (2009); V. Naiker & D. Sharma, *Former Audit Partners on the Audit Committee and Internal Control Deficiencies*, ACCT. REV., Vol. 84(2), 559-87 (2009); C. Li, L. Sun & M. Ettredge, *Financial Executive Qualifications, Financial Executive Turnover, and Adverse SOX 404 Opinions*, J. ACCT. & ECON., Vol. 50(1), 93-110 (2010).

higher risk, such as revenue recognition, income taxes, inventory, accounts receivable, and end-of-period adjustments.<sup>225</sup>

## 2. Discovery and Disclosure of Internal Control Deficiencies

Several academic studies highlight the importance of auditor involvement in the discovery and disclosure of ICDs. Section 404(b) has been described as essential to achieving the larger purpose of Section 404 to find weaknesses in ICFR and correct them.<sup>226</sup> Because auditors' control tests detect many problems, regulations not requiring auditor involvement in control testing may be less effective in promoting accurate disclosure of deficiencies in ICFR as those that require auditor reporting.<sup>227</sup> Specifically, the research revealed that:

- More internal control weaknesses were discovered by the auditor (or auditor and client jointly) and by control tests rather than substantive tests.<sup>228</sup>
- Disclosures of material weaknesses under Section 302 were more likely in the fourth quarter when auditors were on-site at the client's office most frequently and when the audit firm or office had experience with Section 404 audits.<sup>229</sup>
- The majority of ICDs that were classified by the auditor as a significant deficiency or a material weakness were initially classified by the issuer as less severe.<sup>230</sup>

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<sup>225</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 12. See also, H. M. Roybark, *Section 404 Reporting and Attestation Reports: A Descriptive Analysis of Attestation Reports Issued for ICFR During the First Two Years of Section 404 Reporting*, ICFAI U. J. AUDIT PRAC., Vol. 5(3), 7-34 (2008); K. E. Scarborough & M. H. Taylor, *Two Years and Counting*, J. ACCT., Vol. 203(6), 74-80 (2007).

<sup>226</sup> Bedard & Graham, *supra* note 176. Further, the authors conjecture that risk assessments in subsequent years may be less effective without detailed information on issuer controls derived through auditor detection and classification of control weaknesses.

<sup>227</sup> Bedard & Graham, *supra* note 176.

<sup>228</sup> See Hammersley, Myers & Shakespeare, *supra* note 176 at 156. See also, Bedard & Graham, *supra* note 176. The authors found that auditors (or auditor and client jointly) detected 72.1% of all ICDs in their sample, mostly through control testing. Regarding detection method, 63.5% of all ICDs were detected by control tests, while only 9.5% were detected by substantive tests. In addition, 60.6% of remediated (84.3% of material weakness, 89.9% of significant deficiencies, 74.7% of deficiencies) ICDs were identified by the auditor (or auditor and client jointly).

<sup>229</sup> Bedard, Hoitash & Hoitash, *supra* note 176 at 120.

<sup>230</sup> Bedard & Graham, *supra* note 176. The authors conjecture that of all ICDs detected in their sample, fewer than four percent were publicly reported as material weaknesses, demonstrating the importance of auditor involvement through Section 404(b).

- Auditors' classifications of identified ICFR problems were influenced by management's assessment; however, increased documentation requirements mitigated management's influence<sup>231</sup> and more experienced auditors were not persuaded by a favorable control assessment made by management.<sup>232</sup>
- The detection of material weaknesses and significant deficiencies were more likely in issuers using consultants, having longer auditor testing periods, reporting their Section 404 process results to a level at the issuer independent of management, having less effective integration of information technology, and greater resources (issuer size).<sup>233</sup>

In addition, recent summaries of restatement data show a lower restatement rate for accelerated filers that are subject to Section 404(b) than non-accelerated filers that are not, which suggests that auditor attestation on ICFR is correlated with more reliable financial reporting.<sup>234</sup> This trend corroborates the conclusion on the value of auditor involvement in the process. This issue is important because control testing required by Section 404 represents a shift from the predominately substantive audit approach.<sup>235</sup> Researchers, using proprietary audit engagement teams' reports, have suggested that with a substantive audit approach, many control flaws that

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<sup>231</sup> C. E. Earley, V. B. Hoffman & J. R. Joe, *Reducing Management's Influence on Auditors' Judgments: An Experimental Investigation of SOX 404 Assessments*, ACCT. REV., Vol. 83(6), 1461-85 (2008).

<sup>232</sup> S. E. Kaplan, E. F. O'Donnell & B. M. Arel, *The Influence of Auditor Experience on the Persuasiveness of Information Provided by Management*, AUDITING: J. OF PRAC. & THEORY, Vol. 27(1), 67-83 (2008). See also, J. Blaskovich & N.M. Mintchick, *Management's Assessment of Internal Controls, External Consultants, and Audit Efficiency*, Working paper, U. NEB. AT OMAHA & U. MO. AT ST. LOUIS (2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=988194](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=988194); A. A. Gramling, E. O'Donnell & S. D. Vandervelde, *Audit Partner Evaluation of Compensating Controls: A Focus on Design Effectiveness and Extent of Auditor Testing*, AUDITING: J. OF PRAC. & THEORY, Vol. 29(2), 175-87 (2010); J. S. Hammersley, K. M. Johnstone & K. Kadous, *How Do Audit Seniors Respond to Increased Salience of Fraud Cues?* Working paper, U. GA., U. WIS. MADISON & EMORY U. (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1183172](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1183172).

<sup>233</sup> See *id.*

<sup>234</sup> Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers*, Nov. 2009, available at <http://www.complianceweek.com/s/documents/AARestatemments2.pdf>; Audit Analytics, *SOX 404 Dashboard Year 6 Update*, Oct. 2010, available at <http://www.auditanalytics.com/bulletins/2010-11-10-bulletin.php>.

<sup>235</sup> A substantive audit approach consists of more substantive analytical procedures or test of details rather than internal control testing.

could affect current and future financial reporting quality will likely be missed by the auditor, and remain uncorrected.<sup>236</sup>

Overall, the research results show that ICDs, especially severe ICDs such as material weaknesses, are more likely to be discovered by external auditors and usually through control testing. Because auditors detect many ICDs not found by issuers and issuers tend to under-classify the severity of ICDs they detect, fewer ICDs would be remediated or publicly disclosed without auditor involvement. In addition, auditor attestation on ICFR results in lower restatements rates, suggesting more reliable financial reporting.

### 3. Financial Reporting Quality

Although research on the relation between ICDs and earnings quality<sup>237</sup> is somewhat mixed,<sup>238</sup> several of the recent academic studies suggest that the Section 404 internal control requirements result in improved earnings quality and suggest that Section 404 is meeting the objective of improving the overall quality of financial reporting. Strong internal controls provide a significant long-term benefit in improving the accuracy of financial reporting that leads to higher quality of information for investors.<sup>239</sup> The research demonstrates that:

- For internal control deficient issuers, earnings quality improves in the period that an internal control weakness is disclosed and for issuers reporting an effective internal control environment in their Section 404 report, earnings quality improves in the year of the first report.<sup>240</sup>

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<sup>236</sup> Bedard & Graham, *supra* note 176. The authors found that 81.5% of entity-level ICDs are detected by auditors through control tests, while only 15.1% are detected through substantive tests; account-specific ICDs were also more likely detected through control tests. *Id.* In contrast, other findings suggest that enhanced substantive procedures (by sourcing known misstatement as to cause) could be more effective in identifying at least one material weakness due to material and/or numerous audit/year-end adjustments. Kinney & Shepardson, *supra* note 183. However, due to limitations of publicly available data, Kinney & Shepardson's conclusion only relates to company-level reporting of effective or ineffective controls. *See id.*

<sup>237</sup> Earnings quality refers to the reasonableness of earnings reported by companies, reflecting various underlying economic factors across companies.

<sup>238</sup> Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 16.

<sup>239</sup> H. Ashbaugh-Skaife, D. W. Collins, W. R. Kinney & R. LaFond, *The Effect of SOX Internal Control Deficiencies and Their Remediation on Accrual Quality*, ACCT. REV., Vol. 83(1), 217-50 (2008).

<sup>240</sup> J. Bedard, *Sarbanes-Oxley Internal Control Requirements and Earnings Quality*, Working paper, LAVAL U. (2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=926271](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=926271). *See also*, J. S. Hammersley, L. A. Myers & J. Zhou, *The Failure to Remediate Previously Disclosed Material Weaknesses in Internal Controls*,



- Issuers that were in compliance with the Section 404 auditor attestation requirements were less likely to issue materially misstated financial statements than noncompliant issuers.<sup>241</sup>
- Compared to Canadian companies listed on a U.S. exchange (not subject to Section 404 in 2004 or 2005), issuers complying with Section 404 had a larger reduction in the magnitude of absolute abnormal accruals and a larger increase in the ability of earnings to predict future earnings and future cash flows.<sup>242</sup>
- While one researcher found that Section 404 compliance led to lower discretionary accruals (*i.e.*, discretionary earnings) for both domestic and foreign issuers,<sup>243</sup> others found lower accrual quality for internal control weakness issuers, suggesting higher accounting risk.<sup>244</sup>

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Working paper, U. GEORGIA, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1327470](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327470); Ashbaugh-Skaife, Collins, Kinney & LaFond, *supra* note 239; H. Ashbaugh-Skaife, D. W. Collins, W. R. Kinney & R. LaFond, *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, J. ACCT. RES., Vol. 47(1), 1-43 (2009); J. C. Bedard, R. Hoitash, U. Hoitash & K. Westermann, *Material Weaknesses Remediation and Earnings Quality: A Detailed Examination*, Working paper, BENTLEY U. & NORTHEASTERN U. (2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1518544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1518544).

<sup>241</sup> See Nagy, *supra* note 178. See also, Whitehouse, *supra* note 176.

<sup>242</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 16; Z. Singer & H. You, *The Effect of Section 404 of the Sarbanes-Oxley Act on Financial Reporting Quality*, J. OF ACCT., AUDITING & FIN. (2011, forthcoming).

<sup>243</sup> Iliev, *supra* note 183 at 1167, 1192.

<sup>244</sup> See Ogneva, Raghunandan & Subramanyam, *supra* note 223 at 1279. See also, J. T. Doyle, W. Ge & S. McVay, *Accruals Quality and Internal Control over Financial Reporting*, ACCT. REV., Vol. 82(5), 1141-70 (2007); K.C. Chan, B. Farrell & P. Lee, *Earnings Management of Firms Reporting Material Internal Control Weaknesses under Section 404 of the Sarbanes-Oxley Act*, AUDITING: J. OF PRAC. & THEORY, Vol. 27(2), 161-79 (2008); Ashbaugh-Skaife, Collins, Kinney & LaFond, *supra* note 239; R. W. Epps & C. P. Guthrie, *Sarbanes-Oxley 404 Material Weaknesses and Discretionary Accruals*, ACCT. FORUM., Vol. 34(2), 67-75 (2010); B. W. Goh & D. Li, *Internal Controls and Conditional Conservatism*, ACCT. REV., 86(3) (2011, forthcoming). See also, C. Li & Q. Wang, *SOX 404 Assessments and Financial Reporting Errors*, Working paper, U. PITTSBURGH & U. KANSAS (2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=926180](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=926180); R. Nagarajan & P. Carey, *Effectiveness of Internal Control Over Financial Reporting and Financial Statement Restatements: The Role of Management*, Working paper, MONASH U. AUSTRALIA (2008).

#### 4. Cost of Debt and Equity Capital

Several studies have documented evidence about the cost of debt and equity for issuers with ICDs.<sup>245</sup> The research demonstrates that ICD-disclosing firms have a higher cost of debt and, in some cases, a higher cost of equity than non-disclosing firms, and that cost of capital decreases after the issuer receives an unqualified Section 404(b) report. Specifically, researchers found that:

- Lenders' risk assessments and probabilities of extending lines of credit were negatively affected when an issuer had an adverse Section 404(b) report compared to a clean Section 404(b) report.<sup>246</sup>
- Loan spread was higher for ICD borrowers than for non-ICD borrowers, borrowers with company-level ICDs rather than account-level ICDs paid higher loan rates, lenders imposed stricter nonprice terms (*e.g.*, collateral requirements) on ICD borrowers (particularly for company-level ICDs), the number of participant lenders in each loan was smaller for ICDs borrowers, and lenders charged higher loan rates, were more likely to require collateral, and structure loans with fewer participant lenders for borrowers that failed to remediate, or exacerbate previously disclosed internal control weaknesses.<sup>247</sup>

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<sup>245</sup> See, *e.g.*, Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 19; A. Costello & R. Wittenberg-Moerman, *The Impact of Financial Reporting Quality on Debt Contracting: Evidence From the Internal Control Weakness Reports*, J. ACCT. RES., Vol. 49(1), 97-136 (2011); D. S. Dhaliwal, C. E. Hogan, R. Trezevant & M. S. Wilkins, *Internal Control Disclosures, Monitoring, and the Cost of Debt*, ACCT. REV. (forthcoming, 2011); A. Schneider & B. K. Church, *The Effect of Auditors' Internal Control Opinions on Loan Decisions*, J. OF ACCT. & PUB. POL'Y, Vol. 27(1), 1-18 (2008); J. Kim, B. Y. Song & L. Zhang, *Internal Control Weakness and Bank Loan Contracting: Evidence from SOX Section 404 Disclosures*, ACCT. REV. (forthcoming, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1080479](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1080479); Ogneva, Raghunandan & Subramanyam, *supra* note 223.

<sup>246</sup> See Schneider & Church, *supra* note 245. The authors suggest that an adverse Section 404(b) report "weakens the importance assigned to the balance sheet and income statement in lending decisions and reduces lenders' confidence that financial statements are presented fairly in conformance with generally accepted accounting principles." *Id.* at 1.

<sup>247</sup> See Kim, Song & Zhang, *supra* note 245. *But see* Ogneva, Raghunandan & Subramanyam, *supra* note 223, finding that "the higher cost of equity associated with ICW disappears after controlling for primitive firm characteristics and for analyst forecast bias." *Id.* at 1255. Other researchers have documented evidence of an increase in cost of equity for issuers with Section 302 ICDs but not for issuers with Section 404 ICDs. See *e.g.*, M. D. Beneish, M. B. Billings & L. D. Hodder, *Internal Control Weaknesses and Information Uncertainty*, ACCT. REV., Vol. 83(3), 665-703 (2008).

- In the year preceding the initial Section 404(b) report, issuers with adverse Section 404(b) reports had higher credit spreads and lower credit ratings compared to issuers with clean Section 404(b) reports.<sup>248</sup>
- When a borrower's financial statements contained a material internal control weakness, lenders were more likely to require collateral and they continued to distrust financial covenants even after the weakness was corrected.<sup>249</sup>
- When issuers improved their internal control weaknesses and received an unqualified Section 404(b) report, their costs of equity capital decreased from 50 to 150 basis points.<sup>250</sup>
- Non-accelerated issuers voluntarily complying with Section 404(b) experience a lower cost of capital and a decline in the cost of equity and debt capital in the first year of compliance.<sup>251</sup>

## 5. Individual Users' Decision Making

Researchers have examined individual decision making in controlled experiments to examine the effects of ICDs on individual users' decision making. In summary, the studies on individuals' judgments involving lending and investing activities imply that auditors' Section 404(b) reports make a difference in "company risk assessments, probability of extending credit, stock price assessments, internal control strength evaluations, stock purchase recommendations,

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<sup>248</sup> Dhaliwal, Hogan, Trezevant & Wilkins, *supra* note 245. See also, A. Ghosh & M. Lubberink, *Timeliness and Mandated Disclosures on Internal Controls under Section 404*, Working paper, CITY U. N.Y.–BARUCH COLL. & LANCASTER U. AT LANCASTER (Paper presented at the 2006 American Accounting Association Annual Meeting); M. A. Elbannan, *Quality of Internal Control over Financial Reporting, Corporate Governance and Credit Ratings*, INT'L J. DISCLOSURE & GOVERNANCE, Vol. 6(2), 127-49 (2009); M. Liu & M. Magnan, *Financial Reporting Quality and Bond Issue*, Working paper, CONCORDIA U. (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1531955](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531955).

<sup>249</sup> Costello & Wittenberg-Moerman, *supra* note 245.

<sup>250</sup> Ashbaugh-Skaife, Collins, Kinney & LaFond, *The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity*, *supra* note 240.

<sup>251</sup> C. A. Cassell, L. A. Myers & J. Zhou, *The Effect of Voluntary Internal Control Audits on the Cost of Capital*, Working paper, U. ARKANSAS & STATE U. N.Y. BINGHAMTON (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1734300](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1734300).

and confidence in financial statements (current and future), as well as audit reports on them.”<sup>252</sup>

For example:

- Loan officers’ assessments of the risk of extending a line of credit and the probability of extending the line of credit were negatively affected when the issuer received an adverse Section 404(b) report as compared to a clean Section 404(b) report.<sup>253</sup>
- Adverse Section 404(b) reports were significantly associated with investors assessing a higher risk of financial statement misstatement and future restatement, greater information asymmetry, lower financial statement transparency, higher risk premium and cost of capital, lower sustainability of earnings, and lower earnings predictability.<sup>254</sup>
- Investors adjust their investment risk assessments in response to material weakness disclosures.<sup>255</sup>
- When material weakness disclosures include specific and detailed discussion of the pervasiveness of control weaknesses, investors increase assessments of investment risk for less pervasive weaknesses (affect individual accounts or classes of transactions) and decrease assessments of risk for more pervasive weaknesses (system-wide effects).<sup>256</sup>
- Adverse Section 404(b) reports led to higher company risk assessments by investment analysts, as well as lower assessments of internal control strength, and higher likelihoods of unfavorable stock recommendations.<sup>257</sup>

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<sup>252</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 24.

<sup>253</sup> See Schneider & Church, *supra* note 245 at 1.

<sup>254</sup> See T. J. Lopez, S. D. Vandervelde & Y. Wu, *Investor Perceptions of an Auditor’s Adverse Internal Control Opinion*, J. OF ACCT. & PUB. POL’Y, Vol. 28(3), 231-50 (2009).

<sup>255</sup> See J. M. Rose, C. S. Norman & A. M. Rose, *Perceptions of Investment Risk Associated with Material Control Weakness Pervasiveness and Disclosure Detail*, ACCT. REV., Vol. 85(5), 1787-807 (2010).

<sup>256</sup> See *id.*

<sup>257</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 23; S. W. Shelton & O.R. Whittington, *The Influence of the Auditor’s Report on Investors’ Evaluations After the Sarbanes-Oxley Act*, MANAGERIAL AUDITING J., Vol. 23(2), 142-60 (2008).

- Equity analysts who were given Section 404(b) reports with entity-level weaknesses versus those given reports with account-specific weaknesses or no material weaknesses had lower confidence in internal control strength, the most recent year's audited and upcoming financial statements and audit reports on the financial statements.<sup>258</sup>

#### **E. Alternatives to the Requirements of Section 404**

In response to arguments that Section 404 places substantial costs on issuers without sufficient commensurate benefits, some academic researchers have considered alternatives to the requirements to Section 404 and made other recommendations, including the following:<sup>259</sup>

- Do not exempt smaller reporting companies from Section 404 because: (1) it would likely increase the information asymmetry between issuers and their investors; and (2) it would not provide significant value to issuers with strong ICFRs as ordinary investors could easily interpret the relief as a signal that policymakers do not consider ICFRs important for such issuers and therefore, would discount the lack of information.<sup>260</sup>
- Exempt all but the largest issuers from Section 404.<sup>261</sup>

Other researchers conjectured that even without an ICFR audit, guidance in existing audit standards, in particular PCAOB Interim Standards AU 550, *Other Information in Documents Containing Audited Financial Statements*, already requires auditor actions that may cause management to disclose material weaknesses in internal control under either Section 302 or Section 404(a) of the Sarbanes-Oxley Act, and they concluded that:

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<sup>258</sup> See Schneider, Gramling, Hermanson & Ye, *supra* note 173 at 23-24; S. K. Asare & A. Wright, *Equity Analysts' Reactions to Type of Control Deficiency and Likelihood Threshold in Adverse Control Reports*, U. FLA. & NORTHEASTERN U., Working paper (paper presented at the 2008 American Accounting Association Annual Meeting). See also, S. K. Asare & A. Wright, *Evidence on the Factors that Mediate the Relationship between Type of Material Weakness and Investors' Financial Reporting Risk Assessments*, Working paper, U. FLA. & NORTHEASTERN U. (2011); L. Xu & A. P. Tang, *Internal Control Material Weakness, Analysts' Accuracy and Bias, and Brokerage Reputation*, Working paper, MORGAN ST. U. (2008); Ghosh & Lubberink, *supra* note 248.

<sup>259</sup> Note that these alternatives were proffered prior to the Commission's final rule exempting issuers with public float of less than \$75 million from Section 404(b).

<sup>260</sup> See Orcutt, *supra* note 191 at 406-409.

<sup>261</sup> See H. N. Butler & L. E. Ribstein, *The Sarbanes-Oxley Debacle: What We've Learned; How to Fix It*, The American Enterprise Institute Press (2006), available at [http://www.aei.org/docLib/20060308\\_ButlerRibsteinSOXDraft313.pdf](http://www.aei.org/docLib/20060308_ButlerRibsteinSOXDraft313.pdf).

- Unaudited management internal control reports and traditional financial audits may be a cost effective disclosure alternative for smaller issuers;<sup>262</sup> and
- Disclosure of an auditors' analysis of accounting mistakes in lieu of a Section 404(b) attestation might yield substantial disclosures at very low incremental cost for auditors and issuers.<sup>263</sup>

Some of the suggestions to reduce the burden were recommended before the 2007 reforms and were implemented in those reforms.<sup>264</sup> Additionally, the Dodd-Frank Act addressed an exemption for smaller issuers by exempting non-accelerated filers from Section 404(b) which, as noted in Section II, exempted approximately 60% of issuers that would have otherwise been subject to Section 404(b).

One alternative that has not been implemented is an “opt out” of Section 404 compliance for smaller issuers.<sup>265</sup> This would allow investors or management to decide if the cost of compliance with Section 404, including the auditor attestation requirement in Section 404(b), exceeds the benefits. Potential investors would also have information about an issuer's decision on opting out (as opposed to today's requirement that is based primarily on public float) and could respond appropriately.

A disadvantage of permitting voluntary exemption from Section 404(b) would be an increase to private control benefits for issuers where insiders and affiliates control shareholder voting. Insiders might be incentivized to exploit the information asymmetry between themselves and their investors about the incidence and severity of material weaknesses. The protections

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<sup>262</sup> See Kinney & Shepardson, *supra* note 183. The authors suggested that ICDs might be identified without the cost of management's reports on ICFR and only a modest increase in financial audit work regarding the cause of known misstatements.

<sup>263</sup> See *id.*

<sup>264</sup> See Grundfest & Bochner, *supra* note 174.

<sup>265</sup> See Orcutt, *supra* note 191. See also, M. R. Bloomberg & C. E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*, The City of New York, Office of the Mayor, New York, NY & United States Senate, available at [http://www.nyc.gov/html/om/pdf/ny\\_report\\_final.pdf](http://www.nyc.gov/html/om/pdf/ny_report_final.pdf); G. Hubbard, J. L. Thornton & H. S. Scott, *Interim Report of the Committee on Capital Markets Regulation*, Nov. 30, 2006, available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

provided by Section 404(b) compliance may be even more important for investors when there is significant insider and affiliate control of voting.<sup>266</sup>

The frequent movement of issuers into and out of the studied range also reduces the usefulness of this recommendation – after opting out one year, an issuer may be required to comply in the following year due to changes in public float. Also, once effective controls are in place at the issuer, the auditor is more likely to continue to test them even if they are not issuing an auditor attestation under Section 404(b) during a particular year in order to rely on them for purposes of reducing substantive testing in the audit of the financial statements, particularly for issuers that are larger and more complex, as tends to be the case with accelerated filers.

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<sup>266</sup> According to Thomson Datastream, 104 issuers in the illustrative population had public float shares of less than 50% of the total voting shares outstanding.

## **VI. Conclusion and Recommendations**

### **A. Summary of Findings**

#### **1. Analysis of the Issuers Subject to this Study**

Section II of this study, which summarizes the Staff's work to analyze the demographics of issuers that are the subject of this study, shows that the population represents a relatively small portion of issuers (approximately 10% of issuers over the past five years). The population is transient over time, with only about 5% of issuers appearing in the population all five years. Further, approximately 40% of issuers appeared in the population in only one of the five years.

The Staff's analysis reveals that the illustrative population is in some important respects dissimilar to the population of all non-accelerated filers that are already exempt from Section 404(b), particularly in relation to size (by revenue and assets), audit fees relative to size, restatement rates, and internal control issues discovered by management and auditors. Many of the characteristics point to similar financial reporting risks in the illustrative population compared to other issuers with larger public float that also must comply with Section 404(b). These facts suggest that there are not sufficiently unique characteristics in the illustrative population that would justify differentiating these filers from other accelerated filers, including the requirement for an auditor attestation on ICFR pursuant to Section 404(b), which has been required for these issuers since 2004 for domestic issuers and 2007 for foreign private issuers.

Issuers in the illustrative population paid higher audit fees in absolute dollars in 2009 than their smaller counterparts. However, this may be not only due to the auditor attestation requirement under Section 404(b), but in some cases also likely attributable to their size, complexity, and audit risk. Approximately 6% of non-accelerated filers in the illustrative population that voluntarily complied with Section 404(b) had ineffective ICFR in 2009, while approximately 28% of all non-accelerated filers in our EDGAR population had ineffective ICFR. Audit fees as a percentage of assets and revenues for accelerated filers in the illustrative population were similar to those of all accelerated filers in our EDGAR population and lower than those of non-accelerated filers.

The Staff also analyzed the characteristics of global IPOs with respect to those likely to be in the range of issuers subject to this study. Although the U.S. IPO market over time has recovered from the 2007 levels, it has not reached the 1999 levels (*i.e.*, we reviewed IPO activity



over a range of years and noted that it was at a relatively low point during the financial crisis and has since recovered, but not to the peak for the range of years studied). The Staff's analysis shows that the United States has not lost U.S.-based companies filing IPOs to foreign markets for the range of issuers that would likely be in the \$75-\$250 million public float range after the IPO. While U.S. markets' share of world-wide IPOs raising \$75-\$250 million has declined over the past five years, there is no conclusive evidence from the study linking the requirements of Section 404(b) to IPO activity.

Section V demonstrates that the net effect of Section 404 on smaller companies' IPOs is difficult to measure and may be due to other factors, such as the economic environment. There is no consensus in the academic literature on how much influence the Sarbanes-Oxley Act in general or Section 404(b) in particular has had on decisions of where to list IPOs. In addition, with respect to IPOs, we note that the Commission has previously taken action to reduce the compliance burden for new issuers by not requiring the auditor attestation on ICFR for the IPO and the first annual report thereafter.

## **2. The 2009 Staff Study on Section 404**

Section III of this study, which includes additional analysis of the data collected for the Staff's 2009 study on Section 404, demonstrates that subsequent to the 2007 reforms there was a statistically significant decrease in Section 404(b) compliance costs (including audit fees) for issuers subject to this study. Respondents in the studied public float range tend to have a favorable view of Section 404(b) and believe that the 2007 reforms resulted in reduced cost burden as compared to non-accelerated filers, which are now exempt from Section 404(b).

In particular, there were statistically significant declines in Section 404(b) costs and outside vendor costs for the medium (\$75-\$250 million and \$250-\$700 million) and large (> \$700 million) issuers. The survey participants' estimates of the mean share of audit fees allocated to Section 404(b) were also significantly lower post-2007 reforms, except for smaller (< \$75 million) issuers that are now exempt from Section 404(b). However, all issuer size categories projected a statistically significant decline in the percent of audit fees allocated to Section 404(b) beyond the first post-reform year. For all issuer size categories, scaled compliance costs typically decreased with the number of years of Section 404(b) compliance experience, especially for medium (\$75-\$250 million and \$250-\$700 million) and large (> \$700 million) issuers.

In an optional section of the survey, survey participants revealed that, on average, issuers perceived that the 2007 reforms helped reduce the costs of complying with Section 404. Regarding the impact of AS 5 on the amount of time required to complete the independent audit of ICFR, approximately 60% of all respondents believe AS 5 reduced the amount of time required for auditor attestation under Section 404(b). Medium (\$75-\$250 million and \$250-\$700 million) and large (> \$700 million) issuers perceived the impact of AS 5 in the year following the reform to be greater than that perceived by smaller (< \$75 million) issuers, which are now exempt from Section 404(b).

Overall, the four public float analyses reveal that compliance costs typically vary with issuer size (increasing with size), compliance history (decreasing with increased compliance experience), and compliance regime (lower after the 2007 reforms). Across all size categories, including issuers with public float of \$75-\$250 million, compliance costs tended to decrease steadily beyond the post- 2007 reforms year. In addition, small (< \$75 million) issuers in the survey that generally provided less favorable responses about the costs of compliance and 2007 reforms have already been exempted. The results further show that issuers with a public float of \$75-\$250 million tended to be comparable with issuers with a public float of \$250-\$700 million, demonstrating that the \$75-\$250 million issuers more proportionately benefited from the reforms than did the smaller (< \$75 million) issuers that are now exempted. Therefore, in light of the extensive nature of the 2007 reforms, including new auditing standards that were aligned with the new Management Guidance for issuers, the Staff believes that to meaningfully further reduce the compliance burden of Section 404(b), any additional reforms beyond those implemented in 2007 would have to be significant rather than marginal. However, any change of such magnitude also would most likely adversely affect the investor protections provided by Section 404(b).

### **3. Public Input**

Input from the public, as discussed in Section IV, also informed the Staff's recommendations. As demonstrated in Section II, most issuers subject to this study are already accelerated filers and are already subject to the Section 404(b) auditor attestation requirement. While the data suggests that issuers in the studied public float range are transient, issuers with public float in that range are more likely to have already incurred the initial cost of Section 404(b) compliance, and the data derived from other sections of this study suggest that issuers that

are currently complying with Section 404(b) have reduced the burden of compliance by focusing ICFR efforts on controls that are most important to reliable financial reporting.

The feedback from investor groups responding to our October 2010 request for comment strongly opposed any further exemption from Section 404(b). These groups cited the auditors' role in uncovering ICFR deficiencies and increased cost of capital for issuers without the auditor attestation.

There were few suggestions provided from the public input that addressed techniques for further reducing, but not eliminating, the compliance burden while maintaining investor protections. Four commenters to the Commission's request for public comment, including the three industry groups, recommended that the Commission permanently exempt registrants in the studied market capitalization range from the provisions of Section 404(b), as Congress did for non-accelerated filers pursuant to the Dodd-Frank Act.

The Staff also considered this input as well as public input previously received on the compliance burden of Section 404(b) from other Commission and PCAOB actions, but generally did not believe that those suggestions, beyond those previously implemented, were appropriate recommendations for the issuer group the Staff was required to study. However, the Staff believes that certain other suggestions from the public are likely to take into account both the compliance costs and effectiveness for all issuers, including those subject to this study. These relate to suggestions regarding the PCAOB potentially publishing additional observations on Section 404(b) implementation and the COSO's project to update its internal control framework.

#### **4. Other Research on Section 404**

The academic and other research summarized in Section V of this study describes several trends that the Staff considered in forming its recommendations. Most importantly, the research demonstrates that the costs of compliance with Section 404(b), including both total costs and audit fees, have further declined since the 2007 reforms. Specifically, prior to additional guidance from the SEC or the PCAOB, compliance costs were declining over time as issuers and auditors gained more understanding and experience with the requirements, and issuers and auditors understood that they needed to modify their 404 assessments and audit processes in order to gain efficiencies. However, the 2007 reforms have resulted in significantly more cost savings for issuers, suggesting that some of the costs burden of Section 404 might have already

been reduced. Further, the research also suggests that Section 404(b) generally did not affect decisions by issuers to exit the reporting requirements of the SEC, including ICFR reporting.

Academic research also shows that auditor involvement in ICFR promotes more accurate and reliable disclosure of all ICFR deficiencies and that restatement rates for issuers with the auditor attestation are lower than the restatement rates for issuers without this attestation. Disclosure of internal control weaknesses conveys relevant information to investors, who can act on this information. Auditor involvement leads to the finding of more material weaknesses than with management's review alone, thus improving the quality of decision-useful information in the market. Further, auditors are more likely to classify ICDs as significant deficiencies or material weaknesses when management initially classifies them as less severe.

Academic sources of information on Section 404(b) also discuss alternatives that might provide useful information to investors with less cost than the existing 404(b) requirements, many of which were implemented as part of the 2007 reforms. As discussed in Section V, one alternative that has not been implemented is a permitted "opt out" of Section 404 compliance for smaller issuers. "Opt out" approaches can provide a mechanism to allow an issuer options regarding compliance rather than a strict requirement. Under such an approach, so long as an investor was informed as to an issuer's decision to opt out or comply, an investor could consider this decision in allocating capital and otherwise making investment decisions. Although some suggest that allowing flexibility of this type could be beneficial, in the context of Section 404(b) the Staff considered the suggestion of an "opt out" to be too similar to providing a full exemption given the Staff's view of the benefits of auditor involvement to reliable ICFR disclosures and reliable financial reporting. Further, it also could incentivize insiders to exploit the information asymmetry between themselves and other investors about the incidence and severity of material weaknesses in ICFR.

## **B. Recommendations**

The work performed by the Staff reinforces our understanding that the costs of Section 404(b) have declined since the Commission first implemented Section 404, particularly in response to the 2007 reforms, that investors generally view the auditor's attestation on ICFR as beneficial, and that financial reporting is more reliable when the auditor is involved with ICFR assessments. After considering the information gathered from internal and external sources, the Staff has the following specific recommendations:

**1. Maintain existing investor protections of Section 404(b) for accelerated filers, which have been in place since 2004 for domestic issuers and 2007 for foreign private issuers**

The Staff believes that the existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should be maintained (*i.e.*, no new exemptions). There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors. The Staff did not find any specific evidence that such potential savings would justify the loss of investor protections and benefits to issuers subject to the study, given the auditor's obligations to perform procedures to evaluate internal controls even when the auditor is not performing an integrated audit. Also, while the research regarding the reasons for listing decisions is inconclusive, the evidence does not suggest that granting an exemption to issuers that would expect to have \$75-\$250 million in public float following an IPO would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States. The Staff acknowledges that the reasons a company may choose to undertake an IPO are varied and complex. The reasons are often specific to the company, with each company making the decision as to whether and where to go public based on its own situation and the market factors present at the time. The costs associated with conducting an IPO and becoming a public company no doubt factor into the decisions and may be particularly challenging for smaller companies. The Staff appreciates that the costs and benefits of the regulatory actions that the Commission takes – and does not take – certainly can impact these decisions. At Chairman Schapiro's request, the Staff is taking a fresh look at several of the Commission's rules, beyond those related to Section 404(b), to develop ideas for the Commission about ways to reduce regulatory burdens on small business capital formation in a manner consistent with investor protection.<sup>267</sup> However, the Dodd-Frank Act already exempted approximately 60% of reporting issuers from Section 404(b), and the Staff does not recommend further extending this exemption.

**2. Encourage activities that have potential to further improve both effectiveness and efficiency of Section 404(b) implementation**

The Staff recommends that the PCAOB monitor its inspection results and consider publishing observations, beyond the observations previously published in September 2009, on

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<sup>267</sup> See Letter from Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, *supra* note 4.

the performance of audits conducted in accordance with AS 5. These observations could assist auditors in performing top-down, risk based audits of ICFR. These communications could include the lessons that can be learned from internal control deficiencies identified through PCAOB inspections.

The Staff is observing COSO's project to review and update its internal control framework, which is the most common framework used by management and the auditor alike in performing assessments of ICFR. The Staff believes that this project can contribute to effective and efficient audits by providing management and auditors with improved internal control guidance that reflects today's operating and regulatory environment and by allowing constituent groups to share information on improvements that can be made that enhance the ability to design, implement, and assess internal controls.