An Unfair Burden or Economic Darwinism? The Impact of Sarbanes-Oxley Section 404 on Smaller Public Companies

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Introduction

The crumbling of Enron from within severely damaged investor confidence in US Capital Markets. The Sarbanes-Oxley Act (SOX) tightened the regulation of publicly traded companies in an effort to restore investor confidence. Signed into law in July 2002, SOX motivated both managers and auditors to do more work to ensure that the information contained in financial statements is accurate. As a consequence, managers have to reevaluate their accounting practices before subjecting those practices to the additional scrutiny required by SOX.

Specifically, Section 404 of the Sarbanes-Oxley Act (SOX) has required publicly-held companies to incur substantial costs documenting and testing the mechanisms they employ to prevent, detect and correct accounting errors (whether they are intentional or unintentional) before these errors appear in published financial statements; these mechanisms are formally known as internal controls. The standards that auditors must follow in order to assess their clients' compliance with Section 404 have been established by the Public Company Accounting Oversight Board (PCAOB) in Auditing Standard No. 2 (AS 2). In order to be compliant with Section 404, many companies often have had to create, implement and test new internal controls (Dittmar and Wagner 134). The theory behind Section 404 is that better controls and detailed documentation of them will improve the accuracy and reliability of information included in financial

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statements, which investors and lenders rely upon to make decisions. In practice, however, the benefits of publishing more accurate financial statements are not as easily quantified as the costs to create the required internal control structures (Franklin). Consequently, the debate over whether Section 404 provides benefits equal to, or in excess of, the cost of compliance persists nearly five years after the signing of SOX into law.

Lobbying groups, financial analysts, and some politicians have argued that smaller public companies (i.e., market capitalization of $75 million and below), which make up over one-third of the universe of publicly-held companies, should not have to comply with Section 404 because the heavy costs of compliance hit them harder as a percentage of capital resources than larger corporations. (The SEC defines non-accelerated filers as those registered companies with market capitalization less than $75 million. This paper uses the terms "smaller public companies" and "non-accelerated filers" interchangeably.) According to a 2006 US Government Accountability Office (GAO) report, the audit fees in 2003 and 2004 for the 520 public companies with market capitalizations between $75 and $250 million that elected to comply with Section 404 were 0.56% of revenues, four times more than their large cap counterparts! Also, while only 66 non-accelerated filers elected to comply with Section 404 (without being required to do so) in 2003 and 2004, the GAO notes that their audit fees were 1.14% of revenue—over 2 times that of the $75-$250 million market cap group and 8 times that of the large caps! This is consistent with a study of 114 companies conducted by Foley & Lardner which revealed that audit fees increased by 22% for small companies but only 4% for large companies during the first year of 404 compliance (Bednarz).

Opponents of SOX Section 404 for smaller public companies fear that forced compliance in American markets does nothing more than increase costs and force companies to access capital outside of the US (Brown 51). Despite studies illustrating that Section 404 compliance is expensive and drives companies to foreign capital markets, more substantial evidence indicates that compliance actually reduces costs, particularly for smaller companies. Cost reductions result from both more efficient operations achieved by lower error rates and the more indirect effect that enhanced disclosure has on

their costs of capital. Professional financial analysts tend to cover larger companies more than smaller companies; larger companies tend to disclose more information and with greater frequency than smaller companies (Bhushan 255). The result of garnering less attention from professional analysts and disclosing less information with less frequency is that small companies experience greater information asymmetry with their investors than do larger companies. Information asymmetry increases a company's cost of capital (Lundholm and Van Winkle 44). On the other hand, when investors feel that companies are being forthcoming or that information being disseminated is more accurate, they require lower rates of return in exchange for their hard-earned capital.

Before SOX, capital costs were quite high because of weakening investor confidence in the wake of the Enron collapse. In a recent address to the American Accounting Association, Damon Silvers, Associate General Counsel of the AFL-CIO, stated that Section 404 solves a "competitive crisis…of investor confidence." He argued that the mandate that controls could no longer "be approached with blinders on" by companies and their auditors should result in lower costs of capital as a result of improved quality of the information disseminated and the *perception* of that quality. Thus, working toward compliance with Section 404 should mitigate information asymmetry (or at least the perception of asymmetry) and, in turn, reduce costs of capital for smaller companies.

And so goes the debate—the benefits of investor confidence (i.e., lower costs of capital) versus the drain on resources required to instill said confidence vis-à-vis improved internal controls (i.e., higher costs of compliance). If costs of compliance are excessively large for smaller companies, then smaller companies that elected to be 404 compliant ("early adopters") should have experienced weaker financial results relative to a peer group of companies that chose not to be 404 compliant. However, if early adoption is used as an indicator of quality and financial health, then early adopters should have experienced similar (or stronger) financial results than those that chose not to adopt. This paper presents 2005 data that supports the notion that early adopters do exhibit financial performance as strong as, if not stronger than, peer companies that choose not to adopt Section 404. This evidence

pokes a hole in the assertion that Section 404 is causing significant financial damage to those who comply with it. If compliance costs are not an unfair burden on smaller companies, then the benefits of lower costs of capital for firms able to comply might be well worth it. The net effect of Section 404, then, could be an economic Darwinism of sorts in that only the fittest companies will survive…and will enjoy low cost access to capital as the spoils for avoiding extinction.

The Cost of Compliance

In December of 2004, the SEC formed the Advisory Committee on Smaller Public Companies (ACSPC) to examine the impact of the Sarbanes-Oxley Act, particularly Section 404, on smaller public companies. After over a full year of research and deliberation, the ACSPC issued a final report on April 23, 2006. In the report the ACSPC recommended the SEC to do the following:

> Provide exemptive relief from the Section 404 requirements of the Sarbanes-Oxley Act to micro cap companies with less than $125 million in annual revenue, and to small cap companies with less than $10 million in annual product revenue…unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs. (16)

Since the official release of the ACSPC report, the PCAOB began drafting Auditing Standard No. 5 (AS 5), which would replace the much criticized AS 2. The proposed standard AS 5 emphasizes that the audit work required in an internal control audit should be a direct function of client size ("Public Company Accounting Oversight Board"). Additionally, the SEC extended the deadline for compliance until December 31, 2007, its fourth deadline extension for non-accelerated filers, which should be enough time for AS 5 to be approved. Clearly, the burden on smaller public companies is perceived as being so great that the SEC is willing to continue to extend the deadline for compliance until appropriate guidance is passed to reduce the cost of compliance for smaller public companies.

Why does complying with Section 404 cost so much?

Costs come from the activities required to achieve compliance and the additional resources needed to do so. The substantial activities involved in compliance are: (1) documentation of internal controls; (2) management's testing and report on internal controls; (3) the independent auditor's assessment and report on the internal control system. The additional resources needed include: (1) consultants to help management with developing internal controls which usually involve some type of accounting software; (2) director fees because many companies must hire new, independent board members as part of establishing an effective system of internal controls; (3) hiring more internal auditors or outsourcing the internal audit function to a consulting firm.

Financial Executives International (FEI) conducted a survey to estimate year-one compliance costs in March 2005 and "found member companies spent an average of $4.3 million for added internal costs and additional fees spent on auditors and other consultants and software associated with complying with Section 404" (Brod). These costs soared above the FEI's initial estimate of $1.93 million (Colman 8). In a follow-up survey, FEI found that second-year compliance costs fell, but not nearly as much as anticipated, to $3.8 million, down 16.3 percent from year one. Given compliance costs around the $4 million mark in each of the first two years of compliance, it is not surprising that "94 percent of the respondents…indicated that the costs far outweighed the benefits" (Brod).

Why are so many resources needed to comply with Section 404?

Companies are supposed to use a report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as a guide to establishing a system of internal controls. COSO is a private sector organization that periodically issues guidance to help management create, document, and assess internal controls. The SEC, through its implementation of the Sarbanes-Oxley Act, effectively elevated one COSO report to the level of legislation. The report is entitled, "Internal Control – Integrated Framework," and it was published in 1992 but was largely ignored until the Sarbanes-Oxley

Act. "Internal Control – Integrated Framework" assists companies in documenting and operating an efficient system of internal controls.

The COSO Framework as laid out in "Internal Control – Integrated Framework," identifies five components of an effective system of internal controls: (1) Control environment: the tone of the organization should be one in which the importance of internal controls is understood and valued; (2) Risk assessment: all possible risks that threaten to prevent the organization from achieving its goals should be identified, analyzed, and managed; (3) Control activities: the organization should have internal controls documented and tested regularly; (4) Information and communication: an effective system of internal controls depends on an open and continuous flow of information among all members of the organization; (5) Monitoring: As controls change and as staff changes, so should the internal control system. In order to conclude that an effective system of internal controls exists, management must document that the system exhibits all five components. All this must be done prior to the external auditor beginning work on internal controls, hence the heavy year-one compliance costs.

While the COSO Framework represents "the most comprehensive study ever undertaken on control," COSO issued additional guidance for smaller public companies in June 2006 as part of the effort to help reduce the cost of compliance ("Does Your Control"). "Internal Control over Financial Reporting—Guidance for Smaller Public Companies" emphasizes the importance of developing controls aimed at mitigating material risks to the financial reporting system. The report recognizes the special needs of many smaller companies but maintains that the general ideas put forth in "Internal Controls—Integrated Framework," can be applied to smaller companies. In other words, the overall objective is reliable financial statements. Consequently, management should only focus on activities and circumstances material in nature.

What have compliance costs "cost" American capital markets?

Whether or not this new guidance, in conjunction with AS 5, will significantly lower the cost of compliance for smaller public companies remains to be seen. However, the general consensus is that costs are

too burdensome for smaller public companies, and the increased regulatory requirements of publicly traded companies are damaging the U.S. stock markets. In a recent *Wall Street Journal* article, Greg Ip, Kara Scannell and Deborah Solomon outline three measurements of this damage. The first is share of global initial public offering (IPO) proceeds captured by the New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq), which declined from 57% in 1999 to 18% in 2006 (par. 15). Meanwhile, markets in Europe and Asia are increasing their share of IPO proceeds. A second measure is the percentage of foreign companies listed on the NYSE and Nasdaq. Between 2002 and 2006, the authors argue, that percentage declined 4% for the NYSE and 34% for Nasdaq (par. 21). The conclusion is that these companies are going elsewhere to avoid regulatory requirements like the Sarbanes-Oxley Act (Boodoo 1). A third measure of the damage done to U.S. capital markets is the percentage of private-equity buyouts among all mergers and acquisitions in the United States. This percentage rose from 2% in 1996 to 11% in 2002 (Ip, Scannell, and Solomon, par. 32).

The Benefits of Compliance

Current debate focuses on the costs of compliance, primarily because the benefits are more difficult to quantify. Section 404 forces companies to document controls within each of their business processes, which can add value by identifying (and ultimately rectifying) inefficiencies and ineffective activities (Dittmar and Wagner 134). Additionally, firms should consider the lower costs of capital that 404 compliant firms will enjoy versus those firms that do not comply. While both the benefit of increased efficiencies viz-a-viz documentation of controls and of lower capital costs are difficult to quantify, each can make or break any organization.

One aspect of "Internal Controls—Integrated Framework" is that the report helps companies ensure that "ownership and observance of SOX controls is embedded in the fabric of their business activities, which according to a study published by the Institute of Internal Auditors, will help companies "generate the most value" ("SOX Implementation"). Following the COSO framework assists management not only in establishing a sound system of internal

controls, but also in running a better organization. The COSO guidance is solidly based in theory. Value can be created when duplicated tasks and information bottlenecks are identified and processes are streamlined to simplify organizational structure and maximize operating efficiency (Dittmar and Wagner 134).

Requiring companies to follow the COSO Framework should also deliver more accurate financial statements. One way to measure the validity of this statement is to examine the number of restatements filed by 404 compliant and non-compliant companies in recent years. Restatements are amended financial statements that are filed with the SEC again because the initial statement contained one or more material errors. An article in *CFO Magazine* communicated the conclusions of the research of Glass, Lewis & Co., which found that the number of restatements filed by companies forced to comply with Section 404 declined by 26% (Johnson). However, while the restatements of 404 compliant firms decreased, the number of total restatements filed annually continues to increase. The evidence gathered and analyzed by Glass, Lewis & Co. indicates that the responsibility for the increase lies with smaller public companies, which currently do not have to comply with Section 404. In his recent address to the American Accounting Association, William Gradison of the PCAOB concurred, arguing that smaller companies exempt from Section 404 issue restatements more frequently than large companies that have been forced to comply.

The fact that restatements not only are more common in smaller public companies not in compliance with Section 404 but also that the number of restatements is increasing for this group of companies indicates that these smaller public companies stand to benefit even more from compliance. Nicole Jenkins and Paul Hribar found, in their recent study published in the *Review of Accounting Studies*, that firms that issue restatements also experience significantly higher costs of capital in the wake of restatement (Hribar and Jenkins 338). Thus, if 404 compliance can reduce restatements, then perhaps it will also reduce the capital costs of those able to comply with it. In this spirit, John C. Coates stated in a recent paper that "in exchange for higher costs, Sarbanes-Oxley promises a variety of long-term benefits. Investors will face a lower risk of losses from fraud and theft, and

benefit from more reliable financial reporting, greater transparency, and accountability. Public companies will pay a lower cost of capital" (92). Coates bases his argument on the fact that companies able to comply with the Sarbanes-Oxley Act have lower risk of fraud and theft. Since investors are risk averse, they demand a lower return on investment in companies with lower risk. In fact, Cynthia Jamison, a financial systems expert at Tatum Partners, observed that companies compliant with Section 404 "fetch higher purchase prices from buyers—including private equity groups" (Sikora 28). Consistent with Jamison's observations, Virsa, a computer software company specializing in software that assists companies with regulatory compliance, "found that 65% [of 135 analysts surveyed] were willing to pay a 10% premium on share price for firms that could prove they had proper governance systems in place" (Goodwin 16). Former PCOAB Chairman William H. Donaldson reiterates the points that "benefit[s] will come in the long haul, with greater credibility in the marketplace and higher stock price multiples" (Henry et al. 28).

For "high quality" firms, companies that have traditionally prioritized the publication of accurate financial statements and a corresponding commitment to solid controls, Section 404 should not be that burdensome because many of the required controls and related documentation are likely already in place. Conversely, the companies for which Section 404 compliance is the highest are those "low quality" companies that have been operating in environments that lack appropriate structures to prevent, detect and correct errors in their reporting process. A study published in the *Journal of Economic Dynamics and Control* confirms that "an increase in uncertainty, taking the form of an increase in the spread of types, has a depressing effect on investment" (Gaudet and Lassere 73). If investors can't discern between types, then, they will perceive information quality as being a uniform weighted average of "highs" and "lows" across all companies, which benefits "low" types and punishes "high" types. Thus, the 66 smaller public companies that chose to adopt Section 404 without being required to do so in 2003 and 2004 (per the 2006 GAO report) might have been attempting to signal their high quality to investors, while companies that protest 404 the loudest are likely fearful of being exposed as being of low quality.

Currently, among the population of smaller public companies in the United States, these "high quality" companies that have been practicing good internal control practices from day one have already begun to differentiate themselves from their "low quality" counterparts. Russell Lundholm and Matt Van Winkle concluded from a study of motives concerning disclosure that "high quality" firms can benefit by Section 404 compliance because firms with good news can only benefit from additional disclosure requirements which allow them to signal their high quality to the market (44). Ryan LaFond, an Assistant Professor at MIT Sloan School of Management, concludes that "firms with strong internal controls already in place and firms that remediate prior control weaknesses are rewarded with a significantly lower cost of capital" (qtd. in Heffes and Marshall 8).

Evidence on the Impact of 404 Compliance on Profitability

The findings of Lundholm and Van Winkle as well as those from LaFond support the benefits of complying with Section 404. The question of whether or not the benefits are worth it requires a profitability analysis of those smaller companies choosing to comply versus those who have chosen to defer (or avoid) compliance. If the costs are excessive, then 404 compliant firms should, all other things being equal, be less profitable than non-compliant firms because of the excessive costs of compliance. However, if the signaling story holds, whereby compliant firms are actually signaling better financial health than their non-compliant brethren, then perhaps the "costs are too excessive" argument is misguided.

To test the "costs are too excessive" argument, I collected and analyzed data to examine whether the difference between the financial results of compliant and noncompliant companies was statistically significant. The data set (drawn from Compustat Research Insight) includes all firms with under $700 million in market capitalization for the fiscal year 2005. The data points collected for each firm were: market capitalization, net income and sales revenue. This allowed me to calculate profit margin (net income / sales revenue) for each firm. I eliminated foreign firms (known as ADRs), firms in which any of the data items was missing, and outlier firms which I defined as firms having profit margins either greater than 100% or less than -100%.

After making these eliminations, I was left with a sample of 3,034 firms.

Of these 3,034 firms, 1,336 (44%) were compliant with Section 404 in 2005 while the remaining 1,698 (56%) were not. Table 1 summarizes the data I collected. The 404 compliant firms experienced an average profit margin of 5.0% which was significantly *better* than the non-compliant group, which actually reported losses, on average, equal to 3.3% of sales revenues (t-stat = 9.75; p<0.0001). While the 404 compliance burden may have played a role in depressing the profits

Table 1: Summary of 2005 Data for Smaller Public Companies

All Firms (Mkt Cap < $700 Million)	**Number of firms**	**Ave. Sales Revenue (in millions)**	**Ave. Profit Margin**
Compliant with 404	1,336 (44%)	351.036	5.0%
Not compliant with 404	1,698 (56%)	88.474	-3.3%
Firms with Mkt Cap < $75 Million			
Compliant with 404	87	487.359	-9.8%
Not compliant with 404	1,211	50.335	-6.2%
T-Tests for Equality of Profit Margin Means (Compliant Vs Non-Compliant):			
	T-statistic	**p-value**	
Firms (Mkt Cap < $700m)	9.75	<0.0001	
Firms (Mkt Cap < $75m)	1.11	0.1339	

of the 87 smallest (mkt cap < $75 million) compliant firms in 2005 (-9.8% profit (loss) margin), the compliant group's profits were not significantly lower than the -6.2% loss margin exhibited by the 1,211 non-compliant group (t-stat = 1.11; p = 0.1339). While only representing one year of data, this snapshot analysis puts the "compliance costs kill profits" argument in severe doubt. In light of these findings and the proven benefits of compliance, those who espouse the popular "excessive costs" argument should reevaluate their resistance to Section 404. Based on my sample of smaller public companies in 2005, the benefits of 404 compliance appear to be worth the costs.

Conclusion

So, if companies stand to benefit from complying with Section 404, why the controversy? For the past five years, the debate concerning Section 404 focused on the high costs and not the benefits to firms that comply. Admittedly, first-year compliance costs are significant. In addition, companies already complying with Section 404 have experienced second-year costs that failed to fall as much as expected. However, this paper provides evidence that these costs are not prohibitive for firms choosing to be compliant. Actually, this paper includes data that supports 404 compliance as a signal of financial health to capital markets that should allow smaller companies to reduce their capital costs.

No one disputes the importance of small businesses to the U.S. economy; however, their important status should be a reason to require them to follow rules that improve the health of the financial sector, not as a reason to exempt them from scrutiny. Rather, the SEC should take steps to ensure that regulations (i.e., AS 5 from the PCAOB) assist smaller companies (and their auditors) in their attempts to become compliant.

In an article in *Forbes* magazine, Rich Karlgaard wrote that companies have two choices concerning the Sarbanes-Oxley Act: "You can comply grudgingly…Or you can use [SOX] compliance as an excuse to make your company run better" (37). Since the SEC and PCAOB seem determined to make smaller companies comply, smaller companies should follow the advice of Karlgaard, and take the lemons handed them by SOX Section 404 to make some lemonade. Karlgaard advises, "The lemonade way is harder work. But over time it could pay for itself, just as the 1990s drive for greater quality paid for itself. Quality is now free. Compliance can be, too" (37).

While the costs of establishing a solid, well-functioning set of internal control are high, the benefits of more accurate financial reports and lower capital costs for smaller public companies seem necessary in the evolution of our capital markets. Failure to continue down this path toward small company compliance could render extinct the low cost access to capital that has fueled the sustainable growth of the American economy over that past few centuries.

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