The Sarbanes-Oxley Act of 2002

Background

The Sarbanes-Oxley Act of 2002 (SOX) overhauled regulation of the audit profession and effectively ended 100 years of self-regulation relative to public company audits. Crafted in response to financial scandals that occurred at several large public corporations, SOX also dramatically altered the legal and cultural guideposts for corporate America. In addition, it established a comprehensive framework to reform corporate governance, enhance financial reporting, regulate public company audits and strengthen auditor independence. The law, among other things:

- Created the Public Company Accounting Oversight Board (PCAOB) to oversee the audit profession relative to the performance of public company audits;
- Expanded the responsibility and authority of public company audit committees over the audit engagement including the responsibility for safeguarding the auditor’s independence from management; and
- Aimed to strengthen corporate governance by enhancing management’s responsibility and accountability for the reliability of periodic financial reports filed with the U.S. Securities and Exchange Commission (SEC or the Commission).

The reforms under SOX have contributed significantly to restoring investor confidence in public companies’ financial reports, and accordingly, the capital markets. Investors have been well served by SOX. They remain supportive of it, as do audit committee members.

- Eight in 10 individual investors surveyed in 2007 said changes brought about by SOX bolstered their confidence in audited financial information. Sixty-two percent of those participating in a survey conducted for the Center for Audit Quality (CAQ) expressed the view that the rules mandated by the Act should be left fundamentally as they are, with two-thirds saying they would be concerned by any easing of the rules.
- Another CAQ survey conducted in 2008 found that nearly two-thirds of audit committee members agreed that investors should have more confidence in the markets as a result of SOX. In the same survey, audit committee members indicated that they believe the risk of fraud and materially inaccurate financial statements is lower due to tightened internal controls.

Further, Financial Executives International’s most recent report (June 2011) found that public and private companies are continuing to demonstrate overall comfort with the external audit process.

SOX Section 404

- Section 404(a) of SOX requires management to assess the effectiveness of the company’s internal control over financial reporting (ICFR). Section 404(b) requires audit firms to report on the effectiveness of the internal controls of public companies with $75 million or more in market capitalization.
• **Benefits of an independent audit of ICFR outweigh costs** (there have been considerable cost savings over time).
  
  o Average Section 404(b) costs declined approximately 30% (from $950k to $701k) from 2006 – 2008 for all companies that complied with 404(b) (SEC’s 404 Study, September 2009).
  
  o Median costs declined approximately 23% (from $380k to $294k) over the same period (SEC Study).

• In a study mandated by Congress, the SEC in April 2011 concluded that existing provisions of Section 404(b) should be maintained and that no new exemptions should be granted. The SEC has heard repeatedly from investors that they have more confidence in financial reporting as a result.

• In the same study, the SEC’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.

• More recently, SEC Chairman Mary Schapiro reported that the Commission has heard repeatedly from investors that they have more confidence in financial reporting when an auditor conducts an independent assessment of internal control over financial reporting.

• In a letter to U.S. Rep. Scott Garrett on October 4, 2011, Chairman Shapiro also pointed out that the SEC’s study found that companies that do not have an audit of management’s assessment of internal controls over financial reporting tend to have both significantly more material weaknesses in their internal controls and more restatements of their financial statements.

• **According to a June 2011 Protiviti study of more than 400 company executives and professionals, “the initial years of compliance result in high costs for companies in terms of time, money and other resources... Overall, however, costs tend to stabilize and even fall after the initial compliance years, and more organizations find that the benefits – including a stronger internal control environment and improved effectiveness and efficiency in operations – outweigh the costs.”**

• Additionally, other research has underscored the benefits of an independent audit of a public company’s internal controls:
  
  o The authors of a 2011 paper on “The Effect of Voluntary Internal Control Audits on the Cost of Capital” concluded that companies that voluntarily comply with Section 404(b) enjoy a lower cost of capital and enjoy a decline in the cost of equity and debt capital in the first year of compliance. “Our findings are important because they demonstrate an important benefit that small companies can derive from purchasing internal control audits,” they wrote.
  
  o Based on survey responses from more than 3,000 individuals, a 2010 paper concluded that, “the common view that Section 404 adds layers of financial reporting procedures to no avail seems to be overstated, and the evidence indicates that standardization by regulatory intervention is beneficial, as attested by the decrease in reported costs and concomitant increase in perceived net benefits following the 2007 reforms, regardless of company size.”
Another researcher described as problematic the likelihood that exempting smaller reporting companies from Section 404 will significantly increase the information asymmetry between smaller reporting companies and their investors, “since ordinary shareholders are the predominant external shareholders for smaller reporting companies and have historically demonstrated themselves to be vulnerable to just this type of information asymmetry.”

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the Government Accountability Office (GAO) to study and report back to Congress on the impact of Section 404(b) by July of 2013. It would be prudent to understand the results of the GAO study before exempting more companies from Section 404(b).

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